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4.3.1.2 CH. 13 Controlled Foreign Corporations

[4.3.1.2] 13.1 Controlled Foreign Corporations (CFC) Subpart F (05-21-1999)

(1) The taxation of foreign income earned by U.S. controlled foreign corporation drastically changed with the introduction of Subpart F into the Internal Revenue Code in 1962. Subpart F deals with the U.S. taxation of amounts earned by controlled foreign corporations (CFCs). It provides that certain types of income of CFCs, though undistributed, must be included in the gross income of the U.S. shareholder in the year the income is earned by the CFC.

(2) It is important to note that the Subpart F sections of the Code take precedence over the foreign personal holding company sections. Further, the rules contained in Subpart F are to be applied after the income of the CFC has been adjusted to conform to U.S. income tax concepts.

(3) Under certain circumstances, current earnings of a CFC may be deferred from U.S. tax if not actually distributed to the U.S. shareholder. Since domestic entities are currently taxed, it is essential that the relationships between CFCs and domestic entities be at arm's length. Any allocations of income and deductions between the CFC and its related organizations under IRC 482 take precedence over the application of the provisions of Subpart F.

(4) The provisions of Subpart F contain many general rules, special rules, definitions, exceptions, exclusions, and limitations that require careful consideration.

[4.3.1.2] 13.2 Preliminary Information Needed (05-21-1999)

(1) The first step in beginning any examination should be to become familiar with the scope and mode of the taxpayer's operations (e.g., the products and entities involved, etc.). The following information and documents should be secured to meet this objective.

a. Obtain consolidated financial statements (if available) showing balance sheets and operating results of all related and foreign entities;

b. Obtain certified (or other) statements of the individual foreign entities. (Remember, the regulations provide for English translations or the services of a qualified interpreter where the books or records are not maintained in English.);

c. Obtain a statement from the taxpayer characterizing the operations of the various related foreign entities;

d. Obtain minute books of the domestic taxpayer and of the related foreign entities if available;

e. Obtain original Form 1120 and/or Form 1120-F, or copies thereof, if such returns were filed for any related foreign entity;

f. Obtain copies of all foreign tax returns filed by related foreign entities in which the taxpayer is a U.S. shareholder;

g. Obtain or prepare organizational charts showing the relationship of all domestic and foreign entities. Be sure stock ownership percentages are included;

h. Ask for a briefing on changes in accounting procedures designed to meet the requirements relating to IRC 951. If possible, this should be done at the first meeting with the U.S. shareholder or his representative;

i. Examine copies of existing company publications, manuals, instructions, or correspondence that set forth procedures dealing with foreign income reporting.

(2) Subpart F contains many relief provisions. The early stages of the examination should be devoted to determining the applicability of Subpart F and their exclusions, etc. starting with those most easily verified. Audit steps requiring detailed documentation and extensive analyzes should be pursued only after determining that the more apparent relief provisions are not applicable.

[4.3.1.2] 13.3 Identification and Qualifications of CFCs and U.S. Shareholders (05-21-1999)

(1) U.S. Shareholder Defined. A U.S. shareholder is a U.S. person (defined in IRC 957(c)) who owns directly, indirectly, or constructively 10 percent or more of the total combined voting power of all classes of stock entitled to vote in a foreign corporation.

(2) Controlled Foreign Corporation Defined. A controlled foreign corporation is any foreign corporation in which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned directly, indirectly, or constructively by U.S. shareholders on any day during the taxable year of such foreign corporation or more than 50% of the total value of the stock is owned directly, indirectly or constructively by U.S. shareholders on any day during the taxable year of the CFC then it is a CFC.

(3) Note there are special rules for determining whether a foreign corporation is a CFC for purposes of IRC 953(a) (insurance income).

[4.3.1.2] 13.4 Identification Qualification and Guidelines (05-21-1999)

(1) Check the Foreign Information Systems (FIS) Tables for names and stock ownership of U.S. shareholders.

a. Determine if Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations, and income statements plus balance sheets have been filed indicating the existence of a CFC;

b. Analyze U.S. taxpayers' investments and stock records to detect ownership in foreign corporations;

c. Determine direct, indirect, and constructive ownership of voting power of stock in any foreign corporations. It is important to note that the ownership rules relate to voting power of stock. IEs should be alert to attempts to shift formal voting power to avoid qualification. See Regs. 1.951-1(g)(2) and 1.957-1(b)(2) for illustrated situations. Determine value of stock, including

whether any shares have different rights resulting in different values, and ownership of value of stock;

d. Determine who is in actual control of the foreign corporation if the U.S. shareholders appear to be in the minority;

e. Examine income and expense accounts on the U.S. taxpayer's books if there is no investment account. Items that might suggest a foreign investment could include Foreign source income, Foreign legal fees, Foreign travel expenses, Foreign tax paid, and any Other types of expenses suggesting foreign activity;

f. The CFC's stock record books may show ownership of a subsidiary. By applying the indirect ownership rules, a subsidiary of the CFC, if ownership is sufficient, may be considered a CFC;

g. If the taxpayer owns 10 percent or more of a foreign corporation, an analysis of the records may indicate the existence of other U.S. shareholders. Analysis might disclose other owners of the stock that constructively or indirectly might qualify the foreign corporation as a CFC;

h. If the taxpayer has adopted a new accounting period, the conditions of Rev. Proc. 63-7 must be satisfied.

(2) After reviewing the above data, it may be possible to eliminate certain U.S. shareholders and foreign entities from consideration with respect to Non-CFCs; entities that are not CFCs for an uninterrupted period of 30 days or more during the taxable year; or shareholders of foreign investment companies where an election under IRC 1247(a) is in effect. See IRC 951(c).

[4.3.1.2] 13.5 Determination of Amounts to be Included in Income General Rule (05-21-1999)

(1) If the taxpayer qualifies as a U.S. shareholder under IRC 951(b) and owns stock in the CFC directly or indirectly, under Section 958(a), and if the foreign corporation in question is a CFC for the requisite period, then further analysis may be necessary to determine the taxability under IRC 951(a). Taxability would occur as:

a. IRC 951(a)(1)(A)(I) -- Subpart F Income (IRC 952) consisting of: Income from insurance of U.S. risks (IRC 953); Foreign Base Company Income under IRC 954 consisting of; Foreign Personal Holding Company Income, Foreign Base Company Sales Income, Foreign Base Company Services Income, Foreign Base Company Shipping Income, and Foreign Base Company Oil Related Income; Income as determined according to IRC 999, International Boycott; Illegal bribes, kickbacks, or other payments unlawful under the Foreign Corrupt Practices Act of 1977 (Note: IRC 162(c) was amended by the 1982 Tax Equity and Fiscal Responsibility Act);

(2) Previously excluded Subpart F income withdrawn from investment in less developed countries as defined in IRC 955;

(3) Previously excluded Subpart F income withdrawn from investment in shipping operations as defined in IRC 955;

(4) The amount determined under IRC 956.

[4.3.1.2] 13.6 Exceptions to the General Rule (05-21-1999)

(1) Before further considering the includible amounts, the following exclusions, limitations, etc. should be noted and kept in mind during an examination. The IE can conserve audit time by recognizing the applicability of these limitations early in the examination. Additional discussions of certain of these items appear later in the guidelines.

[4.3.1.2] 13.7 Exclusion of U.S. Source Effectively Connected Income (05-21-1999)

(1) Subpart F income does not include any item includible in the CFC's gross income as income from sources within the United States that is effectively connected with the conduct by the CFC of a trade on business or the U.S., unless the income is exempt from tax pursuant to a treaty obligation of the U.S. Section 952(b).

[4.3.1.2] 13.8 Limitation as to Earnings and Profits (05-21-1999)

(1) Subpart F income for any taxable year may not exceed the CFC's earnings and profits for the taxable year IRC 952(c)(1)(A).

(2) In the computation of earnings and profits determine that earnings and profits are reported according to U.S. standards.

[4.3.1.2] 13.9 Certain Prior Year Deficit (05-21-1999)

(1) The amount of subpart F income included in the U.S. Shareholder's gross income may be reduced by his pro rata share of the CFC's prior year qualified deficits IRC 952(c)(1)(B).

1. A qualified deficit is post-1986 deficit in E & P attributable to the same qualified activity as the activity giving rise to the income to be offset. IRC 952(c)(1)(B)(ii).

2. A qualified activity is any activity giving rise to foreign base company shipping income; foreign base company oil related income; foreign base company sales income; foreign base company services income; foreign personal holding company income of qualified insurance company.

[4.3.1.2] 13.10 Certain Deficits of Chain Members (05-21-1999)

(1) A CFC may elect to reduce the amount of Subpart F income attributable to a qualified activity by current year qualified deficit of a qualified chain member. IRC 952(c)(1)(c).

