Chapter 11 Related Party Losses and Expenses

Contents:

a. Introduction

Internal Revenue Code (IRC) §267 sets forth rules relating to the deductibility of either losses or expenses between certain related parties. Its purpose is twofold:

- First, IRC §267 contains an anti-abuse provision to prevent the recognition of loss by a taxpayer if, through a related party transaction, the taxpayer would recognize a loss without substantially modifying its position with respect to the loss property.
- Second, IRC §267 contains a relief provision by allowing the matching of expenses with income incurred between related parties to permit a deduction only when a corresponding recognition of income is made by the related payee.

In the Tax Reform Act of 1986, Congress expanded the payment requirement to include transactions with foreign persons who are related to the taxpayer. California conforms to IRC §267. (Revenue and Taxation Code §24427.)

b. Restrictions of IRC §267

In general, IRC §267 imposes restrictions on recognizing related party transactions.

There are two types of transactions between related parties where recognition is restricted by IRC §267 of the tax law. These transactions are:

1. Sales of property at a loss

As provided in IRC §267(a)(1), losses from sale or exchange of property, directly or indirectly, are disallowed between related parties. When the property is later sold to an unrelated party, any disallowed loss may be used to offset gain on that transaction. However, if the related persons are corporations that are members of a controlled group, the loss is deferred (as opposed to being disallowed) until the property is transferred outside the controlled group as described in IRC §267(f).

Example 1

Mr. A owns 65% of Corp B. Mr. A sells property to Corp B for $500. The property has an adjusted basis of $800 at the time of sale. The loss of $300 is not allowable to Mr. A by reason of IRC §267(a)(1). Corp B later sells this property for $1,000 to an unrelated party. Although Corp B's realized gain is $500 ($1,000 minus $500, its basis), Corp B's recognized gain under IRC §267(d) is only $200, the excess of the realized gain of $500 over the loss of $300 not allowable to Mr. A. (Treasury Regulation (Treas. Reg.) §1.267(d) - 1(a)(4).)

Example 2

Assume the same facts as in Example 1 except that Corp B later sells the property for $300 instead of $1,000. Corp B's recognized loss is $200. The $300 loss realized on the sale from Mr. A to Corp B is not recognized since IRC §267(d) applies only to the non-recognition of gain and does not affect basis in the property.

2. Unpaid expenses and interest

As discussed in IRC §267(a)(2), the matching of income and deductions for transactions between related persons using different methods of accounting (cash versus accrual) is generally required. One related person can deduct an expense (usually for services rendered, royalties, rent, or interest) when the other related person is required to report it as income. This rule applies to amounts that would otherwise be deductible under IRC §162, §163, and §212.

Example 3

Corporation C, an accrual basis taxpayer, is wholly owned by an individual who uses the cash method of accounting for tax purposes. On December 31, 20X1, Corporation C accrues interest expense of $22,000 on a loan from the individual owner, but it does not pay the interest to the individual owner. Corporation C may not deduct the $22,000 until the tax year it actually pays to the individual owner. This rule also applies to other expenses.

The IRS issued regulations in 1992, which, in general, require taxpayers to use the cash method of accounting for expenses paid to related foreign persons. An amount that is owed to a related foreign person and is otherwise deductible may not be deductible by the taxpayer until the amount is paid to the related foreign person. (Treas. Reg. §1.267(a)-3(b).)

c. Related Persons

IRC §267(b) has a complex set of rules to define who is a related party for disallowance purposes. The common related parties would include the following:

- Members of a family:
    - Brothers and sisters (whether by the whole or half-blood)
    - Spouses
    - Ancestors (parents, grandparents)
    - Lineal descendants (children, grandchildren)
- An individual and a corporation, more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly by or for such individual. For example, a corporation and an individual who directly or indirectly owns more than 50 percent of the corporation
- Two corporations which are members of the same controlled group as defined in IRC §267(f)
- Grantor and fiduciary trusts,

Example 4

Reagan Corporation is owned 70% by Mr. A and 30% by Mr. B. Mr. A and Mr. B. are unrelated to each other. Since Mr. A owns greater than 50% of the corporation, Mr. A is deemed the related party to Reagan Corporation. As a result if Mr. A sells property to the Reagan Corporation at a loss, the loss will be disallowed.

