This non-taxpayer-specific Chief Counsel Advice addresses the proper reporting of U.S. taxable income and the proper standard for determining the compulsory amount of creditable foreign taxes imposed with respect to transactions (1) between a U.S. corporation and its foreign disregarded entity (DE) or unincorporated branch operation (branch) and (2) between a U.S. corporation and an affiliated U.S. corporation’s foreign branch or DE.

Transactions between a foreign branch or DE and its U.S. tax owner. A foreign DE is treated as a foreign branch for U.S. tax purposes. See Treas. Reg. §301.7701-3(a). All of the income of a foreign branch or DE is included in the taxable income of its owner for U.S. tax purposes, regardless of whether any of the income is remitted to the owner in the year earned. Transactions between a foreign branch or DE and its owner do not give rise to offsetting amounts of income or expense for U.S. tax purposes. Rather,
such transactions (and, therefore, the resulting interbranch payments) are generally disregarded for tax purposes, although a payment from the foreign branch or DE to its owner may be treated as a branch remittance requiring recognition of currency gain or loss under section 987.

The arm’s length standard is a regulatory implementation of the authority under section 482 to clearly reflect income attributable to the pricing of transactions between controlled taxpayers. See Treas. Reg. §1.482-1(b). Because a foreign branch or DE and its owner are treated as a single entity, and transactions between them do not give rise to income or expense for U.S. tax purposes, an application of the arm’s length standard of the section 482 regulations to such disregarded transactions would not affect the amount of taxable income the U.S. owner recognizes for U.S. tax purposes, and so generally is not meaningful for U.S. tax purposes. However, as discussed below, U.S. transfer pricing principles may be relevant in determining whether non-arm’s length transfer prices in transactions between a foreign branch or DE and its U.S. owner result in noncompulsory payments of foreign tax that are not eligible for a U.S. foreign tax credit, to the extent foreign tax law, as modified by tax treaties to which the foreign country is a party, includes similar arm’s length principles, as most do.

Transactions between a foreign branch or DE of a member of a U.S. consolidated group and another member. A transaction between a foreign branch or DE of a member of a consolidated group and another member of the same group is a transaction between related parties that has effect for U.S. tax purposes. Section 482 applies to these intercompany transactions, as well as to transactions between members of a controlled group that are not members of the same consolidated group (such as between a domestic corporation and its controlled foreign corporation (CFC)). However, section 482 adjustments to such intercompany transactions generally will not have current tax effects, as discussed below.

Transactions between members of a consolidated group are intercompany transactions subject to Treas. Reg. §1.1502-13. Under that regulation, the amount and location of intercompany items are determined on a separate entity basis, but the timing, character, source, and other attributes of the intercompany items and corresponding items are adjusted to produce the effect of transactions between divisions of a single corporation. See, e.g., Treas. Reg. §§1.1502-13(a)(2) and 1.1502-13(c)(7)(ii) Examples 14 (source of income from intercompany sales of inventory) and 15 (timing, source and character of gain on sale of CFC). In addition, section 864(e) and the regulations under that section often operate to eliminate the effect of intercompany transactions in determining the consolidated group’s relative amounts of U.S. and foreign source gross income and the allocation of the corresponding intercompany expense in determining the group’s foreign tax credit limitations under section 904. See, e.g., Treas. Reg. §1.861-11T(e)(2) (intercompany interest income is included in the same class of gross income as that from which the borrower deducted the interest expense); Treas. Reg. §1.861-14T(c)(1)(i) (interaffiliate stock and loans, gross income or sales are eliminated in
determining apportionment fractions for expenses apportioned on the basis of group-wide assets, gross income or sales, respectively).

As a result, adjustments to the transfer price of a transaction between a U.S. corporation and another consolidated group member’s foreign branch or DE generally would result in offsetting amounts of gross income and expense, or adjustments to amounts attributable to intercompany transactions that are not currently taken into account for U.S. tax purposes. Such transfer pricing adjustments would not change the total amount of worldwide taxable income recognized by the U.S. consolidated group in the year to which the transfer pricing adjustments relate. Moreover, such adjustments generally would not affect the relative amounts of the group’s U.S. and foreign source gross income or the relative amounts of the group’s deductible expenses and losses that are allocated and apportioned to U.S. and foreign source gross income. For example, assume that in Year 1 domestic corporation S sells inventory with a $5 cost of goods sold for a transfer price of $10 to a foreign DE of B, another member of S’s consolidated group, and the DE then sells the inventory outside the group for $25. Under Treas. Reg. §1.1502-13(a)(2) the source of the group’s total $20 of gross income ($25 gross receipts - $5 cost of goods sold) will be redetermined to produce the same effect as if S and B were divisions of a single corporation that did not recognize taxable income or loss on the $10 intercompany sale. Accordingly, the group’s $20 of gross income recognized in connection with the sale of inventory outside the group will have the same source regardless of whether the arm’s length intercompany sales price between S and B is $10 or a different amount.