[4.3.1.2] 13.11 Manufacturing Operations (05-21-1999)

(1) If the CFC is strictly a manufacturing operation, (without a sales branch in another jurisdiction) then no further steps as to that entity need to be taken. Manufacturing income is not Subpart F income. However, other related CFCs that purchase from a manufacturing CFC could have Subpart F income. If the taxpayer has a branch operation, it is possible that there could be Subpart F

income. Refer to the branch rule in Reg. 1.954-3(b).

[4.3.1.2] 13.12 Currency and Other Restrictions (05-21-1999)

(1) No part of the earnings and profits of a CFC for any taxable year is included in earnings and profits for purposes of IRC 952, IRC 955, or IRC 956 if such part could not have been distributed by the CFC to U.S. shareholders because of currency or other restrictions or limitations imposed under the laws of any foreign country. Reg. 1.964-2 sets forth definitions, exceptions, and limitations that should be reviewed before an exception is permitted under this provision.

[4.3.1.2] 13.13 De Minimis Rule and Full Inclusion Test (05-21-1999)

(1) IRC 954(b)(3)(A) provides a de minimis rule that excludes all gross income from being considered as foreign base company income or insurance income if the sum of the CFC's gross foreign base company income and gross insurance income is less than the lesser of 5 percent of gross income or \$ 1 million. Under the full inclusion rule of IRC 954(b)(3)(B) if more than 70 percent of the CFC's gross income is foreign base company income and insurance income then all of the CFC's gross income will be treated as foreign base company income or insurance income.

[4.3.1.2] 13.14 De Minimis Rule and Full Inclusion Test Guidelines (05-21-1999)

(1) Verify the taxpayer's determination of gross income for the application of the de minimis test. Be alert to attempts to reduce foreign base company income to qualify for a de minimis exception.

(2) Determine that the de minimis test is applied separately to each CFC.

(3) Check that when computing gross foreign base company income for the de minimis test, that there are no reductions for dividends, interest, or deductions allocable to foreign base company income.

(4) Determine that gross income is computed based on U.S. accounting and tax standards.

(5) Determine whether, for purposes of applying the de minimis test, the anti-abuse rule of Reg. 1.954-1(b)(4) applies to aggregate the income of two or more CFCs.

[4.3.1.2] 13.15 Foreign Base Company Income Defined (05-21-1999)

(1) Foreign base company income consists of:

- . Foreign personal holding company income;
- . Foreign base company sales income;
- . Foreign base company services income;
- . Foreign base company shipping income;

. Foreign base company oil related income.

(2) Remember, IRC 954(b)(5) requires that such income will be reduced by taking into account deductions (including taxes) properly allocable to such income.

[4.3.1.2] 13.16 Foreign Base Company Income Guidelines (05-21-1999)

(1) Inspect CFC operating statements to ascertain the amounts and general nature of income reported.

(2) Discuss the general pattern of foreign operations with the taxpayer or representative.

(3) Determine the type of activity, physical facilities, number of employees in the foreign country, products, processes, major suppliers, and material customers.

(4) Analyze the nature and type of income reported by each CFC to determine the correctness of the reported Subpart F income (or to ascertain the existence of Subpart F income where none is reported). This analysis should include the origin and destination of the products and services that produce the CFC's income.

[4.3.1.2] 13.17 Foreign Personal Holding Company Income Defined (05-21-1999)

(1) Foreign personal holding company income (FPHCI) consists of the following items.

. Dividends, interest, rents royalties, and annuities;

. Net gains from the sale and exchange of certain properties; Including gains from the sale or other disposition of any interest in a partnership or trust;

. Net gains from commodities transactions;

. Net currency gains from nonfunctional transactions;

. Income equivalent to interest.

(2) The following items are excluded from FPHCI:

1. Dividends: From corporation that are related persons organized in the same country with substantial assets (80 percent) in the same country.

2. Interest: From corporations that are related persons organized in the same country with substantial assets (80 percent) in the same country; From export financing interest derived in the conduct of a banking business.

3. Rents: From unrelated persons in ordinary conduct of business; From related persons for property in country of organization.

4. Royalties: From unrelated persons in ordinary conduct of business; From related persons for property in country of organization.

5. Gains: From the sale on exchange of inventory, dealer property, property that gives rise to active rent or royalty income and property that does not give rise to income that is used in the CFC's trade or business; From commodities transactions that are from the sale of commodities in the active conduct of commodities business or from bona fide hedging transactions with respect to such sales; From currency gains and losses directly related to the business needs of the CFC.

[4.3.1.2] 13.18 Foreign Personal Holding Company Income Guidelines (05-21-1999)

(1) The taxpayer's records should set forth the basic inclusions in FPHCI even though exclusions are involved. The IE should:

1. Determine the extent of ownership of the various foreign or domestic stocks to ascertain if the CFC in turn owns most of other foreign corporations. Determine if its interests along with other stockholders, suggest that any of these foreign corporations are CFCs by indirect or constructive ownership by the U.S. person or perhaps another U.S. person. If investments are in U.S. assets, this fact could indicate possible income under IRC 951(a)(1)(B) due to an increase in earnings invested in U.S. property.

2. Be aware that any passive income received by the CFC claimed under IRC 954(c)(2) and (c)(3) as excluded from Subpart F should be checked against the CFC's records to determine that the income does qualify for the exclusion as required by the regulations. To qualify for exclusion, the answer must be a yes to the following questions: If rents or royalties are excluded from this type income, did they come from the active conduct of a trade or business conducted with unrelated persons? (see also 3C below); If dividends, interests, rents, or royalties came from related persons, did the relationship qualify for exclusion under IRC 954(c)(4)?; If interest is derived from conduct of a banking business and which is export financing interest IRC 954(c)(2)(B)?

[4.3.1.2] 13.19 Foreign Base Company Sales Income Defined (05-21-1999)

(1) Foreign base company sales income is income derived from the sale or purchase of personal property with a related person where the property is manufactured and sold outside the country of incorporation. Foreign base company sales income can arise in the following types of transactions:

- a. The purchase of personal property from a related person and its sale to any person;
- b. The sale of personal property to any person on behalf of a related person;
- c. The purchase of personal property from any person and its sale to a related person;
- d. The purchase of personal property from any person on behalf of a related person.

[4.3.1.2] 13.20 Foreign Base Company Sales Income Guidelines (05-21-1999)

(1) Analyze gross income figures to ensure that proper costs are deducted from the gross receipts figures.

1. Ascertain that the costs are limited to the cost figures according to U.S. tax accounting concepts.

2. Determine if, in arriving at the cost of goods sold for Subpart F income sales, the taxpayer was consistent in the method of computation so the de minimis and full inclusions tests are not distorted.

3. Be aware that purchases or sales may be made for a related person with a commission paid to the CFC. The commission paid could be Subpart F income. The commission could come from the unrelated third party.

[4.3.1.2] 13.21 Special Rule for Certain Branch Income (05-21-1999)

(1) A CFC may carry on either selling or manufacturing activities through branches in countries other than the CFC's country of organization. In some situations the use of a branch has substantially the same tax effect as if the branch were a separate corporation. In that case, the branch is treated as a separate corporation and the income attributable to carrying on activities through the branch is foreign base company sales income.

(2) For instance, a CFC may establish a selling branch in another country to escape a 50 percent tax on manufacturing and sales income in the CFC country of organization. The branch country may only tax sales income at 10 percent. The tax advantage would occur only in situations where the CFC country does not tax the branch income. The branch rule in Reg. 1-954-3(b) requires that under such conditions the branch must be treated as a separate corporation. The branch's foreign base company income, if any, must be computed separately from the CFC home office income. In essence, the branch rule treats the branch as a wholly-owned subsidiary of the CFC and, if it is a selling branch, treats the branch as selling on behalf of the remainder of the CFC, or, if the branch is a manufacturing branch, treats the CFC as selling on behalf of the branch.

[4.3.1.2] 13.22 Branch Guidelines (05-21-1999)

(1) Determine the extent to which a CFC operates through branches outside the country of organization of the CFC. This can be accomplished by an examination of financial statements and by discussion with appropriate shareholders or officers.

(2) Review the relevant foreign tax law to learn the advantages of such branch operations.

(3) Determine whether a branch should be treated as a separate corporation by comparing effective tax rates and applying the 90 percent, 5 percentage point tests set forth in the Regulations.

(4) Review the manner in which branch income and expenses are segregated from amounts applicable to the home office or other branches. Consider reallocation if appropriate and material.

[4.3.1.2] 13.23 Property Manufactured, Produced, Grown, or Extracted (05-21-1999)

(1) Foreign base company sales income does not include income derived from property manufactured produced, grown, or extracted in the CFC's country of

incorporation. The regulations provide detailed guidelines for making this determination. (See. Reg. 1.954-3.) Before pursuing this area, the IE should contact the International Field Assistance Specialist who handles the Subpart F area for guidance.

