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Internal Revenue Service
April 6, 2001
DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE
NATIONAL OFFICE
FIELD SERVICE ADVICE
MEMORANDUM FOR: ASSOCIATE AREA COUNSEL
CC:SB:5:KCY Attn: Michael L. Boman, Senior Attorney

FROM: Elizabeth G. Beck
Senior Technical Reviewer CC:INTL:Br6
SUBJECT:

This Chief Counsel Advice responds to your memorandum dated September 15, 1999. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUES

1. Whether the Service should challenge the income tax results in this case, in which a domestic subchapter S corporation (USCorp) made export sales through a foreign sales corporation (FSC A) owned in equal shares by four individual retirement accounts (IRAs) established for the benefit of the four individual shareholders of USCorp (the majority owner and his three minor children).

2. Whether the transactions in this case result in a taxable gift under the gift tax provisions contained in Chapter 12 of Title 26 of the Internal Revenue Code, sections 2501-2524.

CONCLUSIONS

1. Based upon the facts given, we do not recommend challenging the income tax results in this case.

2. Based upon the facts given, the transactions in this case result in a taxable gift, for the reasons and in the amount stated below.

FACTS

USCorp is a domestic subchapter S corporation. Father owns a majority (a%) of the shares of USCorp. Father's three minor children (individually "Child," collectively "Children") own the remaining shares of USCorp equally (each Child owns b% of the shares, Children own collectively c% of the shares). USCorp is in the business of selling Product A and some of its sales are made for export.

Father and each Child own separate IRAs, to which each of them made an initial contribution of $d. Each of the four IRAs acquired a 25% interest in FSC A, a foreign sales corporation ("FSC") pursuant to sections 992(a)(1) and 927(b)(1) of the Code, by entering into a subscription agreement for newly issued shares, after FSC A was formed in Month A of Year 1.

USCorp entered into service and commission agreements with FSC A ("Agreements") in Month A of Year 1. FSC A agreed to act as commission agent in connection with export sales made by USCorp, in exchange for commissions based upon the administrative pricing rules applicable to FSCs. USCorp also agreed to perform certain services on behalf of FSC A, such as soliciting and negotiating contracts, for which FSC A would reimburse USCorp its actual costs.

During Taxable Year 1, FSC A made a total cash distribution of $e to its IRA shareholders, out of earnings and profits derived from foreign trade income relating to USCorp exports. The IRAs owning FSC A each received an equal amount of $f. Combined with previous distributions out of such earnings and profits by FSC A to the IRAs, and with the earnings by the IRAs on such distributions, the value of each IRA on Date 1 was more than $g.

LAW AND ANALYSIS

1. Income Tax Issue

For the taxable year at issue in this case, the FSC provisions, contained in sections 921 through 927 of the Code, allow a foreign corporation to qualify and be taxed as a FSC. [1] Pursuant

to section 925(a), the taxable income of a FSC is determined under a section 482 method or under one of two other alternative methods (the administrative pricing rules).

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[1] The FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423 (2000), repealed sections 921 through 927, effective October 1, 2000, and established a new regime.

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Section 925(c) sets out the requirements for use of the administrative pricing rules. A FSC meets these requirements if all the activities described in section 924(e) attributable to such sale and all the activities relating to the solicitation (other than advertising), negotiation, and making of the contract for such sale have been performed by such FSC (or by another person acting under a contract with such FSC).

The activities described in section 924(e) are advertising and sales promotion; the processing of customer orders and the arranging for delivery of the export property; transportation from the time of acquisition by the FSC (or, in the case of a commission relationship, from the beginning of such relationship for such transaction) to the delivery to the customer; the determination and transmittal of a final invoice or statement of account and the receipt of payment; and, the assumption of credit risk.

Treas. Reg. § 1.924(a)-1T(i)(1) provides, in part, as follows:

> (i) *FSC's entitlement to income–(1) Application of administrative pricing rules of section 925(a).* A corporation which meets the requirements . . . to be treated as a FSC (or small FSC) for a taxable year is entitled to income, and the administrative pricing rules of section 925(a)(1) or (2) apply, . . . as long as the FSC, or someone under contract to it, satisfies the requirements of section 925(c).

For purposes of this advice, we assume that FSC A met the statutory and regulatory requirements for treatment as a FSC (or small FSC) and for use of the administrative pricing

rules. If so, FSC A would be entitled to the income it received (*i.e.,* commissions), as computed under the administrative pricing rules with respect to qualifying sales of USCorp.

There is no specific Code provision or regulation prohibiting an IRA from owning the stock of a FSC. The type of investment that may be held in an IRA is limited only with respect to insurance contracts, under section 408(a)(3), and with respect to certain collectibles, under section 408(m)(1).

