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

DATED: December 21, 1998

MEMORANDUM FOR:

FROM: Chief, Branch 6

SUBJECT:

This Field Service Advice responds to your memorandum dated July 6, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

a =
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nn	=
oo	=
pp	=
qq	=
rr	=
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tt	=
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Activity 1	=
Activity 2	=
Activity 3	=
Activity 4	=
Activity 5	=
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Activity 7 =
Activity 8 =
Activity 9 =
Asset(s) =
Asset 1 =
Asset 2 =
Asset 3 =
Asset 4 =
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Asset 6 =
Asset 7 =
Asset 8 =
Asset 9 =
Asset 10 =
Asset Personnel =
Bank A =
Bank B =
Business =
City A =
City B =
City C =
City D =
City E =
City F =
City G =
City H =
City I =
City J =
City K =
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Contract =
Corp. A =
Corp. B =
Corp. C =
Corp. D =
Corp. E =
Corp. F =
Corp. G =
Corp. H =
Corp. I =
Corp. J =
Corp. K =

Corp. L =
Corp. M =
Corp. N =
Corp. O =
Corp. P =
Corp. Q =
Corp. R =
Country B =
Country C =
Country D =
Country E =
Country F =
Customer(s) =
Date A =
Date B =
Date C =
Date D =
Date E =
Department A =
Department B =
Department C =
Department D =
Department E =
Department F =
Department G =
Enterprise =
Entity =
Gov't Agency 1 =
Gov't Agency 2 =
Gov't Agency 3 =
Group =
Individual =
Lease A =
Location 1 =
Location 2 =
Officer =
Owner A =
Region A =
Region B =
Region C =
Tradename 1 =
Tradename 2 =

Type 1 =

Type 2 =
Type 3 =
Type 4 =
Type 5 =
Type 6 =
Type 7 =
Type 8 =
Type 9 =
Year 1 =
Year 2 =

ISSUES:

1. Whether the Service should give effect to agency agreements executed by a U.S. taxpayer and foreign controlled taxpayers, which required payments to the U.S. taxpayer of specified percentages of net income as compensation for services performed in the United States on behalf of the controlled taxpayers.

2. Whether, in the circumstances described, the Service should make adjustments pursuant to Section 482, in order to reflect the "true taxable income" of the controlled taxpayers.

CONCLUSIONS:

1. The agency agreements failed to create a principal-agent relationship. The agreements themselves were executed after the period under consideration, and the agent performed substantially all functions in the capacity of principal rather than agent.

2. Whether or not the agency agreements created a principal-agent relationship, allocations of income and deductions pursuant to Section 482 may be necessary to determine the "true taxable income" of the controlled taxpayers.

FACTS:

Corp A. is a U.S. corporation and head of a consolidated group for U.S. income tax purposes. Corp. A is owned by a publicly-held Country A corporation, Corp. B of City A. A subsidiary of Corp. A, Corp. C, performed services in connection with the Tradename 1

Enterprise. Members of the corporate group which are relevant to operation of the Tradename 1 Business are identified below.

COUNTRY A

Corp. B is the parent of a corporate group. Corp. B's stock is publicly-traded on the City A Stock Exchange.

Corp. D is a wholly-owned subsidiary of Corp. B with headquarters in City B.

Corp. E is another wholly-owned subsidiary of Corp. B with headquarters in City B.

Corp. F. is a Country A holding company which owns the Country B subsidiaries of Corp. B.

Corp. G is a Country A corporation which performs marketing services for Business in the Region A market.

COUNTRY B

Corp. A is a wholly-owned subsidiary of Corp. F. Corp. A's headquarters are in City C, and its main offices are in City L. Corp. A files a consolidated U.S. income tax return which includes over a subsidiaries.

Corp. C is a wholly-owned subsidiary of Corp. A. Corp. A's headquarters are in City D and other offices are located in City E and City F.

COUNTRY C

Corp. H is the successor corporation to Corp. I, a subsidiary of Corp. J. Corp. B acquired Corp. J in Date A. The registered office of Corp. H is in City G. Corp. H is a wholly-owned subsidiary of Corp. J.

Corp. K is also a wholly-owned subsidiary of Corp. J. The registered office is in City G.

COUNTRY D

Corp. J. was acquired by Corp. B in Date A. Corp. J is a Country D holding company, with a business address in City H. Corp. J owns Corp. H, Corp. K, and Corp. L.

COUNTRY E

Corp. L is a wholly-owned subsidiary of Corp. J with headquarters in City I.

COUNTRY F

Corp. M is a wholly-owned Country F subsidiary of Corp. C, with headquarters in City J. The Country F subsidiary provides services in connection with Tradename 1 Business in Country F Locations 1.

The Tradename 1 Group

During Years 1 and 2, Assets used in the Tradename 1 Enterprise were "operated" by controlled parties within the Corp. B group: Corp. H, Corp. K, and Corp. E.[1] The table below summarizes the ownership of the Assets during Years 1 and 2.

