Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I International Practice Service Transaction Unit

IPS Level	Number	Title	UIL Code	Number
Shelf	N/A	Business Outbound	–	–
Volume	2	Deferral Planning	**Level 1 UIL**	9412
Part	2.1	Foreign Base Company Sales Issues	**Level 2 UIL**	9412.01
Chapter	2.1.2	Application of Branch Rules	**Level 3 UIL**	9412.01-02
Sub-Chapter	2.1.2.2	Manufacturing branch	–	–

Unit Name	Sale by CFC to Unrelated Parties of Products Manufactured by Branch

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Issue and Transaction Overview

Sale by CFC to Unrelated Parties of Products Manufactured by Branch

When a controlled foreign corporation (“CFC”) conducts manufacturing outside its country of incorporation by or through a branch (or similar establishment), **and** the use of the branch has substantially the same tax effect (SSTE) as if the branch were a wholly-owned subsidiary deriving the income, then the manufacturing branch and the remainder of the CFC are treated (for purposes of the foreign base company sales income, or “FBCSI,” rules) as separate corporations. Furthermore, the sales made by or through the remainder of the CFC will be treated as made on behalf of the manufacturing branch, which generally results in FBCSI to the CFC. The term “branch or similar establishment” is not defined in the Code or the Regulations.

The mere existence of a branch outside the CFC’s country of incorporation does not necessarily result in FBCSI to the CFC. The tax rate disparity (TRD) test must be applied in order to determine whether the use of the branch has SSTE as if it were a separate corporation. The TRD test compares the hypothetical effective rate of tax (ERT) with respect to the hypothetical net sales income computed under the laws of the manufacturing jurisdiction (i.e., “hypothetical tax base”, discussed later in the unit) to the actual ERT with respect to that hypothetical tax base. If there is TRD (as discussed below), then the use of the branch is said to have SSTE as if it were a separate corporation, and the branch and the remainder of the CFC will be treated as separate corporations for purposes of determining the CFC’s FBCSI.

Generally, under the TRD test, a manufacturing branch and the remainder of the CFC will be treated as separate corporations if the actual ERT with respect to the hypothetical tax base is less than 90% of, and at least 5 percentage points below, the hypothetical ERT that would apply to that base in the country where the goods are manufactured. If there is TRD, then the branch and the remainder of the CFC are treated as separate corporations, in which case the remainder of the CFC will be treated as selling on behalf of the manufacturing branch, and the CFC generally will have FBCSI.

Note: this unit discusses the application of the branch rules to a CFC with one or more manufacturing branches. The application of the branch rules to a CFC with one or more sales branches is beyond the scope of this unit.

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Issue and Transaction Overview (cont'd)

Sale by CFC to Unrelated Parties of Products Manufactured by Branch

DECISION POINT: Under the "priority of application" (Treas. Reg. 1.954-3(b)(2)(ii)(f)) and "comparison with ordinary treatment" (Treas. Reg. 1.954-3(b)(2)(ii)(e)) rules, if income is FBCSI without regard to the branch rules, or if the income would not be FBCSI if derived by a separate CFC, the branch rules are not invoked. Stated another way, examiners must apply IRC 954(d)(1) first to determine whether the CFC's income is FBCSI without treating the branch as a separate corporation (and if so, examiners should not apply the branch rules), and examiners should not apply the branch rules where the income would not be FBCSI if the branch were a separate CFC.