Exemption from tax, under section 408(e)(1), is the principal tax treatment of an IRA. Notwithstanding this exemption, section 408(e)(1) provides that IRAs are taxable, under section 511, on any unrelated business income. Also, section 408(e)(2) provides that this section 408(e)(1) exemption is lost if an individual for whose benefit an IRA is established, or his beneficiary, engages in any transaction prohibited by section 4975 (prohibited transaction) with respect to such IRA.

In this case, the tax imposed by section 511 on unrelated business income does not apply to the dividends received by the IRAs from FSC A because section 512(b)(1) generally excludes dividends from the definition of unrelated business taxable income for purposes of section 511. [2]

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[2] We are aware that section 995(g) overrides this section 512(b)(1) exclusion with respect to amounts distributed or deemed distributed by a domestic international sales corporation (DISC) to any shareholder in a DISC that is a person subject to tax under section 511, including an IRA, by providing generally that such amounts shall be treated as derived from the conduct of an unrelated trade or business. There is no similar provision in either the Code or the regulations regarding distributions from a FSC to a tax-exempt shareholder.

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We also consider whether there were prohibited transactions in this case. The issue of prohibited transactions, in circumstances similar to those in this case, was addressed in *Swanson v. Commissioner* , 106 T.C. 76 (1996). In that case, after initially alleging that prohibited transactions had occurred, the Service ultimately conceded the case. The U.S. Tax Court, in awarding litigation costs to the taxpayers under section 7430, held that the Service's position regarding prohibited transactions was not substantially justified.

In the *Swanson* case, Mr. Swanson, the sole shareholder of a subchapter S corporation, H&S Swansons' Tool Co. (Tool Co.), arranged in January 1985 for the organization of a DISC, Swansons' Worldwide, Inc. (Worldwide DISC), as well as for the formation of a self-directed IRA (IRA #1) for his benefit. Mr. Swanson was named director and president of Worldwide DISC. On the same day that IRA #1 was created, Mr. Swanson directed the IRA #1 trustee to execute a subscription agreement for 2,500 shares of Worldwide DISC's original issue stock. The shares were subsequently issued to IRA #1, which became the sole shareholder of Worldwide DISC.

For the years 1985 to 1988, Tool Co. paid commissions to Worldwide DISC with respect to the sale by Tool Co. of export property. In the same years, Mr. Swanson, as president of Worldwide DISC, directed Worldwide DISC to pay dividends to IRA #1. The dividends totaled $593,602 for the four years. Tool Co. stopped paying commissions to Worldwide DISC after December 31, 1988, as Mr. Swanson "no longer considered such payments to be advantageous from a tax planning perspective." *Id* . at 79. [3]

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[3] We note in this regard that section 995(g) became effective for taxable years beginning after December 31, 1987, making dividends from a DISC, when received by a tax-exempt DISC shareholder, such as an IRA, unrelated business taxable income. Thus, in a separate case, IRA #1 conceded that it had unrelated business income for taxable year 1988. *Id.* at 85 n.7.

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In 1989, Mr. Swanson directed the trustee of his IRA to transfer $5,000 to a new self-directed IRA (IRA #2) that he created for his benefit and, at the same time, created a FSC, H&S Swansons' Trading Co. (Trading FSC). Mr. Swanson directed the trustee of IRA #2 to execute a subscription agreement for 2,500 newly issued shares of Trading FSC. The shares were subsequently issued to IRA #2, which became the sole shareholder of Trading FSC. A dividend of $28,000 was paid by Trading FSC to IRA #2 in 1990.

The Service issued notices of deficiency to Mr. Swanson and his wife alleging that prohibited transactions had occurred with respect to each IRA and that each IRA ceased to be an individual retirement account pursuant to section 408 because of those transactions. The alleged prohibited

transactions were (1) the sale of stock by Worldwide DISC and Trading FSC to the respective IRAs and (2) the payment of dividends by these companies to their IRA shareholders.

“Prohibited transactions,” include, *inter alia* , any “sale or exchange, or leasing, of any property between a plan and a disqualified person” (section 4975(c)(1)(A)); any “transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan” (section 4975(c)(1)(D)); and any “act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interest or for his own account” (section 4975(c)(1)(E)).

Section 4975(e)(2) defines “disqualified person” to include a fiduciary, an employer any of whose employees are covered by the plan, an owner of an employer, and certain officers and directors of an employer. Section 4975(e)(3) defines “fiduciary” to include any person who exercises discretionary control over the management of the plan assets. Section 4975(e)(1) defines “plan” to include IRAs.

The court in *Swanson* concluded that, when the initial issuance of DISC (or FSC) [4] stock to the IRA was made, the issuing company was not a “disqualified person” because the newly issued stock was not owned by anyone at the time of the sale. Thus, the sale of stock to the IRA was not a sale or exchange of property between a plan (the IRA) and a disqualified person within the meaning of section 4975(c)(1)(A).

