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Memorandum**

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To: Felix Ortueta
International Examiner
Large Business & International

From: Associate Area Counsel (South Florida)
Large Business & International

Subject: – Intercompany Referral Fee

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ISSUES

In computing its pro rata share of subpart F income:

1. Whether _____ (“_____” or the “Taxpayer”) properly characterized intercompany referral fee income in determining foreign base company sales income and foreign base company services income under I.R.C. § 954 in taxable year _____.
2. Whether _____ properly allocated intercompany referral fee expenses in accordance with Treas. Reg. § 1.861-8 in taxable year _____.

CONCLUSIONS

1. _____ did not properly characterize its CFCs’ intercompany referral fee income in determining their foreign base company sales income and foreign base company services income in taxable year _____. Instead of treating _____ % and

% of the intercompany referral fee income as services income and sales income, respectively, should have included all of the intercompany referral fee income in foreign base company sales income.

2. did not properly allocate its CFCs' intercompany referral fee expenses in taxable year . Instead of allocating the intercompany referral fee expenses across all of the CFCs' classes of income, should have allocated the intercompany referral fee expenses solely to non-subpart F sales income.

FACTS

is a domestic corporation that files consolidated federal income tax returns with its affiliated domestic subsidiaries. also has several wholly owned subsidiaries engaged in business in various countries throughout the world. Relevant to the instant issues, each of these wholly owned subsidiaries is a controlled foreign corporation as defined in I.R.C. § 957(a).¹

In addition to selling to third parties, has a network of employee-brokers who refer business internally, which results in the payment of intercompany referral fees from one legal entity to another. See Taxpayer's Response to IDR IE-7, p. 1. For each customer in the and segments, there is a single salesperson that is responsible for developing and maintaining the business relationship with the customer. Id. This salesperson is referred to as the "Customer Broker." Id. When a customer's (or) requires anywhere in the world, the Customer Broker arranges for the through a "Supply Broker" that may be employed by another affiliate. Id.

indicates that generally, the Customer Broker negotiates with the customer regarding the specifications and coordinates with centralized credit function on the terms of the sale. Id. In addition, asserts that the Customer Broker has the responsibility to track its customer's purchases from all affiliates and manage exposure to this particular customer. Id. states that the Supply Broker has the responsibility for identifying and negotiating the price with the direct supplier, arranging the delivery of the to the customer's , receiving the signed documents showing that the per the specifications was

¹ The controlled foreign corporations are: (1) ; (2) ; (3) ; (4) ; (5) ; (6) ; and (7)

delivered to the customer's _____, and invoicing the customer. Id. The Supply Broker records the sales revenue in this scenario.

_____ indicates that as compensation for the Customer Broker's services, the Supply Broker affiliate will pay the Customer Broker a portion of the _____ sales gross margin associated with the transaction. Id. at 2. In the _____ segment, the intercompany referral fee is 50% of the gross margin earned by the _____ seller. Id. In the _____ segment the intercompany referral fee is 10% of the gross margin. Id.²

The Taxpayer provided the following example in its response to IDR IE-7 to explain its intercompany referral fee:

[I]f Customer A requires _____ in the _____ and the Customer Broker is located in _____, then the Customer Broker at the _____ Group Affiliate in _____ arranges for the _____ through a Supply Broker located/employed by _____. The Customer Broker discusses specifications and other customer oriented logistics with Customer A while the Supply Broker arranges for the _____ of the customer's _____ with _____ suppliers on the required date, time, and place. The Supply Broker at the _____ affiliate in this instance would make the _____ sale to Customer A. As compensation for the Customer Broker's services, the Supply Broker affiliate (_____) will pay the Customer Broker a portion of the _____ sales gross margin associated [with] this referred transaction.

_____ contends that _____ % of its intercompany referral fee income is income derived in connection with the performance of services on behalf of a related person (such that it could constitute foreign base company services income). See Taxpayer's Response to IDR IE-15, p. 4. _____ characterizes the remaining _____ % of its intercompany referral fee income as foreign base company sales income. Id. at 8. The amounts that _____ considers services income that it treats as foreign base company services income is detailed in the Taxpayer's Position below.

After _____ determines its gross income and categorizes such income as active/non-subpart F income or one of the various categories of subpart F income (e.g. foreign base company sales income, foreign base company services income, and foreign personal holding company income), _____ allocates and apportions expenditures to these classes of income. See Taxpayer's Response to IDR IE-7, p. 2. Generally, _____ explained, expenses that are attributable to a particular category of gross income, such as third party cost of _____ sales, bad debt expenses, foreign currency gains/losses, and other items that are definitively related to a particular category are directly allocated to the appropriate category. Id. Other expense items that are not definitively related to a particular class of gross income, such as compensation expenses of employees and rent, are apportioned between active/non-

² This memorandum does not address whether the amount of the intercompany referral fee is an arm's length price.

subpart F income and subpart F income based upon the relative proportion of the active/non-subpart F and subpart F income categories, respectively, to the total gross income. Id. allocation and apportionment of its intercompany referral fee expenses is described in detail in the Taxpayer's Position below.

and its CFCs did not enter into written contracts regarding the intercompany referral fee. See Taxpayer's Response to IDR IE-19, p. 1. Instead, the business arrangement is based on verbal agreements between the parties involved. Id.

