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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: STEVEN A. MUSHER
CHIEF, CC:INTL:Br6

SUBJECT:

This Field Service Advice responds to your memorandum dated November 3, 1998 and subsequent conversations. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

A	=		
B	=		
Country C	=		
Country D	=		
Region 1	=		
Purpose F	=		
Year 1	=		
Year 2	=		
Year 3	=		
Year 4	=		
Year 5	=		
Date 1	=	$k	=
$g	=	$m	=
$h	=	$n	=
$j	=	$p	=
		$q	=
		$r	=

$s =
$t =
$u =

ISSUE(S):

Whether taxpayer may report on a timely filed return that sums booked as receivables for royalties, services and sales are properly constructive dividends?

CONCLUSION:

Taxpayer's inconsistent book and tax treatment of the royalties, services, and sales items for U.S. and Country C purposes subjects it to a heightened standard of proof under the rule of law enunciated in Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) and its progeny. In order for A to sustain its position, A must come forth with sufficient evidence to satisfy the heightened standard of proof by demonstrating that A and B consistently respected and reported the items in question as dividends and that the other facts and circumstances justify treating those items in substance as constructive dividends. The facts as developed so far cast doubt on whether A will be able to meet this heightened standard of proof.

If, in light of further development and evaluation of the facts and the taxpayer's heightened standard of proof, the transactions in substance as well as form involved royalties, service fees, and sales receipts, that would not necessarily end the inquiry. It might still be possible for the taxpayer to establish under section 482 principles that the amount of one or more of these items was excessive measured against the arm's length standard and that the excess payment constituted a constructive dividend. See Treas. Reg. § 1.482-1(a)(3); Rev. Rul. 82-80, 1982-1 C.B. 89. In order to prevail under section 482, the taxpayer will need to put forth an analysis regarding the application of the section 482 regulations and methods to the transactions.

If you determine that, in substance, there was no compensatory income to A from royalties, services or sales, or if you determine any of those amounts to be in excess of an arm's length result, you may still consider whether merely accruing

receivables is sufficient to constitute constructive dividends. We have not addressed that issue in this advice.

FACTS:

A is a U.S. corporation that is engaged in the manufacture and sale of products necessary for Purpose F. A is the 100% shareholder of B, a Country C corporation. B is a manufacturer and distributor of A's products for the Region 1 market. B sells A's products exclusively and A does not sell to any unrelated distributors in Region 1.

In Year 2, A, for purposes of computing the section 902 credit and for the section 904 foreign tax credit limitation, reported a dividend from B for $g on its Form 1118 and on the Form 5471, Schedule M (Schedule M). Part of that dividend was a cash dividend of $h for which B withheld tax provided for under the applicable treaty in effect. The remainder $j was not an actual dividend, but rather A considered it a constructive dividend comprised of three items of income that appear on the books for A and B as receivables for royalty income, services income and sales income.[1] No withholding tax was deducted or paid pursuant to the treaty with respect to the $j putative constructive dividend.

There is no written royalty agreement according to A, but it appears from the facts available that the royalty payment is for the know-how and license to manufacture and produce products under patent by A. In year 2, B had book entries for a royalty to A of $k, and A treated the income as royalty income for book purposes. B reported for Country C's tax purposes a deduction for royalty expenses in the amount of $k; however, A does not show the royalty income as paid on its Year 2 Form 1118 or on the Schedule M, thereby creating an inconsistency as between the tax disclosures in the U.S. and in Country B.[2] In several other years A does show royalty amounts paid on its Form 1118s; for Year 1, A showed a $n royalty paid to A from B; in Year 3, A showed a $p royalty paid to A from B; in Year 4, A showed a $q royalty paid to A from B; in Year 5, A showed a $r royalty paid to A from B. The Schedule Ms for Years 1,3 and 4 do not show any royalties paid; however, the Schedule Ms for Years 3 and 4 do show substantial dividends that taxpayer

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[1]We assume for purposes of this discussion that the receivables mentioned above would constitute a constructive dividend provided that taxpayer's characterizations prove correct; however, we do not opine as to whether such treatment is appropriate. See discussion, infra.

