DEPARTMENT OF THE TREASURY
Internal Revenue Service

26 CFR Parts 1 and 602

56 FR 28056

Information With Respect to Certain Foreign-Owned Corporations

T.D. 8353

DATE: June 19, 1991

ACTION: Final regulations.

SUMMARY: This document contains final Income Tax Regulations relating to information that must be reported and records that must be maintained under section 6038A of the Internal Revenue Code. These regulations are necessary to provide appropriate guidance for affected reporting corporations and related parties. The regulations affect any reporting corporation (that is, certain domestic corporations and foreign corporations) as well as certain related parties of the reporting corporation.

DATES:
EFFECTIVE DATE: These regulations are effective for taxable years beginning after July 10, 1989, except as follows:

§ 1.6038A-1 (a), (b), (e) (2), (g) through (n)	December 10, 1990
§ 1.6038A-3	March 20, 1990
§ 1.6038A-6	November 5, 1990
§ 1.6038A-7	December 10, 1990

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ADDRESSES:
FOR FURTHER INFORMATION CONTACT: Carol P. Tello or Grace Perez-Navarro of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224 (Attention: CC:CORP:T:R) (202-377-9493 (Ms. Tello), 202-287-4851 (Ms. Perez-Navarro), not toll-free calls).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1980 *(44 U.S.C. 3504* (h)) under control num-

ber 1545-1191. The estimated average annual reporting burden per respondent is 14 hours and 19 minutes. This time estimate is included in the burden of Form 5472. The estimated average annual recordkeeping burden per recordkeeper is 10 hours.

These estimates are an approximation of the average time expected to be necessary for record maintenance and collection of information. They are based upon such information as is available to the Internal Revenue Service. Individual respondents and recordkeepers may require greater or less time, depending on their particular circumstances.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attention: IRS Reports Clearance Officer T:FP, Washington, DC 20224, and to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

On December 10, 1990, the Internal Revenue Service published in the Federal Register proposed regulations *(55 FR 50706)* to the Income Tax Regulations (26 CFR part 1) under section 6038A of the Internal Revenue Code. Pursuant to section 7805 (f) of the Internal Revenue Code, the notice of proposed rulemaking was submitted to the Small Business Administration for comments on its impact on small business. Over sixty written comments were received from the public. A public hearing was held on February 22, 1991.

Explanation of Changes

General Requirements and Definitions

A number of significant changes were made to this section in response to suggestions from commentators. Most importantly, the de minimis rules now include a small corporation exception based upon the amount of gross receipts for the taxable year. This addition is in response to commentators who were concerned that a small business would not be able to meet the de minimis exception because of the requirement that the aggregate gross payments made to or received from a foreign related party be less than ten percent of the U.S. gross income of the corporation. The new small corporation exception permits corporations with less than $10,000,000 in gross receipts to be exempt from the record maintenance and authorization requirements of section 6038A.

The safe harbor for other corporations with related party transactions of de minimis value was modified to increase the amount of aggregate gross payments to $5,000,000.

Finally, the aggregation rules clarify that for purposes of the gross payments test, gross payments made to foreign related parties are added to gross payments received from foreign related parties.

In response to a number of comments, two exceptions to the definition of a reporting corporation have been provided. Where a foreign corporation doing business in the United States (i) is entitled to the benefits of the business profits article of a bilateral income tax treaty; and (ii) does not have, and is not deemed to have, a permanent establishment in the United States, the corporation is exempt from section 6038A. Additionally, a foreign corporation whose gross income is exempt from U.S. taxation under section 883 is not a reporting corporation, provided that the corporation timely and fully complies with the reporting requirements set forth in *Rev. Proc. 91-12, 1991-6 I.R.B. 12,* necessary to claim the exemption under section 883. If, however, upon audit, the corporation is determined to have a permanent establishment or to have gross income not exempt from U.S. taxation under section 883, section 6038A will apply.

The final regulations also clarify that the definition of a reporting corporation under § 1.6038A-1(c) applies for taxable years beginning before July 11, 1989.

Banks and other financial institutions, previously exempt from the filing requirement under section 6038A, were concerned about the effective date of provisions requiring them to file Form 5472. In response to these concerns, the information filing requirement under § 1.6038A-2 for such institutions will be effective for taxable years beginning after December 10, 1990.

A number of commentators identified the need to clarify whether the section 38 attribution rules or the section 267(c) attribution rules are to be used in applying section 267(b). The final regulations provide that the relationships enumerated in section 267(b) will be determined under the rules of section 318, except to the extent that section 267(c) creates more inclusive attribution rules.

In response to numerous comments, two examples were added to § 1.6038A-1 to illustrate the operation of the related party rules. Many commentators were concerned about the difficulty of securing the cooperation of entities in which the 25-percent foreign shareholder of the reporting corporation owns only a minority interest. The examples contrast a situation in which such a shareholder has control (within the meaning of section 482) of the minority-owned subsidiary with a situation in which it does not. The minority-owned subsidiary is a foreign related party only in the first situation.

The final regulations also incorporate a number of other changes to § 1.6038A-1. In response to concerns of some commentators, a principal operating company as well as a holding company may be authorized to act as an agent under § 1.6038A-5 for a foreign related party. The definition of a 25-percent foreign shareholder has been expanded to include persons that hold the stock of a reporting corporation either directly or indirectly; all direct and indirect 25-percent foreign shareholders must be identified on Form 5472. Also, the rule in the proposed regulations exempting controlled commercial entities as defined by section 892(a)(2)(B) from §§ 1.6038A-3 and 1.6038-5 has been deleted.

A rule permitting the reopening of an examination if the statute of limitations period for that taxable year has not expired has been added. Also added is a rule barring the reopening of a taxable year under section 6038A for examination purposes if the taxable year is open under section 6511 only for purposes of the carryback of net operating losses or net capital losses.

Finally, certain definitions contained in the text of section 6038A are effective for taxable years beginning after July 10, 1989.

Requirement of Information Return

A new exception from the filing requirement for foreign sales corporations was added to the final regulations in response to commentators who observed that under proposed § 1.6038A-2, a foreign sales corporation would be required to file Form 5472 because it is not required to file Form 5471. Under the final regulations, a foreign sales corporation that files Form 1120-FSC for a taxable year is exempt from the Form 5472 filing requirement.

Some commentators expressed concern about the potential difficulty in establishing the fair market value for transactions in which no monetary or nonmonetary consideration is paid. The final regulations are unchanged from the proposed regulations in this respect because the reasonable estimate rules contained in § 1.6038A-2(b)(6) address this problem.

Other commentators were concerned that the new category of "other amounts paid" in § 1.6038A-2(b)(3)(x) required to be reported on Form 5472 is too broad and would include such items as dividends and capital contributions. This paragraph has been clarified in the final regulations. The phrase "other amounts paid" includes only amounts that would be taken into account for the determination and computation of the taxable income of the reporting corporation.

Several commentators requested that the term "total assets," required to be provided by a reporting corporation on Form 5472, be defined. The final regulations provide that for U.S. reporting corporations the term total assets means all the assets of the reporting corporation. The regulations under section 6038C will clarify the meaning of total assets for foreign corporations engaged in a U.S. trade or business.

The final regulations adopt the suggestion of many commentators that disclosure under section 1059A be required only if the inventory costs of imported goods are greater than the costs taken into account in computing the value of the goods for customs purposes.

Finally, the final regulations clarify that if a reportng corporation is exempt from filing Form 5472 because a Form 5471 has been filed that provides duplicate information, the reporting corporation is also exempt from the record maintenane requirements of § 1.6038A-3 and the authorization of agent requirement of § 1.6038A-5. Such a reporting corporation, however, remains subject to the general record maintenance requirements of section 6001.

Record Maintenance

Most of the concerns of commentators focused on the record maintenance requirements of § 1.6038A-3. The majority of commentators stated that the requirements will impose significant burdens on affected foreign corporations. The safe harbor, in particular, was singled out for criticism. Additionally, the material profit and loss statement requirement was criticized as too complex. Many commentators requested that the term "relevant" be delineated or defined.

To be useful, the record maintenance rules must provide guidance for a wide variety of foreign persons located throughout the world, subject to varying record maintenance and record retention standards, who may have little or no familiarity with U.S. accounting and tax standards and tax administrative practices. The general guidance provided by section 6001 and the regulations thereunder do not provide the type of specific, detailed guidance that these persons may need. Additionally, section 6038A will be used by the Service to enforce all Code sections that affect the tax treatment of transactions between the reporting corporation and its foreign related parties; it is not limited to issues arising under section 482 or any other Code section.

For these reasons, an all-inclusive safe harbor is provided, with the instruction that an individual taxpayer or foreign person is required to maintain only those records that are relevant to its particular industry or business and to the U.S tax treatment of its transactions with foreign related parties. The final regulations clarify and expand upon these points.

The safe harbor also serves another function, that of limiting the number of potential profit and loss statements that a reporting corporation might otherwise be required to produce. Without a materiality standard, any product or service sold or provided within the United States, irrespective of its relative economic importance to the reporting corporation, might be the subject of a profit and loss statement.

In response to numerous comments concerning the complexity of the material profit and loss statements, the ten percent identifiable assets and the ten percent operating profit or loss tests have been eliminated from the definition of significant industry segments. For the high profit test, the rate of return on assets has been increased from 10 percent to 15 percent, the rate of return for an industry segment is compared to the group's worldwide operations, and the dollar threshold for U.S.-connected products has been raised to $100,000,000. The paragraph has been restructured to reflect the simpler tests to be applied.

Many commentators were concerned that constructing an accurate material profit and loss statement will be difficult. However, the profit and loss statement is not being used to determine precise U.S. tax liability of a reporting corporation. The tests for determining the material profit and loss statement are intended to identify in broad terms the relative importance of a particular product or product line (or service). For this purpose, any reasonable allocation methods and formats are acceptable.

Other commentators requested that the regulations state whether fair market value or basis of assets should be used for the rate of return on assets test under the high profit test. The final regulations permit any reasonable method to be used as long as that method is applied consistently. Also, the final regulations provide that current year data is to be used for the test.

To satisfy concerns about the meaning of the relevance standard, four new examples illustrate cases in which the record maintenance requirements are not applicable to the reporting corporation's foreign related parties.

In response to suggestions that section 6038A requires more burdensome recordkeeping than section 6001, a description of the record maintenance requirements under section 6001 (as stated by regulations under section 6001 and by official Service publications) has been added. This additional guidance reflects the equivalence of the requirements under the two sections.

Specifically, some commentators criticized the requirement of creating basic accounting records and material profit and loss statements if not otherwise maintained under the safe harbor as more burdensome than the requirements under section 6001. The final regulations in § 1.6038A-3(a) reflect the rule under § 1.6001-1(d) that permits a District Director to require specific records to be created upon notice to the taxpayer. The final regulations also reflect that in appropriate cases the relevant cost data required to construct a profit and loss statement is also necessary to establish the amount of gross income, deductions, credits or other matters required to be shown on an income tax return.

One commentator suggested that the regulations should apply the recordkeeping requirement only to reportable transactions. This suggestion has not been adopted because under the statute the recordkeeping requirement applies to all records that may be relevant to the tax treatment of transactions between a reporting corporation and any foreign related party.

Most commentators requested that the final regulations provide more guidance and more detail concerning the agreements that may be executed with District Directors or the Assistant Commissioner (International). The final regulations clarify that the agreement is to be executed with the District Director or the Assistant Commissioner (International) who has audit jurisdiction over the reporting corporation. The final regulations further provide that the agreement

may include provisions relating to the authorization of agent requirement, the record maintenance requirement, and production and translation time periods that vary the rules contained in the final regulations.

The final regulations also clarify that a reporting corporation that enters into an agreement with a District Director or the Assistant Commissioner (International) generally will be required only to maintain those records specified under the safe harbor that permit an adequate audit of the income tax return of the reporting corporation and that, in most instances, the records required to be maintained under such an agreement would be less than what is required under the safe harbor. Further guidance with respect to District Director agreements will be issued in a revenue procedure.

One commentator suggested an independent review procedure that was endorsed by a number of other commentators. The proposal was not adopted because the regulations provide for individually negotiated agreements with District Directors.

In response to numerous concerns that the annual election to maintain records outside the United States was too burdensome, the final regulations provide that records may be maintained outside the United States if non-U.S. maintenance requirements to produce documents are satisfied. These requirements are identical to the requirements imposed under the annual election contained in the proposed regulations; however, an agreement to meet those requirements is no longer required on Form 5472.

Finally, a clarification suggested by some commentators was adopted that limits the documents required under the category of financial and other documents filed with foreign governments within the safe harbor to the documents relevant to transactions between the reporting corporation and its foreign related parties.

Rules describing how the record maintenance requirements are to be applied to banks and other financial institutions will be coordinated with future regulations under section 6038C. The final regulations under section 6038A reserve these issues.

All records maintained by a foreign related party that are provided to the Service are tax return information, required to be kept confidential under section 6103.

Monetary Penalty

Commentators requested that the regulations describe facts or circumstances that might justify the granting of the reasonable cause exception to the imposition of the monetary penalty. Also requested was a definition of the term "small corporation" for purposes of the reasonable cause exception.