[4.3.1.2] 13.24 Determination of Country of Use, Consumption, or Guidelines (05-21-1999)

(1) The regulations contain rules for making this determination. The ultimate destination of the personal property producing the income is of prime importance. (See. Reg. 1.954-3(a)(3).)

(2) Check sales to determine the ultimate destination of the goods. A sale to a third party within the country of manufacture could be questionable if the third party exports the good.

[4.3.1.2] 13.25 Foreign Base Company Services Income Defined (05-21-1999)

(1) Foreign base company services income is income derived in connection with the performance of:

- . Technical;
- . Managerial;
- . Engineering;
- . Architectural;
- . Scientific;
- . Skilled;
- . Industrial;
- . Commercial;

. Or like services performed for or on behalf of any related person outside the country under the laws of which the CFC is created or organized;

(2) Foreign base company services income also includes services performed by a CFC in a case where substantial assistance contributing to the performance of such services has been furnished by a related person Reg. 1.954-4(b)(1)(iv) and (b)(2)(ii).

(3) Exclusions from foreign base company services income are provided for services that are directly related to:

a. The sale or exchange by the CFC of property manufactured, produced, grown, or extracted by it that is performed before the time of the sale or exchange;

b. An offer or effort to sell or exchange such property.

[4.3.1.2] 13.26 Foreign Base Company Services Guidelines (05-21-1999)

(1) Ascertain whether the services are performed outside the country of incorporation of the CFC for, or on behalf of a related corporation and to what extent.

1. Separate tests must be made to determine the Subpart F income if the CFC is both a selling and service organization.

2. Services will be considered performed where the persons performing the services are physically located at the time services are rendered.

3. The regulations require an allocation when the services are performed partially within and partially without the foreign corporation's country under the same contract or arrangement. [See Regulation 1.954-4(c)].

4. Analyze service contracts performed on, or on behalf of, the related person contract by contract. Income from services performed within the country of incorporation of the CFC is not Subpart F income. Income from services performed outside the country of incorporation is Subpart F income. Note that the term on behalf means the service could be performed for an unrelated party who had purchased a machine from a related party for example. This service income could still be Subpart F income. [See Regulation 1.954-4(c)].

[4.3.1.2] 13.27 Foreign Base Company Shipping Income Defined (05-21-1999)

(1) The term foreign base company shipping income means:

a. Gross income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce;

b. Gross income derived from, or in connection with, the performance of services directly related to the use of any aircraft or vessel in foreign commerce;

c. Gross income incidental to income described above;

d. Gross income derived from the sale, exchange, or other disposition of any aircraft or vessel used or held for use in foreign commerce;

e. Certain dividends, interest, and gains received from certain foreign corporation as described in Reg. 1.954-6(f);

f. Income described in Reg. 1.954-6(g) relating to partnerships and trusts;

g. Any income derived from space and ocean activity.

[4.3.1.2] 13.28 Foreign Base Shipping Income Exclusion and Special Rules (05-21-1999)

(1) For purpose of the foreign base company shipping income rules, an aircraft or vessel is used in foreign commerce to the extent it is used in the transportation of property or passengers between a port (or airport) in U.S. or in a U.S. possession and a port (or airport) in a foreign country or between a port (or airport) in a foreign country and another in the same foreign country or another foreign country. However, foreign base company shipping income, does not include income from the operation of a vessel between two points within

the foreign country in which the CFC is created and/or organized and the aircraft or vessel used is registered. See IRC 954(b)(7).

(2) Income of a corporation that is foreign base company shipping income will not be considered as any other form of foreign base company income.

[4.3.1.2] 13.29 Foreign Base Company Shipping Income Guidelines (05-21-1999)

(1) Ascertain if aircraft or vessel income and related service income have been properly determined.

1. Be aware that, although the 1986 Tax Reform Act repealed for reinvested shipping income, the withdrawal of pre-1987 previously excluded investments in foreign base company shipping operations will be included in Subpart F income under IRC 951(a)(1)(A)(iii). See Reg. 1.954-7(a) and 1.955A-(a).

2. Remember that an oil drilling ship, trawler, and factory ships are not considered used in foreign commerce. They are not considered as qualified investments in foreign base company shipping operations. See Regs. 1.955A-2(b)(2) and 1.9546(b)(3)(i).

3. Check to see if there has been an election to determine the investment at the end of the taxable year following the year of election. See Reg. 1.954-7(b).

4. Remember that pre-1987 qualified investments made by one CFC can be considered as investments of a related corporation. See Reg. 1.955A-3.

[4.3.1.2] 13.30 Foreign Base Company Oil Related Income Defined (05-21-1999)

(1) Foreign base company oil related income is defined as foreign oil related income (within the meaning of IRC 907(c)(2)) with certain exclusions. Foreign oil related income is income from sources outside of the U.S. and its possessions from processing, transportation, distribution and sales of mineral, and related services. Also included is income from the sale or exchange of certain oil-related assets and other amounts to a certain extent.

[4.3.1.2] 13.31 Foreign Base Company Oil Related Income Exclusions (05-21-1999)

(1) Exclusions are provided for income derived from a source within a foreign country in connection with:

- a. Oil or gas extracted from a well located there;
- b. Oil, gas, or a primary product of either that is sold by the CFC or a related person for use or consumption there, or is loaded there on a vessel or aircraft as fuel for such vessel or aircraft.

[4.3.1.2] 13.32 Foreign Base Company Oil Related Income Special Rules (05-21-1999)

(1) Special rules applicable only to foreign base company oil related income are as follows:

a. The term foreign base company oil related income applies only where the CFC qualifies as a large oil producer;

b. The IRC 954(b)(4) high tax exception does not apply to foreign base company oil related income;

c. Under IRC 954(b)(8) income that is foreign base company oil related income is not foreign base company sales income, and foreign base company services income.

[4.3.1.2] 13.33 Final Determination of Includible Subpart F Income (05-21-1999)

(1) After the amount of the U.S. shareholder's Subpart F income has been determined, reference should again be made to the exceptions, exclusions, etc. as listed earlier. In addition, the following factors should be considered at this point.

1. The income to be imputed to the U.S. shareholder is net of all deductions attributable to the income. Deductions must be allocated or apportioned to each item or category of income under Reg. 1.954-1(c).

2. IRC 959 is designed to prevent previously taxed earnings from being taxed again, when the earnings are distributed to another CFC in a chain of ownership or when the earnings are distributed to the shareholders.

[4.3.1.2] 13.34 Increase in Earnings in U.S. Property (05-21-1999)

(1) In general a U.S. shareholder is taxed on his pro rata share of the CFC's increase in earnings invested in U.S. property.

(2) The amount determined under section 956 is the lesser of the excess of:

a. such share holders pro rata share of the average amounts of U.S. property held by the CFC as of the close of each quarter over and the amount of E & P that has previously been included in the U.S. shareholders gross income as a 956 amount (or that would have been included but for Section 956;

b. The amount of E & P that has previously been included in the U.S. shareholders gross income as a 956 amount (or that would have been included but for Section 959) or the shareholder's pro rata share if the applicable earnings of the CFC.

(3) Applicable earnings is the sum of current and accumulated earnings & profits reduced by distributions during the year and previously, taxed 956 amounts under section 959(c)(1).

(4) In general, the source of CFC income invested in U.S. property is immaterial. For example, income derived from manufacturing activities would be subject to this provision. The provision is independent of that taxing Subpart F income.

[4.3.1.2] 13.35 U.S. Property Defined (05-21-1999)

(1) U.S. property means any property acquired after December 31, 1962 that is:

- a. Tangible (personal or real) property located in the United States;
- b. Stock of a domestic corporation;
- c. Any obligation of a U.S. person, including any obligation that the CFC is deemed to hold by reason of its being a pledger or guarantor of such obligation;
- d. Any right to the use in the United States of a patent, copyright, invention, model, design, secret formula or process, or any other similar right, if the right to such use is acquired or developed by the CFC for use in the United States.

[4.3.1.2] 13.36 Exceptions to U.S. Property Definition (05-21-1999)

(1) Exceptions from the definition of U.S. property include:

- a. Obligations of the U.S. government, money or deposits with persons carrying on a banking business in the United States;
- b. Property located in the United States purchased in the United States for export to, or use in, foreign countries;
- c. Any obligation of a U.S. person arising in connection with the sale or processing of property. The amount of these obligations cannot exceed the amount that would be ordinary and necessary to carry on a trade or business with unrelated parties;
- d. Any aircraft, railroad rolling stock, vessel, motor vehicle, or container used in the transportation of persons or property in foreign commerce and used predominantly outside the United States;
- e. Certain insurance reserves;
- f. Stocks and obligations of certain domestic corporations. The acquired stock or obligations may not be in a domestic corporation that is a U.S. shareholder of the CFC. The acquired stock or obligations may not be in a corporation in which immediately after the acquisition a U.S. shareholder of the CFC owns 25 percent or more of the total combined voting power of the domestic corporation;
- g. Any movable property (other than a vessel or aircraft) used for exploring, developing, removing, or transporting resources from the U.S. continental shelf;
- h. An amount of assets of the CFC equal to the earnings and profits accumulated after December 31, 1962 excluded from Subpart F income under IRC 952(b);
- i. Property held by a foreign sales corporation that would otherwise be U.S. property and related to the export activities of the FSC;
- j. Certain trade or service receivables acquired from related U.S. persons. (Section 956(c)(3)).

