TAXPAYERS TAKE NOTE: I.R.S. PUBLISHES AUDIT GUIDES FOR INTERNATIONAL EXAMINERS

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Tags
Branch Rule
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Intangible Property
International Practice Units
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Penalties
Subpart F

The Large Business & International ("LB&I") Division of the I.R.S. is responsible for examining tax returns reporting international transactions. It is in the process of revising the method by which returns are chosen for examination and the the process by which those examinations are conducted. As part of the announced changes, it has published the guidance given to international examiners developing issues as part of an examination.

Historically, wide latitude was given to field examiners to identify and develop issues in the course of an examination. With budget cuts in the I.R.S., there is an emphasis on analyzing how the examination process can be conducted more efficiently. The decision reached is to identify returns and issues through a centrally controlled process. Once an examination begins, LB&I will control the process that will be followed by the examiners.

The goal is to expand the examination base to cover companies with assets between $100 million and $1 billion. According to the I.R.S., taxpayers within this group are "underserved" by the I.R.S. To standardize the process, examiners are being retrained and guidance on specific issues has been prepared in the form of the International Practice Units ("I.P.U.'s"). By the latter part of 2015, 128 I.P.U.'s were prepared and 65 of those I.P.U.'s were published. The I.R.S. believes that this will facilitate the completion of audits because taxpayers and their advisers will not be surprised by detailed document requests designed to generate facts upon which a reasoned decision can be made regarding an adjustment.

In this edition of *Insights*, we address the following International Practice Units:

- Application of the branch rule of Subpart F, which treats branches as if they are subsidiaries where manufacturing operations are separated from sales operations and foreign tax savings are derived
- Application of deemed royalty provisions under Code §367(d) when intangible property is contributed to a foreign subsidiary in a tax-free transaction
- Methods to identify companies that are controlled foreign corporations and U.S. persons that are U.S. Shareholders subject to tax under Subpart F
- Determining whether foreign subsidiaries that use intangible property owned by related parties in the U.S. make arm's length payments in consideration for that use
- Penalties that will be imposed when a U.S. taxpayer fails to prepare a Form 5471 in connection with a foreign subsidiary

We trust it will help the reader when an international examiner begins an examination of international issues.

INTERNATIONAL PRACTICE UNIT: I.R.S. RELEASES SUBPART F SALES AND MANUFACTURING RULES

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Tags
C.F.C.
Branch Rule
F.B.C. Sales Income
International Practice Units
LB&I
Subpart F

Over the summer, the I.R.S. released two International Practice Units ("I.P.U.'s") providing guidance regarding the use of branches to avoid foreign base company sales income ("F.B.C. Sales Income"), a category of "Subpart F" income. I.P.U.'s provide insight on how I.R.S. examiners will audit U.S. multinationals and global supply chains. If a client is being audited by the I.R.S., tax practitioners may be able to anticipate the I.R.S.'s next steps or question an approach that does not follow the guidance in an I.P.U.

CONTROLLED FOREIGN CORPORATION RULES

A U.S. shareholder of a controlled foreign corporation ("C.F.C.") must include in gross income a *pro rata* share of the C.F.C.'s Subpart F income.[1]

A foreign (non-U.S.) corporation is a C.F.C. if more than 50% of the total combined voting power of all classes of stock entitled to vote, or if the total value of the stock of such corporation, is owned directly or indirectly by U.S. shareholders on any day during the corporation's taxable year. Such indirect ownership may exist through a corporation, partnership, or trust owned by the U.S. shareholder or constructively through a related party.[2] Thus, a corporation is a C.F.C. if it meets either the total combined voting power test or the total value of the stock test.

A "U.S. shareholder" is a U.S. person who owns directly, indirectly, or constructively (applying 10% or more of the combined voting power of all classes of stock of such corporation entitled to vote).[3] Once a practitioner identifies a C.F.C., he or she must identify whether that C.F.C. earns Subpart F income. If it does, then the Subpart F income will be included in the income of the C.F.C.'s shareholders.

F.B.C. SALES INCOME – LEGAL BACKGROUND

The F.B.C. Sales Income provision is designed to deny tax deferral where a sales subsidiary is separated from the manufacturing activities and organized in another country in order to have the sales income subjected to a lower tax rate when customers are located in a third country. It is one of the most important categories of Foreign Base Company Income ("F.B.C.I.") to an international manufacturing and sales operation.

Under Code §954(d), F.B.C. Sales Income is income that meets the following three conditions:

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1 Code §951.
2 Code §§958(a), 958(b), 957(a).
3 Code §§951(b), 958(b), 958(a).

1. The income is derived in connection with the purchase of personal property from a related person and the sale to any person, or the purchase of property from any person and the sale to a related person.

2. The property is manufactured, produced, grown, or extracted outside of the C.F.C.'s country of incorporation.

3. The property is sold for use, consumption, or disposition outside of the C.F.C.'s country of incorporation.

> ***"The F.B.C. Sales Income provision is designed to deny tax deferral where a sales subsidiary is separated from the manufacturing activities & organized in another country in order to have the sales income subjected to a lower tax rate when customers are located in a third country."***

In addition, F.B.C. Sales Income also comprises commissions and fees earned by a C.F.C. from the sale of, or fees earned from the purchase of, property that is produced and sold for use outside of the C.F.C.'s country of incorporation, when the underlying sale or purchase is made on behalf of a related party.[4]

In other words, F.B.C. Sales Income arises only where

- the C.F.C. is involved in a purchase and sale of property where a related person is involved, and
- the property is both manufactured and sold for use outside the C.F.C.'s country of incorporation.

Thus, F.B.C. Sales Income does not include income derived from a C.F.C. partaking in the following activities:

- Buying from and reselling to unrelated persons (*i.e.*, it acts as an independent distributor)
- Buying and reselling property manufactured, produced, grown, or extracted in its country of incorporation, regardless of whether a related party is involved
- Buying and reselling property for use, consumption, or disposition within its country of incorporation, regardless of whether a related party is involved
- Manufacturing the property that it sells (the "manufacturing exception")[5]

THE MANUFACTURING BRANCH RULE

Legal Background

Under certain circumstances, Code §954(d)(2) prevents a C.F.C. from using a manufacturing branch to circumvent the F.B.C. Sales Income test. If the use of a manufacturing branch located outside of the C.F.C.'s country of incorporation "has substantially the same tax effect" ("S.S.T.E.") as if the branch were a wholly-owned subsidiary corporation, the income attributable to the manufacturing activity is treated as derived by a corporation separate from the C.F.C.[6]

Sale by C.F.C. to Unrelated Parties of Products Manufactured by Branch

A manufacturing branch will be considered to have S.S.T.E. as a wholly-owned subsidiary corporation if income allocated to the rest of the C.F.C. is taxed at an effective

[4] Code §954(d)(1).

[5] Treas. Reg. §1.954-3(a)(4).

[6] Treas. Reg. §1.954-3(b).

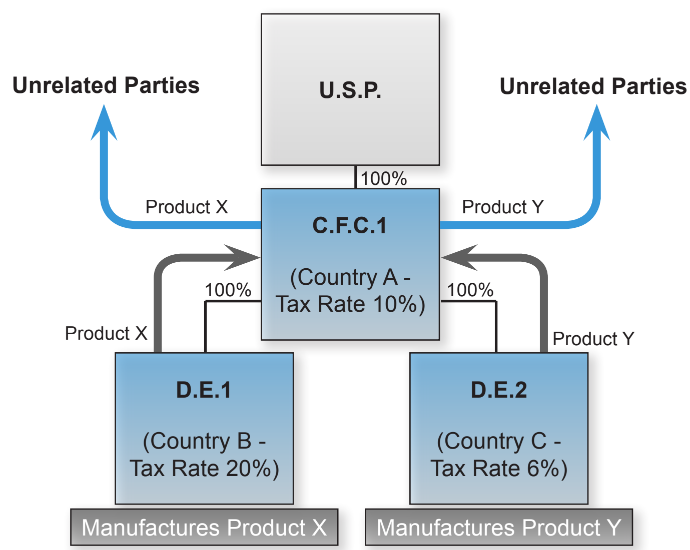
rate of tax ("E.R.T.") that is less than 90% of, and at least 5 percentage points lower than, the rate of tax that would apply to such income if, under the laws where the branch is located, all the income of the C.F.C. were allocated to the branch and treated in that country as being attributable to a permanent establishment. This is known as the manufacturing branch tax rate disparity ("T.R.D.") test.[7] If the E.R.T. under the hypothetical facts meets the percentage differential mentioned above – meaning the E.R.T. in the country of manufacture is greater than the E.R.T. actually paid by the rest of the C.F.C. – the branch is treated for Subpart F purposes as if it were a wholly-owned subsidiary of the C.F.C. (*i.e.*, a "related person" for purposes of applying the foreign base company sales provisions). The remainder of the C.F.C. will be treated as selling on behalf of the manufacturing branch and the C.F.C. will have F.B.C. Sales Income

The I.P.U. explicitly states that it addresses cases targeted by Code §954(d)(2) where a U.S. shareholder of a C.F.C. attempts to avoid the F.B.C. Sales Income rules by shifting the sales income to a lower-tax country through the use of a branch – which is disregarded for U.S. tax purposes – instead of a separate C.F.C.

<u>**Limitations Acknowledged**</u>

According to the I.P.U., if income is F.B.C. Sales Income without regard to the branch rules, or if the income would not be F.B.C. Sales Income if derived by a separate C.F.C., the branch rules are not invoked.[8] Hence, the I.R.S. auditor is advised to first apply the F.B.C. Sales Income rules without treating the branch as a separate corporation, and should not apply the branch rules where the income would not be F.B.C. Sales Income if the branch were a separate C.F.C.

TRANSACTION AND FACT PATTERN[9]



7 Treas. Reg. §1.954-3(b)(1)(ii)(b).

8 So-called priority of application and comparison with ordinary treatment rules under Treas. Reg. §1.954-3(b)(2)(ii)(f), and Treas. Reg. §1.954-3(b)(2)(ii)(e), respectively.

9 See AM2015-002 for information on the computation of the E.R.T.

- C.F.C.1 is incorporated in Country A, where the tax rate is 10%.
- D.E.1 is a hybrid entity (incorporated in Country B, where the tax rate is 20%, and disregarded for U.S. tax purposes).[10]
- D.E.2 is a hybrid entity (incorporated in Country C, where the tax rate is 6%, and disregarded for U.S. tax purposes).[11]
- D.E.1 manufactures Product X (from raw materials purchased from unrelated suppliers), and C.F.C.1 sells Product X to unrelated customers outside Country A.
- D.E.2 manufactures Product Y (from raw materials purchased from unrelated suppliers) and C.F.C.1 sells Product Y to unrelated customers outside Country A.

"Note that the E.R.T. for financia statement purposes is not the same as the actual or hypothetical E.R.T. for purposes of the manufacturing branch rule covered in this unit."

For purposes of this example, it is assumed that the applicable tax rate correlates to the E.R.T. It is noted that in an actual exam fact pattern, the statutory rate will rarely equal the E.R.T. due to variations among tax jurisdictions in exclusions, deductions, credits, and other tax attributes.[12]

According to the I.P.U., the below action steps should be followed by the examiner.

E.R.T. of the Company

The examiner should review the company's audited financial statements to determine the E.R.T. of the worldwide group for the years at issue and compare it to other companies in the same industry. The examiner should look for the total permanently reinvested offshore income ("P.R.I."). Note that the E.R.T. for financial statement purposes is not the same as the actual or hypothetical E.R.T. for purposes of the manufacturing branch rule covered in this unit.

The examiner should determine the tax rates for the C.F.C. and each of its branches, including disregarded entities.

Under the facts outlined above, the following can be determined:

- The tax rate in Country A (10%) is lower than the Country B rate (20%), so profits on Product X moved to Country A are taxed at a rate that is 10 percentage points lower than the Country B rate.
- The tax rate in Country C (6%) is lower than the Country A rate (10%), so profits on Product Y moved to Country C are taxed at a rate that is 4 percentage points lower than the Country A rate.

E.R.T. Impact of Adjustment

Assuming (i) the earnings and profits are P.R.I. under APB 23 (now codified as ASC 740-30), and (ii) the income of the C.F.C.'s is not subject to taxation under Subpart F, the corporate group is able to reduce its worldwide E.R.T. by shifting profits outside

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10 A disregarded entity is treated as a branch for U.S. tax purposes.