A new paragraph, "facts and circumstances taken into account," describes facts and circumstances that might justify the application of the reasonable cause exception. Specifically, if a reporting corporation could be related to a foreign person only within the meaning of section 482 and has a reasonable belief that the foreign person is not so related, reasonable cause exists if, in fact, the foreign person is related within the meaning of section 482. Also, a small corporation is defined as a corporation whose gross receipts for the taxable year are $20,000,000 or less.

Other commentators requested that review procedures be adopted for the denial of the reasonable cause exception. Review procedures are contained in Internal Revenue Manual supplements under section 6038A.

The suggestion that the application of the penalty provisions be phased in has not been adopted because the statute contains a clear effective date.

Authorization of Agent

Most commentators were concerned that the annual authorization of agent requirement would be too burdensome. The final regulations delete the annual authorization of agent requirement and provide that such authorization must be provided within 30 days of a request by the Service, rather than requiring the authorization to be filed with Form 5472.

The final regulations adopt the proposal that a single, consolidated authorization by a foreign parent for itself and on behalf of its group members be permitted. In the event that such a consolidated authorization is not legally enforceable, the noncompliance penalty adjustment under § 1.6038A-7 will apply.

The final regulations clarify that an authorization of agent executed by a foreign related party is to be disregarded in determining whether a trade or business exists for purposes of the Code or whether a permanent establishment under an income tax treaty exists for that foreign related party.

One commentator requested a rule that a subpoena or summons could not be directly issued to, or enforced against, a nonresident alien. See rule 30 of the Federal Rules of Civil Procedure. The legislative history states that the authorization of an agent by a foreign related party is limited to requests by the Service to examine records or produce testimony related to reportable transactions. The Internal Revenue Manual supplement will require that before a request for individual testimony of an employee of a foreign related party is made, every attempt to obtain the information from a U.S. person must be made. Additionally, national office review is required before a summons for individual testimony of an employee of a foreign related party may be issued.

Failure to Furnish Information

The most significant comment with respect to § 1.6038A-6 was the request to require that an applicable treaty exchange of information or Tax Information Exchange Agreement (TIEA) provision be used prior to issuing a section 6038A summons. The final regulations provide that generally a treaty exchange of information or TIEA provision will be used prior to section 6038A procedures where the information sought may be obtained on a timely and efficient basis. The absence or pendency of a treaty or TIEA request may not be asserted as grounds for refusing to comply with a summons or as a defense against the assertion of the noncompliance penalty adjustment under § 1.6038A-7.

The regulations provide that information is available on a timely and efficient basis if it can be obtained from a foreign government within 180 days. The Service's recent experience with the types of treaty requests most likely to be made under section 6038A indicates that the United States generally responds to such requests within 180 days. A new paragraph is added to clarify that the statute of limitations is suspended for the pendency of a court determination (including appeals therein) for the taxable year to which the summons that is the subject of the proceeding relates. This rule reflects the legislative history.

A suggestion that an exception be provided when the reporting corporation has acted in good faith to secure the compliance of the foreign related party was not adopted, because it is contrary to the legislative history.

The IRS Manual will instruct agents generally to use normal administrative requests and summons procedures to obtain relevant records and testimony directly from the reporting corporation. Only where these initial procedures are ineffective will the Service resort to the summons power under the agency authorization to obtain records and testimony of foreign related parties.

Also not adopted was a suggestion that an appeal to the District Director be permitted if it is determined that there has not been substantial compliance. Section 6038A(e)(4)(B) provides for review of such a determination by the federal district court having jurisdiction over the reporting corporation.

Finally, a commentator suggested that a rule be added that requires the issuance of an information document request prior to the issuance of a section 6038A summons. Such a procedure will be described in the Internal Revenue Manual.

Noncompliance Penalty

Some commentators were concerned that § 1.6038A-7 provides too much discretion to the Service. Various remedies were proposed. The legislative history is clear, however, that exercise of the sole discretion to establish allowable amounts of deductions and the cost of goods sold in the event of noncompliance is subject to only limited judicial review. The amounts established by the Service cannot be overturned by a court on the basis that the amount diverges from actual costs or other amounts incurred, or on the basis that they do not clearly reflect income. Furthermore, the fact that the amounts can be proven to be clearly erroneous by reference to materials or information that were not within the knowledge or possession of the Service should not be sufficient alone to cause a court to redetermine allowable amounts of deductions and the cost of goods sold.

Drafting Information

The principal authors of these regulations are Carol P. Tello and Grace Perez-Navarro of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service. Other personnel from the Internal Revenue Service and Treasury Department participated in developing these regulations.

List of Subjects

26 CFR 1.6031-1 through 1.6060-2

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendment to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1 -- INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority for part 1 is amended by adding the following citations:

Authority: *26 U.S.C. 7805* * * * Sections 1.6038A-1 through 1.6038A-7 also issued under *26 U.S.C. 6038A.* * * *

Par. 2. Section 1.6038A-1 is removed.

Par. 3. New §§ 1.6038A-0 through 1.6038A-7 are added to read as follows:

§ 1.6038A-0 Table of contents.

This section lists the captions that appear in the regulations under section 6038A.

§ 1.6038A-1 General requirements and definitions

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(b) In general.

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(ii) Qualified exempt shipping income.

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(e) Attribution rules.

(1) Attribution under section 318.

(2) Attribution of transactions with related parties engaged in by a partnership.

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(g) Foreign related party.

(h) Small corporation exception.

(i) Safe harbor for reporting corporations with related party transactions of *de minimis* value.

(1) In general.

(2) Aggregate value of gross payments made or received.

(j) Related reporting corporations.

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(l) Required information.

(2) Maintenance of records and authorization of agent.

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(1) District Director.

(m) Examples.

(n) Effective dates.

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(2) Section 1.6038A-2.

(3) Section 1.6038A-3.

(4) Section 1.6038A-4.

(5) Section 1.6038A-5.

(6) Section 1.6038A-6.

(7) Section 1.6038A-7.

§ 1.6038A-2 Requirement of return

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(2) Related party.

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(4) Foreign related party transactions involving nonmonetary consideration or less than full consideration.

(5) Additional information.

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(i) Estimate within 25 percent of actual amount.

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(8) Accrued payments and receipts.

(c) Method of reporting.

(d) Time and place for filing returns.

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(3) Transactions with a corporation subject to reporting under section 6038.

(4) Transactions with a foreign sales corporation.

(g) Filing Form 5472 when transactions with related parties engaged in by a partnership are attributed to a reporting corporation.

(h) Effective dates for certain reporting corporations.

§ 1.6038A-3 Record maintenance

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(3) Examples.

(b) Other maintenance requirements.

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(2) Foreign related party or third-party maintenance.

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(3) Material profit and loss statements.

(4) Existing records test.

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(v) Operating profit of an industry segment.

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(8) Example.

(i) Facts.

(ii) Existing records test.

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(d) Liability for certain partnership record maintenance.

(e) Agreements with the District Director or the Assistant Commissioner (International).

(1) In general.

(2) Content of agreement.

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(f) U.S. maintenance.

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(4) Scheduled production for high volume or other reasons.

(5) Required U.S. maintenance.

(g) Period of retention.

(h) Application of record maintenance rules to banks and other financial institutions. [Reserved]

(i) Effective dates.

§ 1.6038A-4 Monetary penalty

(a) Imposition of monetary penalty.

§ 1.6038A-1 General requirements and definitions.

(a) *Purpose and scope.* This section and §§ 1.6038A-2 through 1.6038A-7 provide rules for certain foreign-owned U.S. corporations and foreign corporations engaged in trade or business within the United States (reporting corporations) relating to information that must be furnished, records that must be maintained, and the authorization of the reporting corporation to act as agent for related foreign persons for purposes of sections 7602, 7603, and 7604 that must be executed. Section 6038A(a) and this section require that a reporting corporation furnish certain information annually and maintain certain records relating to transactions between the reporting corporation and certain related parties. This section also provides definitions of terms used in section 6038A. Section 1.6038A-2 provides guidance concerning the information to be submitted and the filing of the required return. Section 1.6038A-3 provides guidance concerning the maintenance of records. Section 1.6038A-4 provides guidance concerning the application of the monetary penalty for the failure either to furnish information or to maintain records. Section 1.6038A-5 provides guidance concerning the authorization of an agent for purposes of sections 7602, 7603, and 7604. Section 1.6038A-6 provides guidance concerning the failure to furnish information requested by a summons. Finally, § 1.6038A-7 provides guidance concerning the application of the noncompliance penalty for failure by the related party to authorize an agent or by the reporting corporation to substantially comply with a summons.

(b) *In general.* A reporting corporation must furnish the information described in § 1.6038A-2 by filing an annual information return (Form 5472 or any successor), and must maintain records as described in § 1.6038A-3.

(c) *Reporting corporation* -- (1) *In general.* For purposes of section 6038A, a reporting corporation is either a domestic corporation that is 25-percent foreign-owned as defined in paragraph (c)(2) of this section, or a foreign corporation that is 25-percent foreign-owned and engaged in trade or business within the United States. After November 4, 1990, a foreign corporation engaged in a trade or business within the United States at any time during a taxable year is a reporting corporation. See section 6038C.

(2) *25-percent foreign-owned.* A corporation is 25-percent foreign-owned if it has at least one direct or indirect 25-percent foreign shareholder at any time during the taxable year.

(3) *25-percent foreign shareholder* -- (i) *In general.* A foreign person is a 25-percent foreign shareholder of a corporation if the person owns at least 25 percent of --

(A) The total voting power of all classes of stock of the corporation entitled to vote, or

(B) The total value of all classes of stock of the corporation.

(ii) *Total voting power and value.* In determining whether one foreign person owns 25 percent of the total voting power of all classes of stock of a corporation entitled to vote or 25 percent of the total value of all classes of stock of a

corporation, consideration will be given to all the facts and circumstances of each case, under principles similar to § 1.957-1(b)(2) (consideration of arrangements to shift formal voting power away from a foreign person).

(iii) *Direct 25-percent foreiqn shareholder.* A foreign person is a direct 25-percent foreign shareholder if it owns directly at least 25 percent of the stock of the reporting corporation, either by vote or by value.

(iv) *Indirect 25-percent foreign shareholder.* A foreign person is an indirect 25-percent foreign shareholder if it owns indirectly (or under the attribution rules of section 318 is considered to own indirectly) at least 25 percent of the stock of the reporting corporation, either by vote or by value.

(4) *Application to prior open years.* For taxable years beginning before July 11, 1989, the definition of a reporting corporation under this paragraph applies in determining whether a foreign-owned corporation is a reporting corporation.

(5) *Exceptions* -- (i) *Treaty country residents having no permanent establishment.* A foreign corporation that has no permanent establishment in the United States under an applicable income tax convention is not a reporting corporation for purposes of section 6038A and this section. Accordingly, such a foreign corporation is not subject to §§ 1.6038A-2, 1.6038A-3, and 1.6038A-5. It must timely and fully provide the required notice to the Commissioner under section 6114. See section 6114 and the regulations thereunder for the notice that such a corporation must file and the applicable penalties for failure to file such notice.

(ii) *Qualified exempt shipping income.* A foreign corporation whose gross income is exempt from U.S. taxation under section 883 is not a reporting corporation provided that it timely and fully complies with the reporting requirements required to claim such exemption. In the event that such a corporation does not timely and fully comply with the reporting requirements under sections 887 and 883, it will be a reporting corporation subject to section 6038A, including the application of the monetary penalty for failure to file required information.

(iii) *Status as foreign related party.* Nothing in this paragraph affects the determination of whether a person is a foreign related party as defined in paragraph (g) of this section.

(d) *Related party.* The term "related party" means --

(1) Any direct or indirect 25-percent foreign shareholder of the reporting corporation,

(2) Any person who is related within the meaning of sections 267(b) or 707(b)(1) to the reporting corporation or to a 25-percent foreign shareholder of the reporting corporation, or

(3) Any other person who is related to the reporting corporation within the meaning of section 482 and the regulations thereunder. However, the term "related party" does not include any corporation filing a consolidated federal income tax return with the reporting corporation.

(e) *Attribution rules* -- (1) *Attribution under section 318.* For purposes of determining whether a corporation is 25-percent foreign-owned and whether a person is a related party under section 6038A, the constructive ownership rules of section 318 shall apply, and the attribution rules of section 267(c) also shall apply to the extent they attribute ownership to persons to whom section 318 does not attribute ownership. However, "10 percent" shall be substituted for "50 percent" in section 318(a)(2)(C), and section 318(a)(3) (A), (B), and (C) shall not be applied so as to consider a U.S. person as owning stock that is owned by a person who is not a U.S. person. Additionally, section 318(a)(3)(C) and § 1.318-1(b) shall not be applied so as to consider a U.S. corporation as being a reporting corporation if, but for the application of such sections, the U.S. corporation would not be 25-percent foreign owned.

