

LB&I International Concept Unit

Level of Concept		Shelf	N/A	Business Outbound
		Volume	2	Deferral Planning
		Part	2.1	Foreign Base Company Sales Issues
	✓	Chapter	2.1.2	Application of Branch Rules

Concept Practice Unit Name	Branch Rules for Foreign Base Company Sales Income
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Document Control Number(DCN)	DPL/CU/C_2.1.2_07(2015)
Date of Last Update	06/18/15

Table of Contents

(View this PowerPoint in “Presentation View” to click on the links below)

[General Overview](#)

[Relevant Key Factors](#)

[Detailed Explanation of the Concept](#)

[Examples of the Concept](#)

[Other Related Concepts](#)

[Training and Additional Resources](#)

[Glossary of Acronyms](#)

General Overview

Branch Rules for Foreign Base Company Sales Income (FBCSI)

A US shareholder of a foreign corporation generally is not subject to tax on the income of the corporation until the shareholder receives a distribution from the corporation. However, under Subpart F, certain types of income earned by a controlled foreign corporation (CFC) are currently included in the income of the CFC's US shareholders even if the CFC does not distribute the income to its shareholders in that year. One such type of income is Foreign Base Company Sales Income (FBCSI), which is income derived by a CFC from a purchase or sale of personal property involving a related party in which the goods are manufactured and sold for use/consumption outside the CFC's country of incorporation. Income from the sale of goods manufactured in the CFC's country (referred to as the "same country manufacturing exception") and from goods sold for use/consumption in the CFC's country (the "same country sales/use exception") does not fall within the definition of FBCSI. In addition, Treasury Regulations provide that FBCSI does not include income from the sale of property manufactured by the CFC itself ("CFC manufacturing exception").

A supply chain structure will very often include some disregarded entities (DEs). Many taxpayers utilize the check the box rules in these structures to disregard a separate foreign entity for US tax purposes. Consequently, a DE may be treated as a separate company under foreign law and a branch or division of its owner for US tax purposes. Although a DE is not generally treated as a separate entity for US tax purposes, the FBCSI branch rules sometimes treat a branch, including a DE, of a CFC as a separate entity for purposes of determining whether the CFC has FBCSI.

General Overview (cont'd)

Branch Rules for Foreign Base Company Sales Income (FBCSI)

The FBCSI rules are intended to prevent a US shareholder from using a CFC to shift sales income from the US or a high-tax foreign country to a low-tax foreign country. The *branch rules* prevent a US shareholder from using a branch, in lieu of a separate CFC, to shift sales income from a high-tax foreign country to a low-tax foreign country. Absent the branch rules, a CFC and its branch would be treated as a single entity for US tax purposes. However, when a CFC carries on selling, purchasing or manufacturing activities by or through a branch outside its country of incorporation and the use of the branch has *substantially the same tax effect* (SSTE) as if the branch were a separate CFC, the branch and the remainder of the CFC will be treated as separate corporations in determining whether the CFC has FBCSI from the sale of property. Furthermore, purchases or sales will be treated as made *on behalf* of the remainder of the CFC (in the case of purchases or sales made by or through a branch), or *on behalf* of the branch (in the case of manufacturing activities performed by or through a branch), which generally results in FBCSI to the CFC.

In order to determine whether the use of the branch has SSTE as a separate CFC, the *tax rate disparity (TRD) test* must be applied. Generally, under the TRD test, the branch and remainder of the CFC will be treated as separate corporations if the actual effective rate of tax (ERT) is less than 90% of, and at least 5 percentage points below, the hypothetical ERT with respect to the sales income (discussed further in the Detailed Explanation of the Concept). In summary, if there is TRD, then the branch and the remainder of the CFC will be treated as separate corporations.