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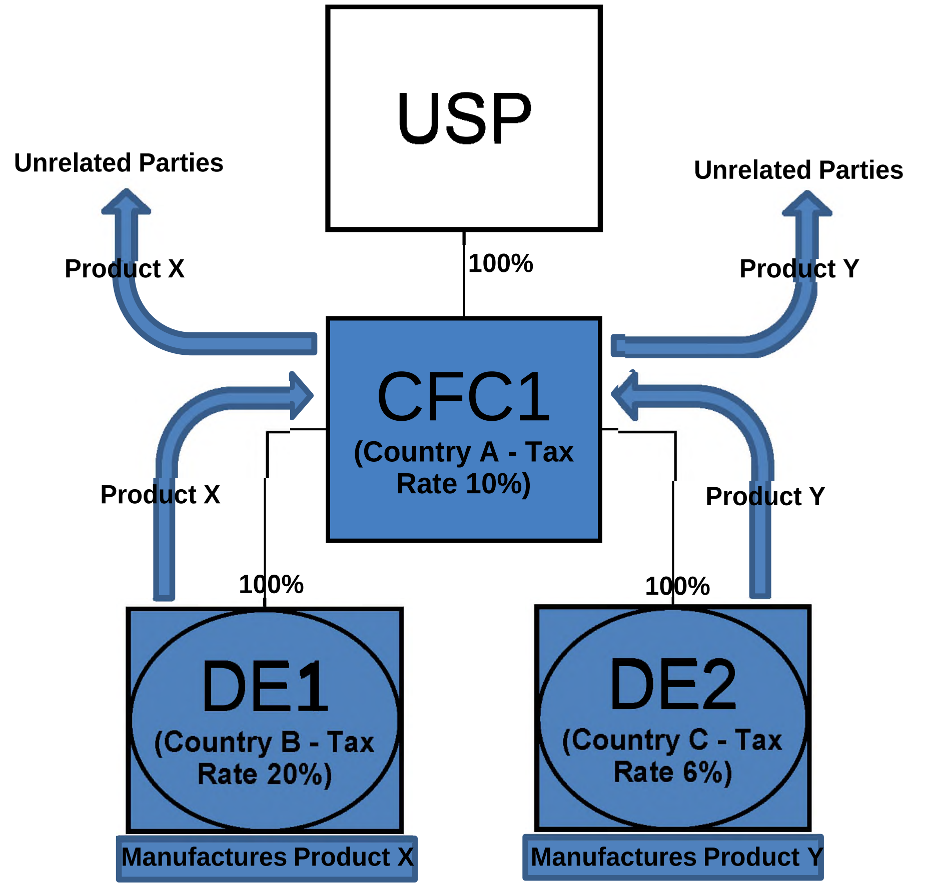
Transaction and Fact Pattern

Sale by CFC to Unrelated Parties of Products Manufactured by Branch

Diagram of Transaction



Facts

- CFC1 is incorporated in Country A, where the tax rate is 10%.
- DE1 is a hybrid entity (incorporated in Country B, where the tax rate is 20%, and disregarded for US tax purposes).
- DE2 is a hybrid entity (incorporated in Country C, where the tax rate is 6%, and disregarded for US tax purposes).
- DE1 manufactures Product X (from raw materials purchased from unrelated suppliers), and CFC1 sells Product X to unrelated customers outside Country A.
- DE2 manufactures Product Y (from raw materials purchased from unrelated suppliers) and CFC1 sells Product Y to unrelated customers outside Country A.

Remember, a DE is considered a branch of the CFC for US tax purposes.

Note: in the example in this unit, the statutory rates are assumed to be the same as the ERT for illustrative purposes only. In an actual exam fact pattern, the statutory rate will rarely equal the ERT due to variations among tax jurisdictions in exclusions, deductions, credits, and other tax attributes. See AM2015-002 for information on the computation of the ERT.

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Effective Tax Rate Overview

Sale by CFC to Unrelated Parties of Products Manufactured by Branch

ETR of Company

- The examiner should review the company's audited financial statements to determine the ETR 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 (PRI). Note that the ETR for financial statement purposes is not the same as the actual or hypothetical ERT for purposes of the manufacturing branch rule covered in this unit.
- The examiner will also have to determine the tax rates for the CFC and each of its branches including disregarded entities.
- 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.

ETR Impact of Adjustment

- Assuming (1) the E&P is PRI under APB 23 (now codified as ASC 740-30) and (2) the income of the CFCs is **not** subject to taxation under subpart F, the corporate group is able to reduce its worldwide ETR by shifting profits outside the US (or from a higher-tax foreign jurisdiction to a lower-tax foreign jurisdiction). This reduction in worldwide ETR is important for financial reporting purposes.
- An inclusion of subpart F income may increase the financial income tax expense of USP, resulting in higher ETR. However, Foreign Tax Credits (FTCs) may offset the increase in ETR if the FTCs had been an unrecognized deferred tax asset (e.g., a valuation allowance had prevented excess FTC carryovers from being recognized in financial statements as a deferred tax asset).

