199914034

CC:INTL:Br2; TAM-115478-97
UIL Number: 957.01-00

AUG 4 1998

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

Corp A =

Corp B =

Corp C =

Corp D =

Corp E =

Country M =

Date 1 =

Date 2 =

Date 3 =

189

Product Y =

Agreement S =

Agreement T =

Agreement U =

Agreement V =

This memorandum is in reply to your request for technical advice dated August 12, 1997.

ISSUE:

Whether for taxable years 1991 and 1992, Corp B owned, within the meaning of section 958 of the Internal Revenue Code, more than 50 percent of the total combined voting power of all classes of stock of Corp E so that Corp E was a controlled foreign corporation under section 957 of the Code.

FACTS:

The following facts were derived solely from documents provided by Corp B, one of the shareholders of Corp E. The other shareholders of Corp E, Corp C and Corp D, were not parties to this technical advice request.

Formation of Corp E

Corp A, a domestic corporation, owns all of the stock of Corp B, also a domestic corporation. On or about Date 1, Corp B, together with Corp C and Corp D, two unrelated Country M corporations, formed Corp E, a Country M joint stock company whose principal business activity was the manufacture and sale of Product Y. In manufacturing Product Y, Corp E used technical and manufacturing processes, know-

how, and various other types of intellectual property developed by Corp B. Corp E acquired the rights to use this intellectual property in the form of an exclusive license from Corp B pursuant to Agreement S. As consideration for the rights acquired from Corp B under Agreement S, Corp E agreed to pay Corp B annual royalties equal to a specified percentage of the net sales of Product Y manufactured by Corp E.

Corp E's Shareholders

At the time of Corp E's formation, Corp B, Corp C and Corp D each subscribed and paid for one-third of the only class of stock issued by Corp E. Each share of Corp E stock had one vote. Corp E's governing documents provided that business could be transacted at a shareholder meeting only if shareholders owning a majority of the total issued shares of Corp E were present.

Any action of the Corp E shareholders at a shareholder meeting generally required an affirmative vote of a majority of the shares present. However, the Articles of Incorporation for Corp E specified that action on certain matters required the affirmative vote of those shareholders (or their representatives) owning at least 80 percent of Corp E's total shares. These matters consisted of (1) amending Corp E's articles of incorporation; (2) electing Corp E's directors and auditors; (3) changing Corp E's capital; (4) assigning the entire or essential part of the business of Corp E to another person; (5) entrusting the management of Corp E to a third party; (6) disposing of Corp E's profits (i.e., declaring and paying dividends); (7) acquiring or disposing of shares in companies other than Corp E; and (8) concluding or altering Corp E's license agreements.

Corp E's Board of Directors

At the time of Corp E's formation, Corp E's board of directors consisted of six directors. Each of Corp E's three shareholders was entitled to choose two of these six directors. In general, the board of directors was responsible for managing Corp E.

To transact business at a meeting of Corp E's board of directors, Corp E's governing documents provided that a majority of the directors currently holding office be present. Any action by the Corp E board of directors at a board meeting required an affirmative vote of a majority of those directors present at the board meeting.

Corp E's articles of incorporation required the board of directors to elect a president and permitted the board of directors to elect a chairman of the board of directors. Agreement T, a shareholder agreement entered into by Corp B, Corp C, and Corp D on or about Date 1, specified that the president and the chairman of the board

of directors (if one were elected) were to be chosen from among the directors elected by the two Country M shareholders, Corp C and Corp D.

Corp E's articles of incorporation provided that the chairman of the board of directors (or the president if the board of directors did not elect a chairman) would preside at meetings of Corp E's board of directors and would have the power to cast a second vote in the event of an equality of votes on any matter requiring a vote of Corp E's board of directors. Agreement T altered this arrangement by eliminating the authority of the chairman (or the president in the absence of a chairman) to cast a tie-breaking vote. Instead, Agreement T provided that any disputes arising among the members of Corp E's board of directors were to be resolved by arbitration.