This unit demonstrates that the TRD test is applied separately with respect to each type of personal property (e.g. Product X, Product Y, etc.). Application of the TRD test in fact patterns involving the manufacture and sale of *the same product* by multiple branches is beyond the scope of this concept unit. In addition, the branch rules apply with respect to FBCSI, and **not** foreign base company services income (FBCSvcl) or foreign personal holding company income (FPHCI). The FBCSvcl and FPHCI rules do not contain a “branch” rule.

Note: before applying the branch rules the examiner should determine whether the CFC has generated FBCSI without the application of the branch rules. If that is the case, the examiner does not need to consider the branch rules (Treas. Reg. 1.954-3(b)(2)(ii)(f)).

Relevant Key Factors

Branch Rules for Foreign Base Company Sales Income (FBCSI)

Key Factors

Three key factors are relevant with respect to the CFC in determining whether to apply the branch rules for FBCSI...

1. Whether the CFC has a branch or similar establishment outside its country of incorporation.
2. Whether the CFC derives sales income from products purchased, sold or manufactured by or through that branch or similar establishment.
3. Whether there is TRD when the actual ERT (in the sales jurisdiction) is compared to the hypothetical ERT (in the manufacturing or CFC remainder jurisdiction).

Separate units address the potential treatment of a branch's income as FPHCI or FBCSvcl.

Relevant Key Factors (cont'd)

Branch Rules for Foreign Base Company Sales Income (FBCSI)

Key Factors

1. Whether the CFC has a branch or similar establishment outside its country of incorporation.

This factor is sometimes a simple question of whether the CFC has an actual branch office or disregarded entity outside its home country. However, much more complicated fact patterns exist in which this determination is not nearly so straightforward. As discussed later, the Code and Regulations do not specifically define what constitutes a branch or similar establishment. Consequently, in situations where it is not immediately clear whether the CFC has a branch or similar establishment, relevant case law and IRS published guidance will be of particular importance (See *Ashland Oil Co. v. CIR* (95 TC 348 (1990)); *Vetco, Inc. v. CIR* (95 TC 579 (1990); Rev. Rul. 97-48, 1997-2 CB 89 (revoking Rev. Rul. 75-7, 1975-1 CB 244)). If necessary, IRS counsel may assist in determining whether the CFC has a branch or similar establishment. Note, however, that a per se corporation (Treas. Reg. 301.7701-2(b)(8)) cannot be treated as a branch or similar establishment.

Relevant Key Factors (cont'd)

Branch Rules for Foreign Base Company Sales Income (FBCSI)

Key Factors

2. Whether the CFC derives sales income from products purchased, sold or manufactured by or through that branch or similar establishment.

The existence of a branch outside the CFC's country of incorporation does not, in and of itself, invoke the branch rules for FBCSI; the second and third factors must also be addressed. A thorough functional analysis will identify the functions and activities that take place in the branch and will reveal *whether the CFC conducts purchasing, selling or manufacturing activities by or through the branch*. Other activities conducted by or through the branch generally will not have any bearing on the identification of the CFC's FBCSI. Note that the regulations (Treas. Reg. 1.954-3(b)(1)(i) & (ii)) use the language "by or through" a branch or similar establishment. As such, whether selling activities are carried on *by* the branch itself (even if the branch does *not* take title to the goods) **or** the sales are merely conducted *through* the branch (e.g. the branch performs little or no activity but merely takes title to the goods), the branch rules may be invoked.

Relevant Key Factors (cont'd)

Branch Rules for Foreign Base Company Sales Income (FBCSI)

Key Factors

3. Whether there is TRD when the actual ERT (in the sales jurisdiction) is compared to the hypothetical ERT (in the manufacturing or CFC remainder jurisdiction).