Summary of Potential Issues

Sale by CFC to Unrelated Parties of Products Manufactured by Branch	
Issue 1	Whether DE1 and the remainder of CFC1 are treated as separate corporations under the branch rules.
Issue 2	Whether CFC1 has FBCSI as a result of its sales of Product X.
Issue 3	Whether DE2 and the remainder of CFC1 are treated as separate corporations under the branch rules.
Issue 4	Whether CFC1 has FBCSI as a result of its sales of Product Y.

All Issues, Step 1: Initial Factual Development

Sale by CFC to Unrelated Parties of Products Manufactured by Branch

The rules for FBCSI are intended to prevent a US shareholder from using a CFC to shift sales income (1) from the U.S. to foreign jurisdictions, or (2) from a high-tax country to a low-tax country. Section 954(d)(2) addresses the situation in which a US shareholder of a CFC attempts to avoid the FBCSI rules by shifting the sales income to a lower-tax country through the use of a branch instead of a separate CFC.

Fact Element	Resources	6103 Protected Resources
▪ Verify whether CFC1 derives income from the purchase and sale of personal property, and determine where the property is manufactured and where the property is sold for use/consumption. ▪ Determine whether CFC1 is conducting manufacturing through DE1 or DE2. Note: in the scenario described in this unit, the sales income of the DEs would not be FBCSI (even if they and the remainder of CFC1 were treated as separate corporations) because the DEs manufacture the goods from which the income is derived. As such, this unit focuses on whether CFC1's income from *its sales* of Products X and Y is FBCSI.	▪ Branch Decision Tree ▪ Consolidating financial statements ▪ Form 5471 for CFC1 ▪ Form 8858 for DE1 and DE2 ▪ 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 ▪ Auditor's Workbench (formerly known as International Information Returns)	

Issue 1, Step 2: Review Potential Issues

Sale by CFC to Unrelated Parties of Products Manufactured by Branch
Issue 1
Whether DE1 and the remainder of CFC1 are treated as separate corporations under the branch rules.

Fact Element	Resources	6103 Protected Resources
When a CFC manufactures by or through a branch or similar establishment outside the CFC's country of incorporation, the manufacturing branch and the remainder of the CFC will be treated as separate corporations if there is TRD. Under the manufacturing branch rules, the TRD test compares the hypothetical ERT with respect to the hypothetical tax base to the actual ERT with respect to that base. Computing the ERTs involves determining the TRD Gross Income, the actual tax with respect to that income, the hypothetical tax base, and the hypothetical tax with respect to that base. Finally, the actual and hypothetical tax are divided by the hypothetical tax base and the resulting ERTs are compared.	▪ Treas. Reg. 1.954-3(b)(1)(ii) ▪ Treas. Reg. 1.954-3(b)(2)(ii)*(c)* ▪ Treas. Reg. 1.954-3(b)(4) *Ex. 2*	

Issue 1, Step 2: Review Potential Issues (cont'd)

Sale by CFC to Unrelated Parties of Products Manufactured by Branch
Issue 1
Whether DE1 and the remainder of CFC1 are treated as separate corporations under the branch rules.

Fact Element	Resources	6103 Protected Resources
1. Determine TRD Gross income, which, in the case of a manufacturing branch with sales in the remainder, of the CFC, is the CFC's gross income derived in connection with the sale of the property in question. 2. Determine the actual tax with respect to the TRD Gross Income (if necessary, determined separately from taxes on other income of the CFC). 3. Determine the hypothetical tax base, which is TRD Gross Income reduced by any exclusions and deductions that would be permitted in the manufacturing country if the income were derived from sources in that country through a permanent establishment (PE) there. 4. Multiply the hypothetical tax base by the applicable marginal tax rate(s) in the manufacturing jurisdiction to determine the hypothetical tax. 5. Divide the actual tax by the hypothetical tax base to compute the actual ERT; divide the hypothetical tax by the hypothetical tax base to compute the hypothetical ERT; compare these ERTs.	▪ Treas. Reg. 1.954-3(b)(1)(ii) ▪ Treas. Reg. 1.954-3(b)(2)(ii)*(c)* ▪ Treas. Reg. 1.954-3(b)(4) *Ex. 2* ▪ AM2015-002 ▪ BNA Portfolios "Business Operations Abroad" ▪ Tax research platform at www.ibfd.org (information regarding tax rates in various countries)	

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Issue 1, Step 3: Additional Factual Development

Sale by CFC to Unrelated Parties of Products Manufactured by Branch
Issue 1
Whether DE1 and the remainder of CFC1 are treated as separate corporations under the branch rules.

