Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: AM2015-002

Release Date: 2/13/2015
CC:INTL:B02:SEMassey
POSTU-122414-14

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 954.03-02, 954.01-04

date: February 09, 2015

to: Cindy S. Kim, IBC IPN Acting Program Manager
(LB&I)

from: Steven A. Musher
Associate Chief Counsel
(International)

---

subject: Application of section 954(d)(2): Determination of effective rates of tax under the tax rate disparity test

This memorandum addresses the proper application of the tax rate disparity test under Treas. Reg. § 1.954-3(b)(1)(i)(b). This memorandum should not be used or cited as precedent.

ISSUE

What is the most appropriate method of calculating the actual effective rate of tax and the hypothetical effective rate of tax for purposes of determining whether there is tax rate disparity pursuant to the regulations under section 954(d)(2) in the case of property manufactured by a CFC?

CONCLUSION

In the case of property manufactured by a CFC, the most appropriate method of calculating the actual effective rate of tax and the hypothetical effective rate of tax is to divide the actual tax and the hypothetical tax by the hypothetical tax base determined under the laws of the manufacturing jurisdiction.

FACTS

In Year 1, CFC, a controlled foreign corporation (“CFC”) incorporated in Country B, purchases raw materials from an unrelated supplier and uses them to manufacture (under the principles of Treas. Reg. § 1.954-3(a)(4)) Product X in Country B. DE is the wholly owned subsidiary of CFC and has elected to be treated as a disregarded entity of CFC pursuant to Treas. Reg. § 301.7701-3(c). DE is located in Country A and does not engage in any manufacturing activities.

DE derives €100x of commission income in connection with the sale of Product X by CFC to unrelated customers located outside of Country A and Country B.[1] DE incurs €30x of sales expenses related to the sale of Product X. CFC has no other income that would constitute foreign base company income under section 954.

Country A and Country B both impose a 20% statutory rate of tax on sales income. Country A allows DE to exclude half of its income from the sale of products manufactured and sold for use outside of Country A. Country B does not tax DE's sales income until it is remitted to CFC as a dividend. Both Country A and Country B would allow a €30x deduction for the sales expenses. DE paid €4x of income tax in Country A in Year 1.

LAW AND ANALYSIS

The branch rule has been part of the foreign base company sales income ("FBCSI") rules of section 954(d) since subpart F was added to the Code in 1962.[2] As described below, the branch rule was included to prevent United States shareholders from using foreign branches, rather than CFCs, to circumvent the FBCSI rules.

The FBCSI rules were enacted to prevent a U.S. taxpayer or its foreign subsidiary from artificially separating manufacturing and sales to reduce taxation on its sales income.[3] Under section 954(d)(1), FBCSI generally includes certain income derived by a CFC in connection with the purchase of personal property from a related person and its sale to any person, the purchase of personal property from any person and its sale to a related

---

[1] For federal income tax purposes, DE is treated as a branch or division of CFC, rather than as a separate entity. Under the laws of Country A and Country B, however, DE and CFC are treated as separate entities, and DE could either purchase Product X from CFC and sell to unrelated customers at a mark-up or receive commissions from CFC, ostensibly for facilitating sales from CFC to unrelated customers, without taking title to Product X. In this memorandum, the facts are such that DE receives sales commissions from CFC.

[2] See section 954(d)(2). This memorandum refers to the rule in section 954(d)(2) as the "branch rule" and the rules in section 954(d)(2) and the regulations thereunder collectively as the "branch rules."

[3] The Senate Report to the Revenue Act of 1962 stated: "The foreign base company sales income referred to here means income from the purchase and sale of property, without any appreciable value being added to the product by the selling corporation. The sales income with which your committee is primarily concerned is income of a selling subsidiary (whether acting as principal or agent) which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income. This accounts for the fact that this provision is restricted to sales of property to a related person, or to purchases of property from a related person. Moreover, the fact that a lower rate of tax for such a company is likely to be obtained only through purchases and sales outside of the country in which it is incorporated accounts for the fact that the provision is made inapplicable to the extent the property is manufactured, produced, grown, or extracted in the country where the corporation is organized or where it is sold for use, consumption, or disposition in that country. Mere passage of title or the place of the sale are not relevant in this connection." S. Rep. No. 1881, 87th Cong. 2d Sess., at 84 (1962), 1962-3 C.B. 703, at 790 & 949.