The third key factor involves determining whether there is TRD when the actual ERT is compared to the hypothetical ERT. Recall that the branch rules are intended to prevent US shareholders of a CFC in a high-tax jurisdiction from using a branch in a low-tax jurisdiction (or vice versa) to avoid the FBCSI rules. In order to ensure that the branch rules are applied only in cases in which the branch could be used to obtain tax benefits, the TRD test is applied (Treas. Reg. 1.954-3(b)(1)(i)(b) and (ii)(b)). The TRD test is discussed further in the Detailed Explanation of the Concept. If there is TRD, the branch and the remainder of the CFC will be treated as separate corporations solely for purposes of determining whether the CFC has FBCSI (Treas. Reg. 1.954-3(b)(2)(i)). For additional information regarding computing TRD, please see AM2015-002.

Detailed Explanation of the Concept

Branch Rules for Foreign Base Company Sales Income (FBCSI)

Analysis

Branch

The term “branch or similar establishment” is not defined in the Code or the Regulations. In a 1975 ruling that has since been revoked (Rev. Rul. 75-7, 1975-1, CB 244), the IRS had determined that an unrelated contract manufacturer was a branch of a CFC (based on several factors, e.g. CFC owned the inventory at all stages of processing; CFC bore risk of loss at all times; CFC controlled timing, quantity, and quality of production and processes). Based on this analysis, the application of the branch rules to a similar fact pattern would have resulted in FBCSI to a CFC if there had been TRD.

The Tax Court subsequently rejected this conclusion in *Ashland Oil Co. v. CIR* (95 TC 348 (1990)). While the CFC in the *Ashland* case did not have the same level of control as the CFC in Rev. Rul. 75-7, the Court did not address this distinction. Rather the Court held that “an unrelated corporation operating under an arm’s-length contractual arrangement with” a CFC is not included in the ordinary use of the term “branch” and the phrase “similar establishment” means “an establishment that bears the typical characteristics of an ordinary-usage branch, yet goes by another name for accounting, financial reporting, local law, or other purposes.” The Tax Court made a similar determination in *Vetco, Inc. v. CIR* (95 TC 579 (1990)), a case in which a foreign subsidiary of the CFC was the contract manufacturer. The Court in *Vetco* determined that a CFC’s foreign subsidiary did not meet the definition of a “branch” or similar establishment.

The results in the *Ashland* and *Vetco* cases made clear that the decision as to whether to allow attribution of manufacturing activities had relevance for two important but conflicting reasons. On the one hand, attributing manufacturing activities to a CFC could create a branch and therefore invoke application of the branch rules. On the other hand, it could allow the CFC to qualify for the CFC manufacturing exception from FBCSI. By refusing to find that attributed activities of a contract manufacturer constitute a branch, the Tax Court effectively created a loophole in the FBCSI rules by undercutting the application of the branch rules in those situations. The IRS responded by issuing Rev. Rul. 97-48, which revoked the 1975 ruling and followed the *Ashland* and *Vetco* cases. The 1997 ruling stated that the Service never intended to allow the activities of a contract manufacturer performed outside the CFC’s country of incorporation to be attributed to the CFC without treating those activities as performed through a branch or similar establishment.

Detailed Explanation of the Concept (cont'd)

Branch Rules for Foreign Base Company Sales Income (FBCSI)

Analysis

Hypothetical Tax Rate

By utilizing a manufacturing branch and selling through the remainder of the CFC, the CFC is effectively shifting sales income out of the manufacturing jurisdiction (where it would *hypothetically* be taxed if the sales income and manufacturing activities were not separated through the use of a branch) to the CFC's country of incorporation (where it is *actually* taxed). Thus, the hypothetical ERT for a manufacturing branch is the rate that would apply to the sales income of the remainder of the CFC under the laws of the country where the manufacturing branch is located. Similarly, by using a sales branch, the CFC is effectively shifting sales income from the CFC country (where the income would *hypothetically* be taxed if not for the use of the branch) to the sales branch country (where it is *actually* taxed). Accordingly, the hypothetical ERT for a sales branch is the rate that would apply to the income of the branch under the laws of the CFC's country of incorporation.