11 Treas. Reg. §1.954-3(b).

12 See AM2015-002 for information on the computation of the E.R.T.

the U.S. (or from a higher-tax foreign jurisdiction to a lower-tax foreign jurisdiction). This reduction in worldwide E.R.T. is important for financial reporting purposes.

An inclusion of Subpart F income may increase the financial income tax expense of U.S.P., resulting in higher E.R.T. However, Foreign Tax Credits ("F.T.C.'s") may offset the increase in E.R.T. if the F.T.C.'s are unrecognized deferred tax assets (*e.g.*, a valuation allowance prevents excess F.T.C. carryovers from being recognized in financial statements as a deferred tax asset).

ISSUES TO PURSUE

According to the I.P.U., the following issues should be pursued by the examiner:

1. Should D.E.1 and the remainder of C.F.C.1 be treated as separate corporations under the branch rules?

2. Does C.F.C.1 have F.B.C. Sales Income as a result of its sales of Product X?

3. Should D.E.2 and the remainder of C.F.C.1 be treated as separate corporations under the branch rules?

4. Does C.F.C.1 have F.B.C. Sales Income as a result of its sales of Product Y?[13]

For all issues, the examiners are advised to determine whether F.B.C. Sales Income rules are applicable, *i.e.*, whether C.F.C.1 derives income from the purchase and sale of personal property, where the property is manufactured, and where it is sold for use/consumption.

Examiner's Resources – Taxpayer's Focus of Documentation

The I.P.U. advises examiners to review the following documentation:

- Branch decision trees
- Consolidating financial statements
- Form 5471 for C.F.C.1
- Forms 8858 for D.E.1 and D.E.2
- Transfer pricing studies, if any, prepared for foreign country reporting
- Subpart F functional analysis (or similar documentation), if any
- Global tax and legal organizational charts

In preparation for a potential I.R.S. audit, taxpayers may want to review the above documents in order to present coherent and favorable responses to specific questions.

[13] Note that because the D.E.'s manufacture the goods from which income is derived, the sales income would not be F.B.C. Sales Income (even if they and the remainder of C.F.C.1 were treated as separate corporations).

EXAMINATION PROCESS FOR EACH ISSUE

Issue 1: Should D.E.1 and the Remainder of C.F.C.1 Be Treated as Separate Corporations under the Branch Rules?

This examination program is split into various steps. The examiner is advised by the I.P.U. to apply these steps as follows:

Step 1: Review Potential Issues

The examiner is guided through the steps to determine the T.R.D., the T.R.D. Gross Income, actual tax with respect to that income, the hypothetical tax base, and the hypothetical tax with respect to that base. The goal is to compare the actual tax paid by the branch with the tax that would have been paid if C.F.C.1 manufactured and sold the inventory to unrelated parties from a base in its home country.

These steps are as follows:

1. Determine T.R.D. Gross income, which, in the case of a manufacturing branch in Country B with sales in the remainder of the C.F.C., is the C.F.C.'s gross income derived in connection with the sale of the property in question. This step identifies the income that has been shifted from the country in which manufacturing operations occur (Country B) to the country of the sales base (Country A), as reported by that sales base.
2. Determine the actual tax with respect to the T.R.D. Gross Income (if necessary, this is determined separately from taxes on other income of the C.F.C.). This step identifies the tax imposed by the country in which the sales operations are located (Country A) on the shifted income.
3. Determine the hypothetical tax base in Country B, which is T.R.D. Gross Income reduced by any exclusions and deductions that would be permitted in the manufacturing country (Country B) if the income were derived from sources in Country B through a permanent establishment. This step looks at the shifted income from the viewpoint of the country in which manufacturing occurs. It identifies the income that has been shifted from that country (Country B) to the country in which sales are conducted (Country A), as reported in that country.
4. Multiply the hypothetical tax base in Country B by the applicable marginal tax rate(s) in the manufacturing jurisdiction (Country B determines the hypothetical tax). This step identifies the amount of tax that has been shifted away from the country where manufacturing occurs.
5. Divide the actual tax by the hypothetical tax base in Country B to compute the actual E.R.T., then divide the hypothetical tax by the hypothetical tax base to compute the hypothetical E.R.T. Compare these E.R.T.'s. This step compares the E.R.T. using the income that would have been taxed by the country of manufacture in the absence of a shifting of sales operations. The E.R.T.'s are computed and the comparison is performed.

"The examiner is guided through the steps to determine the T.R.D., the T.R.D. Gross Income, actual tax with respect to that income, the hypothetical tax base, and the hypothetical tax with respect to that base."

Step 2: Additional Factual Development

The I.P.U. advises the examiner to apply the rules to the facts in issue. In the fact pattern described in the above diagram, the examiner should determine whether the actual E.R.T. in Country A compared to the hypothetical E.R.T. in Country B is less than 90% of, and at least 5 percentage points below, the hypothetical E.R.T. based on Country B tax law. Because this is the case in the example, there is T.R.D. and D.E.1 and the remainder of C.F.C.1 are treated as separate corporations for purposes of determining C.F.C.1's F.B.C. Sales Income

Observations

For the second step above ("*Additional Factual Development*"), the examiner is directed to use the following resources:

- Income Tax Returns filed by C.F.C.1 and D.E.1 in Country A and B
- Transaction contracts/agreements
- Product flows and transaction flowcharts
- Diagrams, analysis, or presentations regarding supply chain (including any supply chain agreements)
- Copies of the tax package, organizer, or similar information from the C.F.C. in order to prepare Forms 5471 and 8858

The taxpayer should be prepared in advance to provide information substantiating the E.R.T. (including credits, deductions, etc.) from the documents listed above.

Issue 2: Does C.F.C.1 Have F.B.C. Sales Income as a Result of Its Sales of Product X?

This examination program is split into various steps. The examiner is advised by the I.P.U. to apply these steps as follows:

Step 1: Review Potential Issues

The I.P.U. advises the examiner to determine whether the necessary facts exist to create F.B.C. Sales Income These facts are as follows:

- A C.F.C. buys/sells personal property from/to (or on behalf of) a related person.
- The property is manufactured, produced, constructed, grown, or extracted outside the C.F.C.'s country of incorporation.
- The property is purchased/sold for use, consumption, or disposition outside the C.F.C.'s country of incorporation.

The income from the sale of property by the C.F.C. is F.B.C. Sales Income unless an exception applies. The U.S. shareholder(s) of the C.F.C. may have a Subpart F inclusion.

Step 2: Additional Factual Development

The I.P.U. advises the examiner to verify whether the sale of Product X by C.F.C.1 falls within the definition of F.B.C. Sales Income (*i.e.*, whether C.F.C.1 sells, on behalf of a related party, property manufactured outside Country A for use outside Country A). In the fact pattern described in the above diagram, C.F.C.1 sold Product X (manufactured outside Country A) for use outside Country A and a T.R.D. exists based on the comparable analysis described above. Consequently, C.F.C.1 is viewed under the branch rule as if it were selling on behalf of D.E.1, a separate, related corporation. C.F.C.1's income from the sale of Product X outside Country A is F.B.C. Sales Income, resulting in a Subpart F inclusion for U.S.P.

Note that D.E.1 would not have F.B.C. Sales Income if it sold Product X itself, even to a related party, because D.E.1 manufactures Product X and therefore the manufacturing exception applies.

Observations

For the second step above ("Additional Factual Development"), it is suggested that the examiner request schedules of sales by destination and copies of local country Value Added Tax ("V.A.T.") returns to verify the place of manufacture, sale, use, or consumption.

A taxpayer in comparable circumstances to C.F.C.1 and D.E.1 may want to consider having D.E.1 sell the products it manufactures, thereby benefitting from the C.F.C. manufacturing exception. The key here is the Country B tax rate that is imposed on the total profits.

"it is prudent for the taxpayer to gather all relevant documentation in order to put forward the best possible argument."

Issue 3: Should D.E.2 and the Remainder of C.F.C.1 Be Treated as Separate Corporations under the Branch Rules?

Here, the analysis is the same as in the first issue. However, factual development in this transaction indicates that the actual E.R.T. with respect to the hypothetical tax base is not less than 90% of, and at least 5 percentage points below, the hypothetical E.R.T. with respect to that base (*i.e.*, there is no T.R.D.). As a result, D.E.2 and the remainder of C.F.C.1 are not treated as separate corporations for purposes of determining C.F.C.1's F.B.C. Sales Income

Observations

As previously stated, it is prudent for the taxpayer to gather all relevant documentation in order to put forward the best possible argument that T.R.D. does not exist. Here the facts were favorable, based on the assumption that the E.R.T. for D.E.2 in the place of manufacture was not significantly greater than the E.R.T, for the balance of the C.F.C.

Issue 4: Does C.F.C.1 Have F.B.C. Sales Income as a Result of Its Sales of Product Y?

Again, based on the facts in the diagram, C.F.C.1 and D.E.2 are not treated as separate corporations because no T.R.D. exists in the facts. C.F.C.1 and D.E.2 are treated under the branch rule as a single economic unit. There is no deemed related party transaction. The income from the sale of Product Y by C.F.C.1 does not qualify as F.B.C. Sales Income Even if the raw materials used to manufacture

Product Y were purchased from related parties, C.F.C.1 would not be deemed to derive F.B.C. Sales Income under the C.F.C. manufacturing exception.[14]

Observations

It is noted in the I.P.U. that if the income from the sale of Product X by C.F.C.1 causes C.F.C.1 to meet the "full inclusion" rule, then all the income of C.F.C.1 would be deemed F.B.C. Sales Income, *i.e.*, F.B.C. Sales Income would even include income from the sale of Product Y, which, on a stand-alone basis, would not be F.B.C. Sales Income The full inclusion rule applies when more than 70% of the gross income of a C.F.C. is considered to be Subpart F income. Where such a fact pattern exists, all other income is tainted. In this case, the taxpayer may want to consider having D.E.2 owned by a sister C.F.C. to C.F.C.1.[15]

BRANCH SALES TO UNRELATED PARTIES OF PRODUCTS MANUFACTURED BY C.F.C.

Legal Background

In a second case study to be discussed, although the fact pattern changes materially, the rules outlined above continue to apply. In this case study, the branch sells the products that are manufactured by the C.F.C., *i.e.*, the roles are reversed for the C.F.C. (which is now manufacturing instead of selling as in the first case study) and the branches (which now sell instead of manufacture).

As with a manufacturing branch, the mere existence of a sales branch outside the C.F.C.'s country of incorporation does not necessarily result in F.B.C.S.I to the C.F.C. The T.R.D. test must be applied in order to determine whether the use of the branch has S.S.T.E. as if it were a separate corporation. The T.R.D. test compares the hypothetical E.R.T. with respect to the hypothetical net sales income computed under the laws of the manufacturing jurisdiction, under the assumption that the income is fully taxable in that country, to the actual E.R.T. with respect to the sales income. If there is T.R.D., the use of the branch is said to have S.S.T.E. as if it were a separate corporation, and the branch and the remainder of the C.F.C. will be treated as separate corporations for purposes of determining the C.F.C.'s F.B.C. Sales Income

A T.R.D. will exist if the actual E.R.T. imposed on the income of the sales branch is less than 90% of, and at least 5 percentage points below, the hypothetical E.R.T. that would apply if the actual income of the branch were allocated to the C.F.C. conducting manufacturing operations, and the entire income were taxed in the country of residence of the C.F.C.[16]

If a C.F.C. has more than one sales branch outside the country in which the corporation is organized, the regulations apply the T.R.D. test to the income of each sales branch. In applying the test, the regulations assume that the purchasing or selling branch being tested is the only branch of the C.F.C. and that all of the other sales branches are separate corporations.

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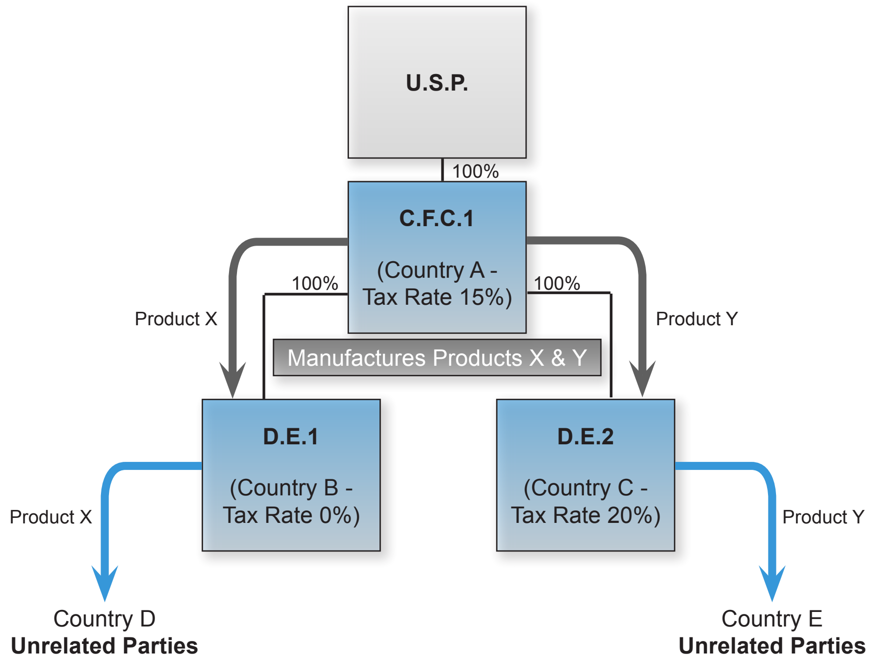
14 Treas. Reg. §1.954-3(a)(4).