person, or the purchase or sale of personal property on behalf of a related person. However, such income is not FBCSI if the personal property is manufactured by the CFC (the “CFC manufacturing exception”), is manufactured by anyone within the CFC’s country of incorporation (the “same country manufacturing exception”), or is sold for use in such country (the “same country sales exception”).[4]

The branch rules apply the general FBCSI rules of section 954(d)(1) to a CFC that carries on purchasing, selling or manufacturing activities by or through a branch or similar establishment located outside the CFC’s country of incorporation. Absent the branch rules, a CFC that manufactures a product in its country of incorporation and sells that product through a sales branch in a low- or no-tax jurisdiction would not have FBCSI due to the CFC manufacturing exception.[5]

Under section 954(d)(2), a branch or similar establishment of a CFC is treated as though it were a wholly owned subsidiary corporation of that CFC if the use of such branch or similar establishment has “substantially the same effect” as if it were a wholly owned subsidiary corporation. In order to determine whether a branch or similar establishment will be treated as a wholly owned subsidiary, the regulations under section 954(d)(2) employ a tax rate disparity test.

The tax rate disparity test as it applies to a sales branch is set forth in Treas. Reg. § 1.954-3(b)(1)(i)(b) and provides in pertinent part:

> The use of the branch or similar establishment for such activities will be considered to have substantially the same tax effect as if it were a wholly owned subsidiary corporation of the controlled foreign corporation if [that income derived by the branch or similar establishment from the purchase or sale of personal property on behalf of a related person] is, by statute, treaty obligation, or otherwise, taxed in the year when earned at an effective rate of tax [(the “actual effective rate of tax”)] that is less than 90 percent of, and at least 5 percentage points less than, the effective rate of tax [(the “hypothetical effective rate of tax”)] which would apply to such income under the laws of the country in which the controlled foreign corporation is created or organized if, under the laws of such country, the entire income of the controlled foreign corporation were considered derived by the controlled foreign corporation from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the corporation were managed and controlled in such country.

[4] See section 954(d)(1) and Treas. Reg. § 1.954-3(a)(2)–(4).
[5] Likewise, absent the branch rules, a CFC that manufactures property through a branch or similar establishment and sells that property through the remainder of the CFC, located in a low- or no-tax jurisdiction, would not have FBCSI due to the CFC manufacturing exception.

The tax rate disparity test as it applies to a manufacturing branch compares the actual effective rate of tax in the CFC's country of organization to the hypothetical effective rate of tax in the manufacturing branch's jurisdiction.[6] It provides in pertinent part:

> The use of the branch or similar establishment for such activities will be considered to have substantially the same tax effect as if it were a wholly owned subsidiary corporation of the controlled foreign corporation if [that income derived by the remainder of the controlled foreign corporation from the purchase or sale of personal property on behalf of a related person] is, by statute, treaty obligation, or otherwise, taxed in the year when earned at an effective rate of tax [(the "actual effective rate of tax")] that is less than 90 percent of, and at least 5 percentage points less than, the effective rate of tax [(the "hypothetical effective rate of tax")] which would apply to such income under the laws of the country in which the branch or similar establishment is located if, under the laws of such country, the entire income of the controlled foreign corporation were considered derived by the controlled foreign corporation from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the corporation were created or organized under the laws of, and managed and controlled in, such country.

Accordingly, with respect to sales income derived in connection with property manufactured by the CFC or a branch of the CFC, the regulations under section 954(d)(2) determine whether there is tax rate disparity by comparing what the effective rate of tax on the sales income actually was in the sales jurisdiction (the "actual ERT") with what the effective rate of tax on the sales income would have been if the sales had occurred in the manufacturing jurisdiction (the "hypothetical ERT").

a. The ERT formulae

The tax rate disparity test compares the "effective rate of tax" that applied or would apply to the income from certain sales transactions in two different countries. For the comparison to be meaningful, an appropriate common tax base must be used to calculate the actual ERT and the hypothetical ERT.[7] Computing the actual and hypothetical ERTs with respect to dissimilar tax bases instead would be contrary to the legislative purpose of section 954(d). It would ignore the incentive to shift income from the manufacturing jurisdiction to a sales jurisdiction that grants exclusions and deductions to derive a smaller tax base.[8] Thus, the most appropriate method of

---

[6] See Treas. Reg. § 1.954-3(b)(1)(ii)(b).