Business Operator	Asset	Ownership Type	Asset Owner
Corp. E	Asset 1	Owned by Corp. B	Corp. B
(Country A)	Asset 2 †	Sale-leaseback	Unrelated party
	Asset 3 †	Sale-leaseback	Unrelated party
	Asset 4 †	Sale-leaseback	Unrelated party
Corp. H	Asset 5	Hire-purchase	Unrelated party
(Country C)	Asset 6 (added on Date B)	Lease A	Unrelated party
	Asset 7	Owned by Corp. H	Corp. H
	Asset 8 (sold on Date B)	Owned by Corp. H	Corp. H
Corp. K	Asset 9	Owned by Corp. L	Corp. L
(Country C)	Asset 10	Owned by Corp. L.	Corp. L

† Corp. D was classified as the Owner A of Assets 2, 3, and 4, pursuant to hire-purchase or sale-leaseback agreements with unrelated parties: Bank A (Assets 3 and 4) and Corp. N (Asset 2). For purposes of this memorandum, these arrangements are treated as financing

[1] This memorandum refers to Corp. H, Corp. K, and Corp. E collectively as the Business operators, consistent with terminology used by the taxpayers. Use of this term does not indicate that the entities are properly classified as the Asset "operators" for any other purposes. Corp. H was both the Enterprise operator and the Asset owner with respect to Assets 7 and 8.

arrangements, rather than true sale-leasebacks. Thus, Corp D is treated as the Asset owner, although another party holds actual legal title to the Assets.

Corp. C made lease payments to the Asset owners on behalf of the Business operators. These payments, sourced from Corp. C's bank accounts, were allocated to the individual Business operators on Corp. C's general ledger. Annual lease payments were as follows:

	Year 1	Year 2
Corp. E	$b	$f
Corp. H	c†	g††
Corp. K	d	h
Total:	$e	$i

† Consists of "net interest" for Asset 5, which was subject to a ten-year hire-purchase agreement with Corp. O, an unrelated party.

†† Consists of "net interest" for Asset 5 (see above), plus Lease A payments for Asset 6 to Corp. P, an unrelated party.

Corp. C did not claim the above amounts as deductions on the consolidated U.S. income tax return filed by Corp. A. Because the Asset-lease payments reduced "net Business income" and therefore reduced the compensation earned by Corp. C (see discussion below), the Service examined the lease payments. The report applied a return-on-capital calculation, based on acquisition costs of the individual Assets, to estimate the arm's- length Type 1 lease rate for each Asset. The report determined that, as compared to the fair market value of the Type 1 leases, lease payments to controlled taxpayers were overstated by $j and $k for Years 1 and 2 respectively.

Agency Agreements Between Controlled Taxpayers

Pursuant to various agreements, Corp. C performed services as an "agent" of the Business operators. According to one agreement, Corp. C "handle[d] the marketing and management of certain operations of the Assets exclusive of the actual operation of such Assets and the Type 3 services related thereto."

Corp. C incurred all expenses associated with these functions, which it accrued on its general ledger for accounting purposes. Corp. C received agency fees on a semi-annual basis, as follows: (1) sales and marketing fee: based on a graduated percentage of net Business revenue; (2) Activity 1 fee: based on a graduated percentage of net Type 2 revenue; (3) Activity 2 fee: based on a fixed percentage of net Business revenue; (4) Activity 3 fee: based on a fixed percentage of net Type 4 costs; and (5) Activity 4 fee: based on a graduated percentage of net Business revenue.

Under a two-tier arrangement, Corp. C provided Type 3 services to the Asset operators, consisting of

and similar services. First, Corp. H entered into "Type 3 Services and Agreements" with Corp. K and Corp. E for providing Type 3 services and Type 3 personnel for Assets 1, 2, 3, 4, 9 and 10. Second, Corp. H subcontracted with Corp. C pursuant to "Type 3 Agreements," requiring Corp. C to provide Type 3 services, Type 3 personnel, and Type 3 for the entire Tradename 1 Group (i.e., the above Assets plus Assets operated by Corp. H: Assets 5, 6, 7, and 8). For ease of reference, we will refer to these agreements collectively as "Tier 1" and "Tier 2" agreements.

Under the Tier 1 agreements, Corp. K and Corp. E paid Corp. H for Type 3 services. The amounts were as follows: reimbursement of the cost of providing the Type 3 personnel (including Type 5 costs), base management fee based on a graduated percentage (l%) of net Business revenue, incentive fee of m% of net profit before interest, and finance and administration fee of n% of net Business revenue.

Under the Tier 2 agreements, Corp. H paid Corp. C to provide Type 3 services specified in the Tier 1 agreements, as well as certain other services. Payments to Corp. C under these agreements were as follows: base management fee based on a graduated percentage (o%) of net Business revenue, an incentive fee equal to p% of net profit before interest, and a finance and administration fee equal to q% of net Business revenue.

The Tier 1 agreements (Type 3 Services and) differed from the Tier 2 agreements (Type 3) in several respects. For example, the Tier 1 agreements did not mention , whereas the Tier 2 agreements required Corp. C to provide such services. Also, agency fees under the Tier 1 and Tier 2 agreements were calculated on different bases, resulting in reduced compensation to Corp. C. Fees paid under the agreements in Years 1 and 2 were as follows:

Year 1 Year 2

	Total	Per Asset	Total	Per Asset
Tier 1: payments to Corp. H	$r	$t	$v	$x
Tier 2: payments to Corp. C	$s	$u	$w	$y

Corp. H had only limited staff. For example, the Tier 2 agreement called for Corp. C to recruit and manage Type 3 services workers, all designated as Corp. H employees by the Tier 1 agreement. However, the Location 2 workers in question were Corp. C employees, who had been hired by Corp. C. During Business, the Location 2 workers reported to the Asset's Individual, who in turn reported to Corp. C's Officer. At Location 2 managers also reported to executives of Corp. C, rather than Corp. H. Discounting the Location 2 individuals who were nominally classified as Corp. H employees, Corp. H had only z employees, all of whom were located in City H. These individuals' duties were limited to payroll disbursement and arranging Type 4 transport for the Location 2 "employees" of Corp. H.