(2) *Attribution of transactions with related parties engaged in by a partnership.* The transactions in which a domestic or foreign partnership engages shall be attributed to any reporting corporation whose interest in the capital or profits of the partnership, either directly or indirectly, combined with the interests of all related parties of the reporting corporation partner, equals 25 percent or more of the total partnership interests. Attribution of such transactions shall be made only to the extent of the partnership interest held by that reporting corporation partner. See sections 875 and 702(a) and the regulations thereunder. (Attribution shall not be made however, of transactions directly between the partnership and a reporting corporation.) Accordingly, a reporting corporation partner that is deemed to engage in transactions with related parties under this rule is subject to the information reporting requirements of § 1.6038A-2, to the record maintenance requirements of § 1.6038A-3, to the monetary penalty under § 1.6038A-4, to the requirement of authorization of agent under § 1.6038A-5, to the rules of § 1.6038A-6 relating to the requirement to produce records, and to the noncompliance penalty adjustment under § 1.6038A-7.

(f) *Foreign person.* For purposes of section 6038A, a foreign person is --

(1) Any individual who is not a citizen or resident of the United States, but not including any individual for whom an election under section 6013 (g) or (h) (relating to an election to file a joint return) is in effect;

(2) Any individual who is a citizen of any possession of the United States and who is not otherwise a citizen or resident of the United States;

(3) Any partnership, association, company, or corporation that is not created or organized in the United States or under the law of the United States or any State thereof;

(4) Any foreign trust or foreign estate, as defined in section 7701(a)(31); or

(5) Any foreign government (or agency or instrumentality thereof). To the extent that a foreign government is engaged in the conduct of commercial activity as defined under section 892 and the regulations thereunder, it will be treated as a foreign person under section 6038A and this section only for purposes of the information reporting requirements of § 1.6038A-2. A foreign government will not be treated as a foreign related party for purposes of §§ 1.6038A-3 and 1.6038A-5.

For purposes of section 6038A, a possession of the United States shall be considered to be a foreign country.

(g) *Foreign related party.* A foreign related party is a foreign person as defined under paragraph (f) of this section that is also a related party as defined under paragraph (d) of this section.

(h) *Small corporation exception.* A reporting corporation that has less than $10,000,000 in U.S. gross receipts for a taxable year is not subject to §§ 1.6038A-3 and 1.6038A-5 for that taxable year. Such a corporation, however, remains subject to the information reporting requirements of § 1.6038A-2 and the general record maintenance requirements of section 6001. For purposes of this paragraph, U.S. gross receipts includes all amounts received or accrued to the extent that such amounts are taken into account for the determination and computation of the gross income of the corporation. For purposes of this test, the U.S. gross receipts of all related reporting corporations shall be aggregated.

(i) *Safe harbor for reporting corporations with related party transactions of de minimis value* -- (1) *In general.* A reporting corporation is not subject to §§ 1.6038A-3 and 1.6038A-5 for any taxable year in which the aggregate value of all gross payments it makes to and receives from foreign related parties with respect to related party transactions (including monetary consideration, nonmonetary consideration, and the value of transactions involving less than full consideration), is not more than $5,000,000 and is less than 10 percent of its U.S. gross income. Such a corporation, however, remains subject to the information reporting requirements of § 1.6038A-2 and the general record maintenance requirements of section 6001. For purposes of this paragraph, U.S. gross income means the gross income reportable by the reporting corporation (or the aggregate gross income reportable by all related reporting corporations) for U.S. income tax purposes. Gross payments made to or received from foreign related parties cannot be netted; rather, the gross payments made to and received from foreign related parties are to be aggregated. Thus, for example, if a reporting corporation receives $4,700,000 of gross payments from a related party and makes $500,000 of gross payments to the same related party, it has aggregate gross payments of $5,200,000, and, therefore, does not qualify for the safe harbor under this paragraph.

(2) *Aggregate value of gross payments made or received.* The aggregate value of gross payments made to (or received from) a foreign related party with respect to foreign related party transactions is determined by totaling the dollar amounts of foreign related party transactions as described in § 1.6038A-2(b) (3) and (4) on all Forms 5472 filed by the reporting corporation or related reporting corporations.

(j) *Related reporting corporations.* A reporting corporation is related to another reporting corporation if it is related to that other reporting corporation under the principles described in paragraphs (d) and (e) of this section.

(k) *Consolidated return groups* -- (1) *Required information.* If a reporting corporation is a member of an affiliated group for which a U.S. consolidated income tax return is filed, the return requirement of § 1.6038A-2 may be satisfied by filing a consolidated Form 5472. The common parent, as identified on Form 851, must attach a schedule to the consolidated Form 5472 stating which members of the U.S. affiliated group are reporting corporations under section 6038A, and which of those are joining in the consolidated Form 5472. The schedule must provide the name, address, and taxpayer identification number of each member whose transactions are included on the consolidated Form 5472. A member is not required to join in filing a consolidated Form 5472 merely because other members of the group choose to file one or more Forms 5472 on a consolidated basis.

(2) *Maintenance of records and authorization of agent.* Either the common parent or the principal operating company of an affiliated group filing a consolidated income tax return may be authorized under § 1.6038A-5 to act as the agent for foreign related persons engaged in transactions with members of the group solely for purposes of section 7602, 7603, and 7604 under section 6038A(e)(1) and § 1.6038A-5. Each member of the group, however, must maintain the records required under section 6038A (a) and § 1.6038A-3 relating to its related party transactions.

(3) *Monetary penalties.* The common parent (or principal operating company) and all reporting corporations that join in the filing of a consolidated Form 5472 are liable jointly and severally for penalties for failure to file Form 5472 and for failure to mantain records under section 6038A(d) and § 1.6038A-4(e). See § 1.1502-77(a) regarding the scope of agency of the common parent corporation.

(1) *District Director.* For purposes of the regulations under section 6038A, the term "District Director" means any District Director, or the Assistant Commissioner (International) when performing duties similar to those of a District Director with respect to any person over which the Assistant Commissioner (International) has appropriate jurisdiction.

(m) *Examples.* The following examples illustrate the rules of this section.

Example 1. P, a U.S. partnership that is engaged in a U.S. trade or business, is 75 percent owned by FC1, a foreign corporation that, in turn, is wholly owned by another foreign corporation, FC2. The remaining 25 percent of P is owned by Corp, a domestic corporation, that is wholly owned by FC3. P engages in transactions solely with FC2 and FC3. These transactions are attributed to FC1 and Corp. Under section 875, FC1 is considered as being engaged in a U.S. trade or business. For purposes of section 6038A and this section, FC1 and Corp are reporting corporations and must report their pro rata shares of the value of the transactions with FC2 and FC3. Thus, Corp must report 25 percent of P's transactions with FC3 and FC1 must report 75 percent of P's transactions with FC2.

Example 2. FC2 and FC3 are both foreign corporations that are wholly owned by FC1, also a foreign corporation. FC2 engages in a trade or business in the United States through a branch. The branch engages in related party transactions with FC1. FC2 is a reporting corporation. FC3 is a foreign related party. FC1 is a direct 25-percent foreign shareholder of both FC2 and FC3. Neither FC1 nor FC3 is a reporting corporation.

Example 3. FC1 owns 25 percent of total voting power in each of FC2 and FC3. FC2 and FC3 each own 20 percent of the total voting power of Corp, a domestic corporation. The remaining stock of Corp is owned by an unrelated domestic corporation. Neither FC2 nor FC3 is engaged in a U.S. trade or business. Under section 318(a)(2)(C) and paragraph (e) of this section, FC1 constructively owns its proportionate share of the stock of Corp owned directly by FC2 and FC3. Thus, FCl is treated as constructively owning five percent of Corp through each of FC2 and FC3 or a total of 10 percent of the Corp stock. Consequently, Corp is not a reporting corporation because no 25 percent shareholder exists.

Example 4. FP owns 100 percent of FCl which, in turn, owns 100 percent of FC2. FC2 owns 100 percent of FC3 which owns 100 percent of RC. FP, FC1, and FC2 are indirect 25-percent foreign shareholders of RC, and FC3 is a direct 25-percent foreign shareholder.

Example 5. FP owns 100 percent of USS, a U.S. corporation, and 25 percent of FS, a foreign corporation. The remaining 75 percent of FS is publicly owned by numerous small shareholders. Sales transactions occur between USS and FS. Applying the rules of this section, USS is a reporting corporation. It is determined that USS and FS are each controlled by FP under section 482 and the regulations thereunder. Therefore, FS is related to USS within the meaning of section 482 and is a related party to USS. Accordingly, the sales transactions between USS and FS are subject to section 6038A.

Example 6. The facts are the same as in *Example 5*, except that the remaining 75 percent of FS is owned by one shareholder that is unrelated to the FP group and it is determined that FS is not controlled by FP for purposes of section 482. Under these facts, FS is not a related party of either FP or USS. Accordingly, section 6038A does not apply to the sales transactions between FS and USS.

Example 7. P, a U.S. multinational, is a holding company that wholly owns X, a U.S. operating company, which in turn wholly owns FS, a controlled foreign corporation. Applying the rule of section 318(a)(3)(C), FS is deemed to own the stock of X that is actually held by P. However, under the rules of paragraph (e) of this section, X will not be a reporting corporation by reason of section 318.

(n) *Effective dates* -- (1) *Section 1.6038A-1.* Paragraphs (c) (relating to the definition of a reporting corporation), (d) (relating to the definition of a related party), (e)(1) (relating to the application of section 318), and (f) (relating to the definition of a foreign person) of this section are effective for taxable Years beginning after July 10, 1989. The remaining paragraphs of this section are effective December 10, 1990, without regard to when the taxable year began.

(2) *Section 1.6038A-2.* Section 1.6038A-2 (relating to the requirement to file Form 5472) is generally effective for taxable years beginning after July 10, 1989. However, § 1.6038A-2 as it applies to reporting corporations whose sole trade or business in the United States is a banking, financing, or similar business as defined in § 1.864-4(c)(5)(i) is effective for taxable years beginning after December 10, 1990.

(3) *Section 1.6038A-3.* Section 1.6038A-3 (relating to the record maintenance requirement) is generally effective December 10, 1990. However, records described in § 1.6038A-3 in existence on or after March 20, 1990, must be maintained, without regard to when the taxable year to which the records relate began.

(4) *Section 1.6038A-4.* Section 1.6038A-4 (relating to the monetary penalty) is generally effective for taxable years beginning after July 10, 1989, for the failure to file Form 5472. For the failure to maintain records or the failure to produce documents under § 1.6038A-4(f)(2), the section is effective December 10, 1990, without regard to when the taxable year to which the records relate began.

(5) *Section 1.6038A-5.* Section 1.6038A-5 (relating to the authorization of agent requirement) is effective December 10, 1990, without regard to when the taxable year to which the records relate began.

(6) *Section 1.6038A-6.* Section 1.6038A-6 (relating to the failure to furnish information under a summons) is effective November 6, 1990, without regard to when the taxable year to which the summons relates began.

(7) *Section 1.6038A-7.* Section 1.6038A-7 (relating to the noncompliance penalty adjustment) is effective December 10, 1990, without regard to when the taxable year began.

§ 1.6038A-2 Requirement of return.

(a) *Form 5472 required* -- (1) *In general.* Each reporting corporation as defined in § 1.6038A-1(c) (or members of an affiliated group filing together as described in § 1.6038A-1(k)) shall make a separate annual information return on Form 5472 with respect to each related party as defined in § 1.6038A-1(d) with which the reporting corporation (or any group member joining in a consolidated Form 5472) has had any reportable transaction during the taxable year. The information required by section 6038A and this section must be furnished even though it may not affect the amount of any tax due under the Code.

(2) *Reportable transaction.* A reportable transaction is any transaction of the types listed in paragraphs (b) (3) and (4) of this section. However, if neither party to the transaction is a United States person as defined in section 7701(a)(30) and the transaction --

(i) Will not generate in any taxable year gross income from sources within the United States or income effectively connected, or treated as effectively connected, with the conduct of a trade or business within the United States, and

(ii) Will not generate in any taxable year any expense, loss, or other deduction that is allocable or apportionable to such income, the transaction is not a reportable transaction.

(b) *Contents of return* -- (1) *Reporting corporation.* Form 5472 must provide the following information in the manner the form prescribes with respect to each reporting corporation:

(i) Its name, address (including mailing code), and U.S. taxpayer identification number; each country in which the reporting corporation files an income tax return as a resident under the tax laws of that country; its country or countries of organization, and incorporation; its total assets for U.S. reporting corporation; the places where it conducts its business; and its principal business activity.

(ii) The name, address, and U.S. taxpayer identification number, if applicable, of all its direct and indirect 25-percent foreign shareholders (for an indirect 25-percent foreign shareholder, explain the attribution of ownership); each country in which each 25-percent foreign shareholder files an income tax return as a resident under the tax laws of that country; the places where each 25-percent shareholder conducts its business; and the country or countries of organization, citizenship, and incorporation of each 25-percent foreign shareholder.

(iii) The number of Forms 5472 filed for the taxable year and the aggregate value in U.S. dollars of gross payments as defined in § 1.6038A-1(h)(2) made with respect to all foreign related party transactions reported on all Forms 5472.