TRD Test

The TRD test compares the hypothetical ERT with respect to the hypothetical net sales income computed under the laws of the manufacturing jurisdiction ("hypothetical tax base") to the actual ERT with respect to that same base. If the actual ERT is sufficiently lower than the hypothetical ERT (as discussed below), then the branch and the remainder of the CFC will be treated as separate corporations for purposes of determining the CFC's FBCSI. The method of determining the actual ERT and the hypothetical ERT is discussed in other IPS units.

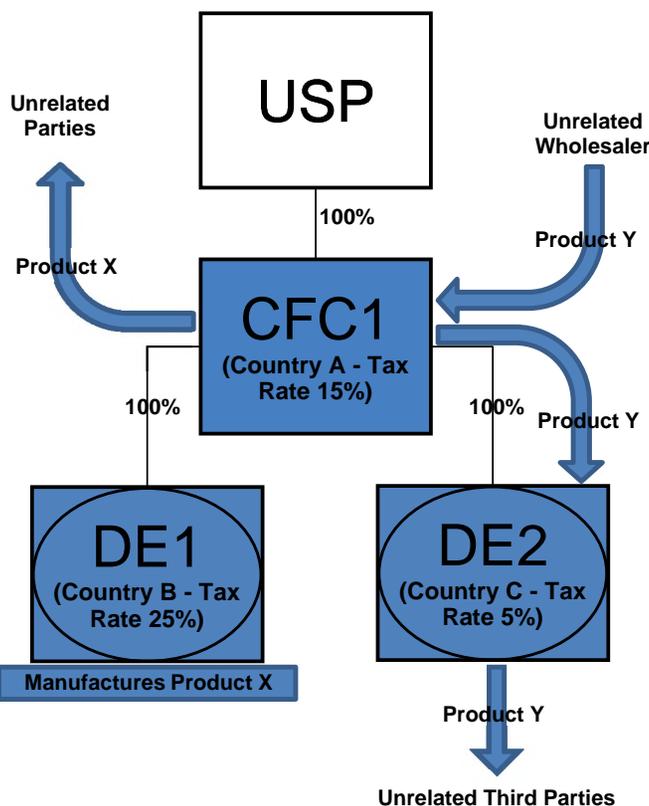
For a CFC with a *purchase/sales* branch, if the actual ERT with respect to the hypothetical tax base is less than 90% of, and at least 5 percentage points lower than, the hypothetical ERT that would apply to that same base in the *CFC's country of incorporation*, then there is TRD. For a CFC with a *manufacturing* branch, if the actual ERT with respect to the hypothetical tax base is less than 90% of, and at least 5 percentage points lower than, the hypothetical ERT that would apply to that same base in the *country where the goods are manufactured*, then there is TRD.

Note: the rules for CFCs with multiple sales branches, or one or more manufacturing branches with one or more sales branches, are beyond the scope of this Concept Unit and are discussed in IPS Practice Transaction units.

Examples of the Concept

Branch Rules for Foreign Base Company Sales Income (FBCSI)

Examples



USP is the 100% owner of CFC1 in Country A. CFC1 in turn has disregarded entities, DE1 and DE2, in Country B and Country C, respectively. Generally speaking, since DE1 is a disregarded entity for US tax purposes, any transactions between CFC1 and DE1 will be ignored for US tax purposes and therefore cannot generate FBCSI; the same is true for DE2. However, if CFC1 engages in purchasing, selling or manufacturing by or through DE1 and/or DE2, then the TRD test should be applied for purposes of determining whether CFC1 has FBCSI.

The ERTs in Country A, B, and C will be relevant in determining whether TRD exists between the actual and hypothetical ERTs of the DEs and the CFC. If TRD exists, then DE1 and/or DE2 have SSTE as separate corporations, and CFC1 may have FBCSI as a result of its sales of Product X on behalf of DE1, or DE2's sales of Product Y on behalf of CFC1.

Note: in the examples in this unit, the statutory rates are assumed to be the same as the ERT for illustrative purposes only. In an actual exam fact pattern, the statutory rate will rarely equal the ERT due to variations among tax jurisdictions in exclusions, deductions, credits, and other tax attributes. Computation of the ERT is beyond the scope of this unit.