TAXPAYER'S POSITION

Referral Fee Income

As stated above, characterizes % of its intercompany referral fee income as services income and the remaining % as sales income. states that the following entities performed the services for which they received intercompany referral fee income within the country that, for U.S. federal tax purposes, is considered the country of incorporation of the CFC of which they are a part: (1) ; (2) ; (3) ; (4) ; and (5)

. See Taxpayer's Response to IDR IE-15, p. 5. Because the alleged services rendered by each of the above listed entities were performed within its country of incorporation, contends that the intercompany referral fee income treated as services income is not described in I.R.C. § 954(e)(1)(B), and is therefore not foreign base company services income. Id. Instead, contends, this intercompany referral fee income is non-subpart F income. Id.

With regard to and states that part or all of the alleged related-party services for which they received intercompany referral fees were performed outside their country of incorporation. Id. To the extent the services were performed outside the country of incorporation, the portion of the fees characterized by as services income (%) was treated as foreign base company services income. The remaining % of the intercompany referral fee was treated as foreign base company sales income. Id.

In support of its bifurcation of the intercompany referral fee income between sales income and services income, cites Treas. Reg. § 1.954-1(e)(1), which provides that income shall be characterized in accordance with the substance of the transaction and not in accordance with the designation applied by the parties. Id. at p. 6. then cites to Examples 1, 8, and 10 of Treas. Reg. § 1.954-4(b)(3) for the proposition that compensation for certain services performed when property is sold may be characterized as income other than "in connection with" such sale. Id. states:

In sum, the regulations and administrative authorities demonstrate that

income from certain sales-related activities (such as solicitation of orders) should be categorized as income from selling on behalf of another, and income from certain non-sales-related activities should be categorized as compensation for the performance of services other than selling (or purchasing) on behalf of another, even where both are paid together in a single fee.

Id. at 7. states that the Customer Broker receives intercompany referral fee income for the following services:

1. Performing the sales function (i.e., the functions performed by a typical, unrelated sales broker) including the solicitation of the sale;
2. Post-Sale Services including: (i) responding to shortages, issues with quality and damages resulting from delays in delivery; (ii) handling billing disputes and negotiating claim settlement with customers; (iii) managing credit risk exposure by tracking [a] customer's overall purchase volume, pattern, and collecting formal and informal information about a customer's credit risk; (iv) tracking outstanding invoices and taking necessary actions to collect payment on behalf of the affiliate; and (v) keeping the customer up to date on current price trends, market dynamics and other factors impacting supply and prices. Among the Post-Sale Functions, the only one an independent sales broker may engage in would be to assist with collections. Id.

In characterizing its intercompany referral fee income, contends that if the service is provided to the seller and is necessary for the sale to occur, it should be considered a sales function, and compensation for it should be sales income. Id. On the other hand, if the sale can be made whether or not the service is provided to the seller (e.g., if the service is provided only after the sale), compensation for that service should not be considered sales income because it constitutes compensation for a service that is distinct from the sales process. Id. argues that the income received with respect to the services related to the performance of the sales function (category 1 above) is derived in connection with the sale of property, and should be considered foreign base company income or not based on whether the definition of foreign base company sales income is satisfied. Id. also posits that the portion of the intercompany referral fee income attributable to the performance of post-sale services (category 2 above) compensate the CFCs for services that are not necessary to consummate sales, and therefore constitute foreign base company income, or not, based on whether the definition of foreign base company services income is satisfied. Id. at 7-8.

In support of its position that the post-sale services in category 2 above are not necessary to consummate sales, states:

The post-sale services provided by Customer Brokers (category 2 above)

are not sales functions, since they occur after the sale has been closed and some of the services are not even tied to any particular sale. Negotiating credit terms (also part of category 2 above) is a service provided by the Customer Broker in connection with a credit function rather than a sales function. Managing risk exposure by tracking a customer's overall purchase volume and patterns is not a service that can be tied to any particular sale since it is an ongoing process and not necessary for any particular sale to occur. The same applies to ensuring customer satisfaction which is maintained independent of any specific sale. Post-sale collection and tracking of invoices is not necessary in order for the sale to occur since these services are provided once the sale has already taken place. Id. at 8, FN 1.

To substantiate its split, engaged (“ ”). See Memorandum from to (the “ Memorandum”). The Memorandum concluded that with respect to the intercompany referral fee income, the portion of the referral fees earned attributable to the sales function (category 1 above) constitutes approximately to percent of the total referral fee. See Memorandum, p. 7. This conclusion is applicable to both the and segments.