(2) *Related party.* The reporting corporation must provide information on Form 5472, set forth in the manner the form prescribes, about each related party, whether foreign or domestic, with which the reporting corporation had a transaction of the types described in paragraphs (b) (3) and (4) of this section during its taxable year, including the following information:

(i) The name, U.S. taxpayer identification number, if applicable, and address of the related party.

(ii) The nature of the reated party's business and the principal place or places where it conducts its business.

(iii) Each country in which the related party files an income tax return as a resident under the tax laws of that country.

(iv) The relationship of the reporting corporation to the related party.

(3) *Foreign related party transactions for which only monetary consideration is paid or received by the reporting corporation.* If the related party is a foreign person, the reporting corporation must set forth on Form 5472 the dollar amounts of all reportable transactions for which monetary consideration (including U.S. and foreign currency) was the sole consideration paid or received during the taxable year of the reporting corporation. The total amount of such transactions, as well as the separate amounts for each type of transaction described below, must be reported on Form 5472, in the manner the form prescribes. Where actual amounts are not determinable, a reasonable estimate (as described in paragraph (b)(6) of this section) is permitted. The types of transactions described in this paragraph are:

(i) Sales and purchases of stock in trade (inventory);

(ii) Sales and purchases of tangible property other than stock in trade;

(iii) Rents and royalties paid and received (other than amounts reported under paragraph (b)(3)(iv) of this section);

(iv) Sales, purchases, and amounts paid and received as consideration for the use of all intangible property, including (but not limited to) copyrights, designs, formulas, inventions, models, patents, processes, trademarks, and other similar intangible property rights;

(v) Consideration paid and received for technical, managerial, engineering, construction, scientific, or other services;

(vi) Commissions paid and received;

(vii) Amounts loaned and borrowed (except open accounts resulting from sales and purchases reported under other items listed in this paragraph (b)(3) that arise and are collected in full in the ordinary course of business);

(viii) Interest paid and received;

(ix) Premiums paid and received for insurance and reinsurance; and

(x) Other amounts paid or received not specifically identified in this paragraph (b)(3) to the extent that such amounts are taken into account for the determination and computation of the taxable income of the reporting corporation.

Amounts required to be reported under paragraph (b)(3)(vii) of this section shall be reported as monthly averages or outstanding balances at the beginning and end of the taxable year, as the form shall prescribe.

(4) *Foreign related party transactions involving nonmonetary consideration or less than full consideration.* If the related party is a foreign person, the reporting corporation must provide on Form 5472 a description of any reportable transaction, or group of reportable transactions, listed in paragraph (b)(3) of this section, for which any part of the consideration paid or received was not monetary consideration, or for which less than full consideration was paid or received. A description required under paragraph (b)(4) of this section shall include sufficient information from which to determine the nature and approximate monetary value of the transaction or group of transactions, and shall include:

(i) A description of all property (including monetary consideration), rights, or obligations transferred from the reporting corporation to the foreign related party and from the foreign related party to the reporting corporation;

(ii) A description of all services performed by the reporting corporation for the foreign related party and by the foreign related party for the reporting corporation; and

(iii) A reasonable estimate of the fair market value of all properties and services exchanged, if possible, or some other reasonable indicator of value.

If, for any transaction, the entire consideration received includes both tangible and intangible property and the consideration paid is solely monetary consideration, the transaction should be reported under paragraph (b) (3) of this section if the intangible property was related and incidental to the transfer of the tangible property (for example, a right to warranty services.)

(5) *Additional information.* In addition to the information required under paragraphs (b) (3) and (4) of this section, a reporting corporation must provide on Form 5472, in the manner the form prescribes, the following information:

(i) If the reporting corporation imports goods from a foreign related party, whether the costs taken into account in computing the basis or inventory cost of such goods are greater than the costs taken into account in computing the valuation of the goods for customs purposes, adjusted pursuant to section 1059A and the regulations thereunder, and if so, the reasons for the difference.

(ii) If the costs taken into account in computing the basis or inventory cost of such goods are greater than the costs taken into account in computing the valuation of the goods for customs purposes, whether the documents supporting the reporting corporation's treatment of the items set forth in paragraph (b)(5)(i) of this section are in existence and available in the United States at the time Form 5472 is filed.

(6) *Reasonable estimate* -- (i) *Estimate within 25 percent of actual amount.* Any amount reported under this section is considered to be a reasonable estimate if it is at least 75 percent and not more than 125 percent of the actual amount.

(ii) *Other estimates.* If any amount reported under this paragraph (b) of this section fails to meet the reasonable estimate test of paragraph (b)(6)(i) of this section, the reporting corporation nevertheless may show that such amount is a reasonable estimate by making an affirmative showing of relevant facts and circumstances in a written statement containing a declaration that it is made under the penalties of perjury. The District Director shall determine whether the amount reported was a reasonable estimate.

(7) *Small amounts.* If any actual amount required under this section does not exceed $50,000, the amount may be reported as "$50,000 or less."

(8) *Accrued payments and receipts.* For purposes of this section, in the case of an accrual basis taxpayer, the terms "paid" and "received" shall include accrued payments and receipts, respectively.

(c) *Method of reporting.* All statements required on or with the Form 5472 under this section and § 1.6038A-5 shall be in the English language. All amounts required to be reported under paragraph (b) of this section shall be expressed in United States currency, with a statement of the exchange rates used.

(d) *Time and place for filing returns.* A Form 5472 required under this section shall be filed with the reporting corporation's income tax return for the taxable year by the due date (including extensions) of that return. A duplicate Form 5472 (including any attachments and schedules) shall be filed at the same time with the Internal Revenue Service Center, Philadelphia, PA 19255.

(e) *Untimely filed return.* If the reporting corporation's income tax return is untimely filed, Form 5472 (with a duplicate to Philadelphia) nonetheless shall be timely filed at the service center where the return is due. When the income tax return is ultimately filed, a copy of Form 5472 must be attached.

(f) *Exceptions* -- *(1) No reportable transactions.* A reporting corporation is not required to file Form 5472 if it has no transactions of the types listed in paragraphs (b) (3) and (4) of this section during the taxable year with any related party.

(2) *Transactions solely with a domestic reporting corporation.* If all of a foreign reporting corporation's reportable transactions are with one or more related domestic reporting corporations that are not members of the same affiliated group, the foreign reporting corporation shall furnish on Form 5472 only the information required under paragraphs (b) (1) and (2) of this section, if the domestic reporting corporations provide the information required under paragraphs (b) (3) through (5) of this section. Such a foreign reporting corporation nonetheless is subject to the record maintenance requirements of § 1.6038A-3 and the requirements of §§ 1.6038A-5 and 1.6038A-6. The name, address, and taxpayer

identification number of each domestic reporting corporation that provided such information must be indicated on Form 5472 in the space provided for the information under paragraphs (b) (1) and (2) of this section.

(3) *Transactions with a corporation subject to reporting under section 6038.* A reporting corporation is not required to make a return of information on Form 5472 with respect to a related foreign corporation for a taxable year for which a U.S. person that controls the foreign related corporation makes a return of information on Form 5471 that is required under section 6038 and this section, if that return contains information required under § 1.6038-2(f)(11) with respect to the reportable transactions between the reporting corporation and the related corporation for that taxable year. Such a reporting corporation also is not subject to §§ 1.6038A-3 and 1.6038A-5. It remains subject to the general record maintenance requirements of section 6001.

(4) *Transactions with a foreign sales corporation.* A reporting corporation is not required to make a return of information on Form 5472 with respect to a related corporation that qualifies as a foreign sales corporation for a taxable year for which the foreign sales corporation files Form 1120-FSC.

(g) *Filing Form 5472 when transactions with related parties engaged in by a partnership are attributed to a reporting corporation.* If transactions engaged in by a partnership are attributed under § 1.6038A-1(e)(2) to a reporting corporation, the reporting corporation need report on Form 5472 only the percentage of the value of the transaction or transactions equal to the percentage of its partnership interest. Thus, for example, if a partnership buys $1000 of widgets from the foreign parent of a reporting corporation whose partnership interest in the partnership equals 50 percent of the partnership interests (and the remaining 50 percent is held by unrelated parties), the reporting corporation must report $500 of purchases from a foreign related party on Form 5472.

(h) *Effective dates for certain reporting corporations.* For effective dates for this section, see § 1.6038A-1(n).

§ 1.6038A-3 Record maintenance.

(a) *General maintenance requirements* -- (1) Section 6001 and section 6038A. A reporting corporation must keep the permanent books of account or records as required by section 6001 that are sufficient to establish the correctness of the federal income tax return of the corporation, including information, documents, or records ("records") to the extent they may be relevant to determine the correct U.S. tax treatment of transactions with related parties. Under section 6001, the District Director may require any person to make such returns, render such statements, or keep such specific records as will enable the District Director to determine whether or not that person is liable for any of the taxes to which the regulations under part I have application. See section 6001 and the regulations thereunder. Such records must be permanent, accurate, and complete, and must clearly establish income, deductions, and credits. Additionally, in appropriate cases, such records include sufficient relevant cost data from which a profit and loss statement may be prepared for products or services transferred between a reporting corporation and its foreign related parties. This requirement includes records of the reporting corporation itself, as well as to records of any foreign related party that may be relevant to determine the correct U.S. tax treatment of transactions between the reporting corporation and foreign related parties. The relevance of such records with respect to related party transactions shall be determined upon the basis of all the facts and circumstances. Section 6038A and this section provide detailed guidance regarding the required maintenance of records with respect to such transactions and specify penalties for noncompliance. Banks and other financial institutions shall follow the specific record maintenance rules described in paragraph (h) of this section.

(2) *Safe harbor.* A safe harbor for record maintenance is provided under paragraph (c) of this section, which sets forth detailed guidance concerning the types of records to be maintained with respect to related party transactions. The safe harbor consists of an all-inclusive list of record types that could be relevant to different taxpayers under a variety of facts and circumstances. It does not constitute a checklist of records that every reporting corporation must maintain or that generally should be requested by the Service. A specific reporting corporation is required to maintain, and the Service will request, only those records enumerated in the safe harbor (including material profit and loss statements) that may be relevant to its business or industry and to the correct U.S. tax treatment of its transactions with its foreign related parties. Accordingly, not every item listed in the safe harbor must be maintained by every reporting corporation. A corporation that maintains or causes another person to maintain the records listed in paragraph (c)(2) of this section that may be relevant to its foreign related party transactions and to its business or industry will be deemed to have met the record maintenance requirements of section 6038A.

(3) *Examples.* The following examples illustrate the rules of this paragraph.

Example 1. RC, a U.S. reporting corporation, is owned by two shareholders, F and P. F is a foreign corporation that owns 30 percent of the stock of RC. P is a domestic corporation that owns the remaining 70 percent. RC purchases tangible property from F; however, the only potential audit issue with respect to these transactions is their treatment under section 482. It is determined that F does not in fact control RC and the two corporations do not constitute a group of "controlled taxpayers" for purposes of section 482 and the regulations thereunder. There are no other reportable transactions between RC and F. Under § 1.6038A-1(g), F is a foreign related party with respect to RC. Accordingly, RC is required to report its purchases of property from F under the reporting requirements of § 1.6038A-2. Nevertheless, because section 482 is not applicable to the transactions between RC and F, the records created by F with respect to its sales to RC are not relevant for purposes of determining the correct tax treatment of these transactions. RC is required to maintain its own records of these transactions under the requirements of section 6001, but the transactions are not subject to the record maintenance requirements of this section. If, however, on audit it is determined that F does control RC, all records relevant to determining the arm's length consideration for the tangible property under section 482 will be subject to these requirements.

Example 2. FP, a foreign person, owns 30 percent of the stock of RC, a reporting corporation. The remaining 70 percent of RC stock is held by persons that are not 25-percent foreign shareholders. It is determined that FP is related to RC within the meaning of section 482 and the regulations thereunder. The only transactions between FP and RC are FP's capital contributions, dividends paid from RC to FP, and loans from FP to RC. Under section 6001, RC is required to maintain all documentation necessary to establish the U.S. tax treatment of the capital contributions, dividends, and loans. RC is not required to maintain records in other categories listed in paragraph (c)(3) of this section because they are not relevant to the transactions between FP and RC. Records of FP not related to these transactions are not subject to the record maintenance requirements under section 6038A(a) and this section.

Example 3. G, a foreign multinational group, creates Sub, a wholly-owned U.S. subsidiary, in order to purchase tangible property from unrelated parties in the United States and resell such property to G. The property purchased by Sub is either used in G's business or resold to other unrelated parties by G. Sub's sole function is to act as a buyer for G and these purchases are the only transactions that G has with any U.S. affiliates. Under all the facts and circumstances of this case, it is determined that an analysis of the group's worldwide profit attributable to the property it purchases from Sub is not relevant for purposes of determining the tax treatment of the sales from Sub to G. Therefore, the records with respect to the profitability of G are not subject to the maintenance requirements of this section. However, all records related to the appropriate method under section 482 for determining an arm's-length consideration for the property sold by Sub to G are subject to the record maintenance requirements of this section.