[4.3.1.2] 13.37 Earnings Invested in U.S. Property Limitation For Tax Years Prior to 1993 (05-21-1999)

(1) For taxable years of a CFC beginning before September 30, 1993, the 956 amount of a CFC's increase in earnings invested in U.S. property. The amount of a CFC's earnings invested in U.S. property at the close of any taxable year is the total amount of such property it directly or indirectly held as of that date, to the extent this amount would have been a dividend if it had been distributed on that date.

(2) To determine the amount of the increase, see the chart in Rev. Rul. 74-436, 1974-2, C.B. 214.

[4.3.1.2] 13.38 Investment in U.S. Property Guidelines (05-21-1999)

(1) (1) Where a U.S. shareholder has reduced the basis of property or excluded property because of the above exceptions, ascertain that the required statement is attached to the return. See Regs. 1.956-1(e)(4) and 1.956-2(b)(2). Example Note: Method of Determining Basis

1. Any property acquired during a taxable year beginning before January 1, 1963, is not U.S. property. See Reg. 1.956-2(a). It should be noted that the total investment in U.S. property as of December 31, 1962 (or the first fiscal year ending after that date) is zero. Thus, any shift of those investments into other U.S. property (except certain tax-free shifts) is an increase although the actual total U.S. investments may be unchanged or even decreased.

2. Under the IRC 956 the basis of property is the adjusted basis on the applicable determination date reduced by depreciation and/or any liability specifically chargeable to it, such as a mortgage. See Reg. 1.956-1(e)(1) and (e)(3).

3. Be alert that a specific charge or liability was not created for the purpose of artificially increasing or decreasing the investment in U.S. property. See Reg. 1.956-1(e)(1).

4. Reg. 1.956-1(e)(1) states that a liability in excess of the adjusted basis of the property subject to a liability will not be taken into account for reducing the adjusted basis of another property that is not subject to a liability.

5. An obligation of a U.S. person to which a CFC is a pledger or guarantor under certain conditions is considered U.S. property. Consult Reg. 1.956-2(c).

6. Receivables due from U.S. persons may constitute investments in U.S. property. If acquired directly or indirectly from a related U.S. person.

7. An obligation of a U.S. person has specific definition. It does not include certain indebtedness arising out of involuntary conversions or any obligation arising in connection with the provision of services by the CFC to the U.S. person if the amount of the obligation doesn't exceed the amount that is ordinary and necessary. The regulation provides a 60 day safe harbor. See Reg. 1.956-2T(d)(2)(B).

8. Be aware that certain financing arrangements are permitted. See the special rules contained in Reg. 1.956-2(c)(2).

[4.3.1.2] 13.39 Earnings and Profits (05-21-1999)

(1) The earnings and profits (E & P) of a CFC will be computed substantially as if such corporation were a domestic corporation. The accounting principles and standards used in foreign countries may vary greatly from those used in the United States. The financial statements of the foreign companies must be revised to clearly reflect income based on U.S. tax accounting principles and methods. The proper revision of the financial statements and correct determination of E & P is vital in the examination of a CFC.

(2) E & P calculations are required for Subpart F income taxable to a U.S. shareholder; Computing foreign tax credit allowed to U.S. shareholders with respect to Subpart F income; Adjustments required for withdrawals of previously excluded Subpart F income and investments in U.S. property.

(3) The audit of a given year may give rise to the determination of correct earnings and profits at different time levels as follows; Current taxable year; Prior years beginning after December 31, 1962, for purposes of IRC 955(a); Any prior year beginning with the most recent and going back as far as February 28, 1913, for purposes of IRC 956(a); Post 1986 pool for computing derived paid taxes with respect to IRC 951 Inclusions.

[4.3.1.2] 13.40 Earnings and Profits Guidelines (05-21-1999)

(1) Determine that the proper books and records were used to compute the profit and loss statement from which the determination of earnings and profits was calculated.

1. Determine that the earnings and profits have not been reduced by amounts included in gross income of U.S. shareholders under IRC 951(a).

2. Review the written statement constituting the elections made by controlled shareholders. Ascertain whether there have been any subsequent modifications or revocations as to these elections.

3. Determine if the proper adjustments have been made to reflect U.S. accounting standards such as; Determine if accounting practices tend to clearly reflect income; Scrutinize asset accounts from time of acquisition and determine method of asset acquisition to ascertain that when the assets are reflected at cost, it is historical cost. Consult Reg. 1.964-1 (b)(2) for the definition of historical costs; Verify that historical cost is the basis for depreciation, depletion, or amortization; Be alert to undervalued assets or overvalued liabilities that may be allowed under foreign law; Scrutinize profit and loss statements for unallowable deductions; Scrutinize balance sheets for arbitrary reserves and determine how they were established; Inspect income and expense accounts to verify that income and expenses have not been equalized over two or more accounting periods; For post 1986 tax years earnings and profits are maintained the CFC functional currency in accordance with the rules of Reg. 1.969-1T(g).

4. Determine if the proper adjustments have been made to reflect U.S. tax standards such as; Ascertain whether the taxpayer has properly taken into

account; Method of accounting provisions under IRC 446; Inventories under IRC 471 and 472; Depreciation under IRC 167; Compensation plans under IRC 404A; Elections made under other applicable provisions of the Code.

5. Determine that the controlling U.S. shareholders of a CFC have complied with all the requirements for an election, adoption or change of an accounting period. Remember timely filed statements are required by the Regulations. All other known U.S. shareholders must be notified with respect to any action taken.

[4.3.1.2] 13.41 Exclusion of Previously Taxed Earnings and Profits
(05-21-1999)

(1) The purpose of IRC 959 is to avoid double taxation that could occur when amounts that have been previously taxed are actually distributed to the U.S. shareholders.

(2) IRC 959 provides that for any taxable year, earnings and profits of a foreign corporation attributable to amounts included in gross income of a U.S. shareholder under IRC 951 will not again be included in gross income of such shareholders when distributed. In addition amounts included in gross income of a U.S. shareholder will not be included in gross income of a foreign corporation when such amounts are distributed through a chain of ownership.

(3) See IRC 986(c) for calculation of exchange gain or loss on a distribution of previously taxed E & P.

[4.3.1.2] 13.42 Adjustments to Basis of Stock Guidelines (05-21-1999)

(1) Basis of stock should be:

a. Increased by the amount of the undistributed IRC 951 (a) income in the U.S. shareholder's tax return;

b. Decreased by a distribution previously taxed as IRC 951(a) income.

[4.3.1.2] 13.43 Special Rules for Foreign Tax Credit (05-21-1999)

(1) Income included in gross income under the provisions of Subpart F as a deemed dividend is eligible for the indirect foreign tax credit. Credits so allowed will not be allowed again when actual distributions are made. In situations where foreign taxes are imposed at the time of actual distribution (a withholding tax), a foreign tax credit will be allowed even though the amounts distributed are not taxable because they were previously included in the U.S. shareholder's income.

(2) The workings of IRC 960 with respect to the inclusion of Subpart F income are generally similar to the workings of IRC 901 and 902 with respect to a dividend distribution from a foreign entity. The gross up provision of IRC 78 similarly applies.

(3) The deviation in the similarity involves the year of receipt of the earnings and profits previously taxed by virtue of IRC 951(a).

(4) The receipt of the funds representing previously taxed earnings and profits does not produce additional indirect foreign tax credits, but may lead

to an additional direct foreign tax credit or increase in limitation under IRC 960(b). As in Reg. 1.960-4, the year in which the Subpart F income was reported will be called the year of inclusion. The year in which the funds are received relative to the included income will be called the year of exclusion.

[4.3.1.2] 13.44 Foreign Tax Credit Guidelines (05-21-1999)

(1) If, in the year of exclusion, the taxpayer claims a deduction for foreign taxes paid on the amount excluded under IRC 959(a)(1), check the Federal income tax return of the year of inclusion to verify that no foreign tax credit was claimed relative to the income included under IRC 951(a).

(2) With respect to the increase under IRC 960(b)(1) in the limitation under IRC 904(a) verify that:

a. the increase in the IRC 904 limitation of the year of inclusion is correctly computed;

b. the amount of foreign taxes allowed as credit because of such increases in the year of inclusion is properly computed. The credit allowed may have exceeded the taxes deemed paid on the income included under IRC 951(a);

c. the increase in limitation under this section for intervening years is properly computed;

d. the increase in limitation in the year of exclusion does not exceed the taxes paid, accrued, or deemed paid for such taxable year on the amount to be excluded under IRC 959(a)(1); Note: Note that if the increase in limitation under IRC 960(b)(1) and Reg. 1.960-4 for a taxable year of exclusion exceeds the tax (before any credits against tax) imposed by Code Chapter 1, such excess will be considered an overpayment of tax. The tax is refundable or creditable according to Code Chapter 65 (IRC 6401 and following).