With respect to the segment, the Memorandum analogized the Customer Broker and Supply Broker relationship to co-brokerage transactions between unrelated brokers to identify similar functions and risks. See Memorandum, p. 3. According to the Memorandum, the Customer Broker undertakes all of the sales functions that a sales broker in an unrelated co-brokerage transaction would undertake, as well as other post-sales functions. See Memorandum, p. 4.³ then identified benchmark fees on a per metric ton basis for each of the two types of services allegedly performed by the Customer Broker (sales and post-sales) and compared them to the total compensation received by the Customer Broker for the segment. See Memorandum, p. 5.

For purposes of the sales function, utilized information regarding the fees charged by uncontrolled third parties acting as sales brokers for sales of by to establish an interquartile range. Id. After adjusting for the assistance that unrelated third parties functioning as the sales broker provide to with respect to collection functions, concluded that the interquartile range for the sales function is for the tax year. Id. Because does not receive customer support, risk monitoring, or other related post-sale services from unrelated third parties functioning as sales brokers, determined that the most reasonable method to benchmark the appropriate fee for the alleged post-sale functions is to allocate the remaining charge not included in the sales

³ See also Taxpayer's Response to ID IE-1, in which also contends that its Customer Brokers provide more comprehensive services than an unrelated sales broker whose sole function is limited to finding a willing customer for the seller.

function benchmark to those post-sale services. See Memorandum, p. 6. In , calculated the average referral fee on referral sales to be . Therefore, determined the interquartile range of the post-sales functions to be . Id.⁴

then calculated the benchmark fee for the sales and post-sales function as a percentage of the referral fee. The range for the sales function is between and , and the range for the post-sales function is to . Id. To confirm its analysis, asked Customer Brokers to estimate the amount of time spent on sales functions. Customer Brokers indicated that the sales functions take up between to percent of their total time. Id.

With respect to the segment, did not calculate an interquartile range using the average referral fee on a basis because such calculation does not provide similarly reliable results for the segment. See Memorandum, p. 7. Instead, relied on time estimates provided by Customer Brokers. The Customer Brokers indicated that they spend to percent of their time on sales functions in the segment. Id. Utilizing the Memorandum, concluded that for both the and segments, of the intercompany referral fee income was derived in connection with the sales function, and of the intercompany referral fee income was not derived in connection with the sales function. See Taxpayer's Response to ID IE-15, p. 8.

A majority of the of intercompany referral fee income characterized as not derived in connection with sales income was determined to be not foreign base company services income. This is because the alleged post-sale functions were performed in the country in which the CFC employing the Customer Broker was organized or created. Most, if not all, of the of the intercompany referral fee income that was characterized as derived in connection with sales was treated by as foreign base company sales income because the was neither produced nor sold for use or consumption in the country in which the Customer Broker CFC was organized or created.

As previously stated, did not require its CFCs to enter into written agreements memorializing the terms of the intercompany referral fee transactions. It therefore cannot be determined if the alleged post-sale functions were contracted for. When asked to substantiate that the post-sale functions were actually provided by the Customer Broker to the Supply Broker's CFC, cites to documentation relied on by in its preparation of a transfer pricing study. See Taxpayer's Response to IDR IE-19, p. 2. This documentation includes interview notes from interviews conducted by with and , respectively. also provided a sample Sales Agreement by and

⁴ The lower quartile, , and the upper quartile, , both equate to .

between , certain of its CFCs, and a third party customer. While the Sales Agreement includes provisions relating to quality and damages, billing disputes, credit terms, and invoicing (i.e. the first four post-sale functions that the Customer Broker allegedly performs for the Supply Broker CFC), the Sales Agreement does not specify the entity responsible for providing these alleged post-sale services. The Sales Agreement also does not include a provision regarding the keeping of customers up to date on current price trends, market dynamics, and other factors, and the Sales Agreement does not reference the intercompany referral fee.

Referral Fee Expenses

I.R.C. § 954(b)(5) provides for the reduction of foreign base company sales income and foreign base company services income by deductions properly allocable to such income. , relying on Treas. Reg. § 1.861-8 and Temp. Treas. Reg. § 1.861-8T, allocated and apportioned the intercompany referral fee expense of the Supply Brokers' CFCs to all of their classes of income in determining their subpart F income.

allocated the intercompany referral fees paid by Supply Brokers to all of their classes of income. In general, states that each CFC that pays intercompany referral fees has the following categories of income: (1) Income from sales to its own customers (as employer of the Customer Broker); (2) Income from sales to customers on referral from other CFCs (as employer of the Supply Broker); and (3) Intercompany referral fees received from referral of customers to other CFCs (as employer of the Customer Broker). See Taxpayer's Response to IDR IE-15, p. 2.

states that the three categories of income are derived from the single activity from which all of income is derived. Id. This activity is the purchase of and from that make or distribute

and its sale to customers that operate and . Id. then argues that in the case of each CFC that is a member of the group, the CFC's deductions incurred as a result of or incident to that sale activity, including intercompany referral fee expenses, are definitely related to each of the three categories of income. Id. To further support its allocation of intercompany referral fee expenses, states:

While a CFC's liability for a referral fee owed to a member of the Group is triggered if and when the CFC generates income in category two above, the CFC is only able to generate income in the first and third categories by virtue of being part of the Group, and to be such a part, the CFC must act as Supply Broker for its fellow Group members' customers, thus incurring liabilities for the referral fees. Membership in the Group is what makes it possible for the CFC to produce income in all three categories, not just the second, as customers purchase worldwide and prefer to transact with a single group able to provide on a worldwide basis. Thus, intercompany referral fee

Intercompany Referral Fee Income

Foreign base company sales income means income (whether in the form of profits, **commissions**, fees, or otherwise) derived in connection with the purchase of personal property from a related person and its sales to any person, the sale of personal property to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person on behalf of a related person where – (A) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and (B) the property is sold for use, consumption, or disposition outside such foreign country, or, in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country. I.R.C. § 954(d)(1) (emphasis added).

Example 3 of Treas. Reg. § 1.954-3(a)(1)(iii) confirms that commissions received by a CFC from a related party for sales on behalf of the related party to customers outside the country in which the CFC was created or organized constitute foreign base company sales income.

Foreign base company services income means income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which – (A) are performed for or on behalf of any related person, and (B) are performed outside the country under the laws of which the controlled foreign corporation is created or organized. I.R.C. § 954(e)(1).

The issue in the instant case is whether [redacted] has appropriately characterized its income as either sales income or services income. As explained below, no portion of the intercompany referral fee income should be characterized as services income. This is so because: (1) [redacted] has not substantiated that a portion of the intercompany referral fee was paid for the post-sale functions; (2) the intercompany referral fee was derived in connection with the purchase and sale of personal property to a person on behalf of a related person (i.e. the fee income is the type of income that would constitute foreign base company sales income); and (3) the requirements for the intercompany referral fee income to be considered foreign base company services income were not satisfied.

First, [redacted] has not substantiated that the intercompany referral fee paid by the CFC employing the Supply Broker to the CFC employing the Customer Broker was for post-sale services performed by the Customer Broker. There is no written agreement between the CFCs employing the Customer Broker and Supply Broker regarding the intercompany referral fee. Similarly, the [redacted] Sales Agreement does not establish that any portion of the intercompany referral fee income relates to post-sale functions. The [redacted] Services Agreement also does not designate the specific [redacted] CFC that is responsible for providing the post-sale functions. [redacted] did produce interview

notes in an attempt to substantiate that the Customer Broker rendered the post-sale functions. However, there are no statements that a portion of the intercompany referral fee relates to post-sale functions. Instead, the interviews generally discussed the functions and risks of the Customer and Supply Brokers, customer development, and the differences between the [redacted] and [redacted] segments. [redacted] and [redacted] did not conduct interviews of [redacted] customers, who could have offered an independent viewpoint as to the CFC that provided the post-sale functions, if they were provided at all. Even if post-sale services were provided by the Customer Brokers, such services would need to be provided with respect to the sales by the Customer Brokers' CFCs, which calls into question the idea that the Supply Broker would pay for such services.

There is no objective evidence indicating whether the intercompany referral fee was paid for anything more than referring the customer. In other words, all of the objective evidence indicates that the intercompany referral fee income was derived solely in connection with the purchase and sale of personal property on behalf of a related person (i.e. the purchase and sale of [redacted] by the Supply Broker on behalf of the Customer Broker), which is foreign base company sales income, as explained below.

All of the income from the intercompany referral fee is foreign base company sales income. Commissions derived in connection with the sale of personal property to any person on behalf of a related person are foreign base company sales income provided the locational requirements are also satisfied. The referral fee in the instant case is a commission that was derived in connection with the purchase and sale of personal property ([redacted]) by the Supply Broker to a person (third party customers) on behalf of a related person (the Customer Broker). The [redacted] which was sold on behalf of the Customer Broker was [redacted] and [redacted] outside the country in which the CFC employing the Customer Broker was created or organized, and was also sold for use and/or consumption outside of that country. Therefore, the intercompany referral fee income is foreign base company sales income.

The conclusion that the intercompany referral fee income is foreign base company sales income is supported by the basis for calculation and payment of the referral fee. The amount of the intercompany referral fee is based on the gross margins of the [redacted] seller. See Taxpayer's Response to IDR IE-7, p. 2. Gross margin is defined as the difference between net sales and cost of goods sold. The gross margins of the [redacted] seller are therefore based on income generated from sales, as the third party [redacted] suppliers in the instant transactions only sell [redacted] to [redacted] and its CFCs and do not provide services for which they are compensated. See [redacted] Memorandum, p. 4. Accordingly, the amount of the intercompany referral fee is determined on the basis of sales and not services income of the payor. Furthermore, the fact that the intercompany referral fee is awarded solely as a result of successful sales activities with no contingency for the completion or efficacy of the purported non-sales services indicates that it is sales income. If the Customer Broker were earning a fee predominantly for non-sales services, as [redacted] contents, it is doubtful that the fee

for such services would be contingent on the supposedly less significant sales services. Thus, it is clear that the intercompany referral fee was derived in connection with the purchase and sale of personal property on behalf of a related party.

