I.R.S. DEFINES MEASURE FOR TAX RATE DISPARITY TEST

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In order to reduce its overall foreign tax rate, a company may attempt to separate its foreign manufacturing from its foreign sales operations. If a foreign manufacturing entity sells products at a low margin to a related foreign sales entity in a low-tax jurisdiction, less foreign taxes are paid than if the foreign manufacturing entity sold the products directly to customers. This type of transaction would generally trigger foreign base company sales income ("F.B.C.S.I.") for the sales entity, while the manufacturing entity could rely on the exception whereby income produced by certain manufacturing activities is not included in F.B.C.S.I. (the "Manufacturing Exception").[1]

If not for a "Branch Rule," one potential way to avoid F.B.C.S.I. would be to have the manufacturing entity sell products to its branch or disregarded entity in a low-tax jurisdiction; from a U.S. tax perspective, the manufacturing entity is selling directly to customers. To prevent such abuse, the Branch Rule provides that the Manufacturing Exception will not apply if the sales and manufacturing activities are located in different jurisdictions and certain thresholds are met.

The Branch Rule will apply where the activities of the branch have "substantially the same effect" as those of a wholly-owned subsidiary, as determined using a tax rate disparity test (the "Tax Rate Disparity Test").[2] If the Branch Rule applies, the entity will not be treated as a branch but rather as a wholly-owned subsidiary of the C.F.C and will itself be subject to F.B.C.S.I. rules. The I.R.S. recently issued chief counsel advice as to how the Tax Rate Disparity Test should be applied.[3]

The Tax Rate Disparity Test consists of comparing the applicable tax rate in the C.F.C.'s country of incorporation to the tax rate where the branch is located, in order to determine whether the sales income (where the branch is located) is subject to a tax rate that is less than 90% of (and at least 5% lower than) the tax rate it would have been subject to if it were located in the manufacturing location. According to the recently released chief counsel advice, the calculation should be made by dividing the actual tax and the hypothetical tax by the hypothetical tax base determined under the laws of the manufacturing jurisdiction.

If a tax rate disparity exists, the entity will not be treated as a branch, but rather as a wholly-owned subsidiary of the C.F.C., and the Manufacturing Exception will not apply. Accordingly, the sales income would be treated as part of F.B.C.S.I.

1 Code §954(d)(1).

2 Treas. Reg. §1.954-3(a)(2)-(4).

3 I.R.S. AM 2015-002, February 9, 2015.