As noted above, a payment from a foreign branch or DE to its tax owner may be treated as a branch remittance that may require an owner to recognize currency gain or loss under section 987. However, transactions between a foreign branch or DE and another member of the consolidated group that includes the owner of the foreign branch or DE generally do not result in remittances requiring recognition of currency gain or loss under section 987 (although they may affect the portion of the total profit or loss taken into account by each member).

**Noncompulsory foreign tax payments.** Transactions that are generally disregarded for U.S. tax purposes because they occur between entities that are disregarded as separate entities from one another may nevertheless significantly impact foreign taxes. For example, a foreign DE that is party to a transaction may be treated for foreign tax purposes as a corporation separate from its counterparty in the transaction. The primary concern raised by non-arm’s length transfer prices in these disregarded transactions is generally not the under-reporting of U.S. taxable income, because as detailed above the total amount of U.S. taxable income in the year of the interbranch or intercompany transaction is not affected by an adjustment to the amount of the transfer price. Rather, the primary concern is often that through the use of a non-arm’s length transfer price the U.S. taxpayer operating through a foreign branch, or its DE, may report too much income to the foreign country or countries in which it operates, resulting in an overpayment of foreign income tax. Similarly, a controlled foreign corporation in
one country that operates through a branch or DE in a foreign third country may report too much income and overpay its foreign taxes in either its home country or the third country.

The legal basis for disallowing credit for overpayments of foreign income taxes attributable to non-arm’s length transfer prices in these situations, as in the case of transactions between separately regarded entities, is not section 482, but rather the noncompulsory payment rule of Treas. Reg. §1.901-2(e)(5). That regulation provides that a foreign tax is not considered “paid” for purposes of section 901 to the extent that the amount paid exceeds the amount of liability under foreign law for tax. Under the regulation, the amount of taxable income reported on the foreign tax return must be computed in accordance with a reasonable interpretation of foreign tax law, as modified by applicable tax treaties.

In the case of a foreign DE, from a foreign tax law perspective the DE is a separately regarded, related entity, and thus transactions between the DE and its U.S. tax owner are respected as transactions between related parties. The domestic laws of most foreign countries apply arm’s length principles to the pricing of transactions between separately regarded entities. In the case of a foreign branch or partnership, certain foreign countries also apply arm’s length transfer pricing principles. In addition, certain U.S. tax treaties with foreign countries allow U.S. taxpayers to apply transfer pricing principles, even where the domestic laws of those countries would not otherwise do so. In all such cases, just as in the case of a transaction between entities that are separately regarded for U.S. tax purposes, if the foreign DE, branch or partnership fails to use an arm’s length transfer price to compute the income reported on a foreign tax return it may have overstated the profits subject to foreign tax and made a noncompulsory payment that is not eligible for a U.S. foreign tax credit.

Under the noncompulsory payment rules as well as section 905(b) and the regulations under that section, a taxpayer must substantiate that its or its DE’s foreign tax return was prepared in accordance with a reasonable interpretation and application of the substantive and procedural provisions of foreign tax law, including with reference to applicable tax treaties, in such a way as to reduce, over time, its reasonably expected liability under foreign law for tax. In addition, the taxpayer must show that it exhausted all effective and practical remedies, including invocation of competent authority procedures if available, to minimize its foreign tax liability. In appropriate cases the Service may require the taxpayer to provide translated copies of the foreign law and relevant foreign law authorities, as well as opinions of foreign tax law advisors to whom the taxpayer has disclosed the relevant facts, to substantiate that it has met this burden. Once on notice that a higher or lower transfer price should have been reported to reduce the taxable income reported on the foreign tax return, a taxpayer must act to preserve its administrative remedies under foreign law or treaties to file an amended foreign tax return reflecting reduced profits and claiming refunds of the overpaid foreign tax. The noncompulsory payment rules do not require the taxpayer to waste time and
money in a futile proceeding, but if there is a reasonable prospect of relief, the credit may be disallowed if the taxpayer chooses not to pursue it.

In summary, U.S. transfer pricing principles may be relevant in determining whether non-arm's length transfer prices result in noncompulsory payments of foreign tax, to the extent foreign tax law, as modified by tax treaties to which the foreign country is a party, includes similar arm's length principles, as most do. Taxpayers have the burden to establish to the satisfaction of the Service that they have properly minimized their creditable foreign tax liability by exhausting all effective and practical remedies (including resort to competent authority proceedings where available) to reduce, over time, their liability for foreign tax.