Although Corp. E hired Asset Personnel for Assets 1, 2, 3, and 4, these personnel reported to Corp. C executives in performing their duties. Corp. E hiring personnel reported directly to Officer at Corp. C.

None of the agency agreements at issue was in existence during Years 1 and 2. Aa of the bb agreements were executed immediately before the IRS examination team's initial meeting with Corp. C personnel on Date C. The other cc agency agreements are undated. The taxpayer contends that it operated the Tradename 1 Assets in a manner consistent with the agency agreements, although the agreements were executed after the period under audit.

Operations and Group Activities

The following is a partial listing of activities performed by Corp. C.

Activity 1.

The Contracts issued to Customers stated that Corp. C entered into the Contracts as an agent for the Entity. Entity was defined as the Asset named in the Contract, its owners, operators, managers, and . The only entity specified by name on the Contracts was Corp. C.

Activity 4.

Supplies and Activity 7. Individuals submitted requests for

to Corp. C's Department D.
were not Business-specific. These costs were aggregated monthly to specific Business and charged to Business operators. Corp. E arranged for Activity 9 if the Asset in question was
Corp. C arranged for Activity 7 in all other cases.

Activity 5. Location 2 personnel faxed Type 6 orders to Corp. C's offices in City D or City E prior to Date E. Corp. C filled the orders and delivered the materials. In some cases, personnel purchased local supplies during the Business. Bills for all Type 6 purchases were sent to Corp. C's Department E. Type 6 expenses were allocated to the Business operators, based on Business and Asset, via entries on Corp. C's general ledger.

Activity 8. Inventory was ordered and accounted for in the same manner as Type 6.

Activity 9. Corp. C's Department F arranged all Activity 9. Expenses were allocated to Business operators by Business and Asset on Corp. C's general ledger.

Location 2 Revenue. Location 2 Type 6 and

Accounting. Substantially all income and expenses of the Business operators flowed through Corp. C accounts in City D. Corp. C's Department G used an accounting system which keyed items to individual Business and derived a total by Business operator. Business-specific items were allocated to individual Business, whereas general and administrative expenses (such as Corp. C's data processing, Activity 1, sales, corporate relations, etc.) remained on Corp. C's ledger. The Business operators' balance sheets listed virtually no liquid assets, other than minimal amounts of cash on-hand in Location 2.

Trademarks. Corp. C is the registered owner of most Tradename 1 trade and service marks in the United States. Corp. C also maintained the Tradename 2 trade and service marks pursuant to an agreement with Corp. Q. Corp. C spent substantial amounts to promote and defend the trademarks, including litigation.

Legal Services. Corp. C was named as the party of record and appeared in various civil, criminal, administrative, and excise tax proceedings which related to Business operations. The agency agreements stated that Corp. C was not authorized to accept service of process on behalf of the Business operators. However, Corp. C accepted service of process in its own right, appeared in actions, and otherwise held itself out to the general public, creditors, and government agencies as the operator of the Tradename 1 Business.

U.S. Income Tax Reporting by Corp. C and Affiliated Parties

Consolidated U.S. income tax returns filed by Corp. A reported that Corp. C derived net income from the agency agreements of approximately $gg and $hh million in Years 1 and 2, respectively. Corp. A reported net operating losses of $ii and $jj million in Years 1 and 2, respectively. Data provided by Corp. C's outside tax advisors indicates that the Business operators in the aggregate earned gross income from U.S. Business operations of $kk and $ll million in Years 1 and 2, respectively.

In Corp. A's consolidated U.S. income tax returns for Years 1 and 2, Corp. C reported annual commissions received from the Business operators. For Years 1 and 2, each Business operator also filed U.S. income tax returns, claiming that

For Year 1, Corp. H, Corp. K, and Corp. E respectively claimed

LAW AND ANALYSIS:

Introduction

In order to determine the taxable income of Corp. C, the Service must first evaluate whether the agency agreements between Corp. C and the Business operators should be respected for U.S. tax purposes. The capacity of the agreements to create a valid agency relationship is determined by analysis of the language of the agreements and the actual conduct of the parties, in view of judicial precedents. This analysis is performed in the first section herein.

In the second section, we consider whether the income reported by Corp. C constituted its "true taxable income" within the meaning of Section 482 and the regulations thereunder. Section 482 vests the Commissioner with broad authority to reallocate income and deductions of a controlled party, to determine what its income would have been had it conducted its activities on an arm's-length basis. Importantly, the Commissioner may exercise this authority whether or not he determines that the agency agreements created valid agency relationships: "The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer . . . been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Treas. Reg. § 1.482-1(c) (1968).

If the Service concludes that no agency relationship was created, the "true taxable income" of Corp. C must be determined by reference to the amount Corp. C would have earned dealing at arm's length with unrelated parties. Treas. Reg. § 1.482-1(b) (1968). That is, Corp. C was entitled to the gross income from U.S. Business operations, from which Corp. C was permitted deductions, including: (1) arm's-length rental charge for Assets leased

from the Business operators, pursuant to Treas. Reg. § 1.482-2(c) (1968), and (2) arm's-length compensation for services provided by the Business operators, pursuant to Treas. Reg. § 1.482-2(b) (1968).