d. Constructive Ownership

Related party rules consider constructive ownership in determining whether parties are related to each other. Under these rules, taxpayers are deemed to own stock owned by certain relatives and related entities. Common constructive ownership rules are as follows and are noted in IRC §267(c):

- A taxpayer constructively owns all the stock owned by his or her spouse, brothers and sisters (whole or half), ancestors, and lineal descendants
- A taxpayer constructively owns his or her proportionate share of stock owned by any partnership, corporation, trust, or estate in which he or she is a partner, shareholder, or beneficiary
- A taxpayer constructively owns any stock owned directly or indirectly by a partner

Example 5

Individual A owns 40% of Corporation D and 40% of Corporation E. Corporation E owns 60% of Corporation D. As Individual A is deemed to own 64% of Corporation D (40% directly and 24% indirectly – (constructive ownership of Corporation E which would be 40%*60%), Individual A is a related party to Corporation D.

e. "Controlled Group" Defined

The term "controlled group" for purposes of IRC §267(f) includes the following:

A. Parent/subsidiary controlled group: One or more chains of corporations connected through stock ownership with a common parent corporation if:

(1) At least 50 percent of the voting stock or 50 percent of the value of all shares of stock of each corporation is owned by one of the other corporations; and
(2) The common parent owns at least 50 percent of the voting stock or 50 percent of the value of all shares of stock of at least one of the other corporations. (IRC §1563(a)(1).)

B. Brother/Sister controlled group: Two or more corporations having five or fewer individuals that own at least 50 percent of the voting stock or 50 percent of the value of all shares of stock of each corporation. (IRC §1563(a)(2).)

C. Combined group: A combined group consists of a parent/subsidiary group where the parent is also in a brother/sister controlled group. (IRC §1563(a)(3).)

f. Loss Disallowance and Loss Deferral Restrictions

1. Loss Disallowance Restriction

IRC §267(a)(1) disallows a deduction for losses on sales or exchanges of property between related persons or parties unless the related parties are members of a controlled group (in which case the loss is deferred.) The language of IRC §267(a)(1) has been viewed as being broad with no allowance for exceptions. Even if the transaction is a bona-fide transaction and is at arm's-length, the loss cannot be deducted if it occurs between related parties.

2. Definitions

- A sale generally means a transfer of property for a fixed price in money or its equivalent. (*J.P. Carlton,* 67-2 USTC 9625; *E.H. Swain,* 81-2 USTC 9575.)
- An exchange is generally considered a reciprocal transfer of property. (*K.A. Spalding,* 7 BTA 588.) The lack of consideration can be evidence of no sale or exchange.
- "Property" is broadly interpreted, and the courts have held that IRC §267(a)(1) applies to such items as a mortgage, an interest in a partnership, and an interest in a joint account. The courts have also held that IRC §267 applies to indirect sales and exchanges as well.

3. Distributions in Complete Liquidation

The loss disallowance restriction does not apply in the case of a distribution in complete liquidation. (IRC §267(a)(1).)

4. Gain Not Recognized To Extent Loss Disallowed

If a taxpayer (who is not a member of a controlled group) acquires property from a related person who sustained a loss which is not allowed by reason of IRC §267(a)(1), then any gain realized by the transferee taxpayer on any subsequent sale or other disposition of the property will be recognized only to the extent that the gain exceeds the amount of the loss realized by the transferor. (IRC §267(d); Treas. Reg. §1.267(d), Example 1.)

5. Determination of Basis and Gain with Respect to Divisible Property under IRC §267(d)

When more than one asset is sold at a loss to a related party, there are rules for allocating the purchase price to determine the amount realized by the transferor on the sale of the various assets. Essentially, the sales price is allocated based on relative fair market value of the assets sold. See IRC §267(d) and Treas. Reg. §1.267(d)-1(b) for more information.

The basis to the related party that purchased the assets is determined in the same manner as the transferor's amount realized. The transferor cannot deduct any loss it incurs on this sale.