15 Code §954(b)(3)(B).

16 Treas. Reg. §1.954-3(b)(1)(i)(c).

TRANSACTION AND FACT PATTERN[17]



- C.F.C.1 is incorporated in Country A, where the tax rate is 15%.
- D.E.1 is a hybrid entity (incorporated in Country B, where the tax rate is 0%, and disregarded for U.S. tax purposes).
- D.E.2 is a hybrid entity (incorporated in Country C, where the tax rate is 20%, and disregarded for U.S. tax purposes).
- C.F.C.1 manufactures Products X and Y from raw materials purchased from unrelated suppliers (D.E.1 and D.E.2 do not perform any manufacturing activities).
- D.E.1 sells Product X to unrelated third parties in Country D (*i.e.*, D.E.1 is a selling branch of C.F.C.1).
- D.E.2 sells Product Y to unrelated third parties in Country E (*i.e.*, D.E.2 is a selling branch of C.F.C.1).

It is noted that if C.F.C.1 derived income from its own sales of Products X and Y to D.E.1 or D.E.2, such income would not be F.B.C. Sales Income because C.F.C.1 would qualify for the "C.F.C. manufacturing exception." This is true even if the use of D.E.1 or D.E.2 has S.S.T.E. as if they are separate corporations.

For purposes of the example, it is assumed that the applicable tax rate correlates to the E.R.T.

According to the I.P.U., the following action steps should be followed by the examiner.

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17 I.P.U. DPL/9412.01_08(2015), updated as of August 3, 2015.

E.R.T. of the Company

As in the prior example related to a manufacturing branch, the I.P.U. directs the examiner to review the audited financial statements to determine the E.R.T. of the worldwide group and its P.R.I.

The examiner should determine the tax rates for the C.F.C. and each of its branches, including disregarded entities.

The examiner is reminded that the statutory rate will rarely equal the E.R.T. due to variations among tax jurisdictions in exclusions, deductions, credits, and other tax attributes.

Under the facts of the example, the following can be determined:

- The tax rate in Country A (15%) is lower than the U.S. rate (35%), so profits moved to Country A are taxed at a rate that is 20 percentage points lower than the U.S. rate.
- The tax rate in Country B (0%) is lower than the Country A rate (15%), so profits on Product X moved to Country B are taxed at a rate that is 15 percentage points lower than the Country A rate.

This illustrates why the I.R.S. places emphasis on identifying possible F.B.C. Sales Income – so that the 20% tax savings under the structure above may be recaptured.

E.R.T. Impact of Adjustment

Again, if the earnings are P.R.I. under ASC 740-30 and the sales do not generate F.B.C. Sales Income that is taxed under Subpart F, the corporate group can shift profits outside the U.S. (or from a higher-tax foreign jurisdiction to a lower-tax foreign jurisdiction). This reduction in worldwide E.R.T. is important for financial reporting purposes.

An inclusion of Subpart F income may increase the financial income tax expense of U.S.P., resulting in higher E.R.T. However, F.T.C.'s may offset the increase in E.R.T. if the F.T.C.'s are unrecognized deferred tax assets.

ISSUES TO PURSUE

According to the I.P.U., the same issues should be pursued by the examiner as were identified in the prior case study:

1. Should D.E.1 and the remainder C.F.C.1 be treated as separate corporations under the branch rules?
2. Does C.F.C.1 have F.B.C. Sales Income as a result of its sales of Product X?
3. Should D.E.2 and the remainder of C.F.C.1 be treated as separate corporations under the branch rules?
4. Does C.F.C.1 have F.B.C. Sales Income as a result of its sales of Product Y?

For all issues, the examiners are advised to determine whether F.B.C. Sales Income rules are applicable, and if they are, whether C.F.C.1 derives income from D.E.1's sales of Products X to unrelated parties. The I.P.U. directs the examiner to identify where the property is manufactured and where it is sold for use/consumption. In addition, the examiner needs to determine whether C.F.C.1 sells by or through D.E.1 or D.E.2.

Examiner's Resources – Taxpayer's Focus of Documentation

The examiners' resources are the same as in the prior example. They include the following:

- Branch decision trees
- Consolidating financial statements
- Form 5471 for C.F.C.1
- Forms 8858 for D.E.1 and D.E.2
- Transfer pricing studies, if any, prepared for foreign country reporting
- Subpart F functional analysis (or similar documentation), if any
- Global tax and legal organizational charts

Observations

Again, the foregoing forms and documents should be reviewed in advance by taxpayers in order to prepare responses for potential audit questions.

EXAMINATION PROCESS FOR EACH ISSUE

Issue 1: Should D.E.1 and the Remainder C.F.C.1 Be Treated as Separate Corporations under the Branch Rules?

This examination program is split into various steps. The examiner is advised by the I.P.U. to apply these steps as follows:

Step 1: Review Potential Issues

As in the prior case study, the examiner is guided through the steps to determine the T.R.D., the T.R.D. Gross Income, actual tax with respect to that income, the hypothetical tax base, and the hypothetical tax with respect to that base. The goal is to compare the actual tax paid by the branch with the tax that would have been paid if C.F.C.1 manufactured and sold the inventory to unrelated parties from a base in the home country.

The steps are as follows:

1. Determine T.R.D. Gross income, which, in the case of a sales branch, is the branch's gross income derived in connection with the sale of the property manufactured by C.F.C.1. This step identifies the income that has been shifted from the country in which manufacturing operations occur to the country of the sales base, as reported by that sales base.

“As in the prior case study, the examiner is guided through the steps to determine the T.R.D., the T.R.D. Gross Income, actual tax with respect to that income, the hypothetical tax base, and the hypothetical tax with respect to that base.”

2. Determine the actual tax with respect to the T.R.D. Gross Income (if necessary, this is determined separately from taxes on other income of the sales branch). This step identifies the tax imposed on the shifted income by the country in which the sales base is located.

3. Determine the hypothetical tax base (i) which is the T.R.D. Gross Income of the branch, (ii) which is allocated to C.F.C.1 in the computation and treated as permanent establishment income in that country, and (iii) is then reduced by any exclusions and deductions that would be permitted in the manufacturing country. This step looks at the shifted income from the viewpoint of the country in which manufacturing occurs. It identifies the income that has been shifted from that country to the country of the sales base, as reported by that sales base.

4. Multiply the hypothetical tax base by the applicable marginal tax rate(s) in the manufacturing jurisdiction to determine the hypothetical tax. This step identifies the amount of tax that has been shifted away from the country where manufacturing occurs.

5. Divide the actual tax of the branch by the hypothetical tax base in the country of manufacture in order to compute the actual E.R.T., and then divide the hypothetical tax by the hypothetical tax base to compute the hypothetical E.R.T. Compare these E.R.T.'s. This step compares the E.R.T. using the income that would have been taxed by the country of manufacture in the absence of a sales base. The E.R.T.'s are computed and the comparison is performed.

Step 2: Additional Factual Development

The I.P.U. advises the examiner to apply the rules to the facts in issue. In this case study, this means that the examiner must determine whether computing the E.R.T. using the actual tax in Country B (where the sales base is located) and the adjusted income in Country A (where the manufacturing base is located) produces an E.R.T. that is less than 90% of, and at least 5 percentage points below, the E.R.T. that would have been incurred under the assumption that the sales were not shifted to Country A. If so, there is T.R.D., and D.E.1 and the remainder of C.F.C.1 are treated as separate corporations for purposes of determining C.F.C.1's F.B.C. Sales Income

Step 3: Develop Arguments

The examiner is directed to look at the following items in carrying out this step:

- Income tax returns filed by C.F.C.1 and by D.E.1
- Transaction contracts/agreements
- Product flows and transaction flowcharts
- Diagrams, analysis, or presentations regarding supply chain (including any supply chain agreements)
- Tax package or organizer used by the C.F.C. to provide information used to prepare Form 5471 and Form 8858

Issue 2: Does C.F.C.1 Have F.B.C. Sales Income as a Result of Its Sales of Product X?

The factual development in this transaction indicates that D.E.1 sells Product X on behalf of C.F.C.1 outside Country B. Although D.E.1 sells to unrelated parties, it does so on behalf of a related party. Consequently, D.E.1's income from the sale of Product X outside Country B is F.B.C. Sales Income, resulting in a Subpart F inclusion to the U.S. parent. The 20-point tax saving from the structure is eliminated.

Issue 3: Should D.E.2 and the Remainder of C.F.C.1 Be Treated as Separate Corporations under the Branch Rules?

This issue replicates the steps that were performed regarding D.E.1. Here, the E.R.T. in Country C is 20%, which exceeds the E.R.T. in Country A. Consequently, if the methodology of computing the tax base in Country C is comparable to the tax methodology used in Country A – meaning that income and expense recognition rules are comparable in both countries – the actual E.R.T. with respect to the hypothetical tax base is not less than 90% of, and at least 5 percentage points below, the hypothetical E.R.T. with respect to that base. There is no T.R.D. As a result, D.E.2 and the remainder of C.F.C.1 are not treated as separate corporations for purposes of determining C.F.C.1's F.B.C. Sales Income.

"The I.P.U.'s may serve taxpayers twofold: first as guidance for taxpayers on documentation to have in place for future I.R.S. audits and second, as tool for identifying reorganization potentials of their structures."

Issue 4: Does C.F.C.1 Have F.B.C. Sales Income as a Result of Its Sales of Product Y?

The factual development in this transaction indicates that C.F.C.1 and D.E.2 are viewed as a single economic unit. D.E.2 and the remainder of C.F.C.1 are not treated as separate corporations. Consequently, C.F.C.1 would not have F.B.C. Sales Income from D.E.2's sales of Product Y because it qualifies for the C.F.C. manufacturing exception from F.B.C. Sales Income.[18]

CONCLUSION

The two I.P.U.'s issued in the summer outline the examination process that will be followed by a U.S.-based group that manufactures inventory through a C.F.C. having manufacturing operations in one country and sales operation in another country. F.B.C. Sales Income may be generated when the inventory is intended to be sold for consumption or use in a third country. The branch rule may apply when manufacturing operations are conducted by a branch of the C.F.C. and sales operations are conducted by the main office of the C.F.C. in its country of incorporation, or when the main office manufactures and a branch carries out sales operations. If the bifurcation between manufacturing and sales results in a tax saving overseas, the branch rule may apply in appropriate circumstances. The I.P.U.'s may serve taxpayers twofold: first, as guidance for taxpayers on documentation to have in place for future I.R.S. audits and second, as tool for identifying reorganization potentials of their structures. This may require the D.E. make a substantial contribution to manufacturing of personal property it sells (which itself causes the D.E. to be viewed as the manufacturer under the contract manufacturer provision in the regulations)[19] or separating product lines between sister C.F.C.'s to avoid the full inclusion rule for the sale of products by a C.F.C. that would otherwise not result in F.B.C. Sales Income on a stand-alone basis.

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[18] Treas. Reg.1.954-3(a)(4).

[19] Treas. Reg. 1.954-3(a)(4)(iv).

INTERNATIONAL PRACTICE UNIT: DEEMED ANNUAL ROYALTY INCOME UNDER CODE §367(D)

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INTRODUCTION

The I.R.S.'s Large Business and International ("LB&I") Division issued a new International Practice Unit on November 4, 2015 called the "Deemed Annual Royalty Income Under I.R.C. 367(d)." This Practice Unit is concerned with how U.S. taxpayers attempt to reduce or eliminate Federal tax consequences under Internal Revenue Code[1] §367(d) when (i) ownership of valuable intangible property ("I.P.") is transferred to a related corporation outside the U.S. pursuant to an exchange under Code §§351 or 361 and (ii) the related person is resident in a low-tax jurisdiction.

