



LB&I International Practice Service Process Unit – Overview

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Unit Name	Conducting Functional Analysis for Foreign Base Company Income (FBCI)
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Introduction

Conducting Functional Analysis for Foreign Base Company Income (FBCI)

- The provisions of subpart F of the Internal Revenue Code (IRC) eliminate deferral of US income tax on certain kinds of foreign income (commonly referred to as “subpart F income”) by requiring US shareholders to currently include their pro rata share of such income earned by their controlled foreign corporations (CFCs), even if the CFC does not currently distribute income to its shareholder(s). Subpart F income includes, in relevant part, foreign base company income (FBCI), which can be further subdivided into categories such as foreign base company sales income (FBCSI), foreign base company services income (FBCSvcl), and foreign personal holding company income (FPHCI). (The detailed rules for these and other categories of subpart F income are beyond the scope of this unit and are covered in other IPS units). Issues involving FBCSI, FBCSvcl, and FPHCI represent three of the strategic priorities found on the Deferral Planning face of the International Matrix. In order to determine which, if any, of the provisions of subpart F apply to a given fact pattern, the examiner generally must conduct a **functional analysis** in order to identify the following.
- **WHAT** is the nature and character of the transaction (e.g. sale, service, interest, dividend, royalty, etc.)?
- **HOW** was the income generated, i.e. the critical functions or activities that generated the income (e.g. services, manufacturing activities, selling/distribution functions, etc.)?
- **WHO** were the parties to the transaction (e.g. related or unrelated, service provider, contract manufacturer, etc.) and the individuals who performed the critical functions or activities (e.g. employees of the US shareholder, CFC, branch, or unrelated party)?
- **WHERE** did the functions or activities take place (e.g. CFC country, branch location, or elsewhere)?

 **CONSULTATION:** The examiner should consult with an IRS Engineer regarding the subpart F functional analysis, and if necessary, request an IRS Engineer be assigned to the case to assist in conducting the functional analysis. This referral request should be made as soon as possible upon identifying a potential FBCI issue. In particular, the IE will need the Engineer’s assistance to evaluate which functions and activities are critical to the transactions at issue.

Introduction (cont'd)

Conducting Functional Analysis for Foreign Base Company Income (FBCI)

- Answering the questions what, how, who, and where is discussed in greater detail in Process Steps 1-4 later in this unit. The ultimate goal of answering these questions (i.e. performing the functional analysis) is to determine whether the transaction at issue generates FBCI, and consequently, whether the US shareholder has a current income inclusion under IRC § 951. Thus, a thorough understanding of the FBCI rules is a prerequisite to performing the functional analysis.
- For example, in order to perform Process Step 1 (“What”) effectively, the examiner must be familiar with the various income items that may be FBCI, such as dividends, interest, royalties, sales income, services income, etc. Similarly, the performance of Process Steps 2-3 (“How” and “Who”) requires an understanding that certain exceptions in the FBCI rules depend on the performance of certain functions or activities by one or more parties to the transaction (e.g. the substantial contribution test for CFC manufacturing exception from FBCSI, the active financing exception from FPHCI, etc.). In addition, the knowledge that certain categories of FBCI only arise from transactions involving related parties (e.g. FBCSI), whereas other categories may arise even from transactions between unrelated parties (e.g. certain types of FPHCI) is relevant in performing Process Step 3. Likewise, Process Step 4 (“Where”) will be more meaningful to the examiner who is aware of the FBCI exceptions that depend on the location of performance of certain functions or activities (e.g. the same-country manufacturing exception from FBCSI). Lastly, examiners who are familiar with FBCI know that certain FBCI rules are impacted by more than one Process Step in the functional analysis (e.g. the active leasing/licensing exception from FPHCI, the FBCSvcl rules, and in fact, most of the other examples already cited).
- These are just a few of the reasons it is so important for examiners to thoroughly understand the FBCI rules before beginning the functional analysis. If necessary, the examiner should review available resources such as the Subpart F Overview Concept Unit (DPL/CU/V_2_01(2013)) and international tax texts available through the Service’s online subscriptions. This will maximize the efficiency and effectiveness of the functional analysis and reduce the burden to both the Service and the taxpayer in the examination process.

Introduction (cont'd)

Conducting Functional Analysis for Foreign Base Company Income (FBCI)

- Conducting a functional analysis for FBCI purposes involves many of the same steps as conducting a transfer pricing functional analysis. In addition, the functional analysis may also be useful in addressing a variety of other tax issues such as the domestic production activities deduction (DPAD), research and experimental (R&E) expenditures, and other issues that are beyond the scope of this unit. Consequently, members of the domestic and international exam team and specialists should collaborate and coordinate information gathering efforts to avoid duplicative work for the exam team and/or unnecessary burden to the taxpayer. For example, consider inviting both the Economist and the Engineer to the taxpayer's presentation of business activities (see Step 1) to facilitate their factual development for their respective issues.