Example 4. S, a U.S. reporting corporation, is the purchasing agent for its multinational parent group. It arranges for the purchase and export of miscellaneous tangible property to X, Y, and Z, each of which is a foreign related party. The miscellaneous tangible property is purchased from unrelated third parties for resale to X, Y, and Z. These resales of miscellaneous tangible property constitute the sole transactions between S and X, Y, and Z. The purchasing agent activity of S is not an integral part of the business activity of S or of any beneficiary of the purchasing agent services provided by S as defined in § 1.482-2(b)(7). Under § 1.482-2(b)(7), the arm's-length charge is deemed to be equal to the costs or deductions incurred with respect to the provision of the purchasing agent services. S is required to maintain records to permit verification upon audit of such costs or deductions. The records of X, Y, and Z are not relevant to the costs or deductions incurred by S with respect to its purchasing agent activities. Therefore, under section 6038A and this section, only the records maintained by S that permit verification of the costs and deductions of the purchasing agent services are relevant. Accordingly, solely with respect to these transactions, records of X, Y, and Z need not be maintained under section 6038A or this section. If, however, upon audit, it is determined that S is not merely engaging in services not integral to its business as defined in § 1.482-2(b)(7), the record maintenance requirements under section 6038A(a) and this section will be applicable to the records of S, X, Y and Z to the extent that such records are relevant for determining the correct tax treatment of transactions engaged in by X, Y, or Z with S. If S has other transactions with X, S must maintain or cause to be maintained records that may be relevant with respect to those transactions.

(b) *Other maintenance requirements* -- (1) *Indirectly related records.* This section applies to records that are directly or indirectly related to transactions between the reporting corporation and any foreign related parties. An example of records that are indirectly related to such transactions is records possessed by a foreign subsidiary of a foreign related party that document the raw material or component costs of a product that is manufactured or assembled by the subsdiary and sold as a finished product by the foreign related party to the reporting corporation.

(2) *Foreign related party or third-party maintenance.* If records that are required to be maintained under this section are in the control of a foreign related party, the records may be obtained or compiled (if not already in the possession of the foreign related party or already compiled) under the direction of the reporting corporation and then maintained by the reporting corporation, the foreign related party, or a third party. Thus, for example, a foreign related party may either itself maintain such records outside the United States or permit a third party to maintain such records outside the United States, provided that the conditions described in paragraph (f) of this section are met. Upon a request for such records by the Service, a foreign related party or third party may make arrangements with the District Director to furnish the records directly, rather than through the reporting corporation.

(3) *Translation of records.* When records are provided to the Service under a request for production, any portion of such records must be translated into the English language within 30 days of a request for translation of that portion by the District Director. To the extent that any requested documents are identical to documents that have already been translated, an explanation of how such documents are identical instead may be provided. An extension of this time period may be requested under paragraph (f)(4) of this section. Appropriate extensions will be liberally granted for translation requests where circumstances warrant. If a good faith effort is made to translate accurately the requested documents within the specified time period, the reporting corporation will not be subject to the penalties in §§ 1.6038A-4 and 1.6038A-7.

(4) *Exception for foreign governments.* A foreign government is not subject to the obligation to maintain records under this section.

(c) *Specific records to be maintained for safe harbor* -- (1) *In General.* A reporting corporation that maintains or causes another person to maintain the records specified in this paragraph (c) that are relevant to its business or industry and to the correct U.S. tax treatment of its transactions with its foreign related parties will deemed to have met the record maintenance requirements of this section. This paragraph provides general descriptions of the categories of records to be maintained; the particular title or label applied by a reporting corporation or related party does not control. Functional equivalents of the specified documents are acceptable. Record maintenance in accordance with this safe harbor, however, requires only the maintenance of types of documents described in paragraph (c)(2) of this section that are directly or indirectly related to transactions between the reporting corporation and any foreign related party. Additionally, to the extent the reporting corporation establishes that records in a particular category are not applicable to the industry or business of the reporting corporation and any foreign related party, maintenance of such records is not required under this paragraph. Record maintenance in accordance with this paragraph (c) generally does not require the original creation of records that are ordinarily not created by the reporting corporation or its related parties. (If, however, a document that is actually created is described in this paragraph (c), it is to be maintained even if the document is not of the type ordinarily created by the reporting corporation or its related parties.) There are two exceptions to the rule. First, basic accounting records that are sufficient to document the U.S. tax effects of transactions between related parties must be created and retained, if they do not otherwise exist. Second, records sufficient to produce material profit and loss statements as described in paragraphs (c)(2) (ii) and (3) of this section that are relevant for determining the U.S. tax treatment of transactions between the reporting corporation and foreign related parties must be created if such records are not ordinarily maintained. All internal records storage and retrieval systems used for each taxable year must be retained.

(2) *Descriptions of categories of documents to be maintained.* The following records must be maintained in order to satisfy this paragraph (c) to the extent they may be relevant to determine the correct U.S. tax treatment of transactions between the reporting corporation and any foreign related party.

(i) *Original entry books and transaction records.* This category includes books and records of original entry or their functional equivalents, however designated or labelled, that are relevant to transactions between any foreign related party and the reporting corporation. Examples include, but are not limited to, general ledgers, sales journals, purchase order books, cash receipts books, cash disbursement books, canceled checks and bank statements, workpapers, sales contracts, and purchase invoices. Descriptive material to explicate entries in the foregoing types of records, such as a chart of accounts or an accounting policy manual, is included in this category.

(ii) *Profit and loss statements.* This category includes records from which the reporting corporation can compile and supply, within a reasonable time, material profit and loss statements of the reporting corporation and all related parties as defined in § 1.6038A-1 (d) (the "related party group") that reflect profit or loss of the related party group attributable to U.S.-connected products or services as defined in paragraph (c)(7)(i) of this section. The determination of whether a profit and loss statement is material is made under the rules provided in paragraph (c)(3) of this section. The material profit and loss statements described in this paragraph (c)(2)(ii) must reflect the consolidated revenue and ex-

penses of all members of the related party group. Thus, records in this category include the documentation of the cost of raw materials used by a related party to manufacture finished goods that are then sold by another related party to the reporting corporation. The records should be kept under U.S. generally accepted accounting principles if they are ordinarily maintained in such manner; if not, an explanation of the material differences between the accounting principles used and U.S. generally accepted accounting principles must be made available. The statements need not reflect tracing of the actual costs borne by the group with respect to its U.S.-connected products or services; rather, any reasonable method may be used to allocate the group's worldwide costs to the revenues generated by the sales of those products or services. An explanation of the methods used to allocate specific items to a particular profit and loss statement must be made available. The explanation of material differences between accounting principles and the explanation of allocation methods must be sufficient to permit a comparison of the profitability of the group to that of the reporting corporation attributable to the provision of U.S.-connected products or services.

(iii) *Pricing documents.* This category includes all documents relevant to establishing the appropriate price or rate for transactions between the reporting corporation and any foreign related party. Examples include, but are not limited to, documents related to transactions involving the same or similar products or services entered into by the reporting corporation or a foreign related party with related and unrelated parties; shipping and export documents; commission agreements; documents relating to production or assembly facilities; third-party and intercompany purchase invoices; manuals, specifications, and similar documents relating to or describing the performance of functions conducted at particular locations; intercompany correspondence discussing any instructions or assistance relating to such transactions provided to the reporting corporations by the related foreign person (or vice versa); intercompany and intracompany correspondence concerning the price or the negotiation of the price used in such transactions; documents related to the value and ownership of intangibles used or developed by the reporting corporation or the foreign related party; documents related to cost of goods sold and other expenses; and documents related to direct and indirect selling, and general and administrative expenses (for example, relating to advertising, sales promotions, or warranties).

(iv) *Foreign country and third party filings.* This category includes financial and other documents relevant to transactions between a reporting corporation and any foreign related party filed with or prepared for any foreign government entity, any independent commission, or any financial institution.

(v) *Ownership and capital structure records.* This category includes records or charts showing the relationship between the reporting corporation and the foreign related party; the location, ownership, and status (for example, joint venture, partnership, branch, or division) of all entities and offices directly or indirectly involved in the transactions between the reporting corporation and any foreign related party; a worldwide organization chart; records showing the management structure of all foreign affiliates; and loan documents, agreements, and other documents relating to any transfer of the stock of the reporting corporation that results in the change of the status of a foreign person as a foreign related party.

(vi) *Records of loans, services, and other non-sales transactions.* This category includes relevant documents relating to loans (including all deposits by one foreign related party or reporting corporation with an unrelated party and a subsequent loan by that unrelated party to a foreign related party or reporting corporation that is in substance a direct loan between a reporting corporation and a foreign related party); guarantees of a foreign related party of debts of the reporting corporation, and vice versa; hedging arrangements or other risk shifting or currency risk shifting arrangements involving the reporting corporation and any foreign related party; security agreements between the reporting corporation and any foreign related party; research and development expense allocations between any foreign related party and the reporting corporation; service transactions between any foreign related party and the reporting corporation, including, for example, a description of the allocation of charges for management services, time or travel records, or allocation studies; import and export transactions between a reporting corporation and any foreign related party; the registration of patents and copyrights with respect to transactions between the reporting corporation and any foreign related party: and documents regarding lawsuits in foreign countries that relate to such transactions between a reporting corporation and any foreign related party (for example, product liability suits for U.S. products).

(3) *Material profit and loss statements.* For purposes of paragraph (c)(2)(ii) of this section, the determination of whether a profit and loss statement is material will be made according to the following rules. An agreement between the reporting corporation and the District Director as described in paragraph (e) of this section may identify material profit and loss statements of the related party group and describe the items to be included in any profit and loss statements for which records are to be maintained to satisfy the requirements of paragraph (c)(2)(ii) of this section. In the absence of such an agreement, a profit and loss statement will be material if it meets any of the following tests: the existing records

test described in paragraph (c)(4) of this section, the significant industry segment test described in paragraph (c)(5) of this section, or the high profit test described in paragraph (c)(6) of this section.

(4) *Existing records test.* A profit and loss statement is material under the existing records test described in this paragraph (c)(4) if any member of the related party group creates or compiles such statement in the course of its business operations and the statement reflects the profit or loss of the related party group attributable to the provision of U.S.-connected products or services (regardless of whether the profit and loss attributable to U.S.-connected products or services is shown separately or included within the calculation of aggregate figures on the statement). For example, a profit and loss statement is described in this paragraph if it was produced for internal accounting or management purposes, or for disclosure to shareholders, financial institutions, government agencies, or any other persons. Such existing statements and the records from which they were complied (to the extent such records relate to profit and loss attributable to U.S.-connected products or services) are subject to the record maintenance requirements described in paragraph (c)(2)(ii) of this section.

(5) *Significant industry segment test* -- (i) *In general.* A profit and loss statement is material under the significant industry segment test described in this paragraph (c)(5) if --

(A) The statement reflects the profit or loss of the related party group attributable to the group's provision of U.S.-connected products or services within a single industry segment (as defined in paragraph (c)(7)(ii) of this section);

(B) The worldwide gross revenue attributable to such industry segment is 10 percent or more of the worldwide gross revenue attributable to the group's combined industry segments; and

(C) The amount of gross revenue earned by the group from the provision of U.S.-connected products or services within such industry segment is $25 million or more in the taxable year.

(ii) *Form of the statements*. Profit and loss statements compiled for the group's provision of U.S.-connected products or services in each significant industry segment must reflect revenues and expenses attributable to the operations in such segment by all members of the related party group. Statements may show each related party's revenues and expenses separately, or may be prepared in a consolidated format. Any reasonable method may be used to allocate the group's worldwide costs within the industry segment to the U.S.-connected products or services within that segment. An explanation of the methods used to prepare consolidated statements and to allocate specific items to a particular profit and loss statement must be made available, and the records from which the consolidations and allocations were prepared must be maintained.

(iii) *Special rule for component sales.* Where the U.S.-connected products or services consist of components that are incorporated into other products or services before sale to customers, the portion of the total gross revenue derived from sales of the finished products or services attributable to the components may be determined on the basis of relative costs of production. Thus, where relevant for determining whether the $25 million threshold in paragraph (c)(5)(i)(C) of this section has been met, the amount of gross revenue derived by the related party group from the provision of the finished products or services may be reduced by multiplying it by a fraction, the numerator of which is the costs of production of the related party group attributable to the component products or services that constitute U.S.-connected products or services and the denominator of which is the costs of production of the related party group attributable to the finished products in which such components are incorporated.

(iv) *Level of specificity required.* In applying the significant industry segment test of this paragraph (c)(5), groups of related products and services must be chosen to provide a reasonable level of specificity that results in the greatest number of separate significant industry segments in comparison to other possible classifications. This determination must be made on the basis of the particular facts presented by the operations of the related party group. The following rules, however, provide general guidelines for making such classifications. First, the related party group's operations that involve the provision of U.S.-connected products should be grouped into product lines. The rules of this paragraph (c)(5) should then be applied to determine if any such product line would, standing alone, constitute a significant industry segment when compared to the related party group's operations as a whole. Any significant industry segments determined at the level of product lines should be further segregated, and tested for significant industry segments, at the level of separate products. Finally, any significant industry segments determined at the level of separate products should be segregated, and tested for significant industry segments, at the level of separate models. Similar principles should be applied in classifying and testing types of services. A profit and loss statement reflecting the related party group's provision of any product or service (or group of products or services as classified under these rules) that constitutes a signifi-

cant industry segment will be considered material for purposes of this paragraph (c)(5). For definitions of the terms "product", "related products or services", "model", and "product line", see paragraph (c)(7) of this section.