[2]On A's Form 1118 for Year 2, a royalty in the amount of $m is shown as paid on the line listed for the Country C controlled foreign corporation (CFC), but it is unclear if this amount is from B or from a Country D CFC.

possibly might also characterize as part actual dividend and part constructive dividend.[3]

A entered into a service agreement with B on Date 1, Year 1. The service agreement calls for A to provide advisory services with regard to accounting, advertising, budgets and cash management, and human resources issues on behalf of B. The agreement provides that the service fee is based on cost plus 10%. In Year 2, B deducted for book and Country C tax purposes $s for advisory services according to the written agreement. A indicated it received an initial payment for services under the agreement as an estimated charge and an additional reconciliation payment, which for book purposes is accounted for as "other income." No compensation was reported as paid by B on the Schedule Ms for Years 2,3 and 4. Form 1118 for Year 5 indicates $t of gross income from services performed in Country C.[4]

B purchases inventory F.O.B. U.S. from A at standard cost plus 20%. In Year 2, it appears that A issued an invoice to B for $u to make a conforming price adjustment on previously invoiced inventory. B claimed the amount as cost for book and Country C tax purposes, and A treated the transaction as giving rise to sales receipts in the same amount on its books.

A's books show receivables in the amounts of $k on account of royalties, $s on account of services fees and $u on account of sales receipts for Year 2. For tax purposes A reported a constructive dividend consisting of those exact items. A determined that the receivables on their books were unnecessary, overstated or lacked proper consideration. A and B did not adjust or correct their accounting books and records to credit B for the receivables in question and A and B did not reflect dividend treatment on their books for those items. A reported for U.S. tax purposes that the three receivables noted were a constructive dividend and effectively reported that no royalty was due in Year 2 and that no services fees were earned under the agreement in Year 2. For Country C tax purposes, B reported the deductions for royalties and services, and failed to withhold and pay tax on the purported constructive dividend.

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[3]The Schedule M for Year 5 was not provided.

[4]This appears to be inconsistent with the nature of the services agreement that seemed to indicate services done by A in the U.S. on behalf of B; however the $t amount is in the same general magnitude and category of income as the $s amount appearing on the books of A and B for Year 2.

In calculating the deemed paid credit, the taxpayer did not adjust the earnings and profits (E&P) of B for the royalties, services and sales transactions that were recharacterized when computing its section 902 credit.[5]

The facts developed so far do not indicate how A determined that the royalty and services receivables lack consideration. A has stated that the upward price adjustments for inventory are erroneous charges and that the original invoices stated the correct price for inventory sold to B. In connection with questions raised upon examination, taxpayer appears to argue that the items on account of royalties, services, and sales were in excess of arm's length amounts. However, taxpayer has not offered any evidence that such considerations were contemporaneously taken into account apart from the filed U.S. tax return.

LAW AND ANALYSIS

A and B, as evidenced by their accounting records, B's tax disclosures in Country C, and by the presence of a services agreement, have transactions for services, royalties and sales. Ordinarily, those transactions would create income in the U.S. and deductible expenses or costs in Country C, and would not have been subject to withholding tax in Country C (by virtue of the applicable treaty in effect between the U.S. and Country C). However, for purposes of the Year 2 tax return, A has taken the position that those transactions lacked consideration and therefore, in substance, are constructive dividends. Dividends would have been nondeductible, and subject to withholding tax in Country C, if the amounts had been consistently reported as dividends for Country C as well as for U.S. income tax purposes.

In general, the substance rather than the form of a transaction governs for federal income tax purposes. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935). Thus, the Commissioner has been allowed to discount the form of a transaction, and determine the tax consequences based on its substance. *See* Gregory v. Helvering; Spector v. Commissioner, 641 F.2d 376, 381 (5th Cir. 1981), *cert. denied*, 454 U.S. 868 (1981); Laidlaw Transportation, Inc. v. Commissioner, T.C. Memo. 1998-232.

The Supreme Court has also long recognized the rule of law that a taxpayer, although free to structure his transaction as he chooses, "once having done so, . . . must accept the consequences of his choice, whether contemplated or not . . . and may not enjoy the benefit of some other route he might have chosen to follow but

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[5]We assume that for purposes of computing B's E&P, A initially treated the expenses or costs as items deductible from E&P, but upon recharacterization of the transactions as a constructive dividend, A also deducted the constructive dividend from E&P without reconciling the account for the previous deductions taken against E&P.

