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

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**Tags**
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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).

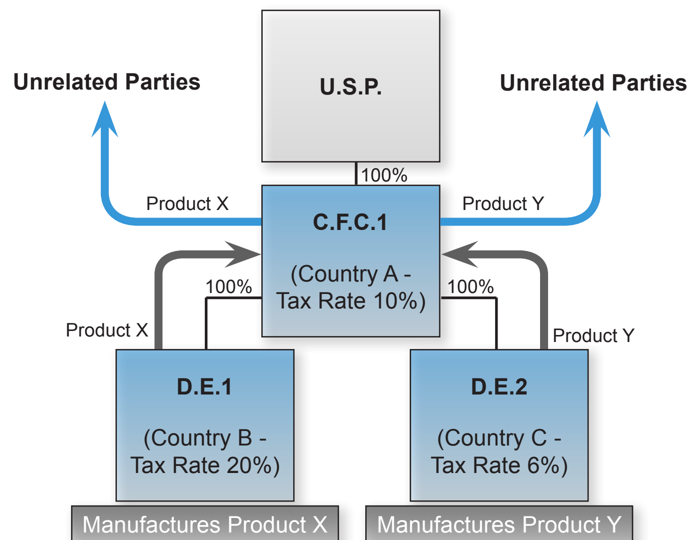
rate of tax ("E.R.T.") that is less than 90% of, and at least 5 percentage points lower than, the rate of tax that would apply to such income if, under the laws where the branch is located, all the income of the C.F.C. were allocated to the branch and treated in that country as being attributable to 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.

### Limitations Acknowledged

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

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

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

*<u>Step 1: Review Potential Issues</u>*

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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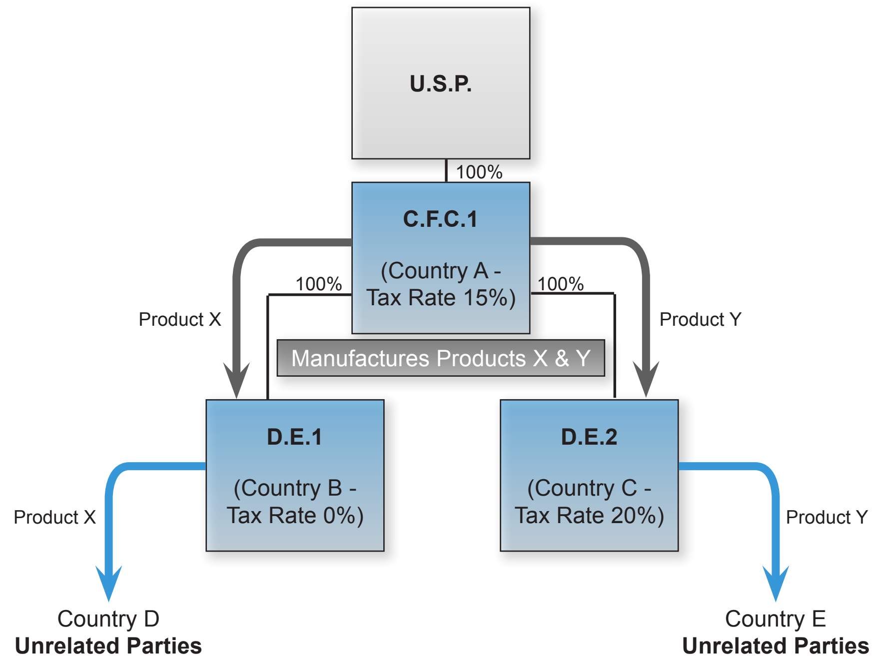
[14] Treas. Reg. §1.954-3(a)(4).

[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.

[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.

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.

***"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."***

*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).

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