 **CAUTION:** The primary purposes of the functional analyses for FBCI and transfer pricing are very different. While transfer pricing functional analysis is a *value-driven analysis* (i.e. it ultimately assigns appropriate *values* to the various aspects of a transaction), the FBCI functional analysis is an *activity-based analysis* (i.e. it focuses on what *activities* are performed, and who performs them). Throughout this unit, the phrase “functional analysis” refers strictly to FBCI functional analysis unless otherwise noted.

Process Overview

Conducting Functional Analysis for Foreign Base Company Income (FBCI)

- In taking a tax return position with respect to an item of income that may be FBCI, taxpayers inevitably consider the WHAT, HOW, WHO, and WHERE mentioned in the Introduction. However, taxpayers do not necessarily document this thought process, let alone summarize the analysis in any kind of condensed document or report. Accordingly, it is incumbent on the examiner not just to review and verify documents provided by the taxpayer in support of its position, but also to perform a functional analysis in order to determine whether the taxpayer has an inclusion under the subpart F rules and/or is eligible for any relevant exceptions from FBCI. Furthermore, even if the taxpayer provides a summarized report analyzing the subpart F implications of a particular transaction, the examiner must perform the necessary audit steps to evaluate the appropriateness of the taxpayer's analysis.
- The FBCI rules do not define the term “functional analysis” or provide a list of procedures that must be completed in order to perform such an analysis. Instead, the general rules and exceptions for each of the major types of FBCI (e.g. FBCSI, FBCSvcl, FPHCI) provide an abstract framework for the procedures needed to perform a functional analysis. In light of the fact that subpart F of the IRC (and related Regulations) do not prescribe a specific process for conducting a functional analysis, this process overview unit is not intended to be an authoritative or all-inclusive list of required audit procedures an examiner must complete. Examiners may perform additional procedures not described in this unit, or forego suggested procedures described here. Similarly, examiners may find that the result of certain procedures described here may preclude the necessity of performing other procedures (e.g. the examiner may determine income is derived from services based on certain audit procedures; this would preclude the need to perform audit procedures related to FBCSI or FPHCI). In summary, this unit provides a non-exclusive list of suggested procedures an examiner may consider performing in order to identify and understand the WHAT, HOW, WHO, and WHERE, and more broadly, the amount, if any, of the taxpayer's subpart F inclusion.

NOTE: The phrase “functional analysis” is sometimes used to refer to the determination of whether a CFC makes a substantial contribution and therefore qualifies for the CFC manufacturing exception from FBCSI pursuant to Treas. Reg. § 1.954-3(a)(4)(iv). This unit covers functional analysis at a broader level. Substantial contribution will be covered in a separate IPS Process Unit.

Detailed Explanation of the Process

Conducting Functional Analysis for Foreign Base Company Income (FBCI)

Analysis

Performing a functional analysis will require an investment of time and resources on the part of the exam team. As such, the examiner should first consider whether a functional analysis is even needed. That is, if the FBCI rules could not apply to a given fact pattern, the examiner does not need to perform the kind of functional analysis described in this unit.

There are three basic requirements under IRC §951(a) for the applicability of the subpart F rules to a US person owning an interest in a foreign corporation.

- The US person must be a “US shareholder” (IRC §951(b)).
- The foreign corporation must be a CFC (IRC §957).
- The CFC must have subpart F income (IRC §952).

If the facts indicate the potential existence of a US shareholder of a CFC that derives FBCI, then the examiner will need to perform a functional analysis in order to identify the relevant transactions, parties and activities involved. Resolving the first two criteria (i.e. US shareholder and CFC) is a key first step in deciding whether to proceed with the FBCI functional analysis.



DECISION POINT: If the US person is not a US shareholder as defined in IRC § 951(b), or the foreign corporation is not a CFC as defined in IRC §957, then the examiner should not proceed with the FBCI functional analysis.

Resolving the third criteria (subpart F income) is determined, in part, through the functional analysis itself. However, in cases where the presence of, or an exception from, FBCI is obvious from the facts, the functional analysis may be significantly scaled back.

Summary of Process Steps

Conducting Functional Analysis for Foreign Base Company Income (FBCI)

Process Steps

Performing a functional analysis will enable the examiner to identify and understand the transaction(s), the key activities performed and the individuals who performed them; and more broadly, the amount, if any, of the taxpayer's subpart F inclusion resulting from such transactions.

Step 1	WHAT is the nature and character of the transaction(s) and income?
Step 2	HOW was the income generated (i.e. what are the functions/activities that generated the income)?
Step 3	WHO were the parties to the transaction and the individuals who performed the key functions/activities that generated the income?
Step 4	WHERE did the key functions and/or activities occur?