did not." Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) (citations omitted). Taxpayers have less freedom than the Commissioner to ignore the transactional form that they have adopted, and are ordinarily bound by the tax consequences that flow therefrom. Illinois Power Co. v. Commissioner, 87 T.C. 1417, 1430 (1986). *See also,* Nestle Holdings, Inc. v. Commissioner, 152 F. 3d 83, 87 (2d Cir. 1998); Spector v. Commissioner, 641 F.2d at 381; Taiyo Hawaii Company, Ltd. v. Commissioner, 108 T.C. 590, 601-603 (1997); Estate of Durkin v. Commissioner, 99 T.C. 561, 572-75 (1992); Little v. Commissioner, T.C. Memo. 1993-281, 65 T.C.M. (CCH) 3025, 3032 (1993), *aff'd*, 106 F.3d 1445 (9th Cir. 1997). This rule of law, which limits a taxpayer's ability to disavow the form of its chosen transaction, seeks to avoid the uncertainty that would result from allowing the taxability of a transaction to depend on whether an alternative form exists under which more favorable tax consequences would result. National Alfalfa, 417 U.S. at 149; Television Indus., Inc. v. Commissioner, 284 F.2d 322, 325 (2nd Cir. 1960).

The case law recognizes that taxpayers are advantaged by having both the power to structure transactions in any form they choose and the access to the facts that reflect the underlying substance. In contrast, the Commissioner is disadvantaged because he does not have direct access to the facts underlying a particular transaction. Consequently, the Commissioner must be allowed to rely on representations made by taxpayers, and must be allowed to evaluate the resulting tax consequences based on such disclosures. This reliance is particularly appropriate in the context of a cross border transaction, such as the present case, where documents and information are not readily available to the Commissioner.

"The Commissioner is justified in determining the tax effect of transactions on the basis in which the taxpayers have molded them . . . ." Television Industries, Inc. v. Commissioner, 284 F.2d at 325. *See also,* FNMA v. Commissioner, 90 T.C. 405, 426 (1988), *aff'd*, 896 F.2d 580 (D.C. Cir. 1990), *cert denied*, 499 U.S. 974 (1991). To freely allow taxpayers to argue for alternative tax treatment of a transaction would be tantamount to administering the tax laws based on a policy that tax consequences flow from the "transaction taxpayers have chosen or from any other form [of transaction] they might have chosen, whichever is . . . [more favorable]." City of New York v. Commissioner, 103 T.C. 481, 493 (1994) (quoting Television Industries, Inc. v. Commissioner, 284 F.2d at 325), *aff'd,* 70 F.3d 142 (D.C. Cir. 1995). For this reason, the courts have generally subjected taxpayers to a heightened standard of proof before they are permitted to contradict the form and have the transaction taxed in accordance with substance. Spector v. Commissioner, 641 F.2d at 382; Estate of Durkin v. Commissioner, 99 T.C. at 572-75; FNMA v. Commissioner, 90 T.C. at 426; Illinois Power v. Commissioner, 87 T.C. at 1431; Little v. Commissioner, 65 T.C.M. at 3032.

The courts have articulated this heightened standard of proof differently. *See* Spector v. Commissioner, 641 F.2d at 382. For example, in Commissioner v. Danielson, 378 F.2d 771 (3rd Cir. 1967), *cert. denied*, 389 U.S. 858 (1967), the court held that where taxpayers executed a contract containing specific terms, conditions and allocations, they may not alter or avoid the tax consequences of that agreement in the absence of fraud, duress, or undue influence.[6] In contrast, the court in Sonnleitner v. Commissioner, 598 F.2d 464 (5th Cir. 1979), determined that before a taxpayer may alter or avoid the tax consequences of a contractual arrangement, the taxpayer must come forth with strong proof that the agreement lacked economic reality. The Tax Court has adopted the strong proof standard and has refused to apply Danielson outside the circuits that recognize it. *See, e.g.*, Meredith Corp. v. Commissioner, 102 T.C. 406, 440 (1994); Elrod v. Commissioner, 87 T.C. 1046, 1065-66 (1986). The strong proof rule, as applied by the Tax Court, requires a showing of somewhat more than a preponderance of the evidence and somewhat less than Danielson. Illinois Power Co. v. Commissioner, 87 T.C. at 1434, n.15. The burden upon the taxpayer is "far heavier when his tax reporting positions and other actions did not consistently reflect the substance which he later argues should control the form." Miller v. Commissioner, 57 T.C.M. at 50-51 (citing Illinois Power Co. v. Commissioner, 87 T.C. at 1430).