On the other hand, if the Service concludes that an agency relationship existed, Corp. C's "true taxable income" is determined not by reference to gross Business income net of deductions (as above), but rather by reference to arm's-length compensation for services which Corp. C provided to the Business operators. Treas. Reg. § 1.482-2 (b) (1968). In conducting this analysis, it may be possible to view the Business operators as the "tested parties," if in fact they performed functions less complex than those performed by Corp. C. That is, if the Business operators provided few services and bore few risks (aside from providing Business Assets), it may be preferable first to determine the return to which the Business operators are entitled, and then to assign the residual amount to Corp. C.

Issue 1: Validity of Agency Agreements Executed by Corp. C

Generally, income and deductions generated by property are taxable or deductible by the taxpayer who owns the property. Helvering v. Horst, 311 U.S. 112, 119 (1940); Britt v. United States, 431 F.2d 227, 229 (5th Cir. 1970). Similarly, income is taxed to the one who earns it. National Carbide Corp. v. Commissioner, 336 U.S. 433, 436, 437 n.19 (1949) , citing, Lucas v. Earl, 281 U.S. 111 (1930); United States v. Basye, 410 U.S. 441 (1973). However, under appropriate circumstances, the law may attribute the tax consequences of property held by a genuine agent to its principal. Commissioner v. Bollinger, 485 U.S. 340 (1988).

The Supreme Court has examined the issue of whether a corporate entity was an agent and therefore not taxable on duties it performed for a related principal. Three of the cases stand out as significant: Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); National Carbide Corp. v. Commissioner, 336 U.S. 433 (1949); Commissioner v. Bollinger, 485 U.S. 340 (1988). Under the standards in these cases, the showing of agency must be unequivocal. Bollinger, 485 U.S. at 349; First Chicago Corporation v. Commissioner, 96 T.C. 421, 445 (1991), aff'd, 135 F.3d 457 (7th Cir. 1998). As such, the finding of agency is "narrowly restricted." Northern Indiana Public Service Co. v. Commissioner, 105 T.C. 341, 348 (1995), aff'd, 115 F.3d 506 (7th Cir. 1997).

In Moline Properties, the taxpayer argued that gains should not be recognized by a corporation, but rather by its sole shareholder. The Supreme Court refused to ignore the corporate form for tax purposes even though the corporation involved was completely dominated by its shareholder and appeared to lack beneficial ownership of its assets and income. The Supreme Court held that a corporation remains a separate taxable entity so long as its "purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation." 319 U.S. at 438-39.

This is known as the “separate entity doctrine” and it is important for the consideration of agency because it establishes that the corporate entity cannot be easily set aside. That is, “a corporation formed or operated for business purposes must share the tax burden despite substantial identity with its owner.” National Carbide, 336 U.S. at 429 . As a consequence, the separate entity doctrine “demands proof positive that the agency relationship exists separate and apart from the subsidiary's ownership by its principal, and that it is not in substance a tax-avoiding manipulation of an otherwise independent legal entity.” First Chicago, 96 T.C. at 445.

Moline Properties essentially equated the “agency” issue with piercing the corporate veil. See National Carbide, 336 U.S. at 430; Moline Properties , 336 U.S. at 440. However, National Carbide distinguished this concept of agency from the one applicable to its own case, because its taxpayer was not attempting to pierce the corporate veil but instead arguing that the purported agent should be taxed only to the extent of “agency” income. That is, the taxpayer recognized the corporate entity but wanted to limit its income under an “agency” agreement. In this sense, the present case is like National Carbide rather than Moline Properties.

National Carbide Corp. v. Commissioner, 336 U.S. 433, 437-438 (1949), listed six conditions or factors that must be considered in determining agency under its facts: (1) whether the corporation operates in the name and for the account of the principal, (2) whether the corporation binds the principal by its actions, (3) whether the corporation transmits money received to the principal, (4) whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal, (5) whether the corporation’s relations with its principal are dependent upon the fact that it is owned by the principal, and (6) whether its business purpose is the carrying on of the normal duties of an agent. The first four factors have been called "indicia" of agency and the last two called "requirements" for the finding of agency. First Chicago, 96 T.C. at 444-45.

In National Carbide, three wholly-owned subsidiaries of a corporation explicitly agreed under written contracts to operate their production plants as "agents" for the parent. The parent was to furnish working capital, executive management and office facilities for its subsidiaries. They, in turn, agreed to pay the parent all profits in excess of six percent on their outstanding stock , which in each case was a nominal sum. The subsidiaries reported as gross income only this sum, but the Commissioner concluded that they should be taxed on the entirety of the profits because they were not really agents.