Fact Element	Resources	6103 Protected Resources
Compare the actual ERT in Country A to the hypothetical ERT in Country B. If the actual ERT is less than 90% of, and at least 5 percentage points below, the hypothetical ERT, then there is TRD, and DE1 and the remainder of CFC1 are treated as separate corporations for purposes of determining CFC1's FBCSI.	▪ Income tax returns filed by CFC1 and DE1 in Country A and B ▪ Transaction contracts/agreements ▪ Product Flows and Transaction Flowcharts ▪ Diagram, analysis or presentation regarding supply chain (including any supply chain agreements) ▪ Many US companies request a tax package, organizer, or other similar information from the CFC in order to prepare the 5471s and 8858s. Request a copy and review for further details of the facts.	

Issue 1, Step 4: Develop Arguments

Sale by CFC to Unrelated Parties of Products Manufactured by Branch
Issue 1
Whether DE1 and the remainder of CFC1 are treated as separate corporations under the branch rules.

Fact Element	Resources	6103 Protected Resources
The factual development in this transaction indicates that the actual ERT with respect to the hypothetical tax base is less than 90% of, and at least 5 percentage points below, the hypothetical ERT with respect to that base (i.e. there is TRD). As a result, DE1 and the remainder of CFC1 are treated as separate corporations for purposes of determining CFC1's FBCSI.	▪ Treas. Reg. 1.954-3(b)(1)(ii) ▪ Treas. Reg. 1.954-3(b)(2)(ii)*(c)*	

Issue 2, Step 2: Review Potential Issues

Sale by CFC to Unrelated Parties of Products Manufactured by Branch
Issue 2
Whether CFC1 has FBCSI as a result of its sales of Product X.

Fact Element	Resources	6103 Protected Resources
FBCSI (a type of subpart F income) arises when all of the following conditions are met. 1. A CFC buys/sells personal property from/to (or on behalf of) a related person, 2. The property is manufactured, produced, constructed, grown, or extracted outside the CFC's country of incorporation, and 3. The property is purchased/sold for use, consumption or disposition outside the CFC's country of incorporation. The income from the sale of property by the CFC is FBCSI unless an exception applies. The U.S. shareholder(s) of the CFC may have a subpart F inclusion.	▪ IRC 954(d)	

Issue 2, Step 3: Additional Factual Development

Sale by CFC to Unrelated Parties of Products Manufactured by Branch
Issue 2
Whether CFC1 has FBCSI as a result of its sales of Product X.

Fact Element	Resources	6103 Protected Resources
▪ Verify whether the sale of Product X by CFC1 falls within the definition of FBCSI (i.e. whether CFC1 sells, on behalf of a related party, property manufactured outside Country A for use outside Country A).	▪ Consider requesting schedules of sales by destination and copies of local country Value Added Tax (VAT) returns to verify place of manufacture, sale, use or consumption.	

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Issue 2, Step 4: Develop Arguments

Sale by CFC to Unrelated Parties of Products Manufactured by Branch
Issue 2
Whether CFC1 has FBCSI as a result of its sales of Product X.

Fact Element	Resources	6103 Protected Resources
The factual development in this transaction indicates that CFC1 sold Product X (manufactured outside Country A) for use outside Country A and that there is TRD. Because there is TRD, the regulations tell us that CFC1 is selling on behalf of DE1 (a separate, related corporation under the branch rules as outlined in Issue 1). Consequently, CFC1's income from the sale of Product X outside Country A is FBCSI, resulting in a subpart F inclusion to USP under IRC 951 (assuming there are sufficient E&P). Note that DE1 would not have FBCSI if it sold Product X itself, even to a related party, (even though DE1 is treated as a separate, related corporation under the manufacturing branch rules) since DE1 manufactures Product X (and therefore qualifies for the CFC manufacturing exception).	▪ IRC 954(d)	

Issue 3, Step 2: Review Potential Issues

Sale by CFC to Unrelated Parties of Products Manufactured by Branch
Issue 3
Whether DE2 and the remainder of CFC1 are treated as separate corporations under the branch rules.