The Tax Court in Estate of Durkin v. Commissioner, 99 T.C. at 574-575 held that, under either a strong proof or Danielson standard, the taxpayers could not disavow their chosen form where: (1) taxpayers were seeking to disavow their own tax return treatment of the transaction, (2) the taxpayers' reporting position and other actions did not show "an honest and consistent respect for the substance of the transaction", (3) the taxpayers were unilaterally attempting to have the transaction treated differently after it had been challenged, and (4) the taxpayers would have been unjustly enriched if he were permitted to belatedly alter the transaction after well-informed negotiations were held with the other party to the transaction.

In the recent opinion of Norwest Corp. v. Commissioner, 111 T.C. 105 (1998), the Tax Court denied the taxpayer's attempt to have a transaction taxed in accordance with its substance, after it was initially reported on the return as a sale and lease-back of real property. The taxpayer argued that there had been no sale, and that the entire transaction, in substance, was merely a financing arrangement. After considering various approaches, the Tax Court concluded that the "taxpayers

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[6] Only certain courts have adopted the Danielson rule. See, e.g., Lane Bryant, Inc. v. United States, 35 F.3d 1570 (Fed. Cir. 1994); Schatten v. United States, 746 F.2d 319 (6th Cir. 1984); Bradley v. United States, 730 F.2d 718 (11th Cir. 1984), *cert. denied*, 469 U.S. 882 (1984); Spector v. Commissioner, 641 F.2d 376, 381 (5th Cir. 1981), *cert. denied*, 454 U.S. 868 (1981).

cannot elect a specific course of action and then when finding himself in an adverse situation extricate himself by applying the age-old theory of substance over form." Norwest Corp. v. Commissioner, 111 T.C. at 146.

In Taiyo Hawaii v. Commissioner, working from the fundamental rule of law enunciated in National Alfalfa that a taxpayer must accept the tax consequences of its choice of transaction, the Tax Court noted that taxpayers have been permitted to assert substance over form where their "tax reporting and other actions have shown an honest and consistent respect" for the substance. Id. at 602 (citing FNMA v. Commissioner, 90 T.C. at 426 and Illinois Power Co. v. Commissioner, 87 T.C. at 1430). Taiyo Hawaii, however, failed to demonstrate an honest and consistent respect for what it contended after the fact was the substance of the transaction. Relying on cases such as Estate of Durkin v. Commissioner and Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959), aff'g. 29 T.C. 129 (1957), the Tax Court stated:

> Petitioner's approach does not show that the substance of the advances was not loans. It merely illustrates that the parties to the transactions did not follow all the formalities that might be considered probative that the advances were debt rather than equity. In that regard, petitioner has not shown that the form of the transaction did not comport with its substance.... Accordingly, we hold that petitioner has not carried its burden of showing that the substance of the transaction was different from its form.

108 T.C. at 602-603 (citations and footnote omitted).

In cases involving cross border transactions, the Tax Court will take into account the global structure of the transaction, including foreign tax disclosures. For instance, in Coleman v. Commissioner, 87 T.C. 178, 200-204 (1986), the Tax Court examined all the facts surrounding the cross border leasing transaction between the U.S. lessee and U.K. lessor in determining whether the former had a depreciable interest in the leased equipment. Prior to the lease arrangement, the U.K. lessor transferred its title, and ownership interest, in the equipment to the lenders. Hence, the U.S. lessee could not acquire a depreciable interest in the equipment since his interest flowed from that of the U.K. lessor. By claiming depreciation deductions, the U.S. lessee was in fact attempting to disavow the form of the transaction that was originally structured between the U.K. lessor and the lenders. The Court stated:

> [t]he fact that the purpose underlying the form of the transaction between [the U.K. lessor] and the lenders was to take advantage of U.K. rather than U.S. tax laws does not, in our opinion, provide a sufficient foundation for permitting petitioners to disavow that form in order to obtain the benefits of U.S. tax laws...

> Moreover, there is ... [no established judicial principles] which compels us to ignore the form of a transaction structured to obtain tax benefits in one jurisdiction and to restructure the transaction, at the insistence of the taxpayer, in order to confer tax benefits in another jurisdiction – in short, to enable the taxpayer to play both ends against the middle.