Restructuring

Between Date 2 and Date 3, several changes were made to Corp E's organizational structure. First, Corp C and Corp D sold to Corp B one-fourth of their respective interests in Corp E. After these sales, Corp B owned 50 percent of the outstanding shares in Corp E, and Corp C and Corp D each owned 25 percent of the outstanding shares in Corp E.

Second, the number of members of Corp E's board of directors was increased from six persons to eight persons, and each of Corp E's shareholders was entitled to designate a number of directors equal to its proportionate interest in Corp E. Thus, Corp B was entitled to designate four directors, and Corp C and Corp D were each entitled to designate two directors.

Third, the shareholders of Corp E transferred to Corp B limited power over the management of Corp E. Initially, the shareholders of Corp E signed Agreement U, which provided that Corp B be given "complete management control" of Corp E, including the power to select and appoint all managers and other officers of Corp E.[1] However, Agreement U excluded from Corp B's managerial authority the following matters: (1) any change in Corp E's capital; (2) any decision to enter into or amend any license agreements with third parties; (3) any decision by a shareholder to transfer its shares in Corp E to another shareholder or to a third party; (3) any decision by Corp E to transfer its shares in another company; and (5) any decision to declare dividends. Decisions on these excluded matters were to require the affirmative vote of all of Corp E's shareholders.

---

[1] In return for performing management services pursuant to Agreement U, Corp B was to receive a management service fee.

Agreement U was signed by the shareholders of Corp E on Date 2. Before its provisions could be implemented, however, it was superseded by Agreement V, which was signed by the shareholders of Corp E on Date 3. Agreement V established a management structure with the following pertinent characteristics:

First, Agreement V provided that Corp E would be managed by the president within the limitations imposed by the board of directors and that Corp B would have the right to select the president.

Second, Agreement V reaffirmed the authority of the chairman of the board of directors to preside at meetings of the board of directors, and it gave the chairman additional authority to cast a tie-breaking vote in the event of any deadlock among the members of Corp E's board of directors. Agreement V did not alter the provision in Corp E's articles of incorporation authorizing the president to act in place of the chairman in the event the board of directors did not elect a chairman.

Third, Agreement V specified that certain matters concerning the management and operations of Corp E required the unanimous consent of all of Corp E's shareholders. These matters consisted of (1) any change in Corp E's authorized and/or issued capital; (2) any change or conclusion of Corp E's license agreements; (3) the acquisition or disposition of an interest in a company other than Corp E; (4) the declaration of dividends; (5) the transfer of the whole or a major part of Corp E's business; and (6) entrusting the management of Corp E to a third party.

Finally, with respect to all matters requiring a vote of the shareholders, Agreement V did not give any person tie-breaking authority in the event of a shareholder deadlock. Instead, it specified that such deadlocked matters were to be discussed by the shareholders in an effort to reach an "amicable solution."

Management of Corp E During the Years in Issue

Based on the documents submitted by Corp B, it appears that Corp E operated during the years in issue in accordance with the management structure established by its articles of incorporation and Agreement V. Corp B appointed a person to serve as the president of Corp E. This person, in turn, engaged in activities relating to the day-to-day management of Corp E.

Based on the documents submitted by Corp B, the board of directors of Corp E engaged in the following activities during the years in issue: (1) discussed and approved business reports, balance sheets, and profit and loss statements for Corp E; (2) elected Corp E's representative and managing directors; (3) considered proposals to renew a successor to Agreement S; (4) reviewed the status of negotiations over Corp

E's head office rental fee and a proposal to construct a head office building owned by Corp E; and (5) reviewed proposals to address labor shortages in one of Corp E's production facilities. Further, during the years in issue, it appears that the president of Corp E acted in the place of a chairman at all meetings of Corp E's board of directors.

Based on the documents submitted by Corp B, the shareholders of Corp E engaged in the following activities during the years in issue: (1) approved corporate balance sheets and income statements; (2) elected directors and auditors; (3) approved director and auditor compensation proposals; and (4) approved the declaration and payment of cash and stock dividends.