When the property is eventually sold by the transferee, any gain is recognized only to the extent that the gain exceeds the amount of loss attributable to that item of property which was not allowable to the transferor.

6. Deferred Losses on Transactions between Controlled Group Members

The loss disallowance rule under IRC §267(a)(1) and §267(d) does not apply to losses on transfers of property between corporations in a controlled group of corporations. Instead, the transferor corporation (the selling member which realized the loss) can recognize the loss when the transferee (the purchasing member) transfers the property outside the group. IRC §267(f)(2) discusses the loss deferral rule.

Example 6

Corporation B is the sole shareholder of Corporation X and Corporation Y. In Year 1, Corporation X sold non-depreciable property with a basis of $8,000 to Corporation Y for $6,000 (its FMV). In Year 2, Corporation Y sold the property to Corporation Z (unrelated party) for $6,500. Corporation X's loss in Year 1 was deferred and in Year 2, Corporation X recognizes $2,000 of deferred loss and Corporation Y recognizes $500 gain.

If the selling member leaves the controlled group, the loss is not recognized pursuant to IRC §267. Instead, the deferred loss is added to the basis of the asset that remains within the group. Within the federal consolidated return intercompany deferral rules, deferred gain or loss is generally recognized when the buyer, the seller, or the asset leaves the group. Unlike the consolidated return intercompany deferral rules, any loss deferred pursuant to IRC §267 is only triggered when the asset leaves the group. The IRC §267(f) loss deferral rules generally override the consolidated return intercompany transaction recognition rules.

The loss deferral restriction does not apply to any loss sustained by a member of a controlled group on the repayment of a loan made to another member of the group if the loan is payable in a foreign currency or is denominated in such a currency and the loss is attributable to a reduction in value of the foreign currency. Treas. Reg. §1.267(f)-1(b)(3) discusses controlled group members.

g. Matching Restriction under IRC §267(a)(2)

The general rule of IRC §267(a)(2) applies to related parties when one corporation accrues an allowable deduction that is not included in the payee's income because of its method of accounting. This section provides that a taxpayer will be denied a deduction for expenses and interest payable to a related party, which are otherwise deductible under IRC §162, §163, and §212 if:

- At the close of the taxpayer's income year within which the expenses and interest accrued, the amount of the expenses and/or interest is not paid, and
- The amount has not been included in the gross income of the related party for US tax purposes because of the payee's method of accounting (i.e., the payee is subject to US tax on the income, but because the payee uses the cash method of accounting the income is not taxable until it is received).

If these conditions exist, the deduction of the expenses incurred by an accrual-method taxpayer is deferred until the amount payable is includible in the gross income of the related party using the cash method. This is referred to as the matching principle.

Example 7

A US corporation has accrued a deduction for a management fee owed to its foreign parent. The services were performed in the US and are effectively connected with the parent's US trade or business. At year's-end, the fee is unpaid.

The matching principle of IRC §267(a)(2) applies, since these payments are ECI to the foreign related party. If the foreign related taxpayer reports this income on its federal/state tax return using the accrual method of accounting, then the taxpayer can take a deduction when accrued. If the foreign person uses the cash method, then the taxpayer (payor) must use the cash method of reporting the deduction.

Example 8

Assume the same facts as in the above Example 7 except that the management fees are not US source (i.e. because the services were provided in a foreign country) and are not ECI.

Because the income is not ECI and is not US source income, the foreign payee is not subject to US tax on the payments. Therefore, IRC §267 does not apply. (Treas. Reg. §1.267(a)-3(b)(2).)

h. Cash Method Requirement IRC §267(a)(3)

IRC §267(a)(3) authorizes the IRS to issue regulations to apply the matching principle to non-US persons (foreign persons.) Regulations were issued which generally require a taxpayer to use the cash method of accounting for certain expenses that are payable to a foreign related person. (Treas. Reg. §1.267(a)-3(b).) The types of payments to foreign related parties covered by the cash method requirement are fixed or determinable, annual or periodical (FDAP) items. FDAP payments include US source interest, rents, royalties, and other fixed or determinable, annual or periodical items *that are not ECI*. (IRC §881(a)(1).) These payments are generally subject to the 30 percent federal withholding tax imposed by IRC §§1441 and 1442. The tax is imposed when the payment is made to the foreign related person. Treaties will sometimes exempt FDAP payments from tax or subject them to a lesser rate of tax. (See WEM 5 for a more detailed description of FDAP income.)