Like Coleman, the Tax Court in Laidlaw Transportation, Inc. v. Commissioner, 75 T.C.M. at 2600-16, also reviewed the structure of the advances on a global basis. The dispute in Laidlaw involved the characterization of cross border advances that were made between controlled taxpayers and classified as debt. The Commissioner challenged the substance of the transactions arguing that the advances constituted equity. In holding for the Commissioner, the Tax Court noted that the advances were structured in a manner that ultimately created a "double deduction" to the Canadian parent on a global basis. Id. at 2602. The Canadian parent borrowed funds from an independent lender and transferred these funds, as capital contributions, to a wholly-owned Netherlands subsidiary. The Netherlands subsidiary in turn loaned those funds, with stated interest, to U.S. sister companies that were also wholly-owned by the Canadian parent. Under this structure, the Canadian parent deducted interest on its loan with the outside lender, and the U.S. subsidiaries deducted interest on its borrowings from the Netherlands subsidiary. During an examination of the parent's returns, the parent represented to the Canadian tax authorities that the advances were capital contributions to the subsidiaries. Id. at 2615-16. The Tax Court viewed this representation as a significant factor in establishing the parent's intent that the advances were equity investments. Id. at 2620.

With respect to the present case, A will be subject to the heightened standard of proof when it attempts to report, for tax purposes, dividends for items arising from transactions that would apparently support royalties, services and sales income and were so booked by A, and consistently so treated by B for both book and Country C tax purposes. A and B's actions do not show an honest and consistent respect for what A claims are dividends in substance resulting from disavowing the invoiced amounts as income. A's argument does not appear to comport with the contemporaneous events underlying the transactions as depicted by B's tax reporting position, the existence of a written contract to perform services and the reciprocal book entries. Further, the constructive dividends claimed by A, do not appear to have borne foreign withholding tax, another factor inconsistent with the treatment of the amounts in questions as dividends. The result is unjust enrichment to A and B through non-taxation of income in Country C and through shifting U.S. source sales and services income to foreign source constructive dividends.

A and B's inconsistent conduct shows that taxpayer is recharacterizing items of income as dividends for U.S. tax treatment, while maintaining B's corresponding

treatment of the same transactions as deductible expenses or costs for Country C tax purposes. In situations involving parent/subsidiary transactions, it is reasonable to expect that the transaction would be accorded harmonious treatment by both parties. The conflicting classification of the transactions show that both parties do not uniformly respect the transferred property as dividends.

A and B may have other inconsistencies that you may consider developing further. As noted above, A has reported no royalty as paid for Year 2 on its Form 1118; however in Years 1, 3, 4 and 5 a royalty is reported on the Form 1118's. The lack of a royalty fee in Year 2 despite B's use of A's patents and manufacturing intangibles seems incongruous given the economic realities of royalty and licensing transactions generally and the circumstantial evidence surrounding this taxpayer.

The presence of the services agreement is suggestive of A and B's intent for A to provide compensable management services on the behalf of B. The intent is further substantiated by the reciprocal book entries showing an expense on the books for B and services income on A's books. The fact that A made two book entries, one showing an estimated charge, and the second, a reconciliation charge seems to indicate that some performance under the agreement occurred.

Another possible source of inconsistency that you may consider concerns the E&P calculations and foreign tax pools for B. If A calculated E&P for B in Year 2 by deducting royalties and services fees and by crediting E&P with sales income reduced by the upward adjustment cost of goods sold, it would have the effect of diminishing B's E&P overall. When a dividend is paid to A from B a larger portion of the foreign tax pool is deemed paid by A under section 902. Therefore A may have calculated the deemed paid credit incorrectly with regard to the total dividend of $g and may further have created an inconsistency by further reducing E&P by the constructive dividend of $j. It would be internally inconsistent for A to reduce B's E&P by deductible expenses and costs and also to reduce E&P for the constructive dividend, which consists of the same items and amounts. This is a matter that you may wish to clarify.

For the foregoing reasons, A will have to meet a heightened standard of proof in order to establish that the transactions in question were, in substance, dividends where the parties themselves did not consistently respect that character.