[4.3.1.2] 13.45 General Rules and Record Keeping Requirements of U.S. Shareholders (05-21-1999)

(1) Reg. 1.964-3 describes the record keeping requirements of the U.S. shareholder. The regulations specifically require that a U.S. shareholder will, within a reasonable time after demand by the District Director, give the District Director:

a. Such permanent books of account or records as are sufficient to satisfy the requirements of IRC 6001 and IRC 964(c) or true copies thereof, as are reasonably demanded;

b. If such books and records are not maintained in the English language either an accurate English translation of such books and records or the services of a qualified interpreter satisfactory to the District Director.

(2) The requirements of IRC 6001 and IRC 964(c) will be considered satisfied if the books or records produced are sufficient to verify for the taxable year:

a. The Subpart F income (and exclusions therefrom) of the CFC;

b. The previously excluded Subpart F income of such corporation withdrawn from qualified investment (IRC 955);

c. The increase in earnings invested by such corporation in U.S. property.

[4.3.1.2] 13.46 Special Rules and Record Keeping Requirements of U.S. Shareholders (05-21-1999)

(1) Reg. 1.964-3(c) provides special rules that state that verification of the Subpart F income of the CFC for the taxable year is not required if either:

a. It can be shown to the satisfaction of the District Director that the locus and the nature of such corporation's activities make it unlikely that the foreign base company income of such corporation exceeded 5 percent of its gross income for the taxable year;

b. If certain conditions are met for certain insurance companies.

(2) Remember that the burden of demonstrating that these conditions exist is upon the taxpayers. If they cannot carry this burden, then the general rules apply.

(3) The special rules refer solely to relief from maintaining records to verify Subpart F income of the CFC. The taxpayer must still maintain records to verify previously excluded Subpart F income, and the increase in investments in U.S. property by the CFC.

(4) IEs should recognize that submission of the required records can be extremely burdensome upon taxpayers if requested indiscriminately. IEs should carefully consider such requests. Request only records most pertinent to each particular situation.

(5) If the taxpayer has not maintained adequate records, the taxpayer should be advised of the nature of the inadequacies and the requirements of the regulations.

(6) Exhibits 1-2 and 2-2 provide guidelines for obtaining information, books, and records of U.S. and foreign entities.

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4.3.12 CH. 5 Planning the Examination

[4.3.12] 5.1 Overview (05-05-1999)

(1) This chapter discusses the CEP examination planning process.

[4.3.12] 5.2 General (05-05-1999)

(1) The three-step planning process, as fully described in Chapter 6, of the Coordinated Examination Program (CEP) Handbook for Field Examination Case Managers, should be followed in planning CEP case examinations. The three-steps are outlined below:

a. Step One -- Formulate the examination scope for general issues and have planning meetings.

b. Step Two -- Peruse the taxpayer's books and records for noncompliance areas.

c. Step Three -- Develop audit procedures.

[4.3.12] 5.3 The Examination Plan (08-30-2000)

(1) The Examination Plan is a three part comprehensive plan that should provide flexibility to permit revisions as the examination progresses. It is the principal tool of the case manager for unifying a diverse group of Service personnel, having separate and distinct responsibilities, into an effective team. For a detailed description of the Examination Plan and a guide to its preparation, see Chapter 6 of IRM 4.3.11, Handbook for Field Examination Case Managers.

(2) There are instances when sections of the Plan may be either modified or omitted. The Service Management Information Section (part 2) of the Plan may be omitted in:

a. limited scope examinations, and,

b. examinations in which there is continuity of either the case manager or team coordinator.

[4.3.12] 5.4 Compliance Checks (08-30-2000)

(1) On a case by case basis, the case manager may identify areas of compliance checks. A compliance check is any procedure or technique employed during an examination which is designed to test the taxpayer's adherence to the law and regulations.

(2) In every CEP examination, steps should be included for the following compliance checks:

a. nondeductible lobbying and political campaign expenses described in IRC 162(e).

b. Review the taxpayer's system of internal controls in the following areas: all other filed returns, related returns, prior/subsequent years, information returns, questionable W-4's, and Forms 8300/CTR's.

(3) Case Managers should give special attention to chapter 8 of the CEP Case Manager's Handbook.

[4.3.12] 5.5 Corporate Improper Payments Procedures (05-05-1999)

(1) In every case the case manager will determine whether or not to ask selected corporate officials, key employees, and other individuals questions 1 thru 5 in Exhibit 4.3.12.5-1. In situations where these questions were answered in a prior examination the guidelines in Exhibit 4.3.12.5-2 should be considered in determining whether the questions should be asked in subsequent years.

(2) Additional questions may be asked when warranted by any response to any question or by the facts and circumstances in a particular case; however, consideration should be given to obtaining the assistance of District Counsel in developing such questions.

(3) The individuals selected for questioning should be those present or former employees or directors who would be likely to have or have had sufficient authority, control or knowledge, of corporate activities to be aware of the possible misuse of corporate funds. This would include, for example, chief executive officer, chief financial officer, officer in charge of international operations, officer in charge of governmental activities, directors who are not corporate officers, but who serve on audit committees or have similar responsibilities, and others, as appropriate.

(4) It should be clearly understood by the individual selected for questioning that the term corporation includes the taxpayer under examination, any subsidiary, parent, or affiliated corporation, and any joint venture, partnership, trust, or association in which such corporation has an interest. The individual being questioned should be advised as to the years to which the questions relate.

(5) The years for which the questions should be asked are to be determined on a case by case basis. Any questions involving docketed or non-docketed years in Appeals or District Counsel will be coordinated with those offices.

(6) The method of proposing the questions, timing of oral responses, and timing of the receipt of the written and attested answers will be determined by the case manager.

(7) If any individual refuses to answer any of the examiner's questions or refuses to confirm a written statement by oath or affirmation, a summons should be issued to that individual and testimony obtained under oath pursuant to IRC 7602.

(8) When any of these questions are answered in the affirmative, all details surrounding the transaction should be secured. Responses to all questions will be reviewed along with all other available information. If further

clarification is required, follow-up interviews will be conducted.

[4.3.12] 5.5.1 Examination Plan and Compliance Checks (05-05-1999)

(1) During the preplanning and the examination of all returns, case managers and examiners will be alert to situations which lend themselves to the creation of illegal or improper payments. When deemed appropriate and necessary, the examination plans will include consideration of the following compliance checks:

a. Examine internal audit reports and related workpapers to determine if any reference is made to the creation of any secret or hidden corporate fund.

b. Review taxpayer's copy of reports filed with other governmental regulatory agencies (such as the Securities and Exchange Commission). See 5.7 of the Coordinated Examination Program (CEP) Handbook for additional information.

c. Give appropriate consideration to foreign entities, operations, contractual or pricing arrangements, fund transfers, and use of tax haven locations. Examination of books and records maintained outside the United States are conducted by Agents of the International District, Compliance Division (see 5.5.3 below).

(2) All case managers should ensure that employees under their supervision are familiar with the former IRM 4233, Tax Audit Guidelines, Individuals, Partnerships, Estates and Trusts, and Corporations. Employees should also familiarize themselves with the former IRM 4235, Techniques Handbook for In-Depth Examinations, where appropriate.

[4.3.12] 5.5.2 Information From Other Government Agencies (05-05-1999)

(1) During the preplanning and examination of corporate cases, case managers, and examiners should consider the former IRM 4083, Information Requested From Government Agencies.

(2) The National Office has established special liaison with the Securities and Exchange Commission to obtain information relating to slush funds, bribes, political contributions, and other tax-related information.

[4.3.12] 5.5.3 Request for Assistance from Office of Assistant Commissioner (International) (05-05-1999)

(1) To properly examine taxpayers with foreign slush fund or improper payment issues and other schemes in the foreign area, it is necessary to obtain first-hand knowledge and, independently, verify information concerning related foreign entities or foreign branches of domestic entities. In most instances, information may be obtained from United States sources more quickly than from foreign sources. However, if it is determined that an on-site examination should be made in a foreign country, a request for a support examination should be made to the International District, Compliance Division (OP:IN:D:C). This request should be made following the coordinated examination support request provisions of 4.4 of this handbook. The International District, Compliance Division, will work with the requesting district in developing the examination plan for an on-site examination and assist in planning other details of the on-site examination.

(2) Once the details have been finalized, a formal request for approval of the on-site examination and foreign travel authorization will be made in accordance with the former IRM 42(10)(10).15 and text 620 of the former IRM 1763, Travel Handbook.