Step 1: WHAT

Conducting Functional Analysis for Foreign Base Company Income (FBCI)

Step 1

WHAT is the nature and character of the transaction(s) and income?

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> • Request a presentation on the taxpayer's business operations. • Review the tax return, annual report, and SEC filings to identify known or potential items of FBCI. • Request details of any transactions or income arising outside the taxpayer's ordinary course of business. • Review transaction agreements or contracts (e.g. sales/purchase, lease, license, service, etc.) for additional information regarding any potential items of FBCI. <p> CONSULTATION: Consult with the relevant IPG for assistance if the nature or character of the income is uncertain or disputed.</p>	<ul style="list-style-type: none"> • IRC 954 • Subpart F Overview DPL/CU/V_2_01(2013) 	

Step 1: WHAT (cont'd)

Conducting Functional Analysis for Foreign Base Company Income (FBCI)

Step 1

WHAT is the nature and character of the transaction(s) and income?

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> • Review Form 5471 amounts reported in the Income Statement section of Schedule C for potential FBCI. • Review Form 5471 data to estimate the effective tax rate (ETR), as a very low ETR may indicate income has been shifted to achieve a lower worldwide ETR and/or may implicate FBCSI branch rules. • Review Form 5471 Schedule F (Balance Sheet) for material decreases in assets as they may indicate the sale of assets resulting in FPHCI or FBCSI or perhaps a restructuring to utilize branches or DEs to avoid FBCSI. • Review Form 5471 Schedule F for material amounts of cash or cash equivalents with little or no corresponding interest income. 	<p>Review Auditor's Workbench (formerly know as IIR) reports such as:</p> <ul style="list-style-type: none"> • Subpart F Sale/Service Income (Outbound Deferral Planning Report Group) • High Tax E&P (Outbound FTC Management Report Group) • Material Decrease in CFCs Assets (Outbound Income Shifting Report Group) 	

Step 1: WHAT (cont'd)

Conducting Functional Analysis for Foreign Base Company Income (FBCI)

Step 1

WHAT is the nature and character of the transaction(s) and income?

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> Review amount, if any, reported as subpart F income on Form 5471 Schedule I (Summary of Shareholder's Income From Foreign Corporation), and reconcile to amounts reported on: Form 5471 Schedules C, F, and M (Transactions Between Controlled Foreign Corporation and Shareholders or Other Related Persons); the income tax return (e.g. Form 1120) as income from CFCs under Subpart F; Form 1118 as foreign source income; Form 5471 Schedule J (Accumulated Earnings and Profits (E&P) of Controlled Foreign Corporation), line 4 as previously taxed income. 		

Step 2: HOW

Conducting Functional Analysis for Foreign Base Company Income (FBCI)

Step 2

HOW was the income generated (i.e. what are the functions/activities that generated the income)?

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> • Request a presentation and a transactional flow diagram of the taxpayer's supply chain showing the flow of goods and/or services. • Interview personnel responsible for sales, purchasing, service, manufacturing, and other functions to gain an understanding of the relevant activities and functions. • Work with your engineer/conduct your own analysis of reporting structure/employee lists to determine who would be most beneficial individuals to interview. • Consider visiting the taxpayer's/CFC's facilities to verify the functions/activities that generated the income. • If taxpayer claims the CFC manufacturing exception from FBCSI, evaluate the activities and functions performed to determine whether they qualify under one of the three tests for the CFC manufacturing exception. 	<ul style="list-style-type: none"> • Centra: Subpart F and the Substantial Contribution Rules August 2013 • Treas. Reg. 1.954-3(a)(4)(ii)-(iv) 	

Step 3: WHO

Conducting Functional Analysis for Foreign Base Company Income (FBCI)

Step 3

WHO were the parties to the transaction and the individuals who performed the key functions/activities that generated the income?

Considerations	Resources	6103 Protected Resources
<p>To identify parties to the transaction(s):</p> <ul style="list-style-type: none"> • Review Form 5471 Schedule M for related party transactions which may give rise to FBCI. • Request a copy of the global tax organization chart with all foreign and domestic entities and branches for each of the audit years. • Review the taxpayer's supply chain presentation to identify parties to the transaction(s). • Review transaction agreements or contracts to identify primary parties to the transaction, parties who are obligated to perform under the contract, guarantors, etc. (Note that the parties who <i>actually</i> perform functions or activities are not necessarily the parties who are contractually <i>obligated</i> to perform.) • Review Forms 8858 Schedule M of CFC-owned DEs for transactions with related parties (other than CFC-owner) that may be FBCSvcl or FPHCI. 	<p>Review Auditor's Workbench (formerly know as IIR) reports such as:</p> <ul style="list-style-type: none"> • Related Party Transactions Summary (Outbound Income Shifting Report Group) 	

Step 3: WHO (cont'd)

Conducting Functional Analysis for Foreign Base Company Income (FBCI)

Step 3

WHO were the parties to the transaction and the individuals who performed the key functions/activities that generated the income?