The Supreme Court agreed. The Court refused to recognize the shifting of income under the "agency" contracts, noting that income should be taxed to the parties who earn it, despite anticipatory agreements. 336 U.S. at 436. The Court found that such an agreement is entirely consistent with controlled corporate relationships and no sure indication of agency. Id. The Court instead looked to the extensive assets, the thousands of employees and the

resulting large sales of the subsidiaries and determined that the vast majority of the earnings were turned over to the parent because it owned and dominated the subsidiaries. Terms were such that the parent could not have commanded the income from a third party. 336 U.S. at 438. In language that also suggested assignment of income, the Court noted that "[i]n the case of a subsidiary who supplies the labor and the capital with which the income is earned . . . it can hardly be contended that it did not earn the income." 336 U.S. at 437 n.19. Looking again to the listed factors, each subsidiary had also represented to its customers that it (not the principal) was the company manufacturing and selling its products, and each had sought to shield the principal from service of legal process. National Carbide, 336 U.S. at 436-39.

In Bollinger, the Supreme Court found that a corporation was acting as an agent for another entity in circumstances very different from the present case. Mr. Bollinger was a Kentucky real estate developer who used corporations formed solely for the purpose of acting as agent to avoid State usury laws for financing purposes. Lenders were willing to finance at eight percent and required the use of a corporate nominee in order to steer clear of the State usury statute. Mr. Bollinger entered into written agreements with the corporations he formed providing that the corporations would hold legal title to the realty solely for the purpose of securing financing, that the corporations were to act as agents, and that Mr. Bollinger would indemnify and hold the corporations harmless for any liability that they might sustain as agents and nominees. The parties to the transactions were aware that the corporation had been interposed as agent or nominee solely for purposes of avoiding usury prohibitions.

In Bollinger, the Supreme Court upheld the six National Carbide factors, but added a further gloss for determining whether an agency relationship exists. In addition to the six National Carbide factors, the genuineness of an agency relationship is "adequately assured" when the fact that the corporation is acting as agent for its shareholders with respect to a particular asset is (1) set forth in a written agreement at the time the asset is acquired, (2) the corporation functions as agent and not as principal with respect to the asset for all purposes, and (3) the corporation is held out as the agent and not principal in all dealings with third parties relating to the asset. Bollinger, 485 U.S. at 349-350.

In Bollinger, the Court agreed with the Commissioner that the normal indicia of agency cannot suffice for tax purposes when, as in Bollinger, the alleged principals are the controlling shareholders of the alleged agent corporation. In that instance, the shareholders of a closely-held corporation could, by clothing the corporation with some attributes of agency with respect to particular assets, leave themselves free at the end of the tax year to make a claim of either agent or owner status, depending upon which choice minimizes their tax liability. 485 U.S. at 345-46. In deciding that Mr. Bollinger was the taxpayer, the Supreme Court pointed to the written agreements between the principal and agent indicating that the corporation was to act as an agent, that the principal would indemnify the agent for

liability they may sustain as agents, and the parties dealing with the corporation were aware that it was acting as an agent.

In factual circumstances distinguishable from Bollinger, assertions that one corporation is acting as an agent are rarely upheld. See, e.g., Bamblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992); Northern Indiana ; First Chicago; Charfoos v. Commissioner, T.C. Memo. 1991-292. Compare Advance Homes, Inc. v. Commissioner, T.C. Memo. 1990-302, where "agency" was found on facts clearly distinguishable from the present case.

In Northern Indiana, the Service argued unsuccessfully that a Netherlands Antilles subsidiary of the taxpayer was its agent. The subsidiary's only activity was to borrow money by issuing Euronotes and then lend the proceeds to the taxpayer at an interest rate one percent greater than the rate on the Euronotes. This arrangement kept the taxpayer from paying withholding taxes on interest paid to nonresident aliens, because Netherlands Antilles corporations were exempted.

In rejecting a finding of "agency," the court stated,

> these instances have been rather narrowly restricted to situations where the corporation's role as agent is made clear; e.g., where the agency relations is set forth in a written agreement, the corporation functions as an agent, and the corporation is held out as an agent in all dealings with third parties related to the transaction.

Northern Indiana, 105 T.C. at 341, citing Bollinger.[2]

The facts of the present case do not meet the Bollinger requirements. No written agency agreements governed Corp. C's role in Tradename 1 Region C operations in Years 1 and 2. None of the agency agreements covering the Assets for Years 1 and 2 were signed prior to Date D. But see Advance Homes, not requiring a written contract. Corp. C did not act as an agent with respect to Tradename 1 Region C operations for all purposes. In fact, Corp. C functioned as a principal with respect to almost all of Tradename 1 Region C operations. Corp. K did not have a bank account, and Corp. H and Corp. E did not have U.S. bank accounts. Except for year-end accounting reconciliations, there is no evidence that any Business income was turned over to the Business operators. Marketing, Type 4, and Type 7 services were provided by Corp. C, with no reference to or mention of the Business operators. See Heaton v. Commissioner, T.C. Memo. 1989-459, aff'd, 920 F.2d 12 (11th Cir. 1990). Based on the facts available, Corp. C seldom identified itself as an agent when dealing with third parties. With the exception of the Type 7 contract (which did not specifically identify the Business operators as principals), and the Location 1 agent fee

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[2] Northern Indiana was decided before the conduit regulations under section 7701(l).

contract with Corp. M, Corp. C generally held itself out as the principal, not the agent, when dealing with third parties in Business-related matters. In addition, Corp. C appeared in, contested, and settled lawsuits arising from Business operations in its own capacity, rather than as an agent for any other party.