[4.3.12] 5.5.4 Use of Summons (05-05-1999)

(1) Every effort should be made to secure taxpayers' records, responses to questions, and other pertinent financial data without the issuance of a summons. However, in certain instances, it may be necessary to issue a summons. Under such circumstances, the former IRM 4022 will be followed in considering the need to issue such a summons.

(2) If there is a need to issue a Designated Summons, refer to the former IRM 4022.95 and IRC 6503(k).

(3) Before issuing a summons where the records are outside the United States, a copy of the proposed summons will be submitted to the appropriate District Counsel for review. District Counsel will coordinate their review with the Associate Chief Counsel (Litigation), CC, which, in turn, will coordinate the matter with the appropriate National Office function. The proposed summons will be accompanied by a statement describing the circumstances and efforts that have been made to secure the records and data from the taxpayer and why the taxpayer will not make the requested records available. In no event will the examiner issue the summons until advice has been received from District Counsel.

[4.3.12] 5.6 Other Factors to Be Considered In Conducting a CEP Examination (05-05-1999)

(1) The examination should involve concurrent consideration of all returns filed by the various entities with the CEP case family unit. This includes excise, employment, and other miscellaneous returns. However, certain circumstances may make this one case approach impractical or simply unwise. For guidance in this area, see IRM 4.3.11 of Coordinated Examination Program (CEP) Handbook, text 2.3 (Control of Miscellaneous Tax Examination) and text 2.4 (Separate Examinations).

(2) An assistant case manager should be designated for significant support audits that would benefit from local, on-site supervision. For guidance in this area see the Coordinated Examination Program (CEP) Handbook, text 2.5 (On-Site Supervision). In addition, support districts will be consulted during the planning process, especially when the current examination involves an entity previously under the control of the support district's CEP.

(3) Subject to the approval by the case manager, specific audit procedures are the responsibility of the individual team members. If subsequent to their approval these procedures prove either ineffective or unwise, they should be revised or abandoned. Substantial procedural modification affecting the overall scope of the examination requires advanced approval from the case manager.

(4) Shortly after completing any key examination area, examiners should complete part C of Form 4764 B (or its facsimile) by recording information (e.g., audit trails) that would be of benefit to examiners of subsequent cycles.

(5) The services of specialist team members are an integral part of any CEP examination. To ensure specialists are available to participate in planning, case managers should provide specialists and their managers as much advanced notification as possible. Recommendations should be sought from specialists concerning potential areas of adjustment (in order of priority) and time requirements to address these areas. Application of planning input from specialists is left to the discretion of the case manager. Furthermore, to make the most efficient use of the limited number of specialists, income tax agents and/or audit accounting aides may be instructed to assist them in any time consuming task or analyses of data. For further guidance in the area, see IRM 4.3.11 Coordinated Examination Program (CEP) Handbook, text 13.1 (Management of Specialists).

(6) Continuity of team leadership is desirable on large examinations. Therefore, team assignments should be staggered so as to preclude the simultaneous rotation of both the case manager and team coordinator. In doing so managers should keep to a minimum conflicts with the provisions of Policy Statement P-4-5. When such conflicts are unavoidable, a request for deviation citing the need for continuity should be considered.

(7) If there is disagreement regarding the resolution of an issue, the case manager will consider all of the facts and then decide the position to be taken. If the disagreement involves a specialist team member the case manager will consult with the appropriate specialist supervisor and then decide the position to be taken. This will be done before any discussion of the Service's position with the taxpayer, or taxpayer's representatives. At no time will individual team members indicate to taxpayer or taxpayer's representatives that they are not in agreement on issues which they or other team members raised. If a team member is in disagreement with the position decided upon, he/she may set forth his/her position in a memorandum to the planning file.

(8) Case managers should be involved in all phases of each of their examinations. The degree of involvement should vary according to the complexity of the case, the attitude of the taxpayer, and the experience of the coordinator and team members. Case managers should plan time so they can be present on cases where they are most needed and can be most effective. He/she, accompanied by a specialist or support district manager when appropriate, must make frequent on-site visitations to observe performance of team members, to check whether the examination is progressing in accordance with the plan, to modify the plan when changes are needed. They will meet with taxpayers to discuss and coordinate, and to assist in resolving problems at an early date so that continuity of the examination can be maintained and time schedules met. He/she is responsible for individual and overall plan changes. At the conclusion of each CEP case involving team members on detail from other groups within the primary district, the case manager will consider whether written comments regarding the team members' work should be submitted to appropriate managers. When prepared these comments should reflect not only how well the team member performed, but what he/she contributed to the team effort in planning and executing the examination. Such written comments will be prepared when total time spent by a team member amounts to more than 25 workdays. The team members' manager may, under special circumstances request an assessment regardless of the time.

(9) During the life of any CEP examination, time allocations and estimated closing dates should be subject to continual managerial review. These projections are to be modified when such changes are called for by any case

related developments or particular needs of the examination. Any significant changes should be communicated to the taxpayer as soon as they are made. This action is especially important for projections made in preparation of the annual examination plan, developed months in advance of any examination activity.

(10) See the former IRM 4615.2 for planning and coordination in a case which includes examination of employment tax returns.

(11) Assignments to team members may be made using either SAIN numbers or other specific designations, such as issue, entity, or taxpayer's account name.

(12) Inventory currency in the CEP is a very desirable goal. A CEP case will be considered current when an examination is started within twelve months of the filing of the most recently filed return in a cycle and the examination span for the cycle is less than the cumulative number of months included in the cycle. Cases should not be closed prematurely to meet general currency objectives.

[4.3.12] 5.7 Coordinated Examination Program (CEP) Case Manager Handbook (08-30-2000)

(1) The purpose of the Handbook is to promote uniformity in the management of CEP cases by providing a comprehensive guide for case managers. The Handbook is not intended to replace individual judgement, but, when action deviates from the practice described in the Handbook, the manager should assure himself or herself that the action is taken for sound program and managerial reasons.

(2) Copies of and revisions to the Handbook are distributed to managers based on a special distribution schedule. Additional copies may be obtained by using Form 7130.

[4.3.12] 5.8 Time Tracking (05-05-1999)

(1) The time tracking reporting system is mandatory for CEP examinations (see text 12.4.6 of IRM 4.3.11 Coordinated Examination (CEP) Handbook). The data captured from time tracking will provide a summary of time expenditures by SAIN on all completed CEP examinations.

(2) The time tracking system has the following objectives and benefits:

a. provide case managers with useful information when planning subsequent cycles;

b. comparison of time tracking information for two or more examination cycles will indicate whether the same SAIN areas are recurring cycle after cycle, as well as whether possible new areas are being pursued;

c. SAIN areas requiring the most significant expenditure of time can be readily identified. In addition, overhead areas, such as planning, coordination, report preparation, etc., may be monitored more effectively by the use of time tracking.

(3) Time tracking reports are not intended nor should they be used for personnel evaluative purposes.

[4.3.12] 5.9 Procedures in Examinations Involving Tentative Carrybacks
(05-05-1999)

(1) Under normal conditions, if a taxpayer has a loss on his/her current year's return which is to be carried back to a return still open in the district, the loss year return is scheduled for immediate examination and, upon completion of the examination, the prior years and the current year returns are processed together.

(2) This is satisfactory for most cases but creates problems in the Coordinated Examination Program (CEP). In this Program, tentative carryback adjustments may have been allowed for returns in a CEP case, but for very practical considerations, it is not feasible to immediately expand a given examination to cover subsequent year returns from which the carrybacks originated.

(3) The interest of the taxpayer and the Service would be better served by continuing normal processing of the prior year returns and deferring only the consideration of the net operating loss deduction and tentative allowance.

[4.3.12] 5.9.1 Scope (05-05-1999)

(1) The following procedures in 5.9.1 of this handbook generally apply to all examinations when a subsequent year return generates either a net operation loss, net capital loss, or a credit carryback.

(2) Special procedures are provided in 5.9.2 and 5.9.3 below for examinations of prior year returns where extension of the examination into the loss year return would result in a substantial delay in submitting the prior year return or returns.

(3) An exact definition of what would constitute a substantial delay cannot be made. The determination is to be made by the District Program Coordinator, on a case-by-case basis after considering the facts and circumstances involved.

[4.3.12] 5.9.2 Examinations Affected by Carrybacks from Subsequent Years Warranting Examinations (05-05-1999)

(1) An examiner may inspect a taxpayer's copy of a subsequent year tax return and determine if it is a loss year affecting the year(s) under examination and warrants examination. In such event, the return should generally be examined and submitted concurrently with the returns under examination.

(2) An exception to the above rule may be permitted by the District Program Coordinator, in coordinated examinations if there would be a substantial delay in submitting the prior year return or returns. In such cases, the NOLD, the net capital loss carryback, or the credit carryback should be allowed subject to future examination of the subsequent year. The allowance should be made only if a Form 1045 or 1139 was filed. This procedure may not be used if a Claim Form 843, 1040X, Amended Individual Income Tax Return or 1120X, Amended U.S. Corporation Income Tax Return, was filed.