Generally, Code §§351 and 361 apply nonrecognition treatment to the transfer of property solely in exchange for stock in the corporation either (i) as a contribution in which the transferor retains control or (ii) pursuant to a plan of reorganization. However, the Code §§351 or 361 exchange will become taxable under Code §367(d) when a U.S. person or entity transfers any I.P. to a foreign corporation. A contingent sale of the I.P. is deemed to occur when the deemed contingent gain payments are treated as a royalty. Typically, this triggers ordinary income for the U.S. entity. Some U.S. taxpayers attempt to avoid this tax or reduce the amount of the deemed royalty by asserting that most of the transferred intangibles are foreign goodwill and going concern values, which are not covered by Code §367(d). This Practice Unit focuses on how to identify the exploitation of Code §367(d) and the issues that arise in an examination.

BACKGROUND

As a way to reduce the effective tax rate, a U.S. entity may transfer I.P. offshore to another foreign corporation through a nonrecognition transfer pursuant to Code §§351 or 361. Under Code §351, no gain or loss is recognized when property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation if immediately after the exchange the group of transferors are in control of the recipient corporation. Under Code §361, no gain or loss is recognized by a corporation that is a party to a reorganization when it exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation that is a party to the reorganization. Under Code §367(d), however, these nonrecognition transactions are subject to income tax.

Code §367(d) provides that when a U.S. person transfers any I.P. to a foreign corporation pursuant to Code §§351 or 361, the U.S. transferor is treated as if it sold the I.P. in exchange for a continuing stream of annual payments. Sales of I.P. for

[1] All section references are to the Internal Revenue Code of 1986, as amended, (the "Code") and the regulations promulgated thereunder.

contingent consideration based on productivity or use are generally treated as giving rise to royalty payments, subject to recovery of basis over the course of the payment stream. The deemed royalty is characterized as ordinary income over the useful life of the property, not to exceed 20 years. The annual royalty payment will increase taxable income and the effective tax rate of the U.S. transferor annually. If, within the intangible's useful life, the foreign corporation subsequently disposes of the property to an unrelated party, the U.S. transferor must recognize all inherent gain equal to the difference between the fair market value of the property and its adjusted basis. Code §482 and the accompanying I.R.S. regulations establish the arm's length and commensurate with income standards that are used to determine the amount of the deemed royalty.[2]

Code §936(h)(3)(B) defines the term "I.P." to mean any

- patent, invention, formula, process, design, pattern, or know-how;
- copyright, literary, musical, or artistic composition;
- trademark, trade name, or brand name;
- franchise, license, or contract;
- method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
- any similar item, which has substantial value independent of the services of any individual.

Code §367(d) does not apply to the transfer of foreign goodwill or going concern ("F.G.W.G.C.") value because Treas. Reg. §1.367(d)-1T(b) provides there is no tax on the transfer of F.G.W.G.C. to a foreign corporation in a Code §§351 or 361 transaction.[3] Foreign goodwill is defined in Treas. Reg. §1.367(d)-1(T)(d)(5)(iii) as the residual value of a foreign business operation conducted outside the U.S. after all other tangible and intangible assets have been identified. This Practice Unit points out that the identification of transferred tangible and intangible assets is critical in analyzing I.P. transfers and cautions that if a substantial portion of the total transfer value is F.G.W.G.C., the transaction should be evaluated carefully and may require specialized resources.[4]

TRANSACTION AND FACT PATTERN

The Practice Unit provides an example of when a U.S. taxpayer's transfer of I.P. to a foreign corporation is treated as a deemed annual royalty income inclusion under Code §367(d) in order to demonstrate how an I.R.S. examiner should perform an audit.

The Practice Unit's fact pattern consists of a U.S. person ("U.S.P.") that is a multinational technology company. U.S.P. incorporates a controlled foreign corporation

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2 "Deemed Annual Royalty Income Under IRC 367(d)," LB&I International Practice Service Transaction Unit, 11/4/2015, p.3.

3 *Id.*

4 *Id.*, p. 4.

("C.F.C. 1") in a low-tax foreign country. U.S.P. transfers valuable I.P., including assets to operate the business, to C.F.C. 1 in exchange for stock in a Code §351 transaction. C.F.C. 1 was previously a foreign branch of U.S.P. that operated with minimal profits in the prior two years. U.S.P. also transferred a significant number of interrelated license agreements to C.F.C. 1 with an average term of 12 years. U.S.P. valued each license agreement separately (not in the aggregate) in its study.

U.S.P. reported on its tax return that a large percentage of the transferred I.P. consisted of F.G.W.G.C. U.S.P. does not receive a royalty from C.F.C. 1. U.S.P. reported the transaction as a Code §367(d) transaction. U.S.P. incorporated its foreign branch and contributed all of the branch assets and additional I.P. to C.F.C. 1 in exchange for stock as part of a Code §351 transaction. Former U.S.P. engineers became employees of C.F.C. 1. These engineers brought significant technical knowhow and reference materials, including manuals and software that were developed by them while being employed by U.S.P. The study provided by U.S.P. identified that a large percentage of the transferred I.P. consisted of F.G.W.G.C. and separately valued the license agreements. In the study, U.S.P. stated that the useful life of the licenses and knowhow is five years. The contracts and other interrelated licenses that U.S.P. transferred to C.F.C. 1 have significant synergistic value.[5]

ISSUES & AUDIT PROCEDURES

The Practice Unit identifies three potential issues that examiners should focus on when a U.S. taxpayer transfers I.P. to a foreign corporation pursuant to Code §§351 or 361 and the income is deemed to be an annual royalty under Code §367(d):

1. Has all the Code §936(h)(3)(B) I.P. transferred from U.S.P. to C.F.C. 1 pursuant to Code §351 been properly identified for purposes of applying Code §367(d)?

2. Did U.S.P. properly value foreign goodwill or going concern pursuant to Treas. Reg. §§1.367(d)-1T(b)?

3. Did U.S.P. properly value the Code §936(h)(3)(B) intangible assets for purposes of computing the Code §367(d) deemed royalty?[6]

The Practice Unit provides a step-by-step approach for conducting an audit of each issue. The first step, which applies to all three issues, is to ensure that the transferred I.P. has been properly identified, for purposes of Code §367(d), by establishing the facts and supporting documentation. The examiner must confirm that U.S.P. actually transferred I.P. to C.F.C. 1 in exchange for stock pursuant to Code §351. In addition, the examiner must confirm that U.S.P. reported this transfer as a Code §367(d) transaction. The examiner must also confirm that the U.S.P. incorporated its foreign branch and contributed all of the branch assets and additional I.P. in exchange for stock pursuant to Code §351. Then, the examiner is instructed to determine whether this is in fact a Code §367(d) transaction, and if so, verify if former U.S.P. engineers became employees of the C.F.C. The Practice Unit suggests referring to the following I.R.S. forms:

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[5] *Id.*, p. 5-6.

[6] *Id.*, p. 8.

- Form 926, *Filing Requirement for U.S. Transferors of Property to a Foreign Corporation*, Part III, Intangible and Part IV, line 17a
- Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, Schedule O and Section E
- Form 1120, *U.S. Corporation Income Tax Return*, Disclosures Pursuant to Code §6038B[7]

The Practice Unit also suggests that examiners request or consider the following documents from the U.S.P. or C.F.C. 1 in order to effectively investigate the taxpayers' transactions:

- Transfer pricing documentation and background documentation
- Pre- and post-transfer organizational charts
- Contracts containing critical facts of the I.P. transfer and reorganization
- I.P. valuation

"The Practice Unit warns that most I.P. transfers have a substantial residual value amount that is classified as foreig goodwill or going concern."

When the documentation is provided, the Practice Unit directs the examiner to

- analyze disclosures made on the tax return pursuant to Code §351 and §367(d) as well as Form 926,
- identify interrelated intangibles from the taxpayer's valuation and transfer pricing studies,
- request the transaction steps,
- verify intangibles transferred from legal documents and contracts, and
- determine if a referral for an economist or engineer is necessary.[8]

Identification of All I.P. Transferred for Purposes of Applying Code §367(d)

In order to address the issue of whether all intangible assets transferred from U.S.P. to C.F.C. 1 have been properly identified for purposes of applying Code §367(d), the Practice Unit emphasizes that the intangibles must clearly be identified. Examiners are aware that taxpayers may transfer intangibles beyond those reported on the return or claimed in the valuation study. The examiner must personally identify and verify all the significant intangibles.

Intangibles that satisfy the definition of Code §936(h)(3)(B) are compensable even though the I.R.S. and some taxpayers may disagree as to whether a particular intangible asset meets this definition. The Practice Unit defines "I.P." under the Code §936(h)(3)(B) definition set forth above. Even if the I.P. at issue may not be specifically named on the list of Code §936(h)(3)(B), it should be included if it is considered to be similar to the items specifically listed. The Practice Unit warns that most I.P. transfers have a substantial residual value amount that is classified as F.G.W.G.C.[9]

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[7] *Id.*, p. 9.

[8] *Id.*, p. 10.

[9] *Id.*, p. 10-11.

The examiner is directed to perform a functional analysis of the I.P. that was transferred in order to clearly identify all the intangibles and determine their values. To assist with analyzing the transfer, the Practice Unit refers to T.A.M. 200907024; Treas. Reg. §1.367(a)-1T(d)(5)(iii); *Hospital Corp. of America v. Commr*, 81 T.C. 520 (1983); and *International Multifoods v. Commr*, 108 T.C. 25 (1997).

The following are the preliminary questions for the examiner to consider:

- Does the valuation date match the transfer date?
- How was the I.P. valued?
- Does the taxpayer's return position include little or no value for I.P. transferred relative to the business enterprise?
- Did the taxpayer identify the transfer as a non-taxable outbound transfer of foreign goodwill and going concern?
- Was the I.P., in fact, transferred via Code §§351 or 361?[10]

After all of the facts are established and the intangibles are properly characterized, the examiner is ready to move to the next issue.

<u>Determining Value of F.G.W.G.C.</u>

In addressing the issue of whether the U.S.P. valued the F.G.W.G.C. properly under Treas. Reg. §1.367(d)-1T(b), the examiners are aware that taxpayers may characterize their transferred I.P. as F.G.W.G.C. in order to avoid tax under Code §367(d). The examiner must determine whether the F.G.W.G.C. value exists, and if so, the examiner must determine its correct value. There is also the issue of whether the goodwill is actually foreign or domestic. If it is domestic, and therefore improperly characterized as foreign, tax is triggered.[11]

"There is also the issue of whether the goodwill is actually foreign or domestic. If it is domestic, and therefore improperly characterized as foreign, tax is triggered."

The Practice Unit explains the crux of the issue as follows:

> When a taxpayer transfers its intangibles offshore through IRC 351 and IRC 361 and categorizes substantially all of it as FGWGC, it:
>
> - Minimizes the value of compensable intangibles under IRC 367(d)so that the federal tax impact from the transfer is reduced (also referred to as 'toll charge');
> - Maximizes the value of foreign goodwill and going concern value because foreign goodwill and going concern value is not compensable (a 'carve out') under IRC 367(d) and is not subject to U.S. taxation.
>
> Treas. Reg. 1.367(d)-1T(d)(5)(iii) provides foreign goodwill is the residual value of a foreign business operation conducted outside the United States after all other tangible and intangible assets have been identified. Often the identification of only some of the transferred assets will result in a large residual value. [The examiner]

[10] *Id.*, p. 14.

[11] *Id.*, p. 15.

must determine whether this residual value is in fact foreign goodwill or going concern.[12]

Foreign going concern value may exist even if foreign goodwill does not exist. The Practice Unit explains that case law suggests that going concern value is the additional element of value that attaches to property by reason of its existence as an integral part of a going concern. The idea is that even without goodwill, the value of a going concern exists when there is excess earning capacity and the ability of a business to continue to function and generate income without interruption as a consequence of the change in ownership.[13]

“The examiner is instructed to scrutinize any U.S. person who asserts that a large percentage of the transferred I.P. consisted of F.G.W.G.C.”