(v) *Examples.* The rules for determining reasonable levels of specificity for significant industry segments may be illustrated by the following examples.

Example 1. A related party group is engaged in the manufacture and worldwide sales of automobiles and aftermarket parts. The group's operations within the categories of "automobiles" and "aftermarket parts". are each sufficient to constitute significant industry segments for the group under the rules of this paragraph (c)(5). No narrower classification of aftermarket parts results in any significant industry segments. Automobiles produced by the group are generally classified for marketing purposes by trade names; aggregating groups of automobiles by these trade names results in three significant industry segments, those for trade names A, B, and C. Finally, two car models sold under the trade name A ("A1" and "A2") and one car model sold under the trade name B ("B3"), produce sufficient revenue to constitute significant industry segments. Such classifications into trade names and car models are generally used in the related party group's industry; moreover, different types of classifications would produce fewer significant industry segments. Accordingly, a reasonable level of specificity for this related party group's industry segments would be eight categories of products consisting of "automobiles", "aftermarket parts", "A", "B", "C", "A1", "A2", and "B3".

Example 2. A related party group is engaged in manufacturing electronic goods that are distributed at retail in the United States by the reporting corporation. The group sells three types of products in the United States: televisions, radios, and video cassette recorders (VCRs). Each of these three broad product areas constitutes a significant industry segment for the group as a whole. VCRs can be further segregated by price into high-end and low-end models, and the provision of each constitutes a significant industry segment for the group. Revenues from only one VCR model, model number VCRX-10, are sufficiently large to make the provision of that model a significant industry segment. With respect to televisions, the group normally accounts for these products by size. Using this classification, portable televisions, medium-sized televisions, and consoles each constitute significant industry segments. Narrower classifications by television model numbers result in no additional significant industry segments. Finally, a single radio product line, those sold under the trade name R, produces sufficient revenue to constitute a significant industry segment, but no other radio models or product groups are large enough to constitute a significant industry segment. In each case, these classifications conform to normal business practices in the industry and result in the greatest possible number of significant industry segments for this related party group. Accordingly, a reasonable level of specificity for this related party group's industry segments would include the ten categories consisting of "VCRs", "high-end VCRs", "low-end VCRs", "model number VCRX-10", "televisions", "portable televisions", "medium-sized televisions", "console televisions", "radios", and "radio trade name R".

(6) *High profit test* -- (i) *In general*. A profit and loss statement is material under the high profit test described in this paragraph (c)(6) if --

(A) The statement reflects the profit or loss of the related party group attributable to the group's provision of U.S.-connected products or services within a single industry segment (as defined in paragraph (c)(7)(ii) of this section);

(B) The amount of gross revenue earned by the group from the provision of U.S.-connected products or services within such industry segment is $100 million or more in the taxable year; and

(C) The return on assets test described in paragraph (c)(6)(ii) of this section is satisfied with respect to the products and services attributable to such segment.

Accordingly, a significant industry segment (as determined under paragraph (c)(5) of this section) must be divided into any narrower industry segments that meet the high profit test of this paragraph (c)(6), even if such narrower segments would not, standing alone, meet the significant industry segment test of paragraph (c)(5) of this section.

(ii) *Return on assets test*. An industry segment meets the return on assets test if the rate of return on assets earned by the related party group on its worldwide operations within this industry segment exceeds 15 percent, and is at least 200 percent of the return on assets earned by the group in all industry segments combined. For purposes of this paragraph, the rate of return on assets earned by an industry segment is determined by dividing that segment's operating profit (as defined in paragraph (c)(7)(v) of this section) by its identifiable assets (as defined in paragraph (c)(7)(iv) of this section).

(iii) *Additional rules*. The rules in paragraphs (c)(5)(ii) through (iv) of this section describing the application of the significant industry segment test shall apply in a similar manner for purposes of the high profit test.

(7) *Definitions*. The following definitions apply for purposes of paragraphs (c)(2)(ii), (c)(5), and (c)(6) of this section.

(i) *U.S. connected products or services*. The term "U.S.-connected products or services" means products or services that are imported to or exported from the United States by transfers between the reporting corporation and any of its foreign related parties.

(ii) *Industry segment*. An industry segment is a segment of the related party group's combined operations that is engaged in providing a product or service or a group of related products or services (as defined in paragraph (c)(7)(vii) of this section) primarily to customers that are not members of the related party group.

(iii) *Gross revenue of an industry segment*. Gross revenue of an industry segment includes receipts (prior to reduction for cost of goods sold) both from sales to customers outside of the related party group and from sales or transfers to other industry segments within the related party group (but does not include sales or transfers between members of the related party group within the same industry segment). Interest from sources outside the related party group and interest earned on trade receivables between industry segments is included in gross revenue if the asset on which the interest is earned is included among the industry segment's identifiable assets, but interest earned on advances or loans to other industry segments is not included.

(iv) *Identifiable assets of an industry segment*. The identifiable assets of an industry segment are those tangible and intangible assets of the related party group that are used by the industry segment, including assets that are used exclusively by that industry segment and an allocated portion of assets used jointly by two or more industry segments. The value of an identifiable asset may be determined using any reasonable method (such as book value or fair market value) applied consistently. Any allocation of assets among industry segments must be made on a reasonable basis, and a description of such basis must be provided. Assets of an industry segment that transfers products or services to another industry segment shall not be allocated to the receiving segment. Assets that represent part of the related party group's investment in an industry segment, such as goodwill, shall be included in the industry segment's identifiable assets. Assets maintained for general corporate purposes (that is, those not used in the operations of any industry segment) shall not be allocated to industry segments.

(v) *Operating profit of an industry segment*. The operating profit of an industry segment is its gross revenue (as defined in paragraph (c)(7)(iii) of this section) minus all operating expenses. None of the following shall be added or deducted in computing the operating profit of an industry segment: revenue earned at the corporate level and not derived from the operations of any industry segment; general corporate expenses; interest expense; domestic and foreign income taxes; and other extraordinary items not reflecting the ongoing business operations of the industry segment.

(vi) *Product*. The term "product" means an item of property (or combination of component parts) that is the result of a production process, is primarily sold to unrelated parties (or incorporated by the related party group into other products sold to unrelated parties), and performs a specific function.

(vii) *Related products or services.* The term "related products or services" means groupings of products and types of services that reflect reasonable accounting, marketing, or other business practices within the industries in which the related party group operates.

(viii) *Model.* The term "model" means a classification of products that incorporate particular components, options, styles, and any other unique features resulting in product differentiation. Examples of models are electronic products that are sold or accounted for under a single model number and automobiles sold under a single model name.

(ix) *Product line.* The term "product line" means a group of products that are aggregated into a single classification for accounting, marketing, or other business purposes. Examples of product lines are groups of products that perform similar functions; products that are marketed under the same trade names, brand names, or trademarks; and products that are related economically (that is, having similar rates of profitability, similar degrees of risk, and similar opportunities for growth).

(8) *Example.* The application of the rules for determining material profit and loss statements under paragraphs (c)(4) through (7) of this section is illustrated by the following example.

Example. (i) *Facts.* A multinational enterprise manufactures 50 different agricultural and chemical products that are sold through Subl, its wholly owned U.S. subsidiary, and other subsidiaries located in foreign countries. The parent company of the enterprise, P, is a foreign corporation. The corporations participating in the enterprise form a related party group, and Subl is a reporting corporation for purposes of section 6038A. Under the facts and circumstances of this case, an analysis of the group's worldwide profit attributable to its products sold in the U.S. is relevant for determining an arm's length consideration under section 482 for the transfers of goods between Subl and its foreign affiliates.

(ii) *Existing records test.* For management purposes, the group prepares profit and loss statements that are segmented by sales in different geographic markets. One of these statements shows the combined worldwide profitability of the group. Another statement shows the profitability of the group attributable to its North American sales. Both of these profit and loss statements reflect aggregate figures that include sales to unrelated parties of products that have been transferred from P and other group members to Subl (that is, the group's "U.S.-connected products"). The two statements meet the existing records test described in paragraph (c)(4) of this section.

(iii) *Significant industry segments.* The group's worldwide gross revenue in all industry segments is $2 billion. An analysis of the group's 50 products demonstrates that they are reasonably grouped into eight industry segments (each of which earns roughly $250 million in worldwide gross revenue). Segments 1 through 6 relate to agricultural products and Segments 7 and 8 relate to other chemical products. More specific categories would result in groupings that generate less than 10 percent of the group's worldwide gross revenue (that is, less than $200 million each); these narrower categories would thus fail the gross revenue percentage test of paragraph (c)(5)(i)(B) of this section. The gross revenue in each of the eight segments from the sale to unrelated parties of U.S.-connected products is as follows: $180 million for Segment 1; $30 million for Segment 2; and less than $25 million for each of Segments 3 through 8. Under the $25 million threshold test of paragraph (c)(5)(i)(C) of this section, the group's significant industry segments are thus limited to Segments 1 and 2. In addition, the combined operations of the group related to agricultural products (encompassing Segments 1 through 6 on an aggregated basis), constitute a single significant industry segment.

(iv) *High profit test.* One highly profitable product line within Segment 1, HPPL, accounts for $120 million gross revenue from Sub1's domestic sales of U.S.-connected products (and thus exceeds the $100 million gross revenue threshold in paragraph (c)(6)(i)(B) of this section). The return on the identifiable assets attributable to the HPPL product line is 85 percent, which is more than 15 percent and more than twice the return on assets earned by the group from its worldwide operations in its combined industry segments. The group's industry segment for HPPL thus meets the high profit test described in paragraph (c)(6) of this section.

(v) *Material Profit and Loss Statements.* The group's material profit and loss statements consist of statements for combined worldwide sales and North American sales (under the existing records test); Segment 1, Segment 2, and aggregated Segments 1-6 (under the significant industry segment test); and HPPL (under the high profit test). Under paragraph (c) of this section, Subl is required to retain the combined worldwide sales and North American sales profit and loss statements and to maintain sufficient records so that it can compile and supply upon request statements of the group's profitability from sales of its U.S.-connected products within Segment l, Segment 2, aggregated Segments 1-6, and HPPL. These records need not be in the possession of Subl and may be kept under the control of and produced by P or any third party. The statements for Segment l, Segment 2, aggregated Segments 1-6, and HPPL do not require tracing of actual costs to the U.S.-connected products; rather, these statements may be prepared by using any reasonable method to allocate a portion of the industry segment's overall operating costs to the sales of U.S.-connected products within that segment.

(d) *Liability for certain partnership record maintenance.* A reporting corporation to which transactions engaged in by a partnership are attributed under § 1.6038A-1 (e)(2) is subject to the record maintenance requirements of this section to the extent of the transactions so attributed.

(e) *Agreements with the District Director* -- (1) *In general.* The District Director who has audit jurisdiction over the reporting corporation may negotiate and enter into an agreement with a reporting corporation that establishes the records the reporting corporation must maintain or cause another to maintain, how the records must be maintained, the period of retention for the records, and by whom the records must be maintained in order to satisfy the reporting corporation's obligations under this section.

(2) *Content of agreement* -- (i) *In general.* The agreement may include provisions relating to the authorization of agent requirement, the record maintenance requirement, and the production and translation time periods that vary the rules contained in these regulations under section 6038A. The District Director will generally require a reporting corpo-

ration to maintain only those records specified under the safe harbor provisions of paragraph (c) of this section that permit an adequate audit of the income tax return of the reporting corporation and to provide such authorizations of agent that permit adequate access to such records. In most instances, required record maintenance for a particular reporting corporation under a negotiated agreement will be less than the broad range of records described under the safe harbor provisions. Additionally, a provision specifying the effective date and the expiration date of the agreement that may vary the effective date of the regulations may be included.

(ii) *Significant industry segment test.* A District Director may determine which industry segment profit and loss statements are material for purposes of requiring the maintenance of records (under either paragraph (a)(1) of this section or the safe harbor described in paragraph (a)(2) of this section). The industry segments that the District Director determines are material need not be the industry segments that meet the significant industry segment test under paragraph (c)(5) of this section or the high profit test under paragraph (c)(6) of this section. For this purpose, a reporting corporation will be required to maintain only those records from which profit and loss statements for the related party group may be constructed with respect to industry segments identified by the District Director. To the extent that existing profit and loss statements are similar in scope and level of detail to statements for industry segments that would otherwise be described under the tests of paragraphs (c)(5) and (6) of this section, the District Director shall accept the existing statements instead of the statements that would otherwise be required under paragraphs (c)(5) and (6) of this section.

(iii) *Example.* The following example illustrates the rules of paragraph (e)(2)(ii) of this section.