(3) In the case of a foreign tax credit claim, except for joint committee cases, this procedure can be used notwithstanding that the claim is made via Form 843 or 1120X.

(4) When a NOLD, net capital loss, foreign tax credit claim, or other credit carryback is allowed subject to future examination of the subsequent year, the report of tax audit change or appeals audit statement should contain the following statement:

The net operating loss deduction (and/or other credit carryback and/or net capital loss carryback and/or foreign tax credit claim) reflected herein is subject to correction upon examination of the tax return from which it originated.

(5) A carryback loss adjustment or similar type of carryback under other provisions of the 1954 IRC does not require permission to reopen (see the former IRM 4023.3:(1)(b)). Reopening authority must be requested if any adjustment to the years affected by the carryback (other than the carryback adjustments) is anticipated. Examiners are to be mindful of this in accomplishing the initial examination in order that this will not become a factor in the examination of the subsequent returns.

(6) CEP cases normally are automatically classified for examination. Consequently, there is little chance the loss/unused credit year will escape consideration. For those rare cases where a loss/unused credit year may not automatically be received, the District Program Coordinator should ensure that appropriate action is taken to secure the return(s).

[4.3.12] 5.9.3 Procedures in Joint Committee Cases Involving Tentative Carrybacks (05-05-1999)

(1) The former IRM 4576.1:(3) provides that if a case is under examination or has been examined but not closed out of Examination Division, and it is learned that the taxpayer has filed an application for a tentative carryback adjustment sufficient to bring the case within the jurisdiction of the Joint Committee, the examination will be extended to the loss year. See the former IRM 4576.2 for special survey procedures regarding certain Joint Committee case returns.

(2) Joint Committee carryback years may be tentatively closed with the permission of the District Program Coordinator if there would be a substantial delay in examining the loss year return.

(3) If the District Program Coordinator permits a tentative closing of the prior year returns in a Joint Committee case, the taxpayer should be fully apprised of the action the district is taking. The examination report should contain a statement as follows:
This examination is subject to review by the Joint Committee upon completion of the examination of the return from which the carryback reflected in this report originated. The Joint Committee review may require additional information and may result in additional assessments or refunds. The net operating loss deduction (or net capital loss or credit carryback) reflected herein which gave rise to the tentative allowance of \$ UNDERSCORE is subject to correction upon examination of the loss year and/or unused credit year.

(4) The following safeguards in the critical areas of statute controls and retention of examination reports and workpapers are to be established:

a. When the case is closed to joint committee review, Form 3198 (Special Handling Notice) should be placed on the top of the file marked Joint Committee Carryback -- Return to Examination After Processing.

b. Form 895 (Notice of Statute Expiration) will be prepared for each taxable year subject to joint committee jurisdiction. The case manager will maintain statute controls on these years. When the return from which the carryback originated is submitted, at least 15 months should remain in the statutory period of all returns (loss year and years tentatively closed).

(5) Established Joint Committee procedures for safeguards in the critical areas of statute controls, retention of examination reports and workpapers will remain in effect with respect to a tentatively closed Joint Committee case and the year from which the carryback originated until these case years are either removed from Joint Committee status or notice is received of their acceptance by the Joint Committee.

(6) In situations in which the carryback year(s) is in Appeals and the Examination Division completes the examination of the loss/unused credit years it will close the case to Appeals. Appeals will prepare the Joint Committee report if Joint Committee review is required as a result of the allowance of the loss/credit carryback. Any agreed portion of a deficiency should be assessed before the case is sent to Appeals.

(7) If it appears that Examination Division will not close the loss/unused credit year(s) within a reasonably short period, Appeals, when it completes action on its case, should close it out. The file and return(s) will then be transmitted to Examination Division for association with the loss/unused credit year. The Examination Division will then be responsible for protecting the statute of limitations on the return it received from Appeals. A date stamped copy of Form 5402, Appeals Transmittal Memorandum and Supporting Statement, (prepared by Appeals) should be returned to them as acknowledgment.

(8) Agreed Examination Division Dispositions. If the taxpayer agrees with the District Director's findings as to the loss/unused credit year, the District Director will close out such year, together with the carryback year(s) previously closed by Appeals. If Joint Committee review is required, Examination Division prepares the report according to its existing procedures. If there are changes to the carryback year(s) previously processed, Form 5344, Audit Examined Closing Record, must be prepared to reflect changes to assessments or overassessments. Form 5344 must also be prepared if there are hold codes on the carryback year(s) previously processed. Examination will enter Transaction Code 300 in Item 12 with zero amount even though there is no tax change. The freeze condition on the account preventing refunds or collection activity will be automatically reversed when Form 5344 is processed. If the previously processed returns were not examined and there are no adjustments to be made or hold codes previously input, the returns may be closed as surveys.

(9) Unagreed Examination Dispositions:

a. If the taxpayer does not agree with the District Director's findings with respect to the loss/unused credit year and the carryback year(s) previously closed by Appeals, but does not request Appeals consideration, the district issues a statutory notice of deficiency or takes other necessary action to process the unagreed disposition. If the taxpayer does not file a petition with the Tax Court, the deficiency should be assessed by the District Director. If Joint Committee review is required, the Examination Division prepares the report according to existing procedures.

b. If the taxpayer does not agree with the District Director's findings with respect to the loss/unused credit year and the carryback year(s) previously closed by Appeals and files a protest requesting Appeals consideration, the case will be closed unagreed by the District Director to Appeals. However, if the amount of the carryback cannot be fully absorbed in the carryback year(s), Appeals will not ordinarily take jurisdiction solely to consider unresolved issues in the loss year and amounts of unused carryovers.

(10) Examination Division will take into account any known or existing tentative carryback allowances in determining examination results for statistical purposes. Follow procedures in 5.9.2(2) above.

[4.3.12] 5.9.4 Special Close-Out Procedures (05-05-1999)

(1) When carryback years are closed out under the provisions of 5.9.2(2) or 5.9.3, entries on Form 5344, Examination Closing Record, will be made in accordance with IRM 104.3, AIMS Handbook.

[4.3.12] 5.9.5 Cases Going to Appeals (08-30-2000)

(1) Unagreed cases going to Appeals should clearly state the status of any loss year or year giving rise to an unused credit which will affect years referred to Appeals. If examination of the loss year or unused credit year is contemplated, the Chief, Examination Division, should discuss the matter with the Chief, Appeals Office prior to referral to avoid possibility of a premature referral. These communications may be subject to the ex parte communications limitation set out in RRA 98 Sec. 1001(a)(4).

[4.3.12] 5.10 Allocation of Examination Results Between Participating Districts (05-05-1999)

(1) In a Coordinated Examination involving assistance by other districts, examination results will be shared on the basis of the ratio of each district's contribution in terms of examination time including specialists time, and issues raised as reflected by additional net income recommended, with equal weight given to each factor. No allocation will be made when key district specialists work on cases located in districts in which they file their own Forms 4502.

(2) Coordinated Examination Program case results will be allocated between primary and supporting districts based upon the following guidelines:

a. add each district's total staff-hours of examination time to obtain a grand total of time expended upon the case;

b. divide district totals by the grand total to derive district percentages;

c. add each district's additional net income recommended, or equivalency where tax credits are involved, to obtain a grand total of additional net income recommended for the case;

d. divide district totals by the grand total to derive district percentages;

e. add the percentages for each district as computed in (b) and (d) above and divide by two to provide equal weight to examination time expended and additional net income recommended;

f. multiply the total case deficiency by the result obtained for each district in (e) above to obtain each participating district's allocable share of the examination results.

(3) Coordinated Examination Program case returns examined will normally be allocated on the basis of the actual returns examined by the respective participating districts when a vertical type examination is employed.

(4) Where a horizontal or mixed type of examination is employed or a consolidated return has been filed, the primary district will receive credit for the return(s) examined.

(5) In situations where the application of these guidelines produces what is considered to be a significantly inequitable result, the primary and support district managers will determine a reasonable allocation.

[4.3.12] 5.11 Potential Fraud Referrals of Coordinated Examination Cases
(05-05-1999)

(1) If, during a coordinated examination, indications of fraud are discovered, it will be the responsibility of the case manager to prepare a report of the findings on Form 2797 (Referral Report for Potential Fraud Cases) as provided in the Fraud Handbook, for transmission through channels to the Chief, Criminal Investigation Division, of the primary district.