A foreign person includes an individual who is not a citizen or resident of the US, and an entity which is not a domestic corporation, partnership, estate, or trust. (Treas. Reg. §1.267(a)-3(b).)

1. Non-Interest Payments

If non-interest FDAP payments are made to foreign related persons, then the taxpayer/payor generally can only deduct the expense when payment is made. (Treas. Reg. §1.267(a)-3(b)(2).) However, if the related foreign person is exempt from income tax on the amount owed pursuant to a tax treaty, neither the cash method rule nor the matching rule apply. (Treas. Reg. §1.267(a)-3(c)(2).) In other words, the payor can deduct the expense when it accrues.

2. Interest Payments

The cash method rules of IRC §267(a)(3) and Treas. Reg. §1.267(a)-3(b) apply to FDAP interest payments (US or foreign source) made by a US person to a foreign related party if the interest is not ECI in the hands of the foreign related party. (The presence of a treaty which exempts FDAP interest payments from tax has no effect on this rule.) Thus, FDAP interest is only deductible when it is paid. (As discussed above, the matching rule of IRC §267(a)(2), rather than the cash method rule of IRC §267(a)(3), applies to interest payments that are ECI.)

Tate & Lyle, Inc. v. Commissioner (87 F.3d 99 (1996)) addressed the validity of the regulation requiring application of the cash method rule for treaty exempt interest. This case involved US source non-ECI interest payments made by a US subsidiary (the taxpayer) to its UK parent. The taxpayer borrowed money from its parent to acquire a business. The taxpayer accrued the interest expense in one year and paid it in the subsequent year. The IRS disallowed the deduction when accrued and allowed it when paid. The UK parent was not subject to the federal withholding tax on the interest because of a treaty. The Tax Court held that because the foreign parent's interest income was exempt and would never be included in gross US income, the matching principle of IRC §267 did not apply. Tax Court ruled that the regulation had stepped outside the authority of IRC §267. The appellate court overturned this decision and concluded that Treas. Reg. §1.267(a)-3 was a permissible construction of IRC §267(a)(3).