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[4] Although the opinion refers primarily to the transactions involving Worldwide DISC and IRA #1, the court’s holdings apply equally to the transactions involving Trading FSC and IRA #2. *See, e.g., id* . at 87 (Service not substantially justified in maintaining that prohibited transactions had occurred with respect to IRA #1, and by implication, IRA #2).

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The payment of dividends by a DISC (or FSC) to an IRA was held not to be the use of IRA assets for the benefit of a disqualified person within the meaning of section 4975(c)(1)(D) because the dividends did not become IRA assets until they were paid.

The court also ruled that the actions of arranging for IRA ownership of DISC (or FSC) stock and for the subsequent payment of dividends by the DISC (or FSC) to the IRA, considered together, did not constitute an act whereby a fiduciary directly or indirectly "deals with income or assets of a plan in his own interest or for his own account," within the meaning of section 4975(c)(1)(E). The court noted that the Commissioner had not alleged that the taxpayer had ever dealt with the corpus of the IRA for his own benefit, stating:

Based on the record, the only direct or indirect benefit that petitioner [Mr. Swanson] realized from the payments of dividends by [Worldwide FSC] related solely to his status as a participant of IRA #1. In this regard, petitioner benefitted only insofar as IRA #1 accumulated assets for future distribution. Section 4975(d)(9) states that section 4975(c) shall not apply to:

receipt by a disqualified person of any benefit to which he may be entitled as a participant or beneficiary in the plan, so long as the benefit is computed and paid on a basis which is consistent with the terms of the plan as applied to all other participants and beneficiaries.

Thus, we find that under the plain meaning of section 4975(c)(1)(E), respondent was not substantially justified in maintaining that the payments of dividends to IRA #1 constituted prohibited transactions.

106 T.C. at 89-90.

In light of *Swanson* , we conclude that a prohibited transaction did not occur under section 4975(c)(1)(A) in the original issuance of the stock of FSC A to the IRAs in this case. Similarly, we conclude that payment of dividends by FSC A to the IRAs in this case is not a prohibited transaction under section 4975(c)(1)(D). We further conclude, considering *Swanson* , that we should not maintain that the ownership of FSC A stock by the IRAs, together with the payment of dividends by FSC A to the IRAs, constitutes a prohibited transaction under section 4975(c)(1)(E).

Accordingly, this case should not be pursued as one involving prohibited transactions. We note, however, that similar transactions may be prohibited under section 4975, based upon the particular facts of such transactions. For example, while FSC A in this case is not a disqualified

person, the owners of the IRAs are disqualified persons as fiduciaries with respect their IRAs and USCorp is a disqualified person with respect to the IRA owned by Individual A, the majority shareholder of USCorp. Thus, if a transaction is made for the purpose of benefitting USCorp, the IRA owners would violate section 4795(c)(1)(D). Also, if the facts were such that the IRA owners' interests in the transaction because of their ownership of USCorp affected their best judgments as fiduciaries of the IRAs, the transaction would violate section 4975(c)(1)(E).

2. Gift Tax Issue

Section 2501(a)(1) provides that a tax is imposed for each calendar year on the transfer of property by gift during such calendar year by any individual, resident, or nonresident.

Section 2511(a) provides that the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible; but in the case of a nonresident not a citizen of the United States, shall apply to a transfer only if the property is situated within the United States.

Section 2512(b) provides that where property is transferred for less than adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

Treas. Reg. § 25.2511-1(c)(1) provides, in pertinent part, that the gift tax also applies to gifts indirectly made. Thus, any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Treas. Reg. § 25.2511-2(a) provides that the gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon the ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

Treas. Reg. § 25.2511-2(b) provides, in pertinent part, that as to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete.

Treas. Reg. § 25.2512-8 provides, in part, that transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor. Thus, the Federal gift tax provisions reach further than the common law concept of gifts. *See Estate of Cullison v. Commissioner* , T.C. Memo. 1998-216, *aff'd* . 221 F.3d 1347 (9th Cir. 2000). Further, "[t]ransactions within a family group are subject to special scrutiny, and the presumption is that a transfer between family members is a gift." *Harwood v. Commissioner* , 82 T.C. 239, 257-258 (1984), *aff'd. without published opinion* , 786 F.2d 1174 (9th Cir.), *cert. denied* , 479 U.S. 1007 (1986).

The legislative history accompanying the Revenue Act of 1932 in discussing the gift tax statute provides, in pertinent part, that:

The terms "property," "transfer," "gift," and "indirectly" are used in the broadest and most comprehensive sense: [sic] the term "property" reaching every species of right or interest protected by law and having an exchangeable value.