Even if one assumes that the post-sale functions were contracted, performed by the Customer Broker, and compensated for, arguments that the post-sale functions are not part of the sales process are misplaced. Each alleged post-sale function is part and parcel of the sale of . Furthermore, it is not clear that the functions were performed by the Customer Broker, and there is no evidence that the Supply Broker made efforts to confirm that the functions were performed.

The first post-sale function allegedly performed and for which the CFC employing the Customer Broker was compensated is “responding to shortages, issues with quality and damages resulting from delays in delivery.” See Taxpayer’s Response to IDR IE 15, p. 7. First, responding to shortages would take place before a sale is consummated or completed and thus cannot be considered a post-sale activity. The same is true for responding to issues with quality. The Services Agreement provides customers the right to inspect and reject purchases that do not conform to certain quality specifications. See Services Agreement, Art. 2.3. The customer has ten days after delivery to make a claim for lack of quality, and if the is not of sufficient quality, is responsible for correcting or removing at its expense the non-conforming . Id. The sales process is not completed until after the customer accepts the and does not protest its quality. Therefore, responding to issues with quality occur prior to the completion of the sale. Similarly, damages resulting from delays in delivery implicitly signify that the sales process was not completed because the has not yet been delivered. This is confirmed by the fact that the customer also has ten days after delivery to make a claim for non-conformity for quantity, as in the case of quality. Id.

Additionally, has not substantiated that the Customer Broker performs the first group of post-sale functions as opposed to the Supply Broker. This is clear from the interview notes from interview with . stated that there are often delays with delivery, and that “[m]ost of these logistical issues are handled by the Supply Broker, but a Customer Broker will always be involved.” See Interview, Response to Question 6. Consequently, the need for the Supply Broker CFC to compensate the Customer Broker CFC with respect to management of delays in delivery is unclear. Also, stated that the Supply Broker assists the Customer Broker in responding to issues with shortages and quality. Id. There is no indication that or the Memorandum took account of this assistance in determining the portion of the intercompany referral fee income related to post-sale functions.

The second alleged post-sale function is “handling billing disputes and negotiating claim settlement with customers.” See Taxpayer’s Response to IDR IE 15, p. 7. According to the Memorandum, the supplier (as opposed to the sales broker, the industry equivalent of a Customer Broker) would generally be responsible for

collections, suggesting that they are generally considered integral to the sale. As it relates to the handling of billing disputes, Article 5.1 of the Sales Agreement provides that all payments shall be made prior to the delivery of any or services. The Sales Agreement also states that “

.” Id. Therefore, it is possible that billing disputes and settlement negotiations take place after a sale has been completed. However, has not proven that the CFC employing the Customer Broker is responsible for handling billing disputes and negotiating claim settlements with customers. According to a Transfer Pricing Analysis for the fiscal year ended prepared by (“Transfer Pricing Study”), U.S. legal department is responsible for collection and the management of third party agreements and contracts with customers, vendors, and resellers. See Transfer Pricing Study, pp. 17-18. While also has legal departments in regional locations (primarily the and), the regional legal team receives guidance from the U.S. legal department. Therefore, the CFC employing the Customer Broker may not have a local legal department, and if it does, assistance is provided by legal department in the U.S. Moreover, stated that the management of billing disputes in the segment is undertaken by teams in the field and centralized resources. See Interview, Response to Question 17. Accordingly, has failed to substantiate that its CFCs employing the Customer Brokers provided the second alleged post-sale function.

The third alleged post-sale function is “managing credit risk exposure by tracking customer’s overall purchase volume, pattern, and collecting formal and informal information about customer’s credit risk.” See Taxpayer’s Response to IDR IE 15, p. 7. Such functions occur before a sale takes place. would not enter into a sale if a prospective or current customer were a credit risk. This is illustrated by Article 5.3 of the Services Agreement, which states that a “ .” Thus, managing credit risk is part of the sales function.

Additionally, the Customer Broker is not the only individual involved in managing credit risk. According to , has a credit committee that obtains details from the Customer Broker, but from all appearances, it is the credit committee that is primarily responsible for making the credit decisions. See Interview, Response to Questions 4 and 6.⁵

The fourth alleged post-sale function consists of “tracking outstanding invoices and

⁵ It is also worth noting that has provided conflicting statements regarding which entity bears credit risk. In the interview of , he stated that “[o]ur Customer Brokers take on the credit risk on behalf of .” See Interview, Response to Question 35. However, in its Transfer Pricing Study, it is stated that “[e]ach affiliate assumes the credit risk borne by its own sales.” See Transfer Pricing Study, p. 13. In a referred sale, it is the Supply Broker that makes the sale. Thus, pursuant to the statement in the Transfer Pricing Study, it is the Supply Broker that bears the credit risk.