The facts of this case also fail to satisfy the conditions required by National Carbide to establish an agency relationship. Corp. C executed most contracts in its own name; rarely in the name of the alleged principals. Based on these contracts, the alleged principals were not bound by Corp. C's actions. Business income was not transmitted to the alleged principals. Business income was attributable to services of employees of Corp. C rather than employees of the Business operators. Corp. H had z employees in City H, mainly to generate payrolls. Corp. K and Corp. E had no Location 2 employees. There is no evidence that Corp. C's agency relationship existed separate and apart from its relationship with its commonly-owned alleged principals. In fact, it appears that the parties attempted to create an agency primarily for tax-avoidance motives.

Most important, the business purpose of Corp. C does not reflect carrying on the normal duties of an agent. In a normal agency contract, the agency makes a monthly accounting to the principal. At that point, the principal reimburses the agent's expenses, and pays an additional fee. Normally, the agent works with the principal's money in the form of an advance. Thus, the monthly fee covers the agent's administrative expenses that are not reimbursable. In this case, Corp. C controlled all funds, alleged principals' and agent's, in its Bank A accounts. Corp. C reported to its own officers monthly; it did not report to the alleged principals' officers. Corp. C only accrued commission income every six months. Corp. C did not receive monthly commission income to offset unreimbursed administrative expenses. In this case, in contrast to a traditional agency relationship, Corp. C's expenses were not reimbursed by the alleged principals. Transfers were handled through intercompany accounts and general ledger allocations. Corp. C acted more as a controlling manager, principal or partner, than as an agent.

In the majority of all contracts, agreements and court proceedings, Corp. C was identified as Tradename 1 Business. Corp. C represented itself as the Asset operator in U.S. District Court suits, in dealings with Government Agency 1, Government Agency 2, Government Agency 3, and the IRS for excise tax purposes. These representations cannot be changed to suit the corporate parent's purposes. See Huddleston v. Commissioner, 100 T.C. 17 (1993); Talavera v. School Bd. Of Palm Beach County, 129 F.3d 1214 (11th Cir. 1997); Rissetto v. Plumbers and Steamfitters Local 343, 94 F.3d 597 (9th Cir. 1996).

Based on the staffing in the organizational charts, Corp. C was the only entity with staff to perform Asset operations, and Corp. C admitted that it performed all such functions. Thus, Corp. C, even more so than the subsidiaries in Union Carbide, was operating its own

business, and not functioning as an agent, which would have required it to act only on behalf of its principal. The argument that Corp. C was acting only as an agent lacks merit.

In addition, Bollinger does not list all the requirements for agency status, but rather describes factors which led to the conclusion that agency status existed in that case. Charfoos v. Commissioner, T.C. Memo. 1991-292; Advance Homes, Inc. v. Commissioner, T.C. Memo. 1990-302. Therefore, other factors indicating agency may be relevant. Advance Homes.

Two additional factors, which have been called essential to a finding of agency, are absent here, i.e., an agent must derive authority for its actions from the principal and must be subject to the principal's control. Consistent with this assertion, the Restatement, Second, Agency § 1, defines "agency" as "the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control and consent by the other so to act." This definition of "agency" has been relied upon by the courts. See, e.g., K Mart Corp. v. First Hartford Realty Corp., 810 F. Supp. 1316, 1329 (D. Conn. 1993); Vitin Garment Manufacturing Corp. v. Shreck Wholesale, Inc., 827 F. Supp. 847, 850 (D. P.R. 1993). Even more explicitly, the definition of "agency" in Black's Law Dictionary 40 (6th ed. 1991) includes the following references to requirements of control and derived authority :

> Relation in which one person acts for or represents another by latter's authority.... The relation whereby one party delegates the transaction of some lawful business ... to another.... Or relationship where one person confides the management of some affair, to be transacted on his account, to other party. Or where one party is authorized to do certain acts for, or in relation to the rights or property of the other. But means more than tacit permission and involves request, instruction, or command. The consensual relation existing between two persons, by virtue of which one is subject to other's control.

See also 2A C.J.S. Agency § 4.

The factors of control and derived authority were not discussed in Bollinger, National Carbide, and Moline Properties, because in those cases the purported "agent" was completely dominated by the purported "principal," and there was no question that the authority to act was derived from the principal. Rather, those cases dealt with the issue that control itself is not sufficient to establish agency. That control in itself is insufficient does not undercut the assertion that control may be necessary to establish agency, and the agent's authority to act must be derived from the principal. In the present case, there is no showing that Corp. C was controlled by the alleged principals or in any way derived its authority from them. The evidence is instead to the contrary. This distinction from Bollinger, National Carbide, and Moline Properties actually makes the present case stronger. In addition, there is a related

principle we have not explored: that an agent cannot serve two masters. See Rev. Rul. 59-247, 1959-2 C.B. 14.

A final factor relevant to the agency inquiry is whether the agent was adequately compensated for the functions it performed. See Vaughn v. United States, 740 F.2d 941, 945-46 (Fed. Cir. 1984). For a genuine agency agreement to exist, the parties must deal with each other at arm's length, and the agreement must provide for adequate compensation, such that an unrelated party would have executed the agreement. See id. and citations therein. The conclusion in Vaughn is also implicit in National Carbide, which noted that the "entire earnings" of the subsidiaries were turned over to the parent, "not because the latter could command this income if the [subsidiaries] were owned by third persons, but because it owns and thus completely dominates the subsidiaries." 336 U.S. at 438. Although Vaughn was decided before Bollinger, it is reconcilable with Bollinger on its facts. See Cruz v. Commissioner, T.C. Memo. 1990-594. To the extent that Corp. C did not receive arm's-length consideration for services performed for the Business operators (see discussion infra), this is an additional factor indicating that no agency relationship was created.