The words "transfer * * * by gift" and "whether * * * direct or indirect" are designed to cover and comprehend all transactions . . . that, property or a property right is donatively passed to or conferred upon another, regardless of the means or the device employed in its accomplishment. [H. Rep. No. 708, 72nd Cong., 1st Sess. (1932) 27-28, 1939-1 C.B. (Part 2) 457, 476-477]

The United States Tax Court has noted that "[t]his legislative history reflects a clear intent on the part of Congress to apply the gift tax "in the broadest and most comprehensive sense." *Griswold v. Commissioner* , 81 T.C. 141 (1983).

In *Smith v. Shaughnessy* , 318 U.S. 176, 180 (1943), the Supreme Court stated, "[e]ven though these concepts of property and value may be slippery and elusive they can not [sic] escape taxation so long as they are used in the world of business. The language of the gift tax statute, 'property . . . real or personal, tangible or intangible,' is broad enough to include property, however conceptual or contingent."

In *Estate of Sanford v. Commissioner* , 308 U.S. 39, 43 (1939), the Supreme Court stated that ". . . the essence of a transfer is the passage of control over the economic benefits of property rather than any technical changes in its title."

To apply these principles in this case, we begin with the fact that the transactions in this case are within a family group and are, therefore, "subject to special scrutiny, and the presumption is that a transfer between family members is a gift." *Estate of Cullison v. Commissioner, supra* . Further, as noted in *Estate of Sanford v. Commissioner, supra* , the essence of a transfer is the passage of control over "economic benefits" and such a transfer may be found to have occurred "regardless of the means or device employed." Treas. Reg. § 25.2511-1(c)(1).

Consistent with the presumption that a transfer between family members is a gift, Father in this case made significant economic benefits available to Children. The "means or device" by which Father made such economic benefits available included causing FSC A to issue 75% of its stock to three IRAs created for the benefit of Children. Children's combined 75% ownership interest in FSC A is significantly larger than their combined c% ownership interest in USCorp. As a result, Children became entitled to receive indirectly, through their ownership of IRAs holding 75% of the shares of FSC A, a much larger share FSC A's earnings and profits than they would have received had their ownership percentage in FSC A been the same as their ownership percentage in USCorp.

As a further element in the "means or device" employed in this case, Father, as controlling shareholder of USCorp, also arranged the Agreements between USCorp and FSC A under which all of FSC A's profits from the relevant sales were earned. We assume, as we concluded above, that FSC A was entitled to the income it received. Nevertheless, through this combination of transactions, Father arranged for Children to receive economic benefits by first placing them in a position to receive a greater share of FSC A's earnings and profits than their share of USCorp's earnings and profits and then by arranging the Agreements under which USCorp afforded FSC A the business opportunity to earn profits as a result of FSC A's transactions with USCorp.

In this connection it is noted that Father is the majority shareholder of USCorp. Therefore, Father has control over the activities of USCorp. As collective owners of c% of the stock of USCorp, Children do not have control over the activities of USCorp. In addition, there is no evidence that USCorp is required to enter into the Agreements with FSC A. USCorp could have chosen to enter into an agreement with one or many other FSCs.

Based upon the information provided, therefore, we conclude that the arrangement by Father for FSC A to be owned 75% by Children and for FSC A to earn profits under Agreements with USCorp, based on commissions paid by USCorp to FSC A in connection with USCorp's relevant sales, results in a taxable gift from Father to Children.

As noted above, under Treas. Reg. § 25-2511-2(b), a gift is complete when, as to any property, or part thereof or interest therein, the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another. In this case, this occurred and the gifts were complete each time USCorp conducted a foreign sales transaction through FSC A. Upon completion of each transaction, Father, as majority owner of USCorp, no longer retained dominion and control over the commissions paid by USCorp to FSC A or over FSC A's earnings and profits.

Generally, as provided by Treas. Reg. § 25.2511-2(a), the amount of a gift is "measured by the value of the property passing from the donor." In this case, the amount of Father's taxable gift is the difference between Children's 75% combined beneficial interest in the amount of earnings and profits realized by FSC A and distributed to Children's IRAs, all as arranged for them by Father, and Children's c% combined interest in the additional profits that USCorp would have earned on the relevant sales, had Father not made the arrangements described above and had USCorp, instead, earned itself all of the profits with respect to the sales. There is no evidence of any additional value provided by Children for their disproportionate ownership of FSC A, which indicates donative intent. The entire amount of the increment in economic benefits received by Children is a taxable gift because this is the amount that was made available by Father to Children without Father having received from Children anything in exchange that would constitute consideration in the form of money or money's worth.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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ELIZABETH G. BECK

Senior Technical Reviewer, Branch 6

Office of the Associate Chief Counsel

(International)