Examples of the Concept (cont'd)

Branch Rules for Foreign Base Company Sales Income (FBCSI)

Examples

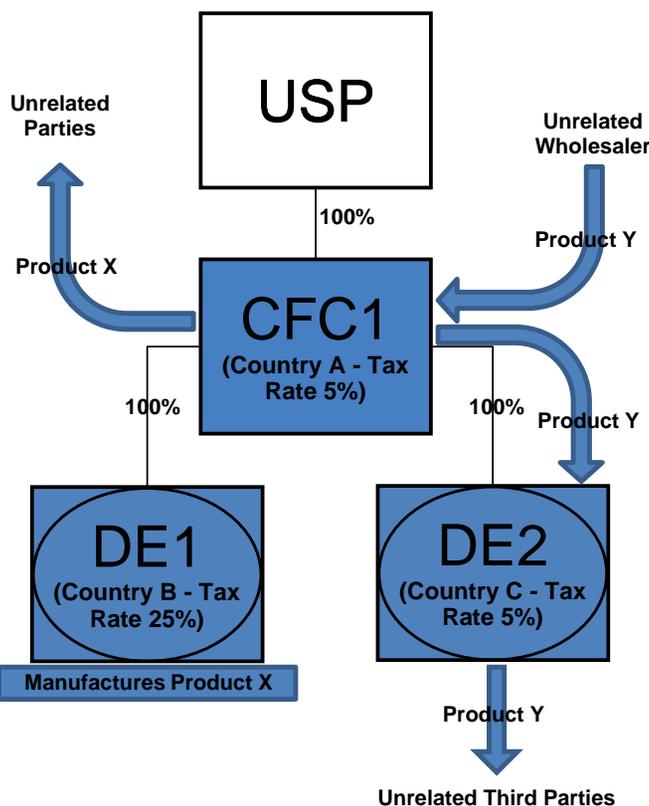
Example 1: CFC1 contracts with DE1 to manufacture Product X that CFC1 then sells to unrelated customers. The tax rate in Country A is 15% (actual ERT), and the tax rate in Country B is 25% (hypothetical ERT). Since the actual ERT in Country A is less than 90% of, and at least 5 percentage points lower than, the hypothetical ERT in Country B, there is TRD, and DE1 and CFC1 are treated as separate corporations. CFC1 is treated as selling Product X (which is manufactured and sold outside Country A) on behalf of DE1 (a related party). CFC1 does not qualify for the CFC manufacturing exception because the activities of DE1 are treated as those of a separate CFC, and consequently CFC1 has FBCSI.

Example 2: CFC1 purchases Product Y from an unrelated wholesaler. DE2 sells Product Y (originally purchased by CFC1) to unrelated third parties. The tax rate in Country A is 15% (hypothetical ERT), and the tax rate in Country C is 5% (actual ERT). Since the actual ERT in Country C is less than 90% of, and at least 5 percentage points lower than, the hypothetical ERT in Country A, there is TRD, and DE2 and CFC1 are treated as separate corporations. DE2 is treated as selling Product Y on behalf of CFC1 outside Country C. As such, CFC1 has FBCSI from DE2's sale of Product Y.

Examples of the Concept (cont'd)

Branch Rules for Foreign Base Company Sales Income (FBCSI)

Examples



Example 3: Same as Example 2, except the tax rate in Country A is 5% (hypothetical ERT). Since the actual ERT in Country C is *not* less than 90% of, and at least 5 percentage points lower than, the hypothetical ERT in Country A, there is no TRD, so DE2 and CFC1 are not treated as separate corporations (nor is DE2 treated as selling on behalf of CFC1). As such, CFC1 is merely buying Product Y from unrelated parties and selling it (through DE2) to unrelated parties. As such, CFC1 does not have FBCSI from DE2's sale of Product Y.