taking necessary actions to collect payment on behalf of the [redacted] affiliate.” See Taxpayer’s Response to IDR IE 15, p. 7. As provided above, invoices are to be paid prior to the delivery of [redacted] and collection matters may be addressed by [redacted] U.S. legal department. Thus, these activities occur prior to the completion of the sales process and are handled or assistance is provided by entities other than the CFC employing the Customer Broker. Moreover, [redacted] U.S. sales analytics team “maintains the Company’s proprietary sales database that provides customer profile information, including customer location, industry, historical demand, etc. The marketing department’s senior management utilizes data from this database to track certain customer data (e.g., credit history, purchases, etc.)” See [redacted] Transfer Pricing Study, p. 20; see also [redacted] Interview, Response to Question 28. Therefore, the United States, and not the CFCs, track customer purchases and credit history further undermining the claim that the Customer Broker should be compensated for such functions (including the managing of credit risk).

The final alleged post-sale functions include “keeping the customer up to date on current price trends, market dynamics and other factors impacting [redacted] supply and prices.” See Taxpayer’s Response to IDR IE 15, p. 7. As indicated above, [redacted] employs a sales analytics team in the United States that is engaged in developing business intelligence, performing market research and other quantitative analysis. See [redacted] Transfer Pricing Study, p. 20. Thus, it is arguable whether the Customer Broker is the entity responsible for providing these functions.

There is no objective evidence that the intercompany referral fee was paid for anything more than Customer Broker’s referral of customers to the Supply Broker. Additionally, because there is no written agreement, it cannot be determined if [redacted] CFCs were obligated to perform the post-sales functions. Also, there is no indication in the [redacted] Services Agreement that the Supply Broker affiliates had been obligated to render the post-sale functions to third party customers and that the Customer Brokers had satisfied those obligations.

The fee is paid for the successful completion of the sales functions. Thus, the predominant character of the intercompany referral fee is sales income. The intercompany referral fee cannot be segregated between the sales and alleged post-sale functions performed by the CFCs because, even if part of the fee were for the alleged post-sale functions, there is no agreement memorializing the amount of the fee or whether the fee was paid for services or not. Indeed, the [redacted] Memorandum relies on employees’ best estimates of the portion of their time spent on the various activities as the basis for allocating the unitary intercompany referral fee. There is also no indication that the income allegedly relating to services was accounted for separately from the portion that relates to sales.

[redacted] takes the position that the character of the intercompany referral fee income can be separately determined, relying on the pronouncement in Treas. Reg. § 1.954-1(e)(3) that it is unusual for a portion of income to not be separately determined. [redacted] produced the [redacted] Memorandum as proof that the amount of the intercompany

referral fee can be allocated between sales and services. The Memorandum however makes assumptions as to the benchmark fees for the post-sale functions for the segment as there were no internal or external benchmarks for such functions. See Memorandum, p. 6. Merely subtracting the benchmark fee for the sales functions from the estimated referral fee on a basis does not mean that the post-sale functions accounted for the difference and thus the asserted portion of the intercompany referral fee. This is so because the assumption upon which the benchmark fee for the post-sale functions is premised is flawed. The Memorandum assumes that “any time not spent by Group Affiliates on a specific sale or similar activity related to the Sales Function is spent on performing the post-sales [functions].” *Id.* This conclusion is flawed because it assumes that the Customer Broker only engages in two sets of functions, sales and post-sales, and nothing else. This ignores any costs and efforts to acquire customers and maintain those relationships as well as any other functions the Customer Broker may engage in. In fact, itself stated in regards to the time spent by Customer Brokers that it is “[p]robably best to think of it in **4 equal parts**: sales, after-sales, general relationship, and business development.” See Interview, Response to Questions 20 (emphasis added). These latter two categories of activities would also be sales-related, even if post-sale activities were not.

Moreover, as it relates to the segment, the Memorandum did not apply the same analysis as in the segment because the results were not reliable. *Id.* at 7. Instead, the Memorandum relies on a “best estimate” that between to percent of the time of the Customer Brokers in the segment are spent on the activities related to the sales function. *Id.* Such methodology is unscientific and completely subjective, particularly in light of the fact the each segment has different fee structures and the amount of the intercompany referral fee is calculated on a different basis for each segment (i.e. a different percentage of gross margin).

Finally, the examples from the regulations cited by do not support its conclusion that the intercompany referral fee income can be separately determined. states that examples 1, 8, and 10 of Treas. Reg. § 1.954-4(b)(3) “clearly contemplate that compensation for certain services performed when property is sold may be characterized as income other than ‘in connection with’ such sale.” See Taxpayer’s Response to IDR IE-15, p. 6. However, unlike in the examples, scenarios which clearly delineate between the sale and service functions, in the instant case there is no such demarcation. In each example, the amount of the fee for services is separately stated from the sales price, thereby providing an objective and easily quantifiable basis for determining the amount of foreign base company sales and services income. In the instant case, even if the post-sales functions were contracted for -- which there is no indication that they were -- the amount of the fee is not separately stated or contingent on the successful completion of the separate functions.