The I.R.S. is concerned about identifying goodwill and going concern intangibles because U.S. some taxpayers attempt to reduce the amount of the deemed royalty under Code §367(d) by claiming that a significant amount of the intangible value is attributable to F.G.W.G.C.[14] The examiner is instructed to scrutinize any U.S. person who asserts that a large percentage of the transferred I.P. consisted of F.G.W.G.C. In the example, U.S.P. attempted to reduce its deemed royalty by reporting a large amount of F.G.W.G.C.[15]

The Practice Unit instructs the examiner to focus on the following:

> The question is whether intangible value categorized as FGWGC by the taxpayer is really another type of IRC 936(h)(3)(B) intangible. Also, it is important to:
>
> - Consider if all tangible and intangible assets have been identified
> - Consider whether the assets are from a foreign business operation conducted outside the United States that may give rise to FGWGC.
>
> In this fact pattern, USP’s branch was operating with minimal profit for two years before incorporating, so it is unlikely that the branch would have developed significant FGWGC value during that period.[16]

In assessing the goodwill or going concern assets, the Practice Unit instructs the examiner to refer to the relevant Code provisions:

- Treas. Reg. §§1.367(d)-1T(b)
- T.A.M. 200907024
- HR Rep. No. 98-432 (1984) – Committee Reports on Tax Reform Act of 1984
- S. Rep. No. 98-169 (1984) – Committee Reports on Tax Reform Act of 1984
- P.L. No. 99-514, Sec.1231(e) – 1986 Modification to Code §936

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12 *Id.*, p. 16.

13 *Id.*, p. 17.

14 *Id.*, p. 19.

15 *Id.*

16 *Id.*, p. 21.

- I.R.M. Exhibit 4.61.3-4 – Transfer Pricing Functional Analysis Questionnaire

The Practice Unit also suggests referring to the following cases:

- *Conestoga Transportation Co. v. Commr*, 17 T.C. 506, 514 (1951)
- *United States v. Cornish*, 348 F.2d 175 (9th Cir. 1965)
- *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 685 (5th Cir. 1971)
- *Computing & Software, Inc. v. Commr*, 64 T.C. 223, 235 (1975)
- *VGS v. Commr*, 68 T.C. 563 (1977)

Proper Valuation of I.P. When Applying Code §367(d)

According to the Practice Unit, the last issue addressed in an audit is whether U.S.P. properly valued the I.P. for purposes of computing the deemed royalty under Code §367(d). Since it is difficult to determine the synergistic value between intangibles, the Practice Unit suggests following the case law to determine the proper value of the transferred I.P. The case law[17] supports valuing interrelated assets in the aggregate so that the synergistic value of the entire collection of assets is reflected in the computation.[18] This reflects a view that the value of the whole is greater than the sum of its parts.

The Practice Unit expands on this critical issue of determining the proper value in great detail:

> As a matter of economic reality and fundamental valuation principles, USP transferring intangibles at arm's length would conclude that the assets should be valued in the aggregate in a manner that properly reflects any synergistic relationships. In a scenario where numerous assets are used as a single integrated asset, it would be inappropriate to value the assets on a separate, stand-alone basis when they have functioned in the past, and will function in the future, as a single asset. Treas. Reg. 1.482-1(f)(2)(i) recognizes such economic realities by providing that multiple transactions should be valued in the aggregate if such transactions, taken as a whole, are so interrelated that an aggregated valuation is the most reliable means of determining the arm's length consideration for the transactions.
>
> - USP may have undervalued IRC 936(h)(3)(B) intangibles by disregarding synergies between separate intangibles that increase their aggregate value. Because FGWGC is a residual, undervaluing IRC 936(h)(3)(B) intangibles overvalues FGWGC.
> - Synergies between separate IRC 936(h)(3)(B) intangibles should be considered when valuing those intangibles. Often,

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17 See *Computing & Software, Inc. v. Commr*, 64 T.C. 223, 235 (1975) and *International Multifoods v. Commr*, 108 T.C. 25 (1997).

18 "Deemed Annual Royalty Income Under IRC 367(d)," LB&I International Practice Service Transaction Unit, 11/4/2015, p. 22.

"I.R.S. examiners are directed to review all items involved in a transfer of I.P. to ensure that the deemed royalty provisions of Code §367(d) are properly applied."

valuing IRC 936(h)(3)(B) intangibles in the aggregate, taking synergies into account, will be the most reliable means to value them.

- USP did not identify knowhow that was transferred. The technical manuals, processes, transferred to CFC1 likely constitute valuable intangibles and CFC1 should compensate USP at an arm's length rate.
- USP may contend that the useful life of an intangible is short, and therefore, the present value period for computing the royalties is also short.[19]

In the example, the examiner must scrutinize the contracts and interrelated licenses that U.S.P. transferred to C.F.C. 1 in order to determine if they have significant synergistic value. The examiner must also confirm (i) that U.S.P.'s study separately valued the license agreements, (ii) whether the technical knowhow and reference materials were in the study, and (iii) the useful life of the technology and whether it should be 12 years, not five years as U.S.P. stated in its study.[20]

The Practice Unit concludes that the study performed by U.S.P. in the fact pattern did not value the synergistic effect of the interrelated technology license agreements because these licenses have a 12-year term, which means the useful life may be 12 years and not five years as U.S.P. stated. The examiner should coordinate with an economist or engineer to determine the proper value of the I.P. since its useful life should be adjusted. The study by U.S.P. also neglected to include the large amount of knowhow when it transferred the engineers with their technical manuals and software. Therefore, an arm's length price for this I.P. should be determined in order to properly adjust the value.[21]

Finally, once the intangible properly is identified and valued, the examiner computes the Code §367(d) annual deemed royalty, which cannot exceed 20 years. The deemed royalty amount must be determined in accordance with the arm's length and commensurate with income standards of Code §482 and the regulations thereunder.[22]

CONCLUSION

When a U.S.-based multinational group expands operations abroad, a transfer of tangible assets is accompanied by a transfer of I.P. to an attractive location abroad, typically one in which I.P. box tax rules are in existence. Financial management is often focused on the tax benefits that may be derived from the global structure; tax management is often focused on the value of F.G.W.G.C. so that the effect of Code §367(d) is reduced. In this fact pattern, it is often forgotten that I.R.S. examiners are directed to review all items involved in a transfer of I.P. to ensure that the deemed royalty provisions of Code §367(d) are properly applied.

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19 *Id.*, p. 22-23.

20 *Id.*, p. 24.

21 *Id.*, p. 25.

22 *Id.*, p. 26.

INTERNATIONAL PRACTICE UNIT: WHAT THE I.R.S. LOOKS FOR WHEN DECIDING IF A U.S. SHAREHOLDER HAS AN INTEREST IN A C.F.C.

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INTRODUCTION

In the flurry of new International Practice Units published by the I.R.S. in October and November, the I.R.S. issued the "Determination of a U.S. Shareholder and C.F.C. Status" (the "Practice Unit").[1] The Practice Unit is designed to identify steps for I.R.S. examiners to use when conducting an audit to determining whether a foreign corporation owned by a U.S. taxpayer is a controlled foreign corporation ("C.F.C.") and whether the taxpayer is a "U.S. Shareholder" for purposes of Subpart F taxation. During the audit, the examiner is encouraged to inquire about ownership interests in all foreign entities owned by the taxpayer and to examine all foreign entities that wire funds to the taxpayer.

BACKGROUND

The foregoing audit steps are encouraged in order to confirm that the profits of the foreign corporation are properly deferred until dividends are received by the U.S. taxpayer. Under U.S. tax law, a U.S. person can defer paying taxes on the profits of a foreign corporation in which it owns an interest until the time that such profits are repatriated in the form of a dividend. Where the U.S. taxpayer controls the foreign corporation, or is part of a U.S. group of major shareholders that control the corporation, this rule is cut back when (i) the foreign corporation is a C.F.C., (ii) the taxpayer is a U.S. Shareholder, and (iii) the C.F.C. has certain income that is characterized as "Subpart F Income" or it makes an "investment in U.S. Property" that creates a major tax benefit. Under the Subpart F rules, the earnings of a C.F.C. that are categorized as Subpart F Income may be taxed when and as earned at the level of its U.S. Shareholders even if no dividend is distributed.

A foreign corporation is a C.F.C. if shares representing more than 50% of its voting power or value are owned by U.S. Shareholders. A U.S. Shareholder is a U.S. person that owns shares representing 10% or more of the total combined voting power of the C.F.C.[2]

The Practice Unit is designed to help the examiner determine if a taxpayer is a U.S. Shareholder in a C.F.C. for U.S. tax purposes and therefore subject to certain filing requirements under Subpart F. If a taxpayer is determined to be a U.S. Shareholder of a C.F.C., certain informational returns, such as Form 5471, must be filed. If the

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1 "Determination of a U.S. Shareholder and C.F.C. Status," LB&I International Practice Service Transaction Unit, 10/7/2015.

2 There is a lower U.S. ownership threshold for certain foreign insurance companies. However, the tax rules applicable to foreign insurance companies that are C.F.C.'s are beyond the scope of this article.

U.S. Shareholder holds shares in a foreign corporation that is not a C.F.C., the taxpayer may have other tax reporting requirements if, for example, the foreign corporation is a P.F.I.C. In both cases, a Form 8938, Statement of Specified Foreign Financial Assets, may be required if the shareholder is an individual meeting the reporting threshold.

ISSUES UNDER EXAMINATION

There are three primary audit issues identified in the Practice Unit with regard to determining the U.S. Shareholder and C.F.C. status for companies other than insurance companies:

1. Does the taxpayer directly, indirectly, or constructively through attribution own shares in a foreign corporation?
2. Is the taxpayer a U.S. Shareholder?
3. Is the foreign entity a C.F.C.?

The examiner is instructed to consider all of the facts and circumstances of how a U.S. person may effectively have control or ownership of the foreign corporation. The examiner will gather background information on the taxpayer and the foreign entity and will determine if the entity has C.F.C. status.[3] In making the decision, the examiner should consider the percentage of ownership and the citizenship and/or residency of the U.S. Shareholder and any other shareholders. Under the constructive ownership rules in which ownership of shares by one person or entity is attributed to another person a U.S. person may have an ownership interest in a foreign corporation that is greater than actual ownership. Therefore, the examiner will need to gather information on related individuals and entities in order to determine how the Subpart F rules may be applied to the taxpayer under examination.

Once the examiner decides that the shareholder possesses a sufficient interest in a foreign entity, the examiner will consider whether the entity is a corporation for U.S. tax purposes. Under the entity classification regulations,[4] certain foreign entities are always treated as corporations. These entities are known as "per se" corporations, and they tend to be entities that are authorized to issue shares that can be listed on a public exchange. Under the regulations, other foreign entities, known as "eligible entities," are allowed to elect classification (*i.e.*, corporation or partnership, if there are two owners; disregarded entity, if there is only one owner) on Form 8832, Entity Classification Election.

The Practice Unit provides a list of information return forms that may shed light on the ownership structure of a C.F.C.:

- Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations, and Instructions*
- Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*
- Form 8832, *Entity Classification Electio*

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[3] Code §§957, 958, 953.

[4] Treas. Reg. §§301.7701-1, 301.7701-2, 301.7701-3.

- Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships, and Instructions*
- Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, and Instructions*
- Form 3520A, *Annual Return of Foreign Trust With a U.S. Owner, and Instructions*
- Form 8938, *Statement of Foreign Financial Assets*

"The examiner will look at the person's direct, indirect, and constructive ownership of shares in the foreign corporation....

However, only direct and indirect ownership is used to determine the amount of income actually included under Subpart F."

Documents that may be requested and reviewed in order to determine the ownership of the foreign corporation include

- foreign entity stock certificates, to determine ownership or control of the entity and the percent owned by each shareholder;
- foreign entity articles of organization, to determine the type of entity and the classes of shares issued and outstanding; and
- a global organization chart, to track direct and indirect ownership of the entity's shares and constructive ownership.

