

## No Subpart F Income if No Related Party Purchase or Sale of Products

Income derived by a controlled foreign corporation (“CFC”) from selling products, as a general rule, is not Subpart F income. Such income is Subpart F income only if it falls within the definition of foreign base company sales income (“FBCSI”) under Code Sec. 954(d).

Code Sec. 954(d)(1) provides that income from the purchase and sale of property is FBCSI only if it is derived by a CFC in connection with either: (1) the purchase of personal property from a related person<sup>1</sup> and its sale to any person, or (2) the purchase of personal property from any person and its sale to a related person.<sup>2</sup> Therefore, FBCSI does not include income derived by a CFC from selling products where the CFC does not purchase the products from a related person, nor sell the products to a related person.<sup>3</sup>

Taxpayers often arrange their global supply chains to minimize the instances when products sold by a CFC are purchased from related persons or sold to related persons. The courts have uniformly upheld, and the government has recognized, such planning structures.

**No Related Party Purchase.** A CFC may source products it sells from unrelated suppliers, including contract manufacturers. The global group may centralize the purchasing functions in several affiliates, such as the U.S. parent and regional subsidiaries. The CFC can purchase the products directly from the unrelated suppliers and pay fees to related entities for procurement and logistic services. Under these circumstances, there is no purchase from a related person of products sold.

A CFC engaged in the business of selling software products may obtain the rights to sell the software from related persons. The CFC acquires the rights to the software pursuant to a license agreement paying the owner of the intangible property a royalty or pursuant to a cost-sharing arrangement paying an annual cost-sharing payment (and typically a buy-in for any preexisting intangible property). Payments of royalties, buy-ins and cost-sharing amounts are not considered as a purchase of the software sold, and thus there is no purchase of property from a related person.

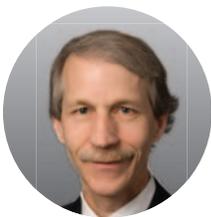
A CFC operating as a principal may sell products manufactured by a related CFC. The CFC principal can purchase raw materials and components from unrelated suppliers and consign them to a related “toll” manufacturer to produce finished products. The CFC pays service fees to related persons to assist with purchasing the raw materials and components and for manufacturing services. Since the CFC principal purchases the raw materials and components from unrelated suppliers and owns the property throughout the manufacturing process, it does not purchase from a related person the products it sells.

**No Related Party Sale.** A CFC may sell products directly to unrelated persons throughout the world. It may pay related companies fees for assisting with sales and distribution functions in various countries. Since the CFC sells the products to unrelated persons, there is no sale to a related person.

A CFC principal may sell products to related companies located in other countries for resale to local customers. The distributor can be owned by the CFC



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principal and electively disregarded for U.S. tax purposes. As a result, the sale of the products to the related distributor is ignored. Thus, the CFC principal is treated as selling the products directly to the unrelated local customers.<sup>4</sup>

A CFC principal may alternatively sell products to local customers through a commissionaire arrangement. Under such an arrangement, a related local distributor markets the products to customers in its own name, sends invoices and collects the purchase price. The commissionaire remits the purchase price to the CFC principal less its commission. With a commissionaire arrangement, title passes from the CFC principal directly to the local customer, and thus there is no sale to a related person.

*Therefore, if a CFC arranges its supply chain such that it purchases property from unrelated suppliers and sells products to unrelated customers, its income is not FBCSI.*

**Subpart F Authorities.** The operative language in Code Sec. 954(d)(1) and the corresponding regulations is unequivocal that the definition of FBCSI does not apply where a CFC selling products neither purchases the products from a related person nor sells the products to a related person. The examples in the regulations uniformly conclude that sales income is not FBCSI where the CFC sells products to unrelated persons that it purchases from unrelated persons.<sup>5</sup>

Over 20 years ago, the IRS sought to apply Subpart F to sales income of a low-taxed CFC that did not have a related party purchase or sale. In *Vetco, Inc.*,<sup>6</sup> a Swiss CFC purchased raw materials from unrelated suppliers, consigned them to a related U.K. CFC, which manufactured finished products, and then the Swiss CFC sold the products to unrelated customers. The Swiss CFC did not have any employees and paid the U.K. CFC for procurement and manufacturing services. Since the Swiss CFC did not purchase products from a related

person nor sell products to a related person, its income was not FBCSI.

The IRS sought to deem a related party transaction under a branch rule, asserting that the Swiss CFC's income should be FBCSI because the taxpayer should not be permitted to avoid the application of Subpart F based on its formal structure. The Tax Court rejected the government's argument finding no basis in the Code or regulations.<sup>7</sup>

Government studies have acknowledged the inapplicability of Code Sec. 954(d)(1) to the above planning structures. The Treasury and the Joint Committee on Taxation both released studies that describe commissionaire, toll manufacturing, software licensing and disregarded entity structures as not resulting in FBCSI because there was no related party purchase or sale.<sup>8</sup> And the Administration's fiscal year 2015 budget confirms this conclusion by proposing to "expand" Code Sec. 954(d)(1) to apply to the type of structure considered in *Vetco*.

Therefore, if a CFC arranges its supply chain such that it purchases property from unrelated suppliers and sells products to unrelated customers, its income is not FBCSI.

#### ENDNOTES

- <sup>1</sup> A person is related to a CFC if such person is controlled by the CFC or is controlled by the same persons that control the CFC. For this purpose, control means, with respect to a corporation, the direct or indirect ownership of more than 50 percent (by vote or value) of the stock of such corporation. Code Sec. 954(d)(3).
- <sup>2</sup> Reg. §1.954-3(a)(1)(i).
- <sup>3</sup> Under certain circumstances, a branch rule can apply to treat a portion of the income as FBCSI. Code Sec. 954(d)(2); Reg. §1.954-3(b).
- <sup>4</sup> The sales branch rule would not apply to the income derived by the disregarded entity where the products are sold for use in its country or a tax rate disparity test does not apply. Reg. §1.954-3(b)(1)(i), (2)(ii)(e).
- <sup>5</sup> See Reg. §1.954-3(a)(5), Ex. 1 & 2; Reg. §1.954-3(b)(4), Ex. 3 (since "[Corporation] D [is] unrelated to [CFC] E, none of the income would be foreign base company sales income because [CFC] E [is] purchasing from and selling to unrelated persons ...").
- <sup>6</sup> *Vetco, Inc.*, 95 TC 579, Dec. 47,001 (1990).
- <sup>7</sup> Two other cases rejected the IRS's attempt to treat low taxed sales income as FBCSI where there was no related person purchase or sale. *Ashland Oil, Inc.*, 95 TC 348, Dec. 46,899 (1990) (Liberian CFC); *Brown Group, Inc.*, CA-8, 96-1 USTC ¶150,055, 77 F3d 217 (Cayman Islands CFC).
- <sup>8</sup> See "Deferral of Income Earned Through U.S. Controlled Corporations: A Policy Study," Office of Tax Policy, Dept. of Treas., Dec. 2000 ("Subpart F Study"); "Present Law Income and Background Related to Possible Income Shifting and Transfer Pricing," JCX-37-10 (July 20, 2010).

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