Overall, even though the character of the intercompany referral fee should be

determined under the predominant character test, if one assumes that the intercompany referral fee can be bifurcated between sales and services, the Memorandum is a subjective and unsupported basis for the 70/30 split. The Memorandum failed to take into account any assistance from related entities that the Customer Broker received in carrying out the post-sale functions, particularly by the Supply Broker. The Memorandum erroneously assumes that the Customer Broker received no assistance in performing the post-sale functions because there is no adjustment accounting for such assistance. As explained above, the Customer Broker was either not responsible for or received assistance from other affiliates in undertaking the post-sale functions. Consequently, has not properly substantiated that its bifurcation of the intercompany referral fee is proper.

The predominant character of the transaction at issue is sales. The post-sale functions allegedly rendered by the Customer Broker are all incident to the sales function. But for the sale, there would be no post-sale activities. This is confirmed by the analysis above that each of the post-sales functions are more appropriately characterized as part of the sales function. Also as explained above, the calculation and payment of the intercompany referral fee solely on the basis of the seller's gross margins and not on the basis of some measure of efficacy of non-sales services lends additional support for the conclusion that the predominant character of the transaction is sales.

did not properly apportion its intercompany referral fee income in determining its foreign base company sales income and foreign base company services income in taxable year . Instead of apportioning and of its intercompany referral fee income to services income and sales income, respectively, should have included all of its intercompany referral fee income in foreign base company sales income.

Intercompany Referral Fee Expense

For purposes of I.R.C. § 954(a), foreign base company services income and foreign base company sales income shall be reduced, under regulations prescribed by the Secretary, so as to take into account deductions (including taxes) properly allocable to such income. I.R.C. § 954(b)(5).

As stated above, "gross foreign base company income" includes foreign personal holding company income, foreign base company sales income, and foreign base company services income. Treas. Reg. § 1.954-1(a)(2). The term "adjusted gross foreign base company income" means the "gross foreign base company income" of a CFC as adjusted by the de minimis and full inclusion rules of Treas. Reg. § 1.954-1(b). Treas. Reg. § 1.954-1(a)(3). The term "net foreign base company income" means the "adjusted gross foreign base company income" of a CFC reduced so as to take account of deductions (including taxes) properly allocable or apportionable to such income under the rules of I.R.C. § 954 and Treas. Reg. § 1.954-1(c). Treas. Reg. § 1.954-1(a)(4). The term "adjusted net foreign base company income" means the "net foreign base company income" of a CFC reduced, first by any items of net foreign base company

income excluded from subpart F income pursuant to I.R.C. § 952(c) and, second, by any items excluded from subpart F income pursuant to the high tax exception of I.R.C. § 954(b). Treas. Reg. § 1.954-1(a)(5).

The term “foreign base company income” as used in the Internal Revenue Code and elsewhere in the Income Tax Regulations means “adjusted net foreign base company income,” unless otherwise provided. *Id.* Therefore, in determining foreign base company income, and thus the amount of subpart F income of the CFCs under I.R.C. § 952(a), the amount of deductions properly allocable or apportionable to foreign personal holding company income, foreign base company sales income, and foreign base company services income needs to be determined.⁶

The “net foreign base company income” of a CFC is computed under the rules of Treas. Reg. § 1.954-1(c)(1). According to Treas. Reg. § 1.954-1(c)(1)(i), the net foreign base company income of a CFC is computed first by taking into account deductions in the following manner:

(A) First, the gross amount of each item of income described in Treas. Reg. § 1.954-1(c)(1)(iii) is determined.

(B) Second, any expenses definitely related to less than all gross income as a class shall be allocated and apportioned⁷ under the principles of I.R.C. §§ 861, 864 and 904(d) to the gross income described in Treas. Reg. § 1.954-1(c)(1)(i)(A).

(C) Third, foreign personal holding company income that is passive within the meaning of I.R.C. § 904 (determined before application of the high-taxed income rule of Treas. Reg. § 1.904-4(c)) is reduced by related person interest expense allocable to passive income under Treas. Reg. § 1.904-5(c)(2); such interest must be further allocated and apportioned to items described in Treas. Reg. § 1.954-1(c)(1)(iii)(B).

(D) Fourth, the amount of each item of income described in paragraph Treas. Reg. § 1.954-1(c)(1)(iii) is reduced by other expenses allocable and apportionable to such income under the principles of I.R.C. §§ 861, 864, and 904(d).

The items of income referred to in Treas. Reg. § 1.954-1(c)(1)(i) include foreign personal holding company income, foreign base company sales income, and foreign base company services income. Treas. Reg. § 1.954-1(c)(1)(iii).

⁶ This memorandum does not address whether the de minimis and full inclusion rules of Treas. Reg. § 1.954-1(b) are applicable in the instant case, or whether any items of net foreign base company income are excluded from subpart F income under I.R.C. § 954(c)(2) or I.R.C. § 954(b).

