



## LB&I International Practice Service Transaction Unit

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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	2.1.3	Other FBCS Issues	Level 3 UIL	9412.01-03
Sub-Chapter	2.1.3.2	Same Country Manufacturing Exception	–	–

<b>Unit Name</b>	CFC Sale to Related Party With Same Country Unrelated Party Manufacturing
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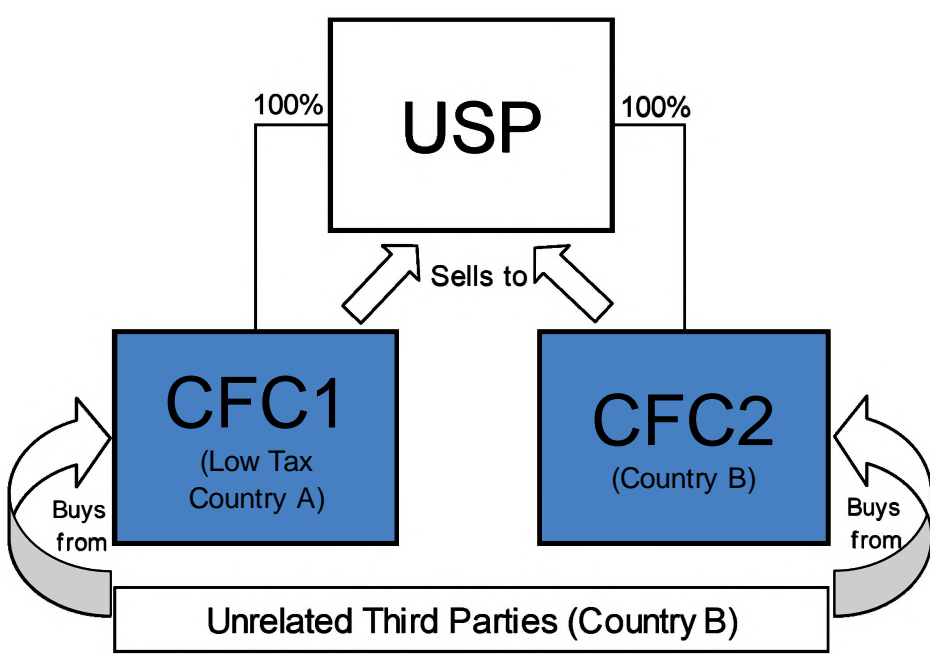
# Issue and Transaction Overview

## CFC Sale To Related Party With Same Country Unrelated Party Manufacturing

- The US shareholders of a foreign corporation generally are not subject to US taxation on the income of the foreign corporation until an actual dividend is remitted to the US shareholders. However, the US shareholders of a controlled foreign corporation (CFC) must include in gross income their pro rata share of the CFC's subpart F income ("subpart F inclusion"). One type of subpart F income is Foreign Base Company Income, which includes Foreign Base Company Sales Income (FBCSI). FBCSI includes income from transactions involving tangible personal property where either the buyer or seller is a related party (defined later in this Unit) with respect to the CFC. Please note that IRC 482 may also apply to purchases and/or sales between related parties because application of IRC 482 and IRC 954 is not mutually exclusive. The examiner should consult with the Transfer Pricing Practice or Income Shifting IPN regarding any potential transfer pricing issues.
- One of the purposes of the FBCSI rules is to prevent taxpayers from shifting sales income to a low- or no-tax jurisdiction. If property is manufactured within the CFC's country of incorporation, it is more likely that the country of incorporation was chosen for valid business purposes rather than tax avoidance.
- As such, one exception from FBCSI is when the property is manufactured (by anyone) within the CFC's country of incorporation (AKA same country manufacturing exception). This Unit examines scenarios in which CFCs purchase tangible personal property from an unrelated vendor and resell the property (without any additional modification or manufacturing) to the US Parent (USP). Specifically, this Unit addresses whether the sales income will qualify for the same country manufacturing exception from FBCSI.
- This Unit does not cover the detailed rules for determining what constitutes manufacturing (e.g. substantial transformation, substantial contribution, etc.) or the computation of Foreign Base Company (FBC) Income (including the high tax exception).
- The examiner should determine early on in the audit process the current amount of unrepatriated offshore earnings and profits (E&P), whether the CFC is engaged in transactions that generate FBCSI, and whether there are foreign tax credit offsets to any potential inclusion for FBCSI. This will allow the examiner to determine the potential tax adjustment net of any offsetting foreign tax credit.