Corp B first filed a Form 5471 for Corp E for the latter's taxable year ending December 31, 1987. For Corp E's taxable years beginning prior to January 1, 1987, Corp B did not file any Forms 2952 and Forms 5471.

LAW:

Section 957(a) of the Code defines the term "controlled foreign corporation" as any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of such foreign corporation is owned (within the meaning of section 958) by United States shareholders on any day during the taxable year of such foreign corporation.

Section 951(b) of the Code defines the term "United States shareholder," with respect to any foreign corporation, as a United States person who owns (within the meaning of section 958) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. The term "United States person" is defined to include a domestic corporation. Section 957(c) (cross-referencing the definition in section 7701(a)(30)).

In determining whether United States shareholders own more than 50 percent of the total combined voting power of all classes of stock of a foreign corporation, section 1.957-1(b)(1) of the Income Tax Regulations mandates that consideration be given to all facts and circumstances. Section 1.957-1(b)(1) of the regulations goes on to provide, however, that in all cases a United States shareholder will be deemed to own the requisite percentage of total combined voting power with respect to a foreign corporation if the facts fit within one of the following three factual scenarios:

(1) The shareholders of the foreign corporation have the power to elect, appoint, or replace a majority of that body of persons exercising, with respect to such corporation, the powers ordinarily exercised by the board of directors of a domestic corporation. Section 1.957-1(b)(1)(i).

(2) The shareholders of the foreign corporation have the power to elect exactly one-half of those persons who, with respect to the foreign corporation, have the power to exercise those powers ordinarily exercised by the board of directors of a domestic corporation, and such shareholders also have the power to elect any person who has the power to cast a vote deciding an evenly divided vote of such governing body. Section 1.957-1(b)(1)(ii).

(3) The shareholders of the foreign corporation have the power to elect, appoint, or replace any person who exercises those powers ordinarily exercised by the board of directors of a domestic corporation. Section 1.957-1(b)(1)(iii).

During the years at issue, any United States shareholder that owned stock in a CFC for an uninterrupted period of 30 days or more during any taxable year of the foreign corporation and who owned such stock on the last day of such taxable year was required to complete a Form 5471 for such CFC. See section 1.6038-2(a) of the regulations (as in effect for the years at issue); Instructions for Form 5471 (November 1987) ("Information Return With Respect to a Foreign Corporation"). This filing requirement had been in effect in substantially the same form since December 31, 1982. See section 1.6038-2(a) (as amended by T.D. 8040, 1985-2 C.B. 291); Instructions to Form 5471 (January 1983) ("Information Return With Respect to a Foreign Corporation").

Prior to December 31, 1982, every United States person that controlled a foreign corporation for an uninterrupted period of 30 days or more during such foreign corporation's annual accounting period was required to complete a Form 2952 for such foreign corporation. See section 1.6038-2(a) of the regulations (T.D. 6621, 1962-2 C.B. 288, as amended in 1968 and 1969); Instructions to Form 2952 (January 1969, January 1975, and January 1982) ("Information Return With Respect to Controlled Foreign Corporations"). A person was deemed to be in control of a foreign corporation if he or she owned stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or more than 50 percent of the total value of shares of all classes of stock of the foreign corporation. Id.

ANALYSIS:

Corp A argues that, during the years in issue, its wholly-owned domestic subsidiary, Corp B, was a United States shareholder that owned more than 50 percent of the total combined voting power of Corp E, a foreign corporation, such that Corp E was a CFC under the general facts and circumstances test in section 1.957-1(b)(1) of the regulations or was deemed to be a CFC under any of the three factual scenarios set

forth in section 1.957-1(b)(1)(i) through section 1.957-1(b)(1)(iii).[2] Corp A also argues that this conclusion is supported by Corp B's consistent treatment of Corp E as a CFC following Corp B's acquisition of exactly 50 percent of Corp E's issued shares and the right to select the president pursuant to the restructuring that occurred between Date 2 and Date 3, dates that are a number of years prior to January 1, 1987.[3]