(2) While the referral report is being prepared and processed by Examination and evaluated by Criminal Investigation, audit activities will continue in accordance with the approved Examination Work Plan, subject to the following restrictions.

a. The audit may continue with respect to any and all corporate books, records and documents, provided that such records are not related to the suspected fraud items. The Criminal Investigation Division is required to evaluate the referral report within 20 days. During the referral period, Examination employees will use Form 5793 (Daily Log-Large Case Examination Activity) to record the case audit activity. If the examination of specific records leads back into the fraud related area, examination action should be suspended in this specific area and a record of this situation made on Form 5793 (see 4.3.12.5-3).

b. If the Examination Work Plan also requires examination of partnership records or the personal records of individuals, that phase of the audit will be suspended pending evaluation of the referral report by Criminal Investigation.

c. The examiners may continue to deal as required with the employees designated by the taxpayer to furnish records and otherwise assist the examiners. However, they will not have discussions or interviews with owners, principals, responsible officers or any other individuals who may have controlled or participated in the suspected fraudulent activities.

d. There will be no contact between Examination employees and Criminal Investigation employees concerning the referral report during the period necessary for its preparation, processing and evaluation, except as provided in (e) below. If sufficient facts are available in the report, Criminal Investigation will make an immediate determination to accept or reject the

referral (the former IRM 9322.3:(3)). If an immediate determination is not feasible, Criminal Investigation will evaluate the referral as expeditiously as possible within the 20 work day period. Criminal Investigation may request extensions; however, these requests must be made only under rare circumstances and then only for a period not to exceed an additional 15 days.

e. Each potential fraud referral report submitted under these provisions will be identified Coordinated Examination, to alert Criminal Investigation function.

[4.3.12] 5.11.1 Scope and Complexity of Referral (05-05-1999)

(1) If the scope and complexity of the referral is such that a valid evaluation cannot be made based on the information in the referral:

a. Meetings may be held with the referring agent(s) and other district officials or District Counsel, as appropriate, to discuss the referral and review any IRS workpapers or corporate books, records or workpapers already in the possession of the IRS;

b. The meetings will be timely held so that the determination to accept or reject the referral can be made within the shortest time period; and

c. A memorandum covering the discussion will be prepared for each meeting, signed by all participants and retained in the case file.

[4.3.12] 5.12 Span of Control -- Coordinated Examination Program (05-05-1999)

(1) Exhibit 4.3.12.1-1 identifies the criteria to be applied in identifying Coordinated Examination Program cases.

(2) The guidelines have been devised to give consideration to the major complexity factors having a direct impact on the time required to effectively manage coordination examination.

(3) The point criteria described in Exhibit 4.3.12.1-1 are to be considered by the district Examination Division in determining the number of case managers necessary to meet workload demands of the Coordination Examination Program.

[4.3.12] 5.12.1 Procedures to Determine the Number of Case Managers Per District (05-05-1999)

(1) Determine point totals for each identified case and accumulate them for all cases in the Coordinated Examination Program for the district.

(2) Assistant case manager assignments should be considered in determining the number of case manager positions per district and individual case manager's span of control. Each assistant case manager will provide 10 points to the support district, plus additional points equal to one point for each 50 days requested for that support examination.

(3) On an overall basis, it has been determined that 160 points represent one Case Manager position with points on in process cases to exceed 80 but not be greater than 110. Where the examination of one or more taxpayers is not actively in process, it may be possible for the case manager's total points in process to exceed 110 points without having an adverse impact on his/her span of control.

For example, where a case is in final closing stages, there may be required less formal case manager involvement and the point levels described above may be exceeded. Another instance could be where a case is under the jurisdiction of the Criminal Investigation Division and the taxpayer will not allow the examining team on site.

a. This is not intended to apply to Industry Specialist Case Managers. (See the former IRM 42(14)4:(1)(d)).

b. Whether a case is actively in process is a matter of judgment to be determined from all of the facts and circumstances in the case.

(4) Divide the point total for all cases in the district's Coordinated Examination Program by denominator of 160. The resultant answer determines the estimated number of case managers for a given district. Where a fraction of a position results in a number which is .75 or more, a position is presumed to be authorized, subject to regional office approval. Where the fraction is less than .75, the district should seriously study the need for that position prior to the establishment of an additional case manager position. The district will perform a position management review and obtain Regional office concurrence.

(5) It is emphasized that these are guidelines and not a substitute for managerial judgement. Any needed staffing changes determined by the district should be based on management's consideration of these guidelines plus all other relevant factors. Factors to be considered should include specific knowledge of additions or losses of cases in subsequent years due to relocation of corporate headquarters, district located in a geographical area experiencing substantial growth or decline, etc.

(6) Any requests for additional case manager staffing must be submitted to the Regional Commissioner, through the Regional Chief Compliance Officer, for approval. Justification for additional case manager staffing should be written in terms of these guidelines plus all other relevant factors. The grade level will be determined by application of Office of Personnel Management position classification standards.

Exhibit 4.3.12.5-1 Questionnaire for Use in Coordinated Examinations
(05-05-1999)

(1)

The following questions are submitted in connection with an examination by the Internal Revenue Service of the corporation's Federal tax liabilities. You may state your position with the corporation and your particular area of responsibility. However, the questions are not limited to knowledge acquired in the course of your official responsibility, but should be answered on the basis of your knowledge, belief, and recollection from whatever source.

You should state under the penalties of perjury that you believe your answers to be true and correct as to every material matter. You may provide explanatory details with your answers. If you are unsure whether a particular transaction

comes within the scope of the question, you may discuss the matter with the examining agent. If, after the discussion, you believe that any answer requires qualification, you should state clearly the nature of the qualification. If the examining agent concludes that any qualification is ambiguous or unreasonable, or if the response to any question requires further information, the agent may submit additional questions to you for response.

All references to corporation herein shall include not only the particular corporation referred to, but any subsidiary, parent, or affiliated corporation, and any joint venture, partnership, trust, or association in which such corporation has an interest.

1. During the period from to , did the corporation, any corporate officer or employee, or any other person acting on behalf of the corporation, make, directly or indirectly, any bribe, kickback, or other payment of a similar or comparable nature, whether lawful or not, to any person or entity, private or public, regardless of form, whether in money, property, or services, to obtain favorable treatment in securing business or to obtain special concessions, or to pay for favorable treatment for business secured or for special concessions already obtained?
2. During the period from to , were corporate funds, or corporate property of any kind, donated, loaned, or made available, directly or indirectly, for the benefit of, or for the purpose of opposing, any government or subdivision thereof, political party, political candidate, or political committee, whether domestic or foreign?
3. During the period from to , was any corporate officer, employee, contractor, or agent compensated, directly or indirectly, by the corporation, for time spent or expenses incurred in performing services, for the benefit of, or for the purpose of opposing, any government or subdivision thereof, political party, political candidate, or political committee, whether domestic or foreign?
4. During the period from to , did the corporation make any loan, donation, or other disbursement, directly or indirectly, to any corporate officer or employee, or any other person, for contributions made or to be made, directly or indirectly, for the benefit of, or for the purpose of opposing, any government or subdivision thereof, political party, political candidate, or political committee, whether domestic or foreign?
5. During the period from to , did the corporation, or any other person or entity acting on its behalf, maintain a bank account, or any other account of any kind, whether domestic or foreign, which account was not reflected in the corporate books and records, or which account was not listed, titled, or identified in the name of the corporation?

Exhibit 4.3.12.5-2 Guidelines for the Use of the Corporate Slush Fund Questionnaire in Subsequent Year Examinations (05-05-1999)

(1)

In prior examinations, the questions have been most productive in cases involving multinational corporations having significant foreign activities. The following factors should be considered in determining whether questions should be asked in subsequent years:

1. Whether in the past the corporation made improper payments or was involved in any slush fund activity;
2. Current information indicating existence of or a strong probability of improper payments or slush fund activity;
3. Whether competitors or others in the same industry are known to have made improper payments or had slush fund activity;
4. The extent of controls maintained by the corporation to prevent improper payments or establishment of slush funds;
5. The extent of verification by the corporation's internal auditors and/or external auditors concerning the use of improper payments or establishment of slush funds;
6. Effective corporate policy concerning improper payments or establishment of slush funds;
7. Whether corporation produces products which are sold in a very competitive market, especially products which are under stringent government controls;
8. Whether the corporation has significant transactions with governments at all levels, whether foreign or domestic, or has activities with foreign quasi-government organizations;
9. Whether the corporation has a foreign entity operating in an autonomous manner with little or no direct control by the U.S. parent;
10. Whether the corporation has made a substantial acquisition or there has been a substantial change in ownership, management or the type of business conducted by the corporation;
11. Whether the examination reveals any attempts to conceal apparent improper activities or uncovers situations involving unusual approvals that bypass normal channels; and
12. Any other factor where, in the opinion of the case manager, the use of the questions might be appropriate.
13. In considering whether the questions are to be asked, no single factor or combination of factors is determinative. The judgment whether to ask the questions shall be based on the case manager's sound discretion considering the guidelines as a whole. The reasons for asking or not asking the questions should be fully explained in the examiner's workpapers.

Exhibit 4.3.12.5-3 Form 5793 (05-05-1999)

[SEE GRAPHIC IN ORIGINAL.]