# Transaction and Fact Pattern

## CFC Sale To Related Party With Same Country Unrelated Party Manufacturing

Diagram of Transaction	Facts
 <p>The diagram illustrates the transaction structure. At the top is a white box labeled 'USP'. Below it are two blue boxes: 'CFC1 (Low Tax Country A)' on the left and 'CFC2 (Country B)' on the right. At the bottom is a white box labeled 'Unrelated Third Parties (Country B)'. Arrows show ownership: '100%' lines connect USP to CFC1 and USP to CFC2. Arrows labeled 'Sells to' point from CFC1 and CFC2 towards USP. Curved arrows labeled 'Buys from' point from the 'Unrelated Third Parties (Country B)' box to CFC1 and from CFC2 to the 'Unrelated Third Parties (Country B)' box.</p>	<ul style="list-style-type: none"><li>▪ USP is a distributor.</li><li>▪ CFC1 (incorporated in Low Tax Country A) and CFC2 (incorporated in Country B) buy personal property from unrelated third parties in Country B and resell the property to USP.</li><li>▪ CFC1 and CFC2 do not modify the personal property in any way or conduct any manufacturing activities.</li><li>▪ USP ultimately resells the property to unrelated US customers.</li></ul>

# Effective Tax Rate Overview

## CFC Sale To Related Party With Same Country Unrelated Party Manufacturing

### ETR of Company

- The examiner should review the company's audited financial statements to determine the ETR 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).
- In the scenario illustrated in this Unit, the tax rate in Low Tax Country A (12.5%) is lower than the US rate (35%), so profits moved to Low Tax Country A are taxed at a rate that is 22.5 percentage points lower than the US rate.
- In the scenario illustrated in this Unit, the tax rate in Country B (approximately 25%) is lower than the US rate (35%), so profits moved to Country B are taxed at a rate that is roughly 10 percentage points lower than the US rate.

### ETR Impact of Adjustment

- Assuming (1) the E&P is PRI under Accounting Principles Board APB 23 (now codified as Accounting Standards Codification, 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 to Country A and Country B. This reduction in worldwide ETR is important for financial reporting purposes.
- An inclusion of FBCSI 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


## CFC Sale To Related Party With Same Country Unrelated Party Manufacturing

<a href="#"><u>Issue 1</u></a>	Whether the sales from CFC1 (in Low Tax Country A) to USP generate FBCSI and result in a subpart F inclusion to USP.
<a href="#"><u>Issue 2</u></a>	Whether the sales from CFC2 (in Country B) to USP generate FBCSI and result in a subpart F inclusion to USP.

# All Issues, Step 1: Initial Factual Development

## CFC Sale To Related Party With Same Country Unrelated Party Manufacturing


Taxpayer may be selling, or merely booking sales income, through a CFC to shift sales profit out of the US (or from a CFC in a relatively high tax jurisdiction) into a country with a lower tax rate.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ CFC1 and CFC2 buy personal property from an unrelated party and resell the property to USP. The related party transactions should be identified on Sch. M of the Form 5471 and should be discussed in the transfer pricing study. In addition, it is possible that the taxpayer may have performed a subpart F or supply chain functional analysis.</li> <li>▪ Whether property sold by CFC1 and CFC2 is manufactured in Country A and Country B, respectively, is addressed in the Additional Factual Development.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Form 5471</li> <li>▪ Form 5471 Instructions</li> <li>▪ Transfer Pricing Information Document Request (IDR)</li> <li>▪ Global Tax and Legal Organizational Charts</li> <li>▪ Steps of Transactions</li> <li>▪ Contracts containing the critical facts of the transactions</li> <li>▪ Product Flows and Transaction Flowcharts</li> <li>▪ International Information Returns (IIR)</li> </ul>	
 <b>CONSULTATION:</b> The examiner should consult with the Transfer Pricing Practice or Income Shifting IPN regarding any potential transfer pricing issues.		

# All Issues, Step 1: Initial Factual Development (cont'd)

## CFC Sale To Related Party With Same Country Unrelated Party Manufacturing

Taxpayer may be conducting selling activities, or merely booking sales income, through a CFC to shift sales profit out of the US (or from a CFC in a relatively high tax jurisdiction) into a country with a lower tax rate.

Fact Element	Resources	6103 Protected Resources
 <b>DECISION POINT:</b> The examiner should review the E&P for each CFC, as a subpart F inclusion is limited to current year E&P.	<ul style="list-style-type: none"><li>▪ IRC 952(c)(1)(A)</li></ul>	



# Issue 1, Step 2: Review Potential Issues

## CFC Sale To Related Party With Same Country Unrelated Party Manufacturing

### Issue 1

Whether the sales from CFC1 (in Low Tax Country A) to USP generate FBCSI and result in a subpart F inclusion to USP.