It is not disputed that, during the years in issue, Corp B owned, within the meaning of section 958, exactly 50 percent of the only class of Corp E's stock. The question is whether, during the years at issue, Corp B owned more than 50 percent of the total combined voting power of all classes of stock of Corp E such that Corp E qualified as a CFC under section 957(a) of the Code. The resolution of this question requires an examination of all relevant facts and circumstances. Section 1.957-1(b)(1) of the regulations. In addition, if the facts of this case fall within one of the three factual scenarios set forth in section 1.957-1(b)(1) of the regulations, Corp E would be deemed to have been a CFC.

Factual Scenarios for Deemed CFC Status

During the years in issue, Corp B elected four of Corp E's eight directors. On this basis alone, Corp E was not a CFC pursuant to section 1.957-1(b)(1)(i) of the regulations.

Moreover, even if Corp B had elected a majority of Corp E's directors, Corp E would still not have qualified as a CFC pursuant to section 1.957-1(b)(1)(i) of the regulations since Corp B did not control (through election or otherwise) that body of persons who exercised powers ordinarily exercised by the board of directors of a domestic corporation. The documents provided by Corp B reflect that a number of the powers ordinarily exercised by such a governing body, such as the declaration and

---

[2] In your request for technical advice, you did not ask that we consider whether Corp B owned more than 50 percent of Corp E's total value. Accordingly, whether Corp E was a CFC on the basis of meeting the value test in section 957(a) of the Code is not addressed in this memorandum.

[3] This date is significant in the context of this case because it is the first day that changes made to the foreign tax credit rules in sections 901-908 of the Internal Revenue Code by the Tax Reform Act of 1986 generally became effective. Specifically, section 1201(a) of the Tax Reform Act of 1986 added paragraph (1)(E) to subsection 904(d) of the Code to provide that dividends paid by "non-controlled section 902 corporations" out of earnings accumulated in post-1986 years would be subject to a separate foreign tax credit limitation on a corporation-by-corporation basis. In contrast, dividends paid by a CFC out of post-1986 earnings became subject to more favorable "look-through" treatment under section 904(d)(3). This change had the effect of encouraging United States persons owning interests in foreign corporations operating in high-tax countries such as Country M to characterize the foreign corporations as CFCs.

payment of dividends and the concluding and altering of license agreements, were not exercised by Corp E's board of directors. Instead, decisions with respect to these matters required the unanimous consent of Corp E's three shareholders, each of whom decided independently whether to grant such consent. To the extent that Corp E's governing documents provided Corp E's shareholders with the authority to decide matters typically decided by the board of directors of a domestic corporation and imposed a unanimity requirement with respect to any decision regarding such matters, Corp B's interest in Corp E was equivalent to the right to elect only one-third of Corp E's governing body. On the basis of these facts, we conclude that during the years in issue Corp B did not have the power to elect a majority of those persons exercising, with respect to Corp E, powers ordinarily exercised by the board of directors of a domestic corporation.

The facts of this case do not satisfy the factual scenario set forth in section 1.957-1(b)(1)(ii) of the regulations. In order for a foreign corporation to be deemed a CFC, this scenario requires the presence of two facts. First, a United States shareholder of a foreign corporation must have the power to elect exactly one-half of those persons who, with respect to the foreign corporation, have the power to exercise those powers ordinarily exercised by the board of directors of a domestic corporation. Second such shareholders must have the power to elect any person who has the power to cast a vote deciding an evenly divided vote of such governing body. During the years at issue, Corp B selected the president, who presided over meetings of the board of directors of Corp E and had the right to cast the deciding vote in the event of a deadlock on any matter requiring a vote of the board of directors. Corp B thus meets the second part of the test in section 1.957-1(b)(1)(ii). However, as discussed above, Corp B did not elect a majority (and thus did not elect exactly one-half) of those persons exercising, with respect to Corp E, the powers ordinarily exercised by the board of directors of a domestic corporation. Accordingly, Corp E was not deemed to be a CFC pursuant to section 1.957-1(b)(1)(ii).