If, in light of further development and evaluation of the facts and the taxpayer's heightened standard of proof, the transactions in substance as well as form involved royalties, service fees, and sales receipts, that would not necessarily end the inquiry. It might still be possible for the taxpayer to establish under the principles of section 482 that the amount of one or more of these items was excessive measured against the arm's length standard. In that event, taxpayer might contend that it was entitled to report on a timely filed Year 2 return results of

its interaffiliate royalties, services, and sales transactions based upon prices different than those actually charged in order to reflect arm's length results. See Treas. Reg. § 1.482-1(a)(3). The amount paid in excess of the arm's length charges for the license, services, and sales would then properly be reflected as a constructive dividend. See Rev. Rul. 82-80, 1982-1 C.B. 89 (indicating that a greater than arm's length amount paid by a U.S. subsidiary to its foreign parent would be a dividend subject to withholding tax, absent treatment of the excess as an account receivable under Rev. Proc. 65-17).[7]

The taxpayer would have to support its contention that the amounts were in excess of arm's length results by appropriate application of the section 482 regulations relevant to the royalties, services, and sales (including, for example, a functional analysis and a discussion of comparable transactions). We do not offer any views in that connection.

We do note that, while analytically distinct, the questions concerning the substance of the transactions, and the appropriate arm's length consideration for those transactions once their substance is determined, may factually overlap. Thus, for example, the assertion that the transactions were wholly lacking in consideration would arguably also justify the position that the receivables were in excess of arm's length amounts. However, that assertion would presumably have already been taken into account in the context of the threshold evaluation of the substance of the transactions. In order to prevail under section 482, A will need to put forth an analysis regarding the application of the section 482 regulations and methods to the transactions. For the purposes of that analysis A should not be able to rely on assertions of fact that effectively have been discounted in the process of determining the substance of the transactions.

Again, while taxpayer appears to argue that the items on account of royalties, services and sales are in excess of arm's length amounts, taxpayer has not offered

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any evidence of contemporaneous consideration of this matter apart from the timely filed U.S. income tax return. The books and Country C tax filings are inconsistent with this position. This leaves open the possible interpretation that taxpayer's returns were an effort to gain favorable, but inconsistent, tax treatment in both countries, rather than an effort to reflect the true substance of the transactions or comply with the arm's length standard.

We also note that Year 2 would appear to be governed by the 1993 temporary section 482 regulations, rather than the 1994 final section 482 regulations, unless the taxpayer elects to retroactively apply the 1994 final regulations to such year and all subsequent years. Treas. Reg. § 1.482-1(j)(2). Under the temporary regulations, the taxpayer would appear to be precluded from reporting results that differ from transactional results recorded in its regular books and records, since it did not comply with the applicable requirements for compensating adjustments. See Treas. Reg. §§ 1.482-1T(a)(3), 1.482-1T(e)(2).[8] The final regulations, however, eliminated these requirements.[9]

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[8]The regulations specify three requirements, (A) a reimbursement or other compensating adjustment is made pursuant to a written compensating adjustment agreement; (B) the arrangement provides for reimbursement or compensating adjustments among members of the group, as necessary to achieve an arm's length result for the controlled transaction under review; and (C) the adjustments are made before the taxpayer's timely filing of its U.S. income tax return for the taxable year of the transaction.

[9]The Preamble to the 1994 final regulations states in pertinent part:

> The provision regarding the taxpayer's use of section 482 (§1.482-1(a)(3)) has been revised to clarify that, although the taxpayer is generally barred from invoking the provisions of section 482, the taxpayer may report an arm's length result on its original tax return, even if such result reflects prices that are different from the prices originally set forth in the taxpayer's books and records. In response to comments, the requirement in the 1993 regulations that such differences be eliminated through the use of "compensating adjustments" has been deleted. Section 482 is concerned only with whether the taxpayer reports its true taxable income, and whether or not this result is consistent with the taxpayer's books, or is corrected in the books, is generally irrelevant to this inquiry. However, the absence of a requirement to eliminate book and tax differences for section 482 purposes has no effect on the mechanisms otherwise provided for reporting and reconciling such differences (e.g., Schedule M-1 of Form 1120). Further, the limited exception provided by this rule does not permit taxpayers to apply section 482 at will; thus, for example, a taxpayer may not rely on section 482 to reduce its taxable income on an amended return.

If you determine that, in substance, there was no compensatory income to A from royalties, services or sales, or if you determine any of those amounts to be in excess of an arm's length result, you may still consider whether merely accruing receivables is sufficient to constitute constructive dividends. We have not addressed that issue in this advice.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

If you have any further questions, please call (202) 874-1490.

By: _____

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