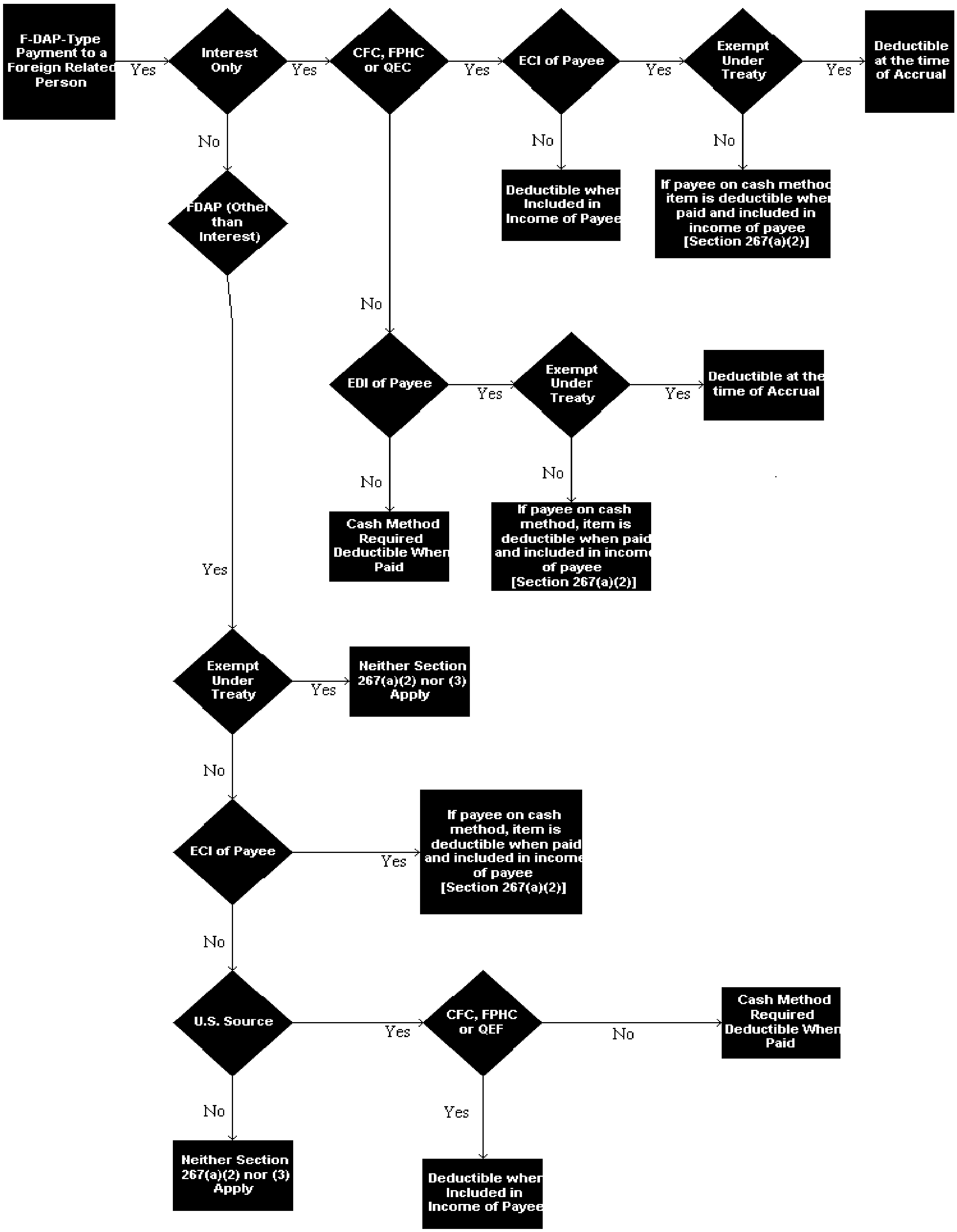
3. Water's-Edge Application

California Code of Regulations (CCR) §25110(d)(2)(F) provides that a foreign entity must include its ECI (both US and foreign sourced). Therefore, the cash method requirement of IRC §267(a)(3) will generally have no effect for California purposes if the following conditions are met:

- The income has a US source under federal law,
- The foreign entity is unitary with the taxpayer, and
- The income is business income under UDITPA

The cash method requirement will generally have no effect in these situations if the unitary foreign entity uses the accrual method of accounting, because the foreign entity is required to be included in the water's-edge combined report to the extent of its ECI. The cash basis rule would generally only apply if the foreign entity uses the cash method of accounting.

IRC §267(a)(3) cash method flowchart



i. Payments to Related Foreign Personal Holding Companies, CFCs, and Passive Foreign Investment Companies

If payments are owed to a related foreign personal holding company (FPHC), Controlled Foreign Corporation (CFC), or passive foreign investment company (PFIC), the amount is allowable as a deduction by the payor as of the day the amount is includible in the income of the related FPHC, CFC, or PFIC. The day on which the payment is includible in the entity's income is determined using the method of accounting the FPHC, CFC, or PFIC uses to compute its income and earnings and profits. (Treas. Reg. §1.267(a)-3(c)(4).)

Example 9

Pips, a US corporation, is a calendar year taxpayer that uses the accrual method of accounting. Pips owns 100 percent of the stock of Frazzle, a CFC. Frazzle computes its income and E&P using the accrual method of accounting. In Year 1, Pips accrues an interest deduction of $100,000 on a loan from Frazzle. Because Frazzle uses the accrual method of accounting, the interest is included in its Year 1 income and E&P. Therefore, Pips can deduct the interest expense in Year 1.