Finally, the fact that Corp E's governing documents gave its shareholders the right to vote on certain matters ordinarily decided by the board of directors of a domestic corporation means that the president, whom Corp B selected, did not have such powers. Accordingly, Corp E was not deemed to be a CFC pursuant to section 1.957-1(b)(1)(iii) of the regulations.

General Facts and Circumstances Test

Although Corp E did not qualify as a CFC on account of different facts than those set forth in the three factual scenarios described in section 1.957-1(b)(1) of the regulations, Corp E could still be treated as a CFC based upon a review of all of the facts and circumstances. In that regard, Corp B has submitted a number of documents,

including minutes of corporate meetings, a corporate practices manual, office correspondence and memoranda, and equipment expenditure requests, purportedly showing that Corp B had the requisite control over Corp E. Significantly, Corp B did not provide copies of Forms 2952 and Forms 5471 for Corp E for taxable years prior to January 1, 1987, the first year that CFC status was beneficial to United States shareholders. Corp B has claimed that it considered Corp E to be a CFC immediately after the restructuring that occurred between Date 2 and Date 3. Under section 6038 of the Code, Corp B had a clear obligation to file these forms for any year that it considered Corp E to be a CFC. However, for years prior to January 1, 1987, it did not do so. There is no apparent basis to conclude that Corp B purposely failed to file the correct forms before January 1, 1987, with regard to Corp E. It is more likely that Corp B's failure to file the forms reflected its understanding that its investment in Corp E did not provide it with the requisite control of Corp E.

After considering all the available facts and circumstances in this case, we conclude that Corp E was not a CFC since Corp B did not own the requisite amount of total combined voting power of Corp E under the general facts and circumstances test in section 1.957-1(b)(1) of the regulations.

Shifting of Formal Voting Power

Corp A argues that a United States shareholder's voting power in a CFC is determined not by reference to the percentage of outstanding stock of the CFC owned by the United States shareholder but rather by the actual control conferred by the stock ownership. In support of this statement, Corp A cites section 1.957-1(b)(2) of the regulations, which states that "[a]ny arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained." The regulation goes on to provide two examples of such a shift of formal voting power in the case of a foreign corporation with only one class of stock outstanding. First, voting power that has been shifted to a non-United States shareholder will be disregarded if there is any agreement, whether express or implied, that the non-United States shareholder will not vote its stock or will vote it only in a specified manner. Section 1.957-1(b)(2). Alternatively, voting power that has been shifted to a non-United States shareholder will be disregarded if there is an agreement, whether express or implied, that shareholders owning no more than 50 percent of the total combined voting power nevertheless will exercise voting power normally possessed by a majority of shareholders. Id. Corp A's argument is misdirected. Section 1.957-1(b)(2) addresses situations in which a non-United States shareholder acquires stock in a foreign corporation but agrees not to vote such stock or to vote it in accordance with the interests of a United States shareholder usually for the purpose of assisting the United States shareholder in preventing the foreign corporation from qualifying as a CFC. See e.g., Koehring Co. v. United States, 433 F.Supp. 929, 935

(E.D.Wisc. 1977) (court found the existence of an implied agreement that the foreign shareholder would not vote its stock or would vote its stock in accordance with the desires of the United States shareholder), aff'd 583 F.2d 313 (7th Cir. 1978). In the present case, no argument was made nor was any evidence produced that the shareholders of Corp E had entered into an agreement providing that Corp C and Corp D would not vote their stock or would vote their stock in accordance with the interests of Corp B. Accordingly, Corp A's reliance on this regulation to support its claim that Corp B should be treated as controlling Corp E is misplaced.

CONCLUSION:

After a review of all the available facts and circumstances in this case, it is determined that, during the years in issue, Corp B did not own the requisite amount of total combined voting power of Corp E such that Corp E was a CFC.

CAVEAT:

A copy of this Technical Advice Memorandum is to be given to the taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

* END *