Note that changing the Country A tax rate to 5% does *not* change the result in Example 1. CFC1 has FBCSI from the sale of Product X on behalf of DE1, since the actual ERT in Country A is less than 90% of, and at least 5 percentage points lower than, the hypothetical ERT in Country B. Also note that if sales of Product X represent more than 70% of CFC1's total income, the "full inclusion rule" (IRC 954(b)(3)(B) and DPL/9412.05_05(2013)) will apply (subjecting the sales of Product Y to FBCI despite the result in Example 3).

Note: as mentioned previously, the rules for CFCs with multiple branches dealing in *the same product* are beyond the scope of this concept unit (and they do not apply to this scenario based on the examples above).

Other Related Concepts

Concept	Associated UIL(s) (If Applicable)	References
▪ Subpart F Overview	▪ 9412	▪ Subpart F Overview DPL/CU/V_2_01(2013)

Index of Related Issues/Topics

Issue	Associated UIL(s)	References
<ul style="list-style-type: none"> ▪ Same country sales/use exception from FBCSI 	<ul style="list-style-type: none"> ▪ 9412.01 	<ul style="list-style-type: none"> ▪ CFC Purchase From Related Party With Same Country Sales DPL/9412.01_01(2015)
<ul style="list-style-type: none"> ▪ Same country manufacturing exception from FBCSI 	<ul style="list-style-type: none"> ▪ 9412.01 	<ul style="list-style-type: none"> ▪ CFC Sale to Related Party With Same Country Unrelated Party Manufacturing DPL/9412.01_03(2015)
<ul style="list-style-type: none"> ▪ Manufacturing branch 	<ul style="list-style-type: none"> ▪ 9412.01-02 	<ul style="list-style-type: none"> ▪ Sale by CFC to Unrelated Parties of Products Manufactured by Branch DPL/9412.01_06(2015)
<ul style="list-style-type: none"> ▪ Sales branch 	<ul style="list-style-type: none"> ▪ 9412.01-02 	<ul style="list-style-type: none"> ▪ Branch Sales to Unrelated Parties of Products Manufactured by CFC DPL/9412.01_08(2015)
<ul style="list-style-type: none"> ▪ Computing Foreign Base Company Income 	<ul style="list-style-type: none"> ▪ 9412.05 	<ul style="list-style-type: none"> ▪ Computing Foreign Base Company Income DPL/9412.05_05(2013)

Training and Additional Resources

Branch Rules for Foreign Base Company Sales Income (FBCSI)		
Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	<ul style="list-style-type: none"> ▪ CLE Centra - Subpart F 20130930 ▪ Training - FY 2011 CPE "Live" Recordings ▪ PPT including slides on Functional Analysis ▪ PPT including slides on Branch Rules ▪ Branch Rules for FBCSI CPE Centra March 2015 	<ul style="list-style-type: none"> ▪ Discussion of branches is included in the Centra sessions at left.
Issue Toolkits		
White Papers / Guidance	<ul style="list-style-type: none"> ▪ Westlaw subscription 	<ul style="list-style-type: none"> ▪ Bittker & Lokken 69.5.5 ▪ TMFEDPORT No. 928-3rd VII. H. Foreign Branch of CFC Treated as Separate Corporation ▪ TMFEDPORT No. 6380-1st IV. D. 2. a. (3) FBCSI The Branch Rule ▪ Treas. Reg. 1.954-3(b)(1)(i)(a) ▪ Treas. Reg. 1.954-3(b)(1)(ii) ▪ Treas. Reg. 1.954-3(b)(2)(i) ▪ AM2015-002
Podcasts / Videos		
Articles		
Bloomberg BNA		

Glossary of Acronyms

Acronym	Definition
CFC	Controlled Foreign Corporation
DE	Disregarded Entity
ERT	Effective rate of tax
FBCSI	Foreign Base Company Sales Income
SSTE	Substantially the Same Tax Effect (as a separate corporation)
USP	US Parent