Example 10

Assume the same facts as Example 9, except that Frazzle uses the cash method of accounting. Further assume that the interest Pips owes Frazzle is paid by Pips in Year 3. Because Frazzle uses the cash method of accounting in computing its taxable income, the interest owed by Pips is included in Frazzle's income and E&P in Year 3. Therefore, the interest is allowable as a deduction by Pips in Year 3, not in Year 1.

Example 11

Frazzle and Dazzle, are both CFCs owned by Pips, a US corporation, and are partially included in Pips California combined report. Frazzle computes its income and E&P using the accrual method of accounting, while Dazzle uses the cash method. In Year 1, Frazzle accrues $250,000 in interest owed to Dazzle that would be allowable as a deduction by Frazzle under its method of accounting. The interest is paid to Dazzle in Year 2. Because Dazzle uses the cash method of accounting in computing its income and E&P, the interest owed by Frazzle is included in Dazzle's income and E&P in Year 2. Therefore, the interest is allowable as a deduction by Frazzle in Year 2, not Year 1.

j. Audit Concerns

IRC §267 is a potential issue whenever a taxpayer reports a material loss from the sale or exchange of property to a related party that is not included in the water's-edge group. If IRC §267 applies, the loss is not deductible until the property leaves the controlled group. Furthermore, when the loss is triggered, the amount of the loss must be substantiated.

Points to keep in mind when examining an IRC §267 issue are:

- To have an IRC §267 examination issue, a member of the combined reporting group must have losses or deductions from related party transactions. Related party is defined by a more than 50 percent ownership; make sure to apply attribution rules.

- Information on related party transactions can be identified by reviewing:
  - The corporation's books and records
  - Federal Form 1120F filed by the payee
  - Federal Form 5472, Information Return of a Foreign-Owned US Corporation or a Foreign Corporation Engaged in a US Trade or Business. Part IV of Form 5472 shows expenses being claimed by the US corporation that are owed to a foreign related person.
  - Federal Form 5471, Information Return of US Persons with Respect to Certain Foreign Corporations
  - Financial Statements and footnotes
  - SEC Forms 10-K and 20-F
  - Form 1042, Annual Withholding Tax Return for US Source Income of Foreign Persons
  - Form 1042S, Foreign Person's US Source Income Subject to Withholding. This form is only required when payment is actually made. If payment was made, collection of the withholding tax under IRC §1441 and §1442 should have occurred. Obtaining Form 1042 or Form 1042S will be a key document at audit. If Forms 1042 and 1042S have not been filed on behalf of the foreign person, there is a good chance amounts were not paid to the foreign person by the member of the combined reporting group.

- Determine if a tax treaty is applicable and its impact. Reminder: CCR§25110(d)(2)(F)1.a. provides that provisions of US treaties to the extent they limit the application of effectively connected provisions of the IRC shall not be followed.

- Inspect the balance sheet for year-end accruals of expenses to related parties.

- Was a material loss reported from the sale or exchange of property?

- A loss that has been disallowed as a tax deduction is still considered in the computation of earnings and profits.

- Other IRC sections may apply before it is necessary to apply IRC §267. For example, IRC §385, Thin Capitalization, would disallow interest expense to the extent debt is determined to be an equity investment. If large amounts of interest are being paid to the parent, the earnings stripping rules per IRC §163(j) may also be applicable. IRC §482 should also be considered when intercompany transactions are present. Thus, when a foreign person lends money at more than an arm's length rate of interest to its US subsidiary, an allocation may be necessary to decrease interest expense under IRC §482. The principals of IRC §482 apply before IRC §267(f). (Treas. Reg. §1.267(f)-1(a)(3).)

- IRC §267(f) overrides any election made by a taxpayer not to defer an intercompany transaction pursuant to the IRC §1502 consolidated return rules. Therefore, even if the selling member and the purchasing member file a consolidated federal return where an election not to defer is in effect, the selling member's loss from the sale remains deferred pursuant to IRC §267. Similarly, for California purposes the taxpayer would not be allowed to currently recognize the loss on the sale or exchange of property between related parties even if the taxpayer has consistently used the current recognition method to report intercompany transactions in a combined report. (CCR §25106.5-1(e)(2)(D)(1).)