Considerations	Resources	6103 Protected Resources
<p>To identify the individuals who performed key functions and activities:</p> <ul style="list-style-type: none"> • Review the taxpayer’s supply chain presentation to identify parties who perform key functions or activities. • Request the personnel organization structure, including titles and position descriptions. • Request employment agreements, resumes, and performance evaluations for relevant personnel. • Visit the taxpayer’s/CFC’s facilities and/or interview relevant personnel to verify who actually performs the relevant functions/activities (and not just who is contractually obligated). • Review Forms 8858 of CFC-owned DEs to identify potential income derived by a CFC purchasing, selling, or manufacturing through a branch/DE, which could be subject to the branch FBCSI rules. 	<ul style="list-style-type: none"> • Branch Rules for FBCSI DPL/CU/C_2.1.2_07(2015) • Centra: Branch Rules for FBCSI March 2015 	

Step 4: WHERE

Conducting Functional Analysis for Foreign Base Company Income (FBCI)

Step 4

WHERE did the key functions and/or activities occur?

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> • Review taxpayer’s website, press releases, financial statements and/or other public data (e.g. SEC filings) for information on location of key activities and/or functions. • Review Form 5471 line 1c and 1e for locations of incorporation and principal business. (If different, consider whether the CFC is purchasing, selling, or manufacturing through a branch/DE potentially triggering the application of the FBCSI branch rules.) • Consider working with CAS to review the location of activities. For example, using the CAS database, compare cost center/trial balance data to supply chain presentation (e.g. costs associated with activities in cost center location vs. another location). If inconsistent, request reconciliation. 		

Step 4: WHERE (cont'd)

Conducting Functional Analysis for Foreign Base Company Income (FBCI)

Step 4

WHERE did the key functions and/or activities occur?

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none">• Conduct interviews and, if possible, visit the taxpayer's/CFC's facilities to verify the functions/activities that take place in each respective location (e.g. home office, branch, manufacturing plant, etc.).• Consider reviewing copies of relevant filings (e.g. income, VAT, customs, etc.) submitted in the jurisdictions in which activities or functions are purported to have taken place.		

Definitions

Conducting Functional Analysis for Foreign Base Company Income (FBCI)

Description

U.S. shareholder: U.S. person who owns 10% or more of the total combined **voting** power of all classes of stock entitled to vote of such foreign corporation. IRC § 951(b).

Controlled foreign corporation (CFC): foreign corporation in which U.S. shareholders own (1) more than 50% of the total combined voting power of all classes of the corporation's stock entitled to vote (voting test), **or** (2) more than 50% of the total value of all classes of the corporation's stock (value test). IRC § 957(a).

Supply chain: the people, activities and resources involved in getting a product or service from the supplier to the customer

Contract manufacturing: outsourcing part or all of the manufacturing process of a product to a related or unrelated third party

Training and Additional Resources

Conducting Functional Analysis for Foreign Base Company Income (FBCI)

Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	<ul style="list-style-type: none">• Subpart F and the Substantial Contribution Rules August 2013 (VNN789444)• IRC Section 954(c)(6) Look-Thru Rules February 2014 (LRQ368149)• Branch Rules for FBCSI March 2015 (KKF544020)	

Glossary of Terms and Acronyms

Term/Acronym	Definition
CAS	Computer Audit Specialist
CFC	Controlled foreign corporation
DE	Disregarded entity
DPAD	Domestic production activities deduction
E&P	Earnings & profits
ETR	Effective tax rate
FBCI	Foreign base company income
FBCSI	Foreign base company sales income
FBCSvcl	Foreign base company services income
FPHCI	Foreign personal holding company income
FTC	Foreign tax credit
IIR	International information return
IPG	Issue Practice Group
IPS	International Practice Service
R&E	Research & experimental

Index of Related Issues

Issue	Associated UIL(s)	References
Subpart F Overview	9412	DPL/CU/V_2_01(2013)
Same country sales/use exception from FBCSI	9412.01-01	DPL/9412.01_01(2015)
Branch Rules for FBCSI	9412.01-02	DPL/CU/C_2.1.2_07(2015)
Same country manufacturing exception from FBCSI	9412.01-03	DPL/9412.01_03(2015)
Concepts of FBCSvcl	9412.02	DPL/CU/P_2.2_10(2015)
Active financing exception from FPHCI	9412.03-02	DPL/9412.03_02(2013)
Look-thru rule/same country exception from FPHCI	9412.03-04	DPL/9412.03_04(2015)
Computing FBCI	9412.05	DPL/9412.05_05(2013)