Example. The District Director determines that RC, a reporting corporation that is a manufacturer of related chemical products, has two industry segments, Segment 1 and Segment 2. While both industry segments meet the significant industry segment test of paragraph 3(c)(5) of this section, Segment 1 has a relatively low volume of sales to foreign related parties. Additionally, Segment 1 consists of products that produce only a small profit margin because the product is generic and other companies also sell the product. The District Director enters into an agreement with RC that requires only records from which a profit and loss statement for the related party group can be constructed for Segment 2. Therefore, RC is not required to maintain records for Segment 1 from which a profit and loss statement for the related party group can be constructed. The other record maintenance requirements under this section apply, however.

(3) *Circumstances of agreement.* The District Director generally will enter into an agreement under this paragraph (e) upon request by the reporting corporation when the District Director believes that the District has or can obtain sufficient knowledge of the business or industry of the reporting corporation to limit the record maintenance requirement to particular documents.

(4) *Agreement as part of APA process.* An agreement with a reporting corporation under this paragraph (e) may be entered into as a part of the Advance Pricing Agreement (APA) process at any time during the APA process, insofar as the agreement relates to the subject matter of the APA.

(f) *U.S. maintenance* -- (l) *General rule.* Records that must be maintained under this section must be maintained within the United States, unless the conditions described in paragraph (f)(2) of this section are met.

(2) *Non-U.S. maintenance requirements.* A reporting corporation may maintain outside the United States records not ordinarily maintained in the United States but required to be maintained in the United States under this section. However, the reporting corporation must either:

(i) Deliver to the Service the original documents (or duplicates) requested within 60 days of the request by the Service for such records and provide translations of such documents within 30 days of a request for translations of specific documents; or

(ii) Move the original documents (or duplicates) requested to the United States within 60 days of the request of the Service for such records; provide the Service with an index to the requested records, the name and address of a custodian located within the United States having control over the records, and the address where the records are located within 60 days of the Service's request for the records; and continue to maintain the records within the United States throughout the period of retention described in paragraph (g) of this section. For summons procedures with respect to records that have been moved to the United States, see sections 6038A(e), 7602, 7603, and 7604.

With respect to any material profit and loss statements required to be created (either under paragraph (c) of this section or under an agreement with the District Director), unless otherwise specified, "120 days" shall be substituted for "60 days" in this paragraph (f)(2), and labels and text with respect to such statements must be in the English language.

(3) *Prior taxable years.* The non-U.S. maintenance requirements described in paragraph (f)(2) of this section apply to records located outside the United States that were in existence on or after March 20, 1990, without regard to the taxable year to which such records relate.

(4) *Scheduled production for high volume or other reasons.* Upon a written request, for good cause shown, the District Director may grant an extension of the time for the production or translation of the requested documents. Such requests should be made within 30 days of the request for records by the Service. If an extension is needed because of the volume of records requested or the amount of translation requested, the District Director may allow production or translation to be scheduled over a period of time so that not all records need be produced or translated at the same time.

(5) *Required U.S. maintenance.* The District Director (with the concurrence of the Assistant Commissioner (International)), may require, for cause, the maintenance within the United States of any records specified in paragraph (f)(1) of this section. Such a requirement will be imposed only if there exists a clear pattern of failure to maintain or timely produce the required records. The assessment of a monetary penalty under section 6038A(d) and § 1.6038A-4 for failure to maintain records is not necessarily sufficient to require the maintenance of records within the United States.

(g) *Period of retention.* Records required to be maintained by section 6038A(a) and this section shall be kept as long as they may be relevant or material to determining the correct tax treatment of any transaction between the reporting corporation and a related party, but in no case less than the applicable statute of limitations on assessment and collection with respect to the taxable year in which the transaction or item to which the records relate affects the U.S. tax liability of the reporting corporation. *See* section 6001 and the regulations thereunder.

(h) *Application of record maintenance rules to banks and other financial institutions.* [Reserved].

(i) *Effective dates.* For effective dates for this section, see § 1.6038A-1(n).

§ 1.6038A-4 Monetary penalty.

(a) *Imposition of monetary penalty* -- (1) *In general.* If a reporting corporation fails to furnish the information described in § 1.6038A-2 within the time and manner prescribed in § 1.6038A-2 (d) and (e), fails to maintain or cause another to maintain records as required by § 1.6038A-3, or (in the case of records maintained outside the United States) fails to meet the non-U.S. record maintenance requirements within the applicable time prescribed in § 1.6038A-3(f), a penalty of $10,000 shall be assessed for each taxable year with respect to which such failure occurs. Such a penalty may be imposed by the District Director or the Director of the Internal Revenue Service Center where the Form 5472 is filed. The filing of a substantially incomplete Form 5472 constitutes a failure to file Form 5472. Where, however, the information described in § 1.6038A-2 (b)(3) through (5) is not required to be reported, a Form 5472 filed without such information is not a substantially incomplete Form 5472.

(2) *Liability for certain partnership transactions.* A reporting corporation to which transactions engaged in by a partnership are attributed under § 1.6038A-1(e)(2) is subject to the rules of this section to the extent failures occur with respect to the partnership transactions so attributed.

(3) *Calculation of monetary penalty . If a reporting corporation fails to maintain records as required by § 1.6038A-3 of transactions with multiple related parties, the monetary penalty may be assessed for each failure to maintain records with respect to each related party. The monetary penalty, however, shall be imposed on a reporting corporation only once for a taxable year with respect to each related party for a failure to furnish the information required on Form 5472, for a failure to maintain or cause another to maintain records, or for a failure to comply with the non-U.S. maintenance requirements described in § 1.6038A-3(f). An additional penalty for another failure may be imposed, however, under the rules of paragraph (d)(2) of this section. Thus, unless such failures continue after notification as described in paragraph (d) of this section, the maximum penalty under this paragraph with respect to each related party for all such failures in a taxable year is $10,000. The members of a group of corporations filing a consolidated return are jointly and severally liable for any monetary penalty that may be imposed under this section.*

(b) *Reasonable cause -- (1) In general. Certain failures may be excused for reasonable cause, including not timely filing Form 5472, not maintaining or causing another to maintain records as required by § 1.6038A-3, and not complying with the non-U.S. maintenance requirements described in § 1.6038A-3(f). If an affirmative showing is made that the taxpayer acted in good faith and there is reasonable cause for a failure that results in the assessment of the monetary penalty, the period during which reasonable cause exists shall be treated as beginning on the day reasonable cause is established and ending not earlier than the last day on which reasonable cause existed for any such failure. Additionally, the beginning of the 90-day period after mailing of a notice by the District Director or the Director of an Internal*

Revenue Service Center of a failure described in paragraph (d) of this section shall be treated as not earlier than the last day on which reasonable cause existed.

(2) *Affirmative showing required -- (i) In general. To show that reasonable cause exists for purposes of paragraph (b)(1) of this section, the reporting corporation must make an affirmative showing of all the facts alleged as reasonable cause for the failure in a written statement containing a declaration that it is made under penalties of perjury. The statement must be filed with the District Director (in the case of failure to maintain or furnish requested information permitted to be maintained outside the United States within the time required under § 1.6038A-3(f) or a failure to file Form 5472) or the Director of the Internal Revenue Service Center where the Form 5472 is required to be filed (in the case of failure to file Form 5472). The District Director or the Director of the Internal Revenue Service Center where the Form 5472 is required to be filed, as appropriate, shall determine whether the failure was due to reasonable cause, and if so, the period of time for which reasonable cause existed. If a return has been filed as required by § 1.6038A-2 or records have been maintained as required by § 1.6038A-3, except for an omission of, or error with respect to, some of the information required or a record to be maintained, the omission or error shall not constitute a failure for purposes of section 6038A(d) if the reporting corporation that filed the return establishes to the satisfaction of the District Director or the Director of the Internal Revenue Service Center that it has substantially complied with the filing of Form 5472 or the requirement to maintain records.*

(ii) *Small corporations. The District Director shall apply the reasonable cause exception liberally in the case of a small corporation that had no knowledge of the requirements imposed by section 6038A; has limited presence in and contact with the United States; and promptly and fully complies with all requests by the District Director to file Form 5472, and to furnish books, records, or other materials relevant to the reportable transaction. A small corporation is a corporation whose gross receipts for a taxable year are $20,000,000 or less.*

(iii) *Facts and circumstances taken into account. The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the experience and knowledge of the taxpayer. Isolated computational or transcriptional errors generally are not inconsistent with reasonable cause and good faith. Reliance upon an information return or on the advice of a professional (such as an attorney or accountant) does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, the reliance was reasonable. A taxpayer, for example, may have reasonable cause for not filing a Form 5472 or for not maintaining records under section 6038A if the taxpayer has a reasonable belief that it is not owned by a 25-percent foreign shareholder. A reasonable belief means that the taxpayer does not know or has no reason to know that it is owned by a 25-percent foreign shareholder. For example, a reporting corporation would not know or have reason to know that it is owned by a 25-percent foreign shareholder if its belief that it is not so owned is consistent with other information reported or otherwise furnished to or known by the reporting corporation. A taxpayer may have reasonable cause for not treating a foreign corporation as a related party for purposes of section 6038A where the foreign corporation is a related party solely by reason of § 1.6038A-1(d)(3) (under the principles of section 482), and the taxpayer had a reasonable belief that its relationship with the foreign corporation did not meet the standards for related parties under section 482.*

(c) *Failure to maintain records or to cause another to maintain records.* A failure to maintain records or to cause another to maintain records is determined by the District Director upon the basis of the reporting corporation's overall compliance (including compliance with the non-U.S. maintenance requirements under § 1.6038A-3(f)(2)) with the record maintenance requirements. It is not an item-by-item determination. Thus, for example, a failure to maintain a single or small number of items may not constitute a failure for purposes of section 6038A(d), unless the item or items are essential to the correct determination of transactions between the reporting corporation and any foreign related parties. The District Director shall notify the reporting corporation in writing of any determination that it has failed to comply with the record maintenance requirement.

(d) *Increase in penalty where failure continues after notification* -- (1) *In general.* If any failure described in this section continues for more than 90 days after the day on which the District Director or the Director of the Internal Revenue Service Center where the Form 5472 is required to be filed mails notice of the failure to the reporting corporation, the reporting corporation shall pay a penalty (in addition to the penalty described in paragraph (a) of this section) of $10,000 with respect to each related party for which a failure occurs for each 30-day period during which the failure

continues after the expiration of the 90-day period. Any uncompleted fraction of a 30-day period shall count as a 30-day period for purposes of this paragraph (d).

(2) *Additional penalty for another failure.* An additional penalty for a taxable year may be imposed, however, if at a time subsequent to the time of the imposition of the monetary penalty described in paragraph (a) of this section, a second failure is determined and the second failure continues after notification under paragraph (d)(1) of this section. Thus, if a taxpayer fails to file Form 5472 and is assessed a monetary penalty and later, upon audit, is determined to have failed to maintain records, an additional penalty for the failure to maintain records may be assessed under the rules of this paragraph if the failure to maintain records continues after notification under this paragraph.

(3) *Cessation of accrual.* The monetary penalty will cease to accrue if the reporting corporation either files Form 5472 (in the case of a failure to file Form 5472), furnishes information to substantially complete Form 5472, or demonstrates compliance with respect to the maintenance of records (in the case of a failure to maintain records) for the taxable year in which the examination occurs and subsequent years to the satisfaction of the District Director. The monetary penalty also will cease to accrue if requested information, documents, or records, kept outside the United States under the requirements of § 1.6038A-3(f) and not produced within the time specified are produced or moved to the United States under the rules of paragraph (f)(2)(ii) of this section.

(4) *Continued failures.* If a failure under this section relating to a taxable year beginning before July 11, 1989 occurs, and if the failure continues following 90 days after the notice of failure under this paragraph is sent, the amount of the additional penalty to be assessed under this paragraph is $10,000 for each 30-day period beginning after November 5, 1990, during which the failure continues. There is no limitation on the amount of the monetary penalty that may be assessed after November 5, 1990.

(e) *Other penalties.* For criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203 and 7206 of the Code. For the penalty relating to an underpayment of tax, see section 6662.

(f) *Examples.* The following examples illustrate the rules of this section.

Example 1 -- Failure to file Form 5472. Corp X, a U.S. reporting corporation, engages in related party transactions with FC. Corp X does not timely file a Form 5472 or maintain records relating to the transactions with FC for Year 1 or subsequent years. The Service Center with which Corp X files its income tax return imposes a $10,000 penalty for each of Years 1, 2, and 3 under section 6038A (d) and this section for failure to provide information as required on Form 5472 and mails a notice of failure to provide inrormation. Corp X does not file Form 5472. Ninety days following the mailing of the notice of failure to Corp X an additional penaly of $10,000 is imposed. On the 135th day following the mailing of the notice of failure, Corp X files Form 5472 for Years 1, 2, and 3. The total penalty owed by Corp X for Year 1 is $30,000. ($10,000 for not timely filing Form 5472, $10,000 for the first 30-day period following the expiration of the 90-day period, and $10,000 for the fraction of the second 30-day period). The penalty for Years 2 and 3 for the failure to file Form 5472 is also $30,000 for each year, calculated in the same manner as for Year 1. The total penalty for failure to file Form 5472 for Years 1, 2, and 3 is $90,000.