Explanation of Issue	Resources
<ul style="list-style-type: none"> <li>▪ When a CFC buys/sells tangible personal property (1) from/to, or on behalf of, a <i>related person</i> and the property is (2) manufactured, produced, constructed, grown, or extracted <i>outside</i> the CFC's country of incorporation and the property is purchased/sold (3) for use, consumption or disposition <i>outside</i> the CFC's country of incorporation, the income from the sale of the property by the CFC is FBCSI. Since FBCSI is one of several types of subpart F income, the US shareholder(s) of the CFC may have a subpart F inclusion.</li> <li>▪ When a CFC buys or sells tangible personal property, you should determine whether the transaction meets the following three requirements for FBCSI:               <ol style="list-style-type: none"> <li>1. Related person requirement.</li> <li>2. Place of manufacture requirement.</li> <li>3. Place of consumption or use requirement.</li> </ol> </li> </ul>	<ul style="list-style-type: none"> <li>▪ IRC 951</li> <li>▪ IRC 954(d)</li> <li>▪ Treas. Reg. 1.954-3</li> </ul>

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

## CFC Sale To Related Party With Same Country Unrelated Party Manufacturing

### Issue 1

Whether the sales from CFC1 (in Low Tax Country A) to USP generate FBCSI and result in a subpart F inclusion to USP.

Explanation of Issue	Resources
<ul style="list-style-type: none"> <li>▪ A person will be considered a <i>related person</i> with respect to a CFC if the person (whether it's an individual, corporation, partnership, trust or estate) controls or is controlled by the CFC (or is controlled by the same person or persons that control the CFC).</li> <li>▪ Control means direct or indirect ownership of (1) in the case of corporations, stock having <i>more than 50%</i> of the total voting power of all classes of stock entitled to vote or of the total value of stock of the corporation; and (2) in the case of a partnership, trust, or estate, <i>more than 50%</i> (by value) of the capital, profits or beneficial interest in the entity.</li> </ul>	<ul style="list-style-type: none"> <li>▪ IRC 951</li> <li>▪ IRC 954(d)</li> <li>▪ IRC 954(d)(3)</li> <li>▪ Treas. Reg. 1.954-1(f)</li> </ul>

# Issue 1, Step 3: Additional Factual Development

## CFC Sale To Related Party With Same Country Unrelated Party Manufacturing

### Issue 1

Whether the sales from CFC1 (in Low Tax Country A) to USP generate FBCSI and result in a subpart F inclusion to USP.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"><li>▪ Related person requirement – although CFC1 purchases from unrelated parties, the examiner should determine whether CFC1 sells to a <i>related person</i>.</li></ul>	<ul style="list-style-type: none"><li>▪ The examiner should have reviewed organizational charts and transaction agreements during initial factual development to establish whether a related party transaction took place.</li><li>▪ No additional factual development should be needed.</li></ul>	

# Issue 1, Step 3: Additional Factual Development (cont'd)

## CFC Sale To Related Party With Same Country Unrelated Party Manufacturing

### Issue 1

Whether the sales from CFC1 (in Low Tax Country A) to USP generate FBCSI and result in a subpart F inclusion to USP.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ Place of consumption or use requirement – the examiner should determine whether the property is sold for use or consumption <i>within</i> Country A (CFC1's country of incorporation).</li>   <li>▪ Note: for additional guidance on whether CFC1 meets the same country sales/use exception, refer to IPS Practice Unit DPL/9412.01_01(2015)a.</li> </ul>	<ul style="list-style-type: none"> <li>▪ The examiner should have reviewed organizational charts and transaction agreements during initial factual development to establish whether the property is sold for use or consumption in the US (i.e. outside Country A).</li>   <li>▪ No additional factual development should be needed.</li> </ul>	

# Issue 1, Step 3: Additional Factual Development (cont'd)

## CFC Sale To Related Party With Same Country Unrelated Party Manufacturing

### Issue 1

Whether the sales from CFC1 (in Low Tax Country A) to USP generate FBCSI and result in a subpart F inclusion to USP.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ Place of manufacture requirement – the examiner should determine whether the property was physically manufactured <i>within</i> Country A (CFC1’s country of incorporation) or whether a person related to CFC1 made a substantial contribution <i>within</i> Country A to the manufacture of the property.</li> <li>▪ Note: this Practice Unit does not cover the definition of what constitutes manufacturing (e.g. substantial transformation, substantial contribution, etc.).</li> </ul>	<ul style="list-style-type: none"> <li>▪ The examiner should request documentation from the taxpayer to substantiate whether the property is manufactured within Country A.</li> <li>▪ If the examiner has reason to doubt that the property was manufactured in Country A, use professional judgment to determine what, if any, additional exam resources should be expended to verify this.</li> </ul>	

# Issue 1, Step 4: Develop Arguments

## CFC Sale To Related Party With Same Country Unrelated Party Manufacturing

### Issue 1

Whether the sales from CFC1 (in Low Tax Country A) to USP generate FBCSI and result in a subpart F inclusion to USP.