In our view, based on the facts in this case, Corp. C did not act as an agent on behalf of the Business operators.

Issue 2: Allocation of Income and Deductions Pursuant to Section 482

Section 482 provides as follows:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

Section 482 provides the Commissioner with broad authority to re-allocate income, deductions, credits, and other items among controlled parties. The Corp. A subsidiaries are subject to I.R.C. § 482 due to their common owner. In evaluating a transaction between related parties, the critical inquiry is "whether the transaction in question would have been similarly effected by unrelated parties dealing at arm's length." Ciba-Geigy Corp. v.

Commissioner, 85 T.C. 172, 221 (1985). If not, the Service has authority to re-allocate income and deductions to achieve an arm's length result.

The 1968 regulations, Treas. Reg. § 1.482-1 and following, are controlling, unless the taxpayer elects to apply the 1994 regulations on a retroactive basis. Treas. Reg. § 1.482-1(j)(2) (1994). We understand that neither Corp. A. nor Corp. C has made an election to have the 1994 regulations apply to Years 1 or 2. Thus, we cite primarily to the 1968 regulations, but also refer to the 1994 regulations, which in many instances re-state or explain provisions contained in the 1968 regulations. See T.D. 8552, 1994-2 C.B. 93, 105-06.

In this memorandum, we provide advice regarding potential Section 482 allocations under two distinct scenarios: (1) Scenario 1: the agency agreements between Corp. C and the Business operators did not create an agency relationship, and Corp. C was entitled to gross Business income; and (2) Scenario 2: the agency agreements created an agency relationship, and the Business operators were entitled to gross Business income. The following reviews an analysis of the transactions under both scenarios, in the event that the Service determines Section 482 adjustments on an alternative basis.

Scenario 1: Agency Agreements Rejected; Corp. C Is Principal

If the agency agreements failed to create a valid principal-agent relationship, Corp. C was entitled to the gross income from Business operations. In that event, Corp. C must compensate the Business operators on an arm's-length basis for services and tangible property which the operators furnished in connection with the Business business. The main compensation due to the Business operators consisted of payments for use of Assets. In the original tax returns, lease payments to Asset owners reduced "net Business income," which in turn reduced the agency fees obtained by Corp. C under the agreements. Thus, under the theory used to approach used in the Corp. A tax return, to the extent that lease payments were inflated, the fee income earned by Corp. C was reduced, albeit indirectly. In contrast, if the Service disregards the agency agreements, the Asset lease payments would become direct deductions from Corp. C's gross income.

In general, lease payments for property owned by controlled taxpayers must reflect the arm's-length rental value of the property. Treas. Reg. §§ 1.482-2(c) (1968), 1.482-2(c) (1994). Based on our understanding of the Business operators' business activities, the cost-based "safe harbor" provision would not apply, and the arm's length lease payments for the

Assets should be determined by reference to payments for comparable Assets on the open market.[3]

Corp. C is also entitled to deduct from gross income arm's-length compensation for services provided by the Business operators. Treas. Reg. §§ 1.482-2(b) (1968), 1.482-2(b) (1994). The Business operators performed services, including hiring, payroll, union contract negotiations, Activity 7, and general management. If, as is likely, these services constituted an "integral part" of the Business operator's business activity, then compensation for such services should be based on market value of the services, rather than the costs incurred by the Business operators to provide the services. Treas. Reg. §§ 1.482-2(b)(7) (1968), 1.482-2(b)(7) (1994). Services provided by the Business operators were relatively limited, in the context of overall operations of the Tradename 1 Enterprise. Accordingly, Corp. C's deductions for these services will likely be small, even if they are calculated on the basis of market value of the services.

If the Service rejects the agency agreements, the net effect would be to allocate to Corp. C 100% of Type 8 income, subject to the deductions discussed above.[4] As a practical matter, this is equivalent to a finding that Corp. C assigned income to the Business operators. In cases of potential overlap between I.R.C. §§ 61 and 482, the courts generally prefer to rely upon the latter provision to allocate income. Rubin v. Commissioner, 429 F.2d 650, 653-54 (2nd Cir. 1970), aff'd after remand, 460 F.2d 1216 (2nd Cir. 1972); Keller v. Commissioner, 77 T.C. 1014, 1031 (1981). Under these circumstances, Section 482 is deemed to permit a "more precise" determination of income than Section 61 or Section 162. Fogelsong v. Commissioner, 621 F.2d 865 (7th Cir. 1980) (personal services provided by individual).

Scenario 2: Agency Agreements Respected; Business Operators Are Principals

If a reviewing court determines that the agency agreements were valid, the gross income from U.S. Business operations would be attributable to the Business operators. However, in that event, Corp. C would be entitled to arm's-length compensation for all

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[3] We have assumed the view in the report that entities within the Corp. A group had de facto ownership of all Assets other than Asset 6 (which was subject to an arm's-length Lease A). Accordingly, Treas. Reg. § 1.482-2(c)(2)(iii)(A) (1968), which addresses subleases of property owned by non-controlled parties, is not applicable to this case. However, if the sale-leasebacks to non-controlled parties are respected, this provision of the regulation would apply.