Transactions involving foreign branches or DE’s of controlled foreign corporations.
Similar issues involving noncompulsory payments of foreign tax may arise in cases involving a controlled foreign corporation that is the U.S. tax owner of a foreign branch or DE, where the foreign branch or DE engages in transactions with its tax owner, a related but separately regarded controlled foreign corporation, a United States shareholder of the controlled foreign corporation tax owner, or a United States shareholder of a related but separately regarded controlled foreign corporation. In such cases, the application of arm’s length transfer pricing principles to transactions between the foreign branch or DE and its controlled foreign corporation tax owner will not affect the amount of the controlled foreign corporation’s income or earnings and profits for U.S. tax purposes. However, the application of such principles to transactions between the foreign branch or DE and a related but separately regarded controlled foreign corporation, a United States shareholder of the branch or DE’s tax owner, or a United States shareholder of a related but separately regarded controlled foreign corporation may result in adjustments to the income or earnings and profits of the controlled foreign corporation(s) and United States shareholder(s) for U.S. tax purposes.

In the case of transactions between a foreign branch or DE of a controlled foreign corporation and both separately and non-separately regarded entities, the foreign income taxes at issue are often those paid or accrued by the foreign corporation and included in the computation of foreign taxes deemed paid by a United States shareholder of the foreign corporation under section 902, 960 or 962. The noncompulsory payment rules of Treas. Reg. §1.901-2(e)(5), including the obligation to exhaust remedies to reduce foreign tax liabilities over time, apply to the same extent to taxes paid or accrued by foreign corporations that may be deemed paid by their United States shareholders. Taxpayers have the burden to establish to the satisfaction of the Service that claims based on deemed-paid credits include only foreign taxes that were properly accrued and paid within the meaning of the applicable regulations. See I.R.C. sections 902(c)(2), 902(c)(4), and 905(b), and Treas. Reg. §§1.901-2(e), 1.902-1(a)(8), 1.902-1(e), and 1.905-2. Under sections 902 and 960, credits for foreign taxes deemed paid are based on multi-year pools of the foreign corporation’s earnings and taxes accumulated in post-1986 taxable years. Because the United States shareholder is eligible to claim a deemed paid foreign tax credit only in connection with a distribution or
inclusion from the foreign corporation, the credit must be substantiated in the taxable year the foreign taxes deemed paid are claimed as a credit, without regard to the year or years in which the foreign taxes were paid or accrued by the foreign corporation.

Transactions involving the U.S. branch or DE of a foreign corporation. This CCA addresses the determination of creditable foreign taxes of U.S. corporations (or CFCs) with foreign DEs or branches. Accordingly, this CCA does not address a foreign corporation’s computation of income that is effectively connected, or treated as effectively connected, with its conduct of a trade or business within the United States. However, as is the case with foreign DEs, transactions between a foreign corporation and its U.S. branch or DE are generally disregarded for U.S. federal income tax purposes. Foreign corporations engaged in trade or business within the United States are subject to tax on gross income that is effectively connected with their conduct of a trade or business within the United States (ECI) and are allowed deductions that are properly allocated and apportioned to such ECI. I.R.C. § 882(a)(1); Treas. Reg. § 1.882-4(a)(1). Because transactions between a branch or DE and its owner are typically disregarded for federal income tax purposes, they do not give rise to ECI or to deductions that are properly allocated and apportioned to ECI. However, in limited circumstances disregarded transactions between the foreign home office of a foreign corporation and its U.S. DE or U.S. branch, which do not give rise to ECI or deductible expenses, may nonetheless be given effect for limited U.S. income tax purposes. For example, a transaction between a U.S. branch and its foreign home office may affect the determination of the source of certain income derived from sources within and without the United States. See, e.g., Treas. Reg. § 1.863-3(b)(3) (sourcing certain inventory sales income by reference to an entity’s books).

Certain U.S. tax treaties adopt the OECD’s approach to attributing profits to a permanent establishment, and therefore generally compute business profits of a foreign corporation that are taxable in the United States by reference to the assets used, risks assumed, and functions performed by the U.S. permanent establishment. See, e.g., Technical Explanation of the Protocol Done at Chelsea on September 21, 2007, Amending the Convention between the United States of America and Canada with Respect to Taxes on Income and on Capital Done at Washington on September 26, 1980, as Amended by the Protocols Done on June 14, 1983, March 28, 1994, March 17, 1995, and July 29, 1997, and the Exchange of Notes dated July 24, 2001, under the Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains (each providing that the OECD Transfer Pricing Guidelines will apply, by analogy, for the purposes of determining the profits attributable to a permanent establishment). Under these treaties, profits of a U.S. permanent establishment may be determined based on all of the permanent establishment's dealings, including transactions between a U.S. permanent establishment and the foreign corporation of which it is a part (or another branch of the foreign corporation).
This is true even though such interbranch dealings would not give rise to income, gain, profits, or loss of that foreign corporation under the Code.

Please call (202) 622-3850 if you have further questions with respect to noncompulsory payments of foreign tax, or (202) 622-3870 for questions with respect to section 987 or the computation of effectively-connected income.