If questions remain, the examiner will consider issuing the following follow-up form and documents:

- Form 4564, Information Document Request ("I.D.R.")
- Formal Document Requests
- Summons

The examiner should also consider using the following follow-up tools:

- Internet Research
- Integrated Data Retrieval System ("I.D.R.S.")
- Accurint
- FinCEN Query
- YK1 Link Analysis

Determining Ownership

To determine if a U.S. person is a U.S. Shareholder of a foreign corporation, the examiner will look at the person's direct, indirect, and constructive ownership of shares in the foreign corporation. Ownership is determined under the rules applicable to each of these categories – the rules are conjunctive not disjunctive. They are applied to categorize income of a C.F.C. that may give rise to an inclusion under Subpart F. However, only direct and indirect ownership is used to determine the amount of income actually included under Subpart F.[5]

Shares owned directly by a foreign entity in a foreign corporation are considered

[5] Code §§951(a)(1), 958(a)-(b); Treas. Reg. §§1.958-1, 1.958-2.

to be owned indirectly by the shareholders, partners, or beneficiaries of that entity in proportion to the respective ownership percentages of the shareholders.[6] When computing indirect ownership, only shares held by a foreign entity are considered shares to be owned by another U.S. person. Shares held by domestic persons are not taken into account. These rules are illustrated in the following fact pattern:

> U.S. persons A and B each own directly 50% of foreign Corporation U. Corporation U owns directly 60% of foreign Corporation V.
>
> A and B are each a 30% indirect shareholder of V (50% x 60% = 30%).
>
> If Corporation U were a domestic corporation, under the indirect ownership rules, neither A nor B would have any indirect ownership in Corporation V, because attribution stops with the first U.S. person in the chain of ownership from the foreign corporation.[7]

Constructive ownership means that shares owned by one person – not necessarily at a lower level in a chain of ownership – are attributed to another person. For example, shares owned directly or indirectly by an individual's spouse, children, grandchildren, or parents are attributed to the individual who becomes the constructive owner of those shares for purposes of applying the Subpart F rules. As a result, constructive ownership rules apply for determining whether the U.S. person is a U.S. Shareholder and whether a foreign corporation is a C.F.C., but they are not considered in determining the amount of a U.S. Shareholder's Subpart F inclusion.[8] A corporation, partnership, trust, or estate that owns more than 50% of the voting shares of a corporation is considered to own 100% of the voting shares of that corporation for purposes of computing the amount reattributed to others. Stock owned by a nonresident alien individual is not treated as owned by a U.S. person.[9]

"Constructive ownership means that shares owned by one person – not necessarily at a lower level in a chain of ownership – are attributed to another person."

More than one family member can be attributed the same shares. For example, shares owned by a child can be attributed to both a parent and a grandparent. There is no attribution between siblings, and shares that have been attributed to a family member cannot be reattributed from that family member to another person. Thus, shares actually owned by grandparents can be attributed to their children. However, the same shares cannot be reattributed from the children to the grandchildren. There is no direct attribution from grandparents to grandchildren.

The Practice Unit presents the following fact pattern illustrate the determination of constructive ownership:

> A, B, C, and D are U.S. persons. A and B are married and each owns 25% of foreign Corporation X. Additionally, C, their daughter, and D, C's daughter, each own 25% of Corporation X. A and B are each considered to own 100% of Corporation X because they are attributed each other's shares, as well as the shares owned by C (their daughter) and D (their granddaughter).

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6 Code §958(a)(2).

7 Practice Unit, p. 13.

8 Code §958(b).

9 Treas. Reg. §1.958-2.

> C also constructively owns 100% of Corporation X, because she is attributed shares actually owned by her parents and her daughters shares. D constructively owns 50% (only her own and [through attribution] her mother's stock).
>
> If D were a nonresident alien, A, B, and C would only constructively own 75% of Corporation X because shares of a nonresident alien is not attributed to a U.S. person.[10]

To determine the direct ownership by the U.S. person, the examiner is instructed to review the foreign entity's share certificates. If there is more than one owner in a foreign entity, the examiner is instructed to investigate whether the U.S. person has ownership in a foreign entity (such as a foreign corporation, foreign partnership, or foreign estate) that itself owns shares in the foreign corporation. The shares owned by the foreign entity will be attributed to its shareholders in proportion to their ownership interests in the foreign entity, under the rules and the adjustment discussed above. The examiner will also consider other ways the U.S. person may have direct, indirect, or constructive ownership in a foreign entity. For example, the taxpayer may have

- nominee ownership, which exists when shares are held for the benefit of a U.S. person through a third party (*e.g.*, an agent, attorney, or a trustee) in order to provide that the U.S. person obtains an actual or constructive benefit;[11]
- signature authority, which exists when a U.S. person effectively controls the foreign entity through a power of attorney or a corporate directorship; and
- voting agreement, which exists when a U.S. person has a proxy to select a majority of the board of directors.[12]

The tools available to the examiners to make this determination include the following:

- Taxpayer interviews
- Internet research
- Organization charts
- Accurint
- FinCEN Query
- Contacting Exchange of Information ("E.O.I.") and/or the Joint International Tax Shelter Information and Collaboration Network ("J.I.T.S.I.C."), which are governmental collaborative groups to which the I.R.S. belongs on a global level

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[10] Practice Unit, p. 15. See also Code §958(b).

[11] Bank statements of the foreign corporation can provide evidence that may support the substantive control the taxpayer has over an entity. See *Garlock v. Commissioner*, 489 F .2d 197 (2d Cir. 1973).

[12] Code §958(a); Treas. Reg. §§1.958-1, 1.951-1(g)(2).

Determining U.S. Shareholder Status

If, after reviewing all the documents, the examiner concludes that the U.S. taxpayer has direct, indirect, or constructive ownership, then the examiner is instructed to consider whether the taxpayer is a U.S. Shareholder.

For purposes of determining C.F.C. status, a U.S. Shareholder is a U.S. person owning shares of the foreign entity representing 10% or more of the total combined voting power of all classes of shares of the foreign entity that are entitled to vote for the entity's Board of Directors.[13] A U.S. person is

- a citizen of the United States,[14]
- a non-U.S. citizen who is a U.S. resident (including a lawful permanent resident or an individual who meets the substantial presence test),[15]
- a domestic partnership,[16]
- a domestic corporation,[17] or
- any estate or trust other than a foreign estate or trust.

If a U.S. person owns the requisite percentage of shares, the U.S. person has the status of a U.S. Shareholder, meaning that an inclusion in income is possible if the foreign entity is a C.F.C. and the C.F.C. derives Subpart F Income or makes an investment in U.S. property. The following actions are suggested in making such a determination:

"If, after reviewing all the documents, the examiner concludes that the U.S. taxpayer has direct, indirect, or constructive ownership, then the examiner is instructed to consider whether the taxpayer is a U.S. Shareholder."

- The examiner may request documents of how and when the taxpayer acquired ownership (*e.g.*, Form 926, *Return by U.S. Transferor of Property to a Foreign Corporation*; Articles of Organization; organization chart).
- The examiner may obtain foreign records from E.O.I. or treaty requests, or utilize the assistance of the I.R.S. Tax Attaché covering a particular country, J.I.T.S.I.C., or the Information Gathering I.P.N.
- The examiner may gather information on related parties to consider how ownership of shares may be attributed to the taxpayer.
- The examiner may use internet research to look for articles or documents associating the taxpayer to foreign entities.

Determining C.F.C. Status

Once the examiner determines that a taxpayer is a U.S. Shareholder, the examiner is instructed to examine whether the foreign entity is a C.F.C.

As mentioned above, the foreign entity must be a corporation for U.S. tax purposes in order to be treated as C.F.C. The regulations provide a list of corporations that are "per se" corporations for U.S. tax purposes. Other foreign entities can qualify as

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[13] Code §957(c).

[14] Code §7701(a)(30).

[15] Code §7701(b)(3).

[16] Code §7701(b)(7).

[17] Code §951(b).

corporations under default rules if unlimited liability exists for one or more members, and if not, the entity can make a check-the-box election.

A foreign corporation is a C.F.C. for a particular year if, on any day during such year, U.S. Shareholders own shares representing more than

- 50% of the total combined voting power of all classes of shares entitled to vote, or
- 50% of the total value of the shares.[18]

"To help to make a decision, the examiner is instructed to perform internet research and conduct taxpayer interviews."

Usually, if a corporation is organized in a U.S. commonwealth territory, or possession, it will be considered a foreign corporation and may be treated as a C.F.C.

A U.S. Shareholder is subject to the current inclusion rules of Subpart F only if the foreign corporation was a C.F.C for an uninterrupted period of 30 days or more during the taxable year and the U.S. Shareholder owned shares in the foreign corporation on the last day of such taxable year.[19]

In addition to considering the mere number of votes that a U.S. Shareholder is entitled to cast, the examiner is also instructed to look the U.S. Shareholder's substantive voting power with regard to

- electing, appointing, or replacing a majority of the board of directors (or corresponding governing group under local law);
- electing exactly half of the members of the board of directors and breaking a deadlock, or exercising managerial powers during a deadlock; and/or
- electing the person who exercises the powers ordinarily exercised by the board of directors.

The examiner is instructed to investigate and determine whether any arrangements exist to shift formal voting power away from a U.S. Shareholder.[20] These arrangements will not be given effect if in reality voting power is retained. For example, if there is an agreement that a shareholder owning 50% or less of the voting power will exercise power normally possessed by a majority of shareholders, the agreement should be disregarded. If the constitutive document of an entity calls for supermajority votes on specific issues, that should not be a disguised voting arrangement as the U.S. Shareholder owns only a veto power.

To help to make a decision, the examiner is instructed to perform internet research and conduct taxpayer interviews. The examiner can also request and review the following documents:

- Organization charts
- Corporate minutes
- Foreign country Articles of Organization
- Shareholder Agreements

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18 Code §957; Treas. Reg. §1.957-1(b).

19 Code §§951(a)(1), 7701(a)(3).

20 Treas. Reg. §1.957-1(b)(2).

Once the examiner determines that the taxpayer is a U.S. Shareholder and the foreign entity is a C.F.C., the Subpart F income of the C.F.C., if any, will be attributed to the U.S. Shareholder to the extent of its interest in the foreign entity.

CONCLUSION

The Practice Unit provides a roadmap for an examiner looking to determine whether an inclusion of income under Subpart F is appropriate when reviewing a tax return of a U.S. taxpayer owning shares in a foreign corporation. But, by doing so publicly, it alerts U.S. taxpayers to the level of detail involved in an examination of a tax return with foreign items. The examiner is encouraged to look at original documents, global structure charts, public sources of information, tax treaty information exchange channels, and global governmental collaborative groups to which the I.R.S. belongs in order to test the veracity of the information on a Form 5471. The I.R.S. has investigative tools at its disposal, and it will use them more and more in the course of an examination.

INTERNATIONAL PRACTICE UNIT: LICENSE OF INTANGIBLE PROPERTY FROM U.S. PARENT TO A FOREIGN SUBSIDIARY

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INTRODUCTION

The I.R.S.'s Large Business and International ("LB&I") Division issued a new International Practice Unit on November 4, 2015 called "License of Intangible Property from U.S. Parent to a Foreign Subsidiary" (the "Practice Unit").[1] As the name suggests, this Practice Unit focuses on the transfer of intangible property ("I.P.") exclusively by means of a license from a U.S. parent ("U.S.P.") to a related foreign entity, which may be the U.S.P.'s wholly-owned controlled foreign corporation ("C.F.C.").

The transfer pricing rules dictate that a license of I.P. from a U.S. person to a related foreign subsidiary must be at arm's length, as determined by Internal Revenue Code §482[2] and Treas. Reg. §1.482-4. The I.R.S. has decided to focus on this issue because if a foreign related entity pays its U.S.P. compensation for the use of I.P. that is less than an arm's length consideration, the U.S.P. will report income that is below the level of true taxable income.[3] Under Code §482, the I.R.S. can reallocate the income by increasing the U.S.P.'s income and decreasing the foreign entity's income. The Practice Unit is designed to target the C.F.C.'s use of the licensed I.P. and consider whether the C.F.C. paid the U.S.P. an arm's length amount to use the property.[4]

TRANSACTION AND FACT PATTERN

The Practice Unit provides an example of the I.P. license transaction involving a U.S.P. and its C.F.C. in order to present the issues and to provide a step-by-step audit approach to the examination of the license transaction.

The fact pattern established in the Practice Unit is that of a U.S.P. that was formerly only a U.S. business but has globally expanded to become a parent company of a worldwide group, which designs, develops, manufactures, sells, and distributes products worldwide. The U.S.P. conducts all research and development, owns all intellectual property, and sells and distributes products into the U.S. market. In order to expand, the U.S.P. licenses its I.P. to a C.F.C. in order for the C.F.C. to use the property to sell and distribute products into all non-U.S. markets.[5] The C.F.C. is

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1 "License of Intangible Property from U.S. Parent to a Foreign Subsidiary," LB&I, November 4, 2015.

2 All section references are to the Internal Revenue Code of 1986, as amended, (the "Code") and the regulations promulgated thereunder.

3 "License of Intangible Property from U.S. Parent to a Foreign Subsidiary," p. 3.

4 *Id.*

5 *Id.*, p. 5.

in a country with a low corporate tax rate. The overall effective tax rate in this fact pattern will be reduced improperly since income will be shifted to the low-tax foreign corporation from the U.S.[6]

It is important to note that if the C.F.C. is in a country in which a withholding tax provision of a tax treaty applies, the royalty payments received by the U.S.P. must utilize the treaty withholding rate reduction since any overpayment of withholding tax would not be categorized by the I.R.S. as a mandatory tax payment. Instead, it is viewed as a "voluntary payment" rather than a tax and would not be eligible to be claimed as a foreign tax credit.