Fact Element	Resources	6103 Protected Resources
When a CFC manufactures by or through a branch or similar establishment outside the CFC's country of incorporation, the manufacturing branch and the remainder of the CFC will be treated as separate corporations if there is TRD resulting from the use of the manufacturing branch. The TRD test compares the hypothetical ERT with respect to the hypothetical tax base to the actual ERT with respect to that base. Computing the ERTs involves determining the TRD Gross Income, the actual tax on that income, the hypothetical tax base, and the hypothetical tax with respect to that base. Finally, the actual and hypothetical tax are divided by the hypothetical tax base and the resulting ERTs are compared.	▪ Treas. Reg. 1.954-3(b)(1)(ii) ▪ Treas. Reg. 1.954-3(b)(2)(ii)*(c)* ▪ Treas. Reg. 1.954-3(b)(4) *Ex. 2*	

Issue 3, Step 2: Review Potential Issues (cont'd)

Sale by CFC to Unrelated Parties of Products Manufactured by Branch
Issue 3
Whether DE2 and the remainder of CFC1 are treated as separate corporations under the branch rules.

Fact Element	Resources	6103 Protected Resources
1. Determine TRD Gross income, which, in the case of a manufacturing branch with sales in the remainder of the CFC, is the CFC's gross income derived in connection with the sale of the property in question. 2. Determine the actual tax with respect to the TRD Gross Income (if necessary, determined separately from taxes on other income of the CFC). 3. Determine the hypothetical tax base, which is TRD Gross Income reduced by any exclusions and deductions that would be permitted in the manufacturing country if the income were derived from sources in that country through a permanent establishment (PE) there. 4. Multiply the hypothetical tax base by the applicable marginal tax rate(s) in the manufacturing jurisdiction to determine the hypothetical tax. 5. Divide the actual tax by the hypothetical tax base to compute the actual ERT; divide the hypothetical tax by the hypothetical tax base to compute the hypothetical ERT; compare these ERTs.	▪ Treas. Reg. 1.954-3(b)(1)(ii) ▪ Treas. Reg. 1.954-3(b)(2)(ii)*(c)* ▪ Treas. Reg. 1.954-3(b)(4) *Ex. 2* ▪ AM2015-002 ▪ BNA Portfolios "Business Operations Abroad" ▪ Tax research platform at www.ibfd.org (information regarding tax rates in various countries)	

Issue 3, Step 3: Additional Factual Development

Sale by CFC to Unrelated Parties of Products Manufactured by Branch
Issue 3
Whether DE2 and the remainder of CFC1 are treated as separate corporations under the branch rules.

Fact Element	Resources	6103 Protected Resources
Compare the actual ERT in Country A to the hypothetical ERT in Country C. If the actual ERT is less than 90% of, and at least 5 percentage points below, the hypothetical ERT, then there is TRD, and DE2 and the remainder of CFC1 are treated as separate corporations for purposes of determining CFC1's FBCSI.	▪ Income tax returns filed by CFC1 and DE2 in Country A and C ▪ Transaction contracts/agreements ▪ Product Flows and Transaction Flowcharts ▪ Diagram, analysis or presentation regarding supply chain (including any supply chain agreements) ▪ Many US companies request a tax package, organizer, or other similar information from the CFC in order to prepare the 5471s and 8858s. Request a copy and review for further details of the facts.	

Issue 3, Step 4: Develop Arguments

Sale by CFC to Unrelated Parties of Products Manufactured by Branch
Issue 3
Whether DE2 and the remainder of CFC1 are treated as separate corporations under the branch rules.

Fact Element	Resources	6103 Protected Resources
The factual development in this transaction indicates that the actual ERT with respect to the hypothetical tax base is **not** less than 90% of, and at least 5 percentage points below, the hypothetical ERT with respect to that base (i.e. there is no TRD). As a result, DE2 and the remainder of CFC1 are no**t** treated as separate corporations for purposes of determining CFC1's FBCSI.	▪ Treas. Reg. 1.954-3(b)(1)(ii) ▪ Treas. Reg. 1.954-3(b)(2)(ii)*(c)*	

Issue 4, Step 2: Review Potential Issues

Sale by CFC to Unrelated Parties of Products Manufactured by Branch
Issue 4
Whether CFC1 has FBCSI as a result of its sales of Product Y.