[7] Importantly, the tax rate disparity test cannot be applied simply by comparing the statutory tax rates in the relevant countries.

[8] See S. Rep. No. 1881, 87th Cong., 2d Sess. 84 (1962), 1962-3 C.B. 703, at 790 (indicating that the FBCSI rules are intended to deny deferral when a CFC is used to shift certain sales income from a high-tax jurisdiction to a low-tax jurisdiction).

computing the actual ERT and the hypothetical ERT is to use the hypothetical sales income tax base in the manufacturing jurisdiction (the "hypothetical tax base") as the common denominator to determine the difference in the ERTs on the sales income shifted from the manufacturing jurisdiction.[9] The ERT calculation formulae are summarized in the chart below.[10]

Actual effective rate of tax	**Hypothetical effective rate of tax**
Actual tax / Hypothetical tax base	Hypothetical tax / Hypothetical tax base

b. Calculation of actual tax, hypothetical tax base, and hypothetical tax

The tax rate disparity test can be conducted in five steps. First, the relevant income upon which the test will be based must be determined. Second, the actual tax imposed on that income must be determined. Third, the hypothetical tax base must be determined. Fourth, the hypothetical tax that would have been imposed on that income must be determined. Finally, the actual tax and hypothetical tax are divided by the hypothetical tax base and the resulting ERTs are compared.

First, the tax rate disparity test requires the identification of the relevant income on which the tax would be imposed.[11] In the case of income derived by a branch from the sale of property manufactured by the remainder of the CFC, Treas. Reg. § 1.954-

---

To illustrate, assume that Country X and Country Y each have a statutory tax rate of 25% on taxable income, but Country Y excludes from taxable income one-half of income derived from the sale of property that is neither produced in Country Y nor sold to customers in Country Y. This special exclusion produces a smaller taxable base and an incentive to shift sales income from high-tax Country X to low-tax Country Y. However, if the actual ERT for the tax disparity test were determined with respect to Country Y's tax base, and the hypothetical ERT were determined with respect to Country X's tax base, the test generally would have the effect of comparing statutory tax rates and ignoring the incentive to shift income.

[9] It should be noted that use of the taxable income computed under the laws of the sales jurisdiction as the common denominator is more likely to result in a branch being treated as a separate subsidiary corporation under the tax rate disparity test. This is because the taxable income in the sales jurisdiction is often less than the hypothetical taxable income in the manufacturing jurisdiction and when used as the common tax base will produce ERTs in both jurisdictions that are higher, but not proportionally higher, such that it is more likely the ERTs will differ by more than 5 percentage points. Thus, if the sales jurisdiction permits the same or additional deductions as the manufacturing jurisdiction and there is not tax rate disparity calculated using the taxable income in the sales jurisdiction as the common tax base, there is no need to recalculate using the hypothetical tax base as the common denominator.

[10] If the branch(es) and the CFC use different functional currencies, a reasonable method must be used consistently to translate the currencies into a single currency so that the calculations are performed in the same currency.

[11] The analysis that follows assumes that the manufacturing took place in the remainder of CFC (*i.e.*, by CFC's employees in CFC's country of incorporation) and sales income was received by DE. Thus, the following analysis focuses on the determination of ERTs when there is a sales branch. However, manufacturing could instead take place in a branch, in which case the five-step process described herein would be applied to compare the hypothetical ERT in the manufacturing branch's jurisdiction with the actual ERT in the country of incorporation of the remainder of the CFC.