ISSUES & AUDIT PROCEDURES

The Practice Unit has identified three potential issues that examiners should focus on when a U.S.P. licenses I.P. to a C.F.C.:

1. What I.P. rights have been licensed from the U.S.P. by the C.F.C.?
2. Did the U.S.P. receive arm's length consideration for the license of I.P. to the C.F.C.?
3. Was the consideration commensurate with income ("C.W.I.") attributable to the I.P.?[7]

The Practice Unit provides a step-by-step approach for how to conduct an audit of each issue. The first step, which applies to all three issues, is to ensure that a license of I.P. occurred by establishing the facts and supporting documentation to substantiate the license.

The Practice Unit focuses on five elements in order to establish the facts of the transaction:

1. Did the U.S.P. transfer I.P. under a licensing agreement to its C.F.C.?
2. What type of I.P. did the U.S.P. license to its C.F.C.?
3. Are the I.P. routine in nature or non-routine type I.P.?
4. What form of consideration (*e.g.*, lump sum, contingent payment, or installment payment) was received by the U.S.P.?
5. Does the Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, represent that rents, royalties, and license fees were paid by the C.F.C.?[8]

In order to examine these elements, the Practice Unit suggests referring to the following resources for guidance: transfer pricing studies, organizational charts, license agreements, intercompany agreements, invoices, taxpayer's financial statements, transfer pricing roadmaps, the taxpayer's internet site, and/or a mandatory

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[6] *Id.*, p. 6.

[7] *Id.*, p. 7.

[8] *Id.*, p. 8.

transfer pricing I.D.R. To establish the facts under the element regarding Form 5471, the Practice Unit suggests referring to schedule M, line 20.[9]

Once the facts for each case are developed, the analysis of each issue begins. The Practice Unit instructs the examiner to review potential sub-issues, perform additional factual development, and finally develop arguments for each issue concerned with the I.P. licensing.

Rights Licensed to the C.F.C.

In order to address the issue of what I.P. rights have been licensed from the U.S.P. to the C.F.C., the Practice Unit defines the terms at issue and explains the subject of the examination as outlined below:

- For purposes of section 482, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual:
    - Patents, inventions, formulae, processes, designs, patterns, or know-how;
    - Copyrights and literary, musical, or artistic compositions;
    - Trademarks, trade names, or brand names;
    - Franchises, licenses, or contracts;
    - Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
    - Other similar items. For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.
- A controlled transfer of Intangible Property means any transaction or transfer of such property between two or more members of the same group of controlled taxpayers. Determine if in fact an intangible as defined in Treas. Reg. 1.482-4(b) has been transferred from the USP to the CFC under a licensing arrangement.
- Determine what rights to the intangibles were transferred? Here are examples of the type of rights that may be transferred under a licensing arrangement.
    - Exclusive v. Non Exclusive
    - Sublicensing Rights
    - Geographic Rights

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9 *Id.*

- Manufacturing, Marketing, Distribution (Make/Sell)
- Research Rights.[10]

The Practice Unit instructs the examiner to refer to Treas. Reg. §1.482-1(i)(7), Treas. Reg. §1.482-1(i)(8), and Treas. Reg. §§1.482-4(a) and (b).

Next, the Practice Unit instructs the examiner to answer the following questions by referring to the U.S.P.'s and C.F.C.'s transfer pricing roadmaps and studies, license agreements, intercompany agreements, and/or their internet sites:

"In a controlled transfer of I.P., arm's length consideration must be determined under one of four methods listed in Treas. Reg. §1.482-4(a)."

- Is there a license of I.P. between controlled parties?
- What type of I.P. is being licensed?
- What rights to the I.P. were licensed?[11]

The examiner must consider all the facts and circumstances of each specific case in order to determine whether the U.S.P.'s I.P. has been licensed. The examiner must establish that there is a controlled transfer of I.P. under a licensing arrangement pursuant to Treas. Reg. §§1.482-1(i)(7) and (i)(8), and §§1.482-4(a) and (b). In the analysis, the examiner must determine the type of I.P., the rights associated with that I.P., and whether the U.S.P. was properly compensated for the transfer of such I.P. under the licensing arrangement.[12] If the examiner determines that there was a license of I.P. rights that required the C.F.C. to make an arm's length payment to the U.S.P., the examiner may proceed to the next issue.[13]

Arm's Length Consideration for the License

In order to address the issue of whether the U.S.P. received arm's length consideration for the I.P. license to the C.F.C., the Practice Unit establishes that in a controlled transfer of I.P., arm's length consideration must be determined under one of four methods listed in Treas. Reg. §1.482-4(a), *i.e.*, the Comparable Uncontrolled Transaction ("C.U.T.") method,[14] Comparable Profits Method ("C.P.M."),[15] Profit Split method,[16] or the Unspecified Method.[17] Each method must be applied according to the provisions of Treas. Reg. §1.482-1, including the Best Method Rule of Treas. Reg. §1.482-1(c), the comparability analysis of Treas. Reg. §1.482-1(d), and the arm's length range of Treas. Reg. §1.482-1(e). The Practice Unit further explains the issue as follows:

- If the Taxpayer applies one of the methods in Treas. Reg. 1.482-4(a), and that method achieves the most reliable measure of an arm's length result, it will be considered the best method.

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[10] *Id.*, p. 9-10.

[11] *Id.*, p. 11.

[12] *Id.*, p. 12.

[13] *Id.*, p. 13.

[14] Treas. Reg. §1.482-4(c).

[15] Treas. Reg. §1.482-5.

[16] Treas. Reg. §1.482-6.

[17] Treas. Reg. §1.482-4(d).

- If the CUT Method is selected as the best method, additional comparability analysis under Treas. Reg. 1.482-4(c)(2) needs to be considered, as well.
- If the consideration received by the USP falls within the arm's length range under the best method, no adjustment is necessary.[18]

The Practice Unit instructs the examiner to consider the amount paid by the C.F.C. to the U.S.P., as well as the following questions, in light of the company's various agreements, ledgers, financial statements, and other documents that could be useful in determining whether there was arm's length consideration:

- What was the form of the consideration?
    - Lump sum
    - Installment
    - Contingent payment *e.g.* Royalty
- What method did USP select in determining the arms length compensation to receive from CFC?
    - Comparable Uncontrolled Transaction
    - Comparable Profits Method
    - Profit Split
    - Unspecified Method
- What are the functions, risks, and assets employed respectively by the USP and CFC?
- Was the method selected the best method based on facts and circumstances?
    - Comparability
    - Completeness and Accuracy of Data
    - Reliability of Assumptions
    - Sensitivity of Results
- What was the arm's length range under the best method selected?
    - Comparables
    - Multiple Year Data
    - Interquartile Range[19]

[18] "License of Intangible Property from U.S. Parent to a Foreign Subsidiary," p. 14.

[19] *Id.*, p. 15-17.

After establishing that there is a controlled transfer of I.P. by the U.S.P. to the C.F.C. under a licensing arrangement, the examiner must determine whether the U.S.P. received an arm's length consideration from the C.F.C. The arm's length consideration must be determined under one of the methods enumerated in Treas. Reg. §1.482-4(a): C.U.T., C.P.M., Profit Split, or Unspecified Method.[20] The examiner must consider all the facts and circumstances of each specific case in order to determine whether the best method was chosen. Furthermore, the examiner must ensure the U.S.P.'s comparables are truly comparable to its line of business and its controlled transfer. If the consideration received by the U.S.P. is not within the arm's length range, the examiner is instructed to adjust the income.[21]

"The arm's length consideration for the transfer of an intangible from USP to CFC must be commensurate with the income attributable to the intangible."

Consideration that is Commensurate with Income ("C.W.I.") from I.P.

In order to address the issue of whether the consideration paid by the C.F.C. was C.W.I. attributable to the I.P. licensed by the U.S.P., the Practice Unit defines the terms for purposes of an examination and explains the subject as follows:

- The arm's length consideration for the transfer of an intangible from USP to CFC must be commensurate with the income attributable to the intangible. There are exceptions to applying CWI to the compensation charged by USP if the requirements under Treas. Reg. 1.482-4(f)(2)(ii)(A),(B),(C),(D) and (E) are met.
- Typically, if USP retained a substantial interest in the licensed intangible property, the arms length consideration subject to CWI shall be in the form of a periodic (usually annual) royalty, calculated at the time of the license using forecasted profits or cost savings attributed to the licensed intangible.
- Generally, if the licensing arrangement between USP and CFC covers more than one year, it may be possible to make an adjustment to the compensation charged in each taxable year under the method chosen to ensure that it is commensurate with the income being generated from the use of the intangible by CFC.
- Such adjustment may be possible if all of the requirements for applying CWI are met and the taxpayer does not qualify for one of the exceptions.
- The questions that need to be answered by the examiner when considering CWI:
    1. Are the profits being earned by the CFC materially disproportionate (in the manner described in the section 482 regulations) to the projected profits that both parties anticipated at the time of original transfer or intangibles?
    2. Does the taxpayer meet any of the exceptions to the application of CWI?

[20] *Id.*, p. 18.

[21] *Id.*, p. 19.

If the answer to question 1 is yes and the answer to the question 2 is no, then it may be possible to make a CWI adjustment.[22]

The Practice Unit instructs the examiner to answer the following questions by referring to the transfer pricing roadmaps and studies, contracts, intercompany agreements, and annual reports of the U.S.P. and C.F.C.:

- Does the license arrangement cover more than one year?
- Was nominal or no consideration charged by USP to CFC for the licensed intangible at the inception of the license?
- Did USP retain a substantial interest in the licensed intangible?
- Does the license agreement require CFC to make periodic payments to USP for use of the intangible?
- Do any of the exceptions to CWI apply?
  - CUT with same intangible
  - CUT with Comparable Intangible or Other Method
- Written contract, defined terms and time period, no substantial changes in functions performed, and actual profits or cost savings fall within 80% to 120% of forecasts.
  - Extraordinary events that could not reasonably have been anticipated
  - No CWI adjustments made after 5 years beginning with the first year in which substantial periodic consideration was required to be paid under the license agreement[23]

If all of the requirements for applying the C.W.I. principle have been satisfied and the U.S.P. does not meet an exception, the consideration charged by the U.S.P. to the C.F.C. in each taxable year might be adjusted to ensure it is commensurate with the income attributable to such I.P. under Treas. Reg. §1.482-4(f)(2).[24]

CONCLUSION

The three issues discussed above outline the focus of an I.R.S. examination of whether a C.F.C. paid an arm's length amount to use I.P. developed and owned by its U.S.P. As U.S.-based groups expand abroad and license I.P. to foreign related entities, I.R.S. examinations should be anticipated. The Practice Unit describes how such examinations will be conducted with regard to the arm's length nature of license fees that were, or should have been, paid.

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22 *Id.*, p. 20-21.

23 *Id.*, p. 22-23.

24 *Id.*, p. 24.

INTERNATIONAL PRACTICE UNIT:
MONETARY PENALTIES FOR FAILURE TO FILE FORM 5471

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Tags
C.F.C.
Failure to File
Form 5471
International Practice Units
LB&I
Penalties
Reasonable Cause
T.I.G.T.A.

INTRODUCTION

Background

Concern among governments regarding the level of international tax compliance has been on the rise in recent years. This has lead to the enactment of the Foreign Accounts Tax Compliance Act ("F.A.T.C.A."), the O.E.C.D. Common Reporting Standard, and the O.E.C.D. Base Erosion and Profit Shifting ("B.E.P.S.") project.

In the U.S., the I.R.S. has initiated increased enforcement efforts to ensure compliance with information reporting obligations. Such efforts include increased assessment of penalties. Form 5471 is one of the key information forms for U.S. companies operating abroad. The I.R.S. takes this form seriously, as reflected in the severity of penalties that can be imposed for compliance failures. Several years ago, the I.R.S. initiated an automated penalty process as the first measure to increase compliance. In late 2013, the Treasury Inspector General for Tax Administration ("T.I.G.T.A.") issued a report recommending tightening the penalty abatement procedures applicable to the automated penalties. The recommendation to tighten the abatement of penalties is a negative incentive to file a complete and accurate Form 5471.