Example 2 -- Failure to maintain records. Assume the same facts as in *Example 1.* In Year 5, Corp X is audited for Years 1 through 3. Corp X has not been maintaining records relating to the transactions with FC. The District Director issues a notice of failure to maintain records. Corp X has already been subject to the monetary penalty of $10,000 for each of Years 1, 2, and 3 for failure to file Form 5472 and, therefore, a monetary penalty under paragraph (a) of this section for failure to maintain records is not assessed. However, an additional penalty is assessed after the 90th day following the mailing of the notice of failure to maintain records. Corp X develops a record maintenance system as required by section 6038A and § 1.6038A-3. On the 180th day following the mailing of the notice of failure to maintain records, Corp X demonstrates to the satisfaction of the District Director that the newly developed record maintenance system will comply with the requirements of § 1.6038A-3 and the increase in the monetary penalty after notification ceases to accrue. The additional penalty for failure to maintain records is $30,000. An additional penalty of $30,000 per year is assessed for each of years 2 and 3 for the failure to maintain records for a total of $90,000.

(g) *Effective dates.* For effective dates for this section, see § 1.6038A-1(n).

§ 1.6038A-5 Authorization of agent.

(a) *Failure to authorize.* The rules of § 1.6038A-7 shall apply to any transaction between a foreign related party and a reporting corporation (including any transaction engaged in by a partnership that is attributed to the reporting corporation under § 1.6038A-1(e)(2)), unless the foreign related party authorizes (in the manner described in paragraph (b) of

this section) the reporting corporation to act as its limited agent solely for purposes of sections 7602, 7603, and 7604 with respect to any request by the Service to examine records or produce testimony that may be relevant to the tax treatment of such a transaction or with respect to any summons by the Service for such records or testimony. The fact that a reporting corporation is authorized to act as an agent for a foreign related party is to be disregarded for purposes of determining whether the foreign related party either has a trade or business in the United States for purposes of the Code or a permanent establishment or fixed base in the United States for purposes of an income tax treaty.

(b) *Authorization by related party* -- (1) *In general.* Upon request by the Service, a foreign related party shall authorize as its agent (solely for purposes of sections 7602, 7603, and 7604) the reporting corporation with which it engages in transactions. The authorization must be signed by the foreign related party or an officer of the foreign related party possessing the authority to authorize an agent for purposes of Rule 4 of the Federal Rules of Civil Procedure. The reporting corporation will accept this appointment by providing a statement to that effect, signed by an officer of the reporting corporation possessing the authority to accept such an appointment. The agency shall be effective at all times. For taxable years beginning after July 10, 1989, the authorization and acceptance must be provided to the Service within 30 days of a request by the Service to the reporting corporation for such an authorization. The authorization must contain a heading and statement as set forth below. A foreign government is not subject to the authorization of agent requirement.

AUTHORIZATION OF AGENT

"[Name of foreign related party] hereby expressly authorizes [name of reporting corporation] to act as its agent solely for purposes of sections 7602, 7603, and 7604 of the Internal Revenue Code with respect to any request to examine records or produce testimony that may be relevant to the U.S. income tax treatment of any transaction between [name of the above-named foreign related party] and [name of reporting corporation] or with respect to any summons for such records or testimony.

--

Signature of or for [name of foreign related party]

--

(Title)

--

(Date)

(If signed by a corporate officer, partner, or fiduciary on behalf of foreign related party: I certify that I have the authority to execute this authorization of agent to act on behalf of [name of foreign related party]).

--

Type or print your name below if signing for a foreign related party that is not an individual.

--

[Name of reporting corporation] accepts this appointment to act as agent for [name of foreign related party] for the above purpose.

--

Signature for (Name of Reporting Corporation)

--

(Title)

--

(Date)

I certify that I have the authority to accept this appointment to act as agent on behalf of (name of foreign related party) and agree to accept service of process for the above purposes.

Type or print your name below.

--

(2) *Authorization for prior years.* A foreign related party shall authorize a reporting corporation to act as its agent with respect to taxable years for which a Form 5472 is required to be filed prior to the date on which the final regulations under section 6038A are published by providing the above executed authorization of agent within 30 days of a request by the Service for such an authorization.

(c) *Foreign affiliated groups* -- (1) *In general.* A foreign corporation that has effective legal authority to make the authorization of agent under paragraph (b) of this section on behalf of any group of foreign related parties may execute such an authorization for any members of the group. A single authorization may be made on a consolidated basis. In such a case, the common parent must attach a schedule to the authorization of agent stating which members of the group would otherwise be required to separately authorize the reporting corporation as agent. The schedule must provide the name, address, relationship to the reporting corporation, and U.S. taxpayer identification number, if applicable, of each member.

(2) *Application of noncompliance penalty adjustment.* In circumstances where a consolidated authorization of agent has been executed, if the agency authorization for any member of the group is not legally effective for purposes of sections 7602, 7603, and 7604, the noncompliance penalty adjustment under section 6038A(e) and § 1.6038A-7 shall apply.

(d) *Legal effect of authorization of agent.* The legal consequences of a foreign related party authorizing a reporting corporation to act as its agent for purposes of sections 7602, 7603, and 7604 of the Code are as follows.

(1) *Agent for purposes of commencing judicial proceedings.* A reporting corporation that is authorized by a foreign related party to act as its agent for purposes of sections 7602, 7603, and 7604 (including service of process) is also the agent of the foreign related party for purposes of --

(i) The filing of a petition to quash under section 6038A(e)(4)(A) or a petition to review an Internal Revenue Service determination of noncompliance under section 6038A(e)(4)(B), and

(ii) The commencement of a judicial proceeding to enforce a summons under section 7604, whether commenced in conjunction with a petition to quash under section 6038A(e)(4)(A) or commenced as a separate proceeding in the federal district court for the district in which the person to whom the summons is issued resides or is found.

(2) *Foreign related party found where reporting corporation found.* For any purposes relating to sections 7602, 7603, or 7604 (including service of process), a foreign related party that authorizes a reporting corporation to act on its behalf under section 6038A(e)(1) and this section may be found anywhere where the reporting corporation has residence or is found.

(e) *Successors in interest.* A successor in interest to a related party must execute the authorization of agent as described in paragraph (b) of this section.

(f) *Deemed compliance* -- (1) *In general.* In exceptional circumstances, the District Director may treat a reporting corporation as authorized to act as agent for a related party for purposes of sections 7602, 7603, and 7604 in the absence of an actual agency appointment by the foreign related party, in circumstances where the actual absence of an appointment is reasonable. Factors to be considered include --

(i) If neither the reporting corporation nor the other party to the transaction knew or had reason to know that the two parties were related at the time of the transaction, and

(ii) The extent to which the taxpayer establishes to the satisfaction of the District Director that all transactions between the reporting corporation and the related party were on arm's length terms and did not involve the participation of any known related party.

(2) *Reason to know.* Whether the reporting corporation or other party had reason to know that the two parties were related at the time of the transaction will be determined by all the facts and circumstances.

(3) *Effect of deemed compliance.* If a reporting corporation is deemed under this paragraph (f) to have been authorized to act as an agent for a foreign related party for purposes of sections 7602, 7603, and 7604, such deemed compliance is applicable only for that particular transaction and other reportable transactions entered into prior to the time when the reporting corporation knew or had reason to know that the related party, in fact, was related. The noncompliance rule of § 1.6038A-7 shall apply to any transaction subsequent to that time with the same related party, unless the

related party actually authorizes the reporting corporation to act as its agent under paragraph (a) of this section. In addition, the record maintenance requirements of § 1.6038A-3 will apply to all subsequent transactions and, with respect to prior transactions, will apply to relevant records in existence at the time the relationship was discovered.

(g) *Effective dates.* For effective dates for this section, see § 1.6038A-1(n).

§ 1.6038A-6 Failure to furnish information.

(a) *In general.* The rules of § 1.6038A-7 may be applied with respect to a transaction between a foreign related party and the reporting corporation (including any transaction engaged in by a partnership that is attributed to the reporting corporation under § 1.6038A-1(e)(2)) if a summons is issued to the reporting corporation to produce any records or testimony, either directly or as agent for such related party, to determine the correct treatment under Title 1 of the Code of such a transaction between the reporting corporation and the related party; and if --

(1)(i) The summons is not quashed in a proceeding, if any, begun under section 6038A(e)(4) and is not determined to be invalid in a proceeding, if any, begun under section 7604 to enforce such summons; and

(ii) The reporting corporation does not substantially and timely comply with the summons, and the District Director has sent by certified or registered mail a notice under section 6038A(e)(2)(C) to the reporting corporation that it has not so complied; or

(2) The reporting corporation fails to maintain or to cause another to maintain records as required by § 1.6038A-3, and by reason of that failure, the summons is quashed in a proceeding under section 6038A(e)(4) or in a proceeding begun under section 7604 to enforce the summons, or the reporting corporation is not able to provide the records requested in the summons.

(b) *Coordination with treaties.* Where records of a related party are obtainable on a timely and efficient basis under information exchange procedures provided under a tax treaty or tax information exchange agreement (TIEA), the Service generally will make use of such procedures before issuing a summons. The absence or pendency of a treaty or TIEA request may not be asserted as grounds for refusing to comply with a summons or as a defense against the assertion of the noncompliance penalty adjustment under § 1.6038A-7. For purposes of this paragraph, information is available on a timely and efficient basis if it can be obtained within 180 days of the request.

(c) *Enforcement proceeding not required.* The District Director is not required to begin an enforcement proceeding to enforce the summons in order to apply the rules of § 1.6038A-7.

(d) *De minimis failure.* Where a reporting corporation's failure to comply with the requirement to furnish information under this section is *de minimis,* the District Director, in the exercise of discretion, may choose not to apply the noncompliance penalty. Thus, for example, in cases where a particular document or group of documents is not furnished upon request or summons, the District Director (in the District Director's sole discretion), may choose not to apply the noncompliance penalty if the District Director deems the document or documents not to have significant or sufficient value in the determination of the correctness of the tax treatment of the related party transaction.

(e) *Suspension of statute of limitations.* If the reporting corporation brings an action under section 6038A (e)(4)(A) (proceeding to quash) or (e)(4)(B) (review of secretarial determination of noncompliance), the running of any period of limitation under section 6501 (relating to assessment and collection of tax) or under section 6531 (relating to criminal prosecutions) for the taxable year or years to which the summons that is the subject of such proceeding relates shall be suspended for the period during which such proceeding, and appeals therein, are pending. In no event shall any such period expire before the 90th day after the day on which there is a final determination in such proceeding.

(f) *Effective dates.* For effective dates for this section, see § 1.6038A-1(n).

§ 1.6038A-7 Noncompliance.

(a) *In general.* In the case of any failure described in § 1.6038A-5 or § 1.6038A-6, the rules of this § 1.6038A-7 apply to the reporting corporation. In such a case --

(1) The amount of the deduction allowed under subtitle A for any amount paid or incurred by the reporting corporation to the related party in connection with such transaction, and

(2) The cost to the reporting corporation of any property acquired in such transaction from the related party or transferred by such corporation in such transaction to the related party, may be determined by the District Director.

(b) *Determination of the amount.* The amount of the deduction or the cost to the reporting corporation shall be the amount determined by the District Director (in the District Director's sole discretion) from the District Director's own knowledge or from such information as the District Director may choose to obtain through testimony or otherwise. The District Director shall consider any information or materials that have been submitted by the reporting corporation or a foreign related party. The District Director, however, may disregard any information, documents, or records submitted by the reporting corporation or the related party if (in the District Director's sole discretion) the District Director deems that they are insufficiently probative of the relevant facts.

(c) *Separate application.* If the noncompliance penalty of this section applies with respect to transactions with a related party of the reporting corporation, it will not be applied with respect to any other related parties of the reporting corporation solely upon the basis of that failure. Thus, for example, if a reporting corporation engages in transactions with related party A and related party B, and the reporting corporation does not respond to a summons for records related to the transactions between the reporting corporation and related party A, the noncompliance penalty imposed as a result of such failure will not apply to the transactions between the reporting corporation and related party B. If a separate summons is issued for records relating to the transactions between the reporting corporation and related party B and the reporting corporation does not produce such records, the noncompliance penalty may be applied to those transactions.

(d) *Effective dates.* For effective dates for this section, see § 1.6038A-1(n).

PART 602 -- OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority for part 602 continues to read as follows:

Par. 5. The table of OMB Control Numbers in § 602.101(c) is amended by removing the entry for § 1.6038A-1 and adding the following entries to read as follows:

"§ 1.6038A-2 . . . 1545-1191"

"§ 1.6038A-3 . . . 1545-1191"

Fred T. Goldberg, Jr.,

Commissioner of Internal Revenue.

Approved:

Kenneth W. Gideon,

Assistant Secretary of the Treasury.

[FR Doc. 91-14459 Filed 6-14-91; 8:45 am]

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