[4] If the Service allocates 100% of Business income to Corp. C, the controlled taxpayers may be entitled to an offset pursuant to I.R.C. § 482. Treas. Reg. §§ 1.482-1A(d)(3) (1968), 1.482-1(g)(4) (1994). This Memorandum does not address the availability of such an offset.

services performed on behalf of the Business operators and other controlled taxpayers. E.g., InverWorld, Inc. v. United States, T.C. Memo. 1996-301 (U.S. corporation performing services on behalf of controlled parties must earn arm's length return for those services); Hospital Corp. of America v. Commissioner, 81 T.C. 520, 586-87 (1983) (foreign subsidiaries were not shams, U.S. entity entitled to arm's length return on functions performed). Consequently, Section 482 remains relevant if the agreements are viewed as creating an agency relationship.

In order to determine Corp. C's "true taxable income" under Scenario 2, the Service must determine the arm's-length compensation for services performed by Corp. C on behalf of the Business operators and other controlled taxpayers. Treas. Reg. §§ 1.482-2(b) (1968), 1.482-2(b) (1994). Controlled parties other than Corp. C provided the Business Assets and performed some ancillary and corporate-oversight functions. However, Corp. C performed virtually all other functions necessary to Business operations. Because Corp. C's principal activity was day-to-day operation of Business, the services it provided constitute an integral part of its operations for purposes of Section 482. Treas. Reg. § 1.482-2(b)(7)(ii) (1994). Thus, the arm's-length charge for Corp. C's services consists of the amount which "would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts." Treas. Reg. § 1.482-2(b)(3) (1994).

Although the regulations require the Service to determine the "value" of the services provided by Corp. C, it may be difficult to assign an arm's-length value to these services by reference to comparable uncontrolled transactions. We understand that only a few competitors are comparable to Tradename 1, and most or all are vertically-integrated. Therefore, the Service will probably need to use an alternative methodology in order to assign a value to the services performed by Corp. C.

Assuming that Corp. C bore substantially all the risks of the U.S. Business operations, it may be appropriate to perform a residual analysis. Under this approach, the Service would first determine the arm's-length charge for leases of the Business Assets provided by the Business operators.[5] After deducting that charge and other appropriate amounts, the Service should allocate to Corp. C most or all of the residual from Business operations. See Hospital Corporation, 81 T.C. 600-602 (75% allocation to party which performed most functions with respect to transferred contracts). The 1994 regulations regarding the comparable profits method specifically contemplate analysis of profits earned by the "least complex of the controlled taxpayers." Treas. Reg. § 1.482-5(b)(2)(i), -5(e) Ex. 4 (1994). See also Treas.

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[5] This deduction would include fair-market lease payments of Assets supplied by Corp. H. The report contained estimated Type 1 lease values for these Assets, although they were either owned by Corp. H (Assets 7 and 8), subject to hire-purchase agreement (Asset 5), or subject to a Lease A with an unrelated party (Asset 6).

Reg. § 1.482-2(e)(3), Exs. 1 and 2 (1968) (in applying resale price method, Service may select party which would require fewest adjustments).

A conclusion that the agreements created an agency relationship does not require that the Service also accept the agreements for purposes of Section 482. In the context of Section 482, an agreement between controlled parties is valid only if the parties actually followed the agreement, and only if the agreement otherwise conformed with the "economic substance" of the transactions. Treas. Reg. § 1.482-1(d)(3)(iii) (1994). In this context, "economic substance" is determined by reference to the risks borne by the parties, and the extent (if any) to which the written agreements re-allocated such risks from one party to another. Treas. Reg. § 1.482-1(d)(3)(iii)(B) (1994) (emphasis added). See also Temp. Treas. Reg. § 1.482-1T(c)(3)(ii)(B) (1993) (applying similar criteria).

Arguably, the agency agreements failed to shift risks to parties other than Corp. C. For example, it is doubtful whether the Business operators could bear the risks assigned to them by the agreements, because their balance sheets contained virtually no liquid assets. In addition, Corp. C incurred liabilities, made expenditures, supervised personnel, and otherwise acted as if it were conducting the U.S. Business activity on its own behalf. Only by means of entries on Corp. C's general ledger and other year-end accounting reconciliations were the controlled taxpayers placed in the economic position contemplated by the agreements. If functional and risk analysis confirms this view, it may be appropriate for the Service to rely upon the "economic reality" of the underlying transactions, rather than the agency agreements, for purposes of identifying comparable parties or transactions under Section 482.

Finally, we note that Corp. C generated taxable income of $uu million on gross receipts of $vv million in Year 1, and reported a net loss of $ww million on gross receipts of $yy million in Year 2. If Corp. C was acting as an agent of the Business operators, it arguably should have earned positive net returns for both years, as a true commission agent operating at arm's length would simply decline to perform if it was likely to generate a net operating loss. See generally National Semiconductor Corp. v. Commissioner, 67 T.C.M. 2849, 2873 (1994) ("[D]ue to the interdependent nature of their relationship, petitioner should not have sustained losses over the years in issue while the Asian subsidiaries maintained high profits and, thus, in order to clearly reflect income, some adjustment needs to be made."). The fact that Corp. C generated a net operating loss in Year 2 is inconsistent with an agency relationship.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

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If you have any additional questions, please contact Branch 6 at (202) 874-1490.

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