Explanation of Adjustment	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ The factual development should have included a review of the organization charts and transaction agreements.</li> <li>▪ The factual development in this case indicates CFC1 buys property manufactured outside Country A from an unrelated party and sells the property to a related party, USP, outside Country A. CFC1's sales income is FBCSI, and USP has an inclusion under IRC 951.</li> </ul>	<ul style="list-style-type: none"> <li>▪ IRC 954(d)</li> <li>▪ Treas. Reg. 1.954-1(f)(1) &amp; (2)</li> <li>▪ Treas. Reg. 1.954-3(a)(3)(i)</li> <li>▪ Treas. Reg. 1.954-3(a)(2)</li> <li>▪ Bittker &amp; Lokken Fundamentals of International Taxation 69.5</li> <li>▪ Form 5471</li> <li>▪ Form 5471 Instructions</li> </ul>	

# Issue 1, Step 4: Develop Arguments (cont'd)

## CFC Sale To Related Party With Same Country Unrelated Party Manufacturing

### Issue 1

Whether the sales from CFC1 (in Low Tax Country A) to USP generate FBCSI and result in a subpart F inclusion to USP.

Explanation of Adjustment	Resources	6103 Protected Resources
<ul style="list-style-type: none"><li>▪ Calculate the amount of the FBCSI (see UIL 9412.05 General Subpart F Computational Issues), and be sure to consider Foreign Tax Credit (FTC) implications when computing any adjustments on Form 5701.</li><li>▪ Note that transfer pricing policies may impact the amount of subpart F inclusions, hence the need to review the transfer pricing study in conjunction with subpart F analysis.</li></ul>		

# Issue 2, Step 2: Review Potential Issues

## CFC Sale To Related Party With Same Country Unrelated Party Manufacturing

### Issue 2

Whether the sales from CFC2 (in Country B) to USP generate FBCSI and result in a subpart F inclusion to USP.

Explanation of Issue	Resources
<ul style="list-style-type: none"><li>When a CFC buys/sells tangible personal property from/to (or on behalf of) a <i>related person</i> and the property is purchased/sold for use, consumption or disposition <i>outside</i> the CFC's country of incorporation and the property is manufactured, produced, constructed, grown, or extracted <i>within</i> the CFC's country of incorporation, the income is <i>not</i> FBCSI under IRC 954, and the US shareholder(s) will not have a subpart F inclusion. This is commonly referred to as the "same country manufacturing exception" from FBCSI.</li></ul>	<ul style="list-style-type: none"><li>IRC 951</li><li>IRC 954(d)</li><li>Treas. Reg. 1.954-3</li></ul>



# Issue 2, Step 3: Additional Factual Development

## CFC Sale To Related Party With Same Country Unrelated Party Manufacturing

### Issue 2

Whether the sales from CFC2 (in Country B) to USP generate FBCSI and result in a subpart F inclusion to USP.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"><li>▪ Related person requirement – although CFC2 purchases from unrelated parties, the examiner should determine whether CFC2 sells to a <i>related person</i>.</li></ul>	<ul style="list-style-type: none"><li>▪ The examiner should have reviewed organizational charts and transaction agreements during initial factual development to establish whether a related party transaction took place.</li><li>▪ No additional factual development should be needed.</li></ul>	

# Issue 2, Step 3: Additional Factual Development (cont'd)

## CFC Sale To Related Party With Same Country Unrelated Party Manufacturing

### Issue 2

Whether the sales from CFC2 (in Country B) to USP generate FBCSI and result in a subpart F inclusion to USP.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ Place of consumption or use requirement – the examiner should determine whether the property is sold for use or consumption <i>within</i> Country B (CFC2's country of incorporation).</li>   <li>▪ Note: for additional guidance on whether CFC2 meets the same country sales/use exception, refer to IPS Practice Unit DPL/9412.01_01(2015)a.</li> </ul>	<ul style="list-style-type: none"> <li>▪ The examiner should have reviewed organizational charts and transaction agreements during initial factual development to establish whether the property is sold for use or consumption in the US (i.e. outside Country B).</li>   <li>▪ No additional factual development should be needed.</li> </ul>	