Fact Element	Resources	6103 Protected Resources
FBCSI (a type of subpart F income) arises when all of the following conditions are met. 1. A CFC buys/sells personal property from/to (or on behalf of) a related person, 2. The property is manufactured, produced, constructed, grown, or extracted outside the CFC's country of incorporation, and 3. The property is purchased/sold for use, consumption or disposition outside the CFC's country of incorporation. The income from the sale of property by the CFC is FBCSI unless an exception applies. The U.S. shareholder(s) of the CFC may have a subpart F inclusion.	▪ IRC 954(d)	

Issue 4, Step 3: Additional Factual Development

Sale by CFC to Unrelated Parties of Products Manufactured by Branch
Issue 4
Whether CFC1 has FBCSI as a result of its sales of Product Y.

Fact Element	Resources	6103 Protected Resources
▪ Determine whether the sale of Product Y by CFC1 falls within the definition of FBCSI (i.e. whether CFC1 sells, on behalf of a related party, property manufactured outside Country A for use outside Country A).	▪ Consider requesting schedules of sales by destination and copies of local country Value Added Tax (VAT) returns to verify place of manufacture, sale, use or consumption.	

Issue 4, Step 4: Develop Arguments

Sale by CFC to Unrelated Parties of Products Manufactured by Branch
Issue 4
Whether CFC1 has FBCSI as a result of its sales of Product Y.

Fact Element	Resources	6103 Protected Resources
The factual development in this transaction indicates that CFC1 and DE2 are viewed as a single economic unit (i.e. DE2 and the remainder of CFC1 are not treated as separate corporations as outlined in Issue 3). Consequently, the sale of Product Y by CFC1 does not generate FBCSI because there are no related parties involved in the transaction. Note that even if the raw materials used to manufacture Product Y were purchased from related parties, CFC1 would qualify for the CFC manufacturing exception from FBCSI under Treas. Reg. 1.954-3(a)(4). Note: if the income from the sale of Product X causes CFC1 to meet the “full inclusion” rule, then all the income of CFC1 is FBCI (including income from the sales of Product Y, which would not otherwise be FBCSI).	▪ IRC 954(d) ▪ IRC 954(b)(3)(B)	

Training and Additional Resources

Chapter 2.1.2 Application of Branch Rules		
Type of Resource	**Description(s) and/or Instructions for Accessing**	**References**
CENTRA sessions	▪ CLE Centra - Subpart F 20130930 ▪ Training - FY 2011 CPE "Live" Recordings ▪ Centra Subpart F June 2010 ▪ Branch Rules for FBCSI CPE Centra March 2015	▪ Discussion of branches is included in the Centra sessions linked at left.
White Papers / Guidance	▪ Westlaw subscription	▪ Bittker & Lokken 69.5.5 ▪ TMFEDPORT No. 928-3rd VII. H. Foreign Branch of CFC Treated as Separate Corporation ▪ TMFEDPORT No. 6380-1st IV. D. 2. a. (3) FBCSI The Branch Rule

Glossary of Terms and Acronyms

Acronym	Definition
CFC	Controlled foreign corporation
DE	Disregarded entity
E&P	Earnings & profits
ERT	Effective rate of tax
ETR	Effective tax rate
FBCI	Foreign base company income
FBCSI	Foreign base company sales income
FTC	Foreign tax credit
IIR	International Information Return
PE	Permanent establishment
PRI	Permanently reinvested (offshore) income
SSTE	Substantially the Same Tax Effect (as a separate corporation)
USP	United States parent

Index of Related Issues

Issue	Associated UIL(s)	References
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Branch rules for FBCSI	9412.01-02	▪ Branch Rules for FBCSI DPL/CU/C_2.1.2_07(2015)
Sales branches	9412.01-02	▪ Branch Sales to Unrelated Parties of Products Manufactured by CFC DPL/9412.01_08(2015)