3(b)(1)(i)(b) requires allocation to a branch of only that income derived by the branch or similar establishment that is described in Treas. Reg. § 1.954-3(a) (ignoring the same country exceptions and the manufacturing exceptions in Treas. Reg. §1.954-3(a)(2), (3), and (4)) when the special rules of Treas. Reg. § 1.954-3(b)(2)(i) are taken into account. Treas. Reg. § 1.954-3(a)(1)(i) provides that such income of a CFC "shall . . . consist of gross income" derived in connection with the purchase or sale of property to, from, or on behalf of a related person. The special rules of Treas. Reg. § 1.954-3(b)(2)(i) treat the branch as a wholly owned subsidiary corporation selling on behalf of the CFC.[12] In sum, the relevant income on which the tax rate disparity test (as applied to a sales branch) is based is the branch's gross income derived in connection with the sale of property sold on behalf of the CFC ("TRD Gross Income").[13]

Second, the actual tax with respect to the TRD Gross Income, if any, must be determined.[14] If the sales branch also earned income other than TRD Gross Income and paid or incurred income tax with respect to its entire income, the amount paid or incurred with respect to the TRD Gross Income must be separately determined.

Third, the hypothetical tax base must be determined by calculating the amount of TRD Gross Income that hypothetically would be subject to the sales income tax in the CFC's jurisdiction. The relevant tax laws to be taken into account in determining the hypothetical tax base are those of the CFC's country of incorporation (*i.e.*, the manufacturing jurisdiction).[15] The regulations under section 954(d)(2), however, require that certain assumptions be made in applying the tax laws of the country for which the hypothetical tax base and hypothetical tax are being computed. Specifically, the hypothetical tax computations must be made assuming that, under the laws of such country, the entire income of the CFC is considered derived by the CFC from sources within such country from doing business through a permanent establishment therein, is received in such country, and is allocable to such permanent establishment, and the corporation is managed and controlled in such country.[16] Thus, the TRD Gross Income determined by applying the special rules of Treas. Reg. § 1.954-3(b)(2)(i) is reduced by exclusions and deductions that would be permitted under the laws of the country in which the property is manufactured (regardless of whether those exclusions and deductions would be allowed for U.S. federal income tax purposes), taking into account

---

[12] Treas. Reg. § 1.954-3(b)(2)(i) treats the branch as selling on behalf of the CFC, notwithstanding the fact that the branch may be a hybrid entity that, in its country of incorporation, is treated as a separate corporation that purchases property from the CFC and sells the property to customers or purchases property from suppliers, contracts with the CFC to manufacture the property, and then sells the property to customers.
[13] Treas. Reg. § 1.954-3(b)(2)(i)(a) and (b)(1).
[14] For this purpose, any income tax actually imposed on the TRD Gross Income by the manufacturing jurisdiction is taken into account, in addition to any income tax actually imposed by the sales jurisdiction. See Treas. Reg. § 1.954-3(b)(2)(i)(e)("Tax determinations shall be made by taking into account only the income, war profits, excess profits, or similar tax laws (or the absence of such laws) of the countries involved.") However, under the facts of this memorandum, Country B (the manufacturing jurisdiction) does not impose any tax on DE's TRD Gross Income until it is remitted to CFC as a dividend.
[15] Treas. Reg. § 1.954-3(b)(2)(i)(e).
[16] Treas. Reg. § 1.954-3(b)(1)(i)(b).

the source of income and permanent establishment assumptions in Treas. Reg. § 1.954-3(b)(1)(i)(b), to determine the hypothetical tax base.

Fourth, the hypothetical tax base is multiplied by the applicable marginal tax rate(s) in the CFC's country of incorporation (*i.e.*, the manufacturing jurisdiction) to yield the hypothetical tax.

Finally, for the reasons set forth above, the hypothetical tax and the actual tax paid on the TRD Gross Income are each divided by the hypothetical tax base[17] to determine the ERTs that will be compared for purposes of determining whether there is tax rate disparity.[18]

c. Application to Facts

Under these facts, the actual ERT in Country A (where DE is located) must be compared with the hypothetical ERT in Country B (where CFC manufactures Product X) to determine whether there is tax rate disparity such that DE will be treated as a wholly owned subsidiary of CFC.

First, TRD Gross Income must be determined. Because DE derives €100x of gross income in connection with the sale of Product X, the TRD Gross Income here is €100x.