⁷ This memorandum does not address apportionment of the intercompany referral fee expense, only allocation.

The rules contained in Treas. Reg. § 1.861-8 apply in determining taxable income of the taxpayer from specific sources and activities under sections of the Code referred to in Treas. Reg. § 1.861-8 as “operative sections.” Treas. Reg. § 1.861-8(a)(1). Treas. Reg. § 1.861-8(f)(1) lists the “operative sections,” and included therein is foreign base company income. Treas. Reg. § 1.861-8 provides rules for identifying which deductions are properly allocable to foreign base company income. Treas. Reg. § 1.861-8(f)(1)(v).

A taxpayer to which Treas. Reg. § 1.861-8 applies is required to allocate deductions to a class of gross income and, then, if necessary to make the determination required by the operative section of the Code, to apportion deductions within the class of gross income between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income. Treas. Reg. § 1.861-8(a)(2). Except for deductions, if any, which are not definitely related to a class of gross income and which, therefore, are ratably apportioned to all gross income, all deductions of the taxpayer must be so allocated and apportioned. Id. Allocations and apportionments are made on the basis of the factual relationship of deductions to gross income. Id.

For purposes of Treas. Reg. § 1.861-8, the gross income to which a specific deduction is definitely related is referred to as a “class of gross income” and may consist of one or more items of gross income enumerated in I.R.C. § 61 or subdivision thereof. Treas. Reg. § 1.861-8(a)(3). The term “statutory grouping of gross income” or “statutory grouping” means the gross income from a specific source or activity which must first be determined in order to arrive at taxable income from such specific source or activity under an operative section. Treas. Reg. § 1.861-8(a)(4). Gross income from other sources or activities is referred to as the “residual grouping of gross income” or “residual grouping.” Id.

Allocation is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to such class of gross income. Treas. Reg. § 1.861-8(b)(1). A deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. Treas. Reg. § 1.861-8(b)(2).

Each affiliate has four categories of income to which deductions may be allocated. These categories of gross income include: (1) income from sales to its own customers (as employer of the Customer Broker); (2) income from sales to customers on referral from other affiliates (as employer of the Supply Broker); (3) intercompany referral fee income received from referrals of customers to other affiliates (as employer of the Customer Broker); and (4) foreign personal holding company income. As explained above, takes the position that its intercompany referral fee expense is definitely related to all of its categories of income, and therefore, the expense should be allocated across its categories of income. Thus, from perspective, all of its categories of income are the “class of gross income” to which the intercompany referral fee expenses are definitely related. As

explained below, allocation is improper.

The intercompany referral fee expenses are not definitely related to each category of income. Rather, the intercompany referral fee expenses are definitely related only to category two above - income from sales to customers on referral from other affiliates (as employer of the Supply Broker). But for this income derived from a referral, the intercompany referral fee expense would not exist. This is the definite relationship that the regulations require. Furthermore, the definite relationship of the intercompany referral fee expense to the income from sales to customers on referral is borne out by the fact that the gross margin of these sales is the basis for calculating the intercompany referral fee. Because the amount of the expense is based on the gross margin of the sale, and not on the amount of services provided or other sales, there is a direct relationship between these sales and the expense.

argument is nothing more than a tenuous connection between the incidence of the expense and all of its categories of income. This is illustrated by allocation of the intercompany referral fee expense to foreign personal holding company income.⁸ There is absolutely no basis for concluding that there is a definite relationship between the expense and foreign personal holding company income. Such an allocation undermines arguments and demonstrates the fallacy in concluding that the expense is directly related to all categories of income. Additionally, the intercompany referral fee expense would be eliminated if CFCs ceased providing to customers of its other CFCs; however, the CFCs could still earn income by providing to their own customers. Such a scenario challenges the idea that the intercompany referral fee is a necessary expense incurred to earn all types of income.

The intercompany referral fee expense is properly allocable only to income from sales to customers on referral from other affiliates (as employer of the Supply Broker). This income generated by the CFC employing the Supply Broker is non-subpart F income.

CONCLUSIONS

1. did not properly apportion its CFCs' intercompany referral fee income in determining their foreign base company sales income and foreign base company services income in taxable year . Instead of treating and of the intercompany referral fee income as services income and sales income, respectively, should have included all of the intercompany referral fee income in foreign base company sales income.

⁸ did not include foreign personal holding company income as a category of income in its response to IDR IE-15, even though its calculation of its subpart F inclusion allocates the intercompany referral fee expense to foreign personal holding company income. See Exhibit A for a copy of calculation of its subpart F inclusion.

2. did not properly allocate its CFCs' intercompany referral fee expenses in taxable year . Instead of allocating the intercompany referral fee expenses across all of the CFCs' classes of income, should have allocated the intercompany referral fee expenses solely to non-subpart F sales income.

If you wish to discuss this matter, please call me at (305) 982-5266.

Andrew M. Tiktin
Associate Area Counsel (LB&I)

By: _____
Michael S. Kramarz
Senior Attorney (Miami)
Large Business & International