The complicated and overlapping rules applicable to the preparation of Form 5471 are explained in a "how to" article published in *Insights* Vol. 1 No. 2.[1] This article addresses the penalties that can be imposed when the I.R.S. reviews a case involving a Form 5471 that has been filed late or that is filed on time but is not substantially complete. The goal is to explain the opportunity of abating penalties that may be imposed.

The Monetary Penalty and Reasonable Cause Relief – T.I.G.T.A. Report

The penalty for not filing a required Form 5471, for filing not timely, or for filing a substantially incomplete form is $10,000 per form per year (the "initial penalty"). Additional penalties for continued failure may be imposed, up to $50,000 per Form 5471 required (the "continuation penalty").

While the systematic imposition of penalties has improved compliance, the government found that many penalties were abated, perhaps inappropriately. The T.I.G.T.A. report made the following findings:

- In 43% of the cases reviewed, the penalties were inappropriately abated.
- In 45% of the inappropriately abated cases, the taxpayer claimed that the

[1] Galia Antebi and Stanley C. Ruchelman, "Tax 101 – Introductory Lessons: Form 5471 – How to Complete the Form in Light of Recent Changes," *Insights* 1, no. 2 (2014).

Form 1120 was timely filed, but did not provide any proof to support the claim.

- In 15% of those cases, the taxpayer requested relief as a first-time filer.
- In 12.5% of such cases, the taxpayer claimed an absence of knowledge regarding the form or relied on advice from a tax professional that was not knowledgeable of the filing obligation.
- In 10% of such cases, the taxpayer claimed an inability to timely file Form 1120 with an attached Form 5471 because the financial records were unobtainable or because of a financial problem.
- In 10% of such cases, the taxpayer claimed that the late filing was caused by either an unintentional taxpayer or tax preparer oversight.

"For returns file after March 18, 2010… the S.O.L. for assessing tax for an income tax return associated with a substantially incomplete Form 5471 expires three years after the date on which a substantially complete Form 5471 is provided."

The report stated that according to I.R.S. policy, the abatement request should have been denied in all such cases. It stated that ignorance of the law, forgetting to request an extension, being a first-time filer, having difficulty obtaining financial information, or having financial problems are not grounds for relief of penalties.

THE PRACTICE UNIT

The above-mentioned T.I.G.T.A. report recommended tightening the abatement process, and the I.R.S. is now focusing on the assessment of a monetary penalty process internally and on the review of reasonable cause applications. On October 7, 2015, the I.R.S. issued the International Practice Service Process Unit – Audit (the "Practice Unit"), a guide that provides I.R.S. agents with advice on how to handle audit cases where it has been determined the taxpayer had a requirement to file a Form 5471.[2] This Practice Unit is limited to the review of cases where the requirement to file was that of Category 4 and 5 Filers, *i.e.*, those having control over foreign corporations (Category 4) and those owning at least 10% of a Controlled Foreign Corporation ("C.F.C.") on the last day of the corporation's tax year (Category 5).[3]

The Practice Unit provides that for returns filed after March 18, 2010, or returns filed prior to March 19, 2010 for which the statute of limitations ("S.O.L.") was otherwise open on that date, the S.O.L. for assessing tax for an income tax return associated with a substantially incomplete Form 5471 expires three years after the date on which a substantially complete Form 5471 is provided. The extended S.O.L. applies to any tax return or period to which the information relates, *i.e.*, it applies to all items of income and deduction reported on the income tax return to which the Form 5471 was required to be attached. In addition, related income tax returns for prior periods are not required to be under examination in order to assess penalties for those years. Therefore, the Practice Unit suggests that I.R.S. agents who find that Form 5471 was required but not filed for the exam year also review earlier years to determine whether this form was required but not filed in such years. In reviewing whether all required forms were timely and properly filed, the Practice Unit suggests reviewing and comparing different documents as part of the audit process. The goal is to ensure that the examiner has a full picture of the global structure. Thus, the

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2 Practice Unit FEN/9433.01_06(2013)(c).

3 Constructive ownership rules apply in determining ownership for both categories of filers.

examiner should look at all returns and forms,[4] tax organization charts, and legal entity charts for the year under audit plus the two preceding tax years, as well as forms filed with the Securities Exchange Commission.

For income tax returns filed late, the initial penalty is assessed automatically, even when a request for reasonable cause was submitted with the tax return. The assessment results in a notice stating that the taxpayer may pay the penalty or request an abatement of the penalty for late filing due to reasonable cause.[5] After review of the reasonable cause statement, the penalty is either abated or the taxpayer must pay it or petition to the Office of Appeals.

If reasonable cause is found to exist for late filing, penalties may nevertheless be assessed if Form 5471 was substantially incomplete. While the first step in the process is a review of the face of the form for completeness and consistency, the complete review must include the taxpayer's explanation as well as an assessment of the magnitude and the complexity of the error found. The information required on Form 5471 must be furnished even if that information may not affect the amount of any tax due under the Code. According to the Practice Unit, the following could be an indication that Form 5471 is not substantially complete:

- Any error on page 1 of the form is an indication that the form is not "substantially complete." This includes
  - omitting to check the box of the category of the filer or incorrectly checking this box,
  - omitting the percentage of voting stock owned or filling in an incorrect percentage,
  - not attaching all the required schedules,
  - omitting the name or address of the foreign corporation or certain information regarding its corporate formation.
- Required schedules that are missing constitute by themselves an incomplete form.
- When inconsistencies or math errors are found on the face of the form and such errors are significant in amount, the form is substantially incomplete.
- When a Form 5471 is filed with a statement saying the required information will be furnished upon request or audit, the form is substantially incomplete.
- Providing consolidated financial statements of two or more foreign corporations is a common reason for noncompliance or error in completing the form.
- Filing requirements do not apply to a foreign corporation that has been dissolved. However, I.R.S. agents are encouraged to seek that the winding up transactions are reported on the final Form 5471. To do that, the Practice

[4] *E.g.*, Form 1120, *Corporate Income Tax Return, and Form 8832, Entity Classification Electio* .

[5] This notice does not initiate the 90-day period for application of the continuation penalty. The I.R.S. must send taxpayers a letter notifying them of the requirement to file and that a 90-day count begins.

Unit suggests that I.R.S. agents request a copy of all exam-year general ledger transactions for such companies and look for significant transactions that may have occurred and been unreported.

- Filing requirements also apply to a dormant foreign corporation.

Providing too much of the required information can also be an indication that the form is not substantially complete. A 1997 Field Service Advice ("F.S.A.") mentioned in the Practice Unit states that Congress did not intend that providing excessive information be treated as substantial compliance. Under a strict interpretation of the regulation, over-reporting is problematic because the error itself undermines the ability of the I.R.S. to rely upon the taxpayer's reporting of related-party transactions. Nevertheless, the F.S.A. recommended that "substantial compliance" be determined by reference only to significant items. The examiner should determine if an error was significant in amount and whether the I.R.S.'s ability to gather information necessary to conduct an effective examination was impacted.

Under Chief Counsel Advice ("C.C.A.") 200429007, a facts and circumstances analysis is the preferred analysis over a strict interpretation of the regulations. This C.C.A., while only an informal guide, provides seven factors to use in such analysis. No one factor is necessarily more important than any other factor, but the factors themselves may contain evaluation characteristics which, when combined with other facts, indicate the completeness of the reporting. According to the C.C.A., the following are the facts and circumstances that should be considered:

- The magnitude of the underreporting or overreporting of the erroneous reported transaction
- Whether the reporting corporation has reportable transactions other than the erroneous reported one with the same related party and whether such other transactions were correctly reported
- The magnitude of the erroneous reported transaction in relation to all of the other correctly reported transactions
- The magnitude of the erroneous reported transaction in relation to the corporation's volume of business and overall financial situation
- The significance of the erroneous reported transaction to the corporation's business in a broad functional sense
- Whether the erroneous reported transaction occurred in the context of a significant ongoing transactional relationship with the related party
- Whether the erroneous reported transaction is reflected in the determination and computation of the reporting corporation's taxable income

"Providing too much of the required information can also be an indication that the form is not substantially complete."

Under C.C.A. 200645023, significant pieces of required information, the lack of which will be treated as "significantly incomplete," include

- balance sheets and income statements, in accordance with U.S. Generally Accepted Accounting Principles ("G.A.A.P."), and
- income statements and income tax amounts that are in both functional and U.S. currencies.

Once an agent determines that the taxpayer has failed to timely file an accurate information return, he must issue a notice letter to the taxpayer. Such notice letter will initiate the count for the application of the continuation penalty, which begins 90 days after the date of the letter and continues until a substantially complete Form 5471 is provided. Extensions on the 90-day period are not provided for in the Code and are subject to the discretion of the agent. The Practice Unit warns that the notice letter must be sent to the taxpayer, not its representative, because such action can assist the taxpayer in his or her claim in appeals or in court that the notice letter was ineffective. If in response to the notice a substantially incomplete Form 5471 is filed, the continuation penalty period is still in effect. In such circumstances, while an I.R.S. agent is not required to send a second notice letter, it is good practice for appeals and in court, as it will show that the taxpayer had knowledge that the subsequently submitted Form 5471 was substantially incomplete.

"Reasonable cause could not have existed earlier than the due date for filing or the dat of the notice letter."

Reasonable Cause

As mentioned above, the Code provides that the initial penalty can be abated if the compliance failure is due to "reasonable cause" and not due to willful neglect. In order for the exception to apply, the taxpayer must file a statement in writing that provides all the facts alleged to be reasonable cause and contains a declaration that the statement was made under penalties of perjury. When a proper statement is filed, the I.R.S. will consider whether the reporting requirements should be treated as met. I.R.S. agents should look for the dates of the supporting documents and events, as reasonable cause could not have existed earlier than the due date for filing or the date of the notice letter. The Practice Unit further instructs agents to review all tax years open under the statutes and assure that such years are in compliance prior to considering reasonable cause relief.

The Practice Unit provides that the following facts may be treated under certain circumstances as reasonable cause:

- Erroneous advice or reliance
- Unable to obtain records
- Death, serious illness, or unavoidable absence

Ignorance of the law, by itself, is not reasonable cause. However, in conjunction with other factors, it might be. An honest misunderstanding of the law that is reasonable in light of all the relevant facts could suggest reasonable cause. To determine whether reasonable cause exists, the additional factors that should be considered include

- the taxpayer's education,
- past penalties,
- whether the taxpayer could not reasonably be expected to know of recent changes in the law or forms, and
- the level of complexity of a tax or compliance issue.

Generally, the most important factor in determining whether a taxpayer has reasonable cause and acted in good faith is the extent of the taxpayer's efforts to report the proper tax liability. In U.S. v. Boyle, the Supreme Court noted that reasonable cause requires the taxpayer to demonstrate that it exercised “ordinary business care and prudence” but nevertheless was “unable to file the return within the prescribed time.”

Generally, reliance on the substantive advice of an informed, qualified professional is reasonable. In contract, reliance on a professional to carry out ministerial duties not requiring special expertise, such as timely filing a return, is not reasonable cause. Arguments based on distance to the place where the company’s books and records are kept, language limitations, currency, and accounting practice and systems may not be reasonable cause for reporting errors because most persons required to file Form 5471 have the same circumstances. The cost of converting the financial statements to U.S. dollars and U.S. G.A.A.P. would constitute reasonable cause only if the exercise of ordinary business care and prudence would not have allowed the corporation to make the conversions because such conversion would have caused it undue hardship. While an isolated error may indicate inadvertence, not intention, a large number of incomplete Forms 5471 filed by a taxpayer do not indicate an isolated oversight but an intentional decision to file incomplete Forms 5471. Moreover, a taxpayer’s strong compliance history may indicate that the failure to file complete forms is not inadvertent.

Note that the fact that a foreign jurisdiction would impose civil or criminal penalties on the taxpayer or any other person for disclosing the required information and/or refusal on the part of a foreign trustee to provide information for any other reason does not constitute a reasonable cause.

If reasonable cause is determined to exist, the extended S.O.L. only applies to items related to the missing information on Form 5471.

CONCLUSION

Filing an incomplete or inaccurate Form 5471 results in high penalties under the practice now followed by the I.R.S. Reasonable cause relief is now more tightly reviewed by the I.R.S. and strong arguments are needed, supported by documentation demonstrating ordinary business care and prudence were exercised but nevertheless a complete return could not be timely filed.

It should be noted that the automatic relief from penalties for delinquent Forms 5471, which was available to taxpayers that had no underreported tax liabilities under F.A.Q. 18 to the 2012 Offshore Voluntary Disclosure Program, was eliminated when F.A.T.C.A. became effective on July 1, 2014.