---

[17] As noted in footnote 5, if the sales jurisdiction permits the same or additional deductions as the manufacturing jurisdiction and a taxpayer has used the taxable income in the sales jurisdiction as the common denominator rather than the hypothetical tax base—but otherwise has followed the steps above, including adjusting the sales income to the laws of the manufacturing jurisdiction to arrive at the correct hypothetical tax—and has satisfactorily demonstrated that no tax rate disparity exists, it is not necessary to perform further calculations. However, it is critical to verify that the taxpayer is not simply applying the statutory tax rate in the manufacturing jurisdiction to the taxable income as calculated in the sales jurisdiction.

Furthermore, minor differences in the deductions allowed or the timing of the deductions in the two jurisdictions should not materially affect the analysis and therefore may be ignored in appropriate cases. For example, if the sales jurisdiction provides a 19-year useful life for a particular asset for depreciation purposes, and the manufacturing jurisdiction provides a 20-year useful life for that asset, the resulting difference in tax bases likely would not be material. The determination of whether a difference between the actual tax base in the sales jurisdiction and the hypothetical tax base in the manufacturing jurisdiction is material to the tax rate disparity analysis depends on the facts and circumstances of the particular case. See, e.g., Treas. Reg. § 1.964-1(a)(2) (for purposes of calculating a foreign corporation's earnings and profits, no adjustment to conform the corporation's profit and loss statement to the accounting principles enumerated in the regulation is required "unless it is material" and "[w]hether an adjustment is material depends on the facts and circumstances of the particular case, including the amount of the adjustment [and] its size relative to the general level of the corporation's total assets and annual profit or loss…").

[18] If the hypothetical tax base is subject to a single statutory tax rate, the hypothetical ERT will equal that statutory rate. If, however, the hypothetical tax base is subject to graduated tax rates, the hypothetical ERT will be a weighted average of the applicable tax rates.

Second, the actual tax paid or incurred in Country A must be determined. Under these facts, the actual tax paid or incurred in Country A is €4x, calculated as follows:

Actual Tax Calculation

	(€)
TRD Gross Income	100x
Exclusion	(50x)
Sales expenses	(30x)
= Country A taxable income	20x
Apply statutory rate of 20%	4x

Third, the hypothetical tax base must be determined. Here, the hypothetical tax base is €70x, calculated by taking the €100x of TRD Gross Income less the €30x of sales expenses that are allocable and apportionable to the TRD Gross Income under Country B's tax laws.

The fourth step is to determine the hypothetical tax that would have been incurred if the TRD Gross Income had been derived in Country B. The hypothetical tax that would apply in Country B is €14x, calculated as follows:

Hypothetical Tax Calculation

	(€)
TRD Gross Income	100x
Sales expenses	(30x)
= Hypothetical tax base	70x
Apply statutory rate of 20%	14x

Finally, the actual tax and the hypothetical tax are each divided by the hypothetical tax base, which was determined in the third step above to be €70x, to arrive at the ERTs that will be compared to determine whether there is tax rate disparity between DE and the remainder of CFC:

Actual ERT (Country A)	**Hypothetical ERT (Country B)**
€4x / €70x = 5.71%	€14x / €70x = 20%

On these facts, the actual ERT is 5.71%, and the hypothetical ERT is 20%. Therefore, the actual ERT in Country A (the sales jurisdiction) is less than 90% (28.55%) of, and at least 5 (14.29) percentage points below, the hypothetical ERT in Country B (the manufacturing jurisdiction). Thus, there is tax rate disparity between DE and the remainder of CFC and, pursuant to Treas. Reg. § 1.954-3(b)(1)(i)(b), DE will be treated as a wholly owned subsidiary of CFC under section 954(d)(2) in Year 1.[19]

Please call (202) 317-6934 if you have any further questions.

[19] Once it has been concluded that tax rate disparity exists, additional steps must be performed to determine the correct amount of net income under U.S. tax principles attributable to the branch and to determine whether any exceptions to FBCSI apply. See section 954(d)(2); Treas. Reg. § 1.954-3(b)(2)(ii) & (b)(3).