# Issue 2, Step 3: Additional Factual Development (cont'd)

## CFC Sale To Related Party With Same Country Unrelated Party Manufacturing

### Issue 2

Whether the sales from CFC2 (in Country B) to USP generate FBCSI and result in a subpart F inclusion to USP.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ Place of manufacture requirement – the examiner should determine whether the property was physically manufactured <i>within</i> Country B (CFC2’s country of incorporation) or whether a person related to CFC1 made a substantial contribution <i>within</i> Country B to the manufacture of the property.</li> <li>▪ Note: this Practice Unit does not cover the definition of what constitutes manufacturing (e.g. substantial transformation, substantial contribution, etc.).</li> </ul>	<ul style="list-style-type: none"> <li>▪ The examiner should request documentation from the taxpayer to substantiate whether the property is manufactured in Country B.</li> <li>▪ If the examiner has reason to doubt that the property was manufactured in the same country, use professional judgment to determine what, if any, additional exam resources should be expended to verify this.</li> </ul>	

## Issue 2, Step 4: Develop Arguments

### CFC Sale To Related Party With Same Country Unrelated Party Manufacturing

#### Issue 2

Whether the sales from CFC2 (in Country B) to USP generate FBCSI and result in a subpart F inclusion to USP.

Explanation of Adjustment	Resources	6103 Protected Resources
<ul style="list-style-type: none"> <li>▪ The factual development should have included a review of the organization charts and transaction agreements.</li> <li>▪ The factual development in this case indicates CFC2 buys property manufactured in Country B from an unrelated party and sells the property to a related party, USP, outside Country A. CFC2's sales income meets the same country manufacturing exception and is <i>not</i> FBCSI.</li> </ul>	<ul style="list-style-type: none"> <li>▪ IRC 954(d)</li> <li>▪ Treas. Reg. 1.954-1(f)(1)</li> <li>▪ Treas. Reg. 1.954-3(a)(3)(i)</li> <li>▪ Treas. Reg. 1.954-3(a)(2)</li> </ul>	

# Training and Additional Resources

Chapter 2.1.3 Other FBCS Issues		
Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	<ul style="list-style-type: none"> <li>FY10 IBC CPE Subpart F</li> </ul>	<ul style="list-style-type: none"> <li>International Current Topics in Subpart F</li> </ul>
White Papers / Guidance	<ul style="list-style-type: none"> <li>Refer to items listed at right</li> </ul>	<ul style="list-style-type: none"> <li>IRM 4.61.7 Controlled Foreign Corporations</li> <li>PLR 201206003</li> </ul>
Podcasts / Videos	<ul style="list-style-type: none"> <li>FY2011 CPE</li> </ul>	<ul style="list-style-type: none"> <li>Training - FY2011 CPE Live Recordings</li> <li>Training Deferral Planning CPE July 2011</li> </ul>
Reference Materials - Treatises	<ul style="list-style-type: none"> <li>Other Reading Materials</li> </ul>	<ul style="list-style-type: none"> <li>Subpart F: Same Country of Manufacturing Exception Yoder Article</li> <li>Kuntz &amp; Peroni US International Taxation B3.05</li> <li>Bittker &amp; Lokken Fundamentals of International Taxation 69.5</li> </ul>

# Training and Additional Resources (cont'd)

Chapter 2.1.3 Other FBCS Issues		
Type of Resource	Description(s) and/or Instructions for Accessing	References
Other Training Materials	<ul style="list-style-type: none"><li>IE Phase Training</li></ul>	<ul style="list-style-type: none"><li>On-the-Job Training for International Examiners (IE) - Subpart F</li><li>Phase I IE Training Subpart F Module</li><li>Phase III IE Training Subpart F Module</li></ul>

# Glossary of Terms and Acronyms

Term/Acronym	Definition
CFC	Controlled Foreign Corporation
E&P	Earnings and Profits
ETR	Effective Tax Rate
FBC	Foreign Base Company
FBCSI	Foreign Base Company Sales Income
FTC	Foreign Tax Credit
IIR	International Information Returns
PLR	Private Letter Ruling
PRI	Permanently Reinvested (Offshore) Income
USP	United States Parent

# Index of Related Issues

Issue	Associated UIL(s)	References
Sales or leases of tangible property/goods	▪ 9411.05	
General Subpart F Computational Issues	▪ 9412.05	
FTC Management	▪ 9413	
Determination of CFC Status	▪ 9435.01-01	