Kumquat: The U.S. International Tax Issues

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In this article, the author explores the U.S. tax issues facing a hypothetical U.S. corporation and its controlled foreign corporation and disregarded affiliate entities, from the effectively connected rules to the branch rules of subpart F to certain transfer pricing implications.

Kumquat Inc. (Kumquat) is a publicly owned corporation organized in the United States and headquartered in a coastal state. It has thousands of employees at its headquarters, including all of its senior executives. Kumquat is engaged in a worldwide business of manufacturing and distributing electronic products.

One of Kumquat's most successful products is the paliograph, a device that allows communication with aliens in outer space. The product has been exceptionally popular. Kumquat periodically revises and improves the paliograph, releasing new versions to great fanfare and, usually, record-breaking sales. Sales of the paliograph have produced considerable profits.

Kumquat owns all the stock of Kumquat Caribe (KC), a corporation organized under the laws of a Caribbean island nation. That nation imposes corporate income tax at a rate of 25 percent and employs a "managed and controlled" test for corporate residence. KC is managed and controlled in the United States by personnel at Kumquat's headquarters, and is therefore not a tax resident of the Caribbean nation. (Nor, of course, is it a tax resident of the United States.) There is an income tax treaty in force between the Caribbean nation and the United States, but KC is not entitled to resident benefits.

KC has many foreign subsidiary entities, all of which it wholly owns. Several of these entities are organized in the Caribbean nation, but none are managed and controlled there. Other subsidiary entities are found throughout the world, mostly in developed countries where sales of the paliograph are strong. Most of these entities are tax residents of the countries where they are organized and pay corporate income tax to those countries. All these entities have a presence in the countries where they are organized and perform certain functions there, not limited to functions relating to sales of the paliograph. Kumquat and its affiliates manufacture and distribute a variety of other products.

All the foreign subsidiary entities of KC are disregarded for U.S. tax purposes.

KC is a party to a cost-sharing arrangement with Kumquat, whereby intangible property rights relating to manufacture and sale of the paliograph outside the United States have been transferred to KC. Those rights include the Kumquat brand and universally recognized trademark, as well as the "paliograph" name and all trade secrets and patented processes that enter into the manufacture of the paliograph. As a result, all profits earned from sales of the paliograph outside the United States have been booked by KC. The Caribbean nation does not tax these profits.

The paliographs sold by KC are manufactured in an Asian country. Raw materials needed for manufacture are obtained from independent local suppliers under contracts negotiated by Kumquat headquarters personnel on behalf of KC. Materials are transported to unrelated local manufacturers, who assemble them and affix the Kumquat brand and trademark to the finished product, again pursuant to contracts with KC negotiated by Kumquat headquarters personnel. The paliographs are then shipped from the Asian country to distributors, some unrelated and some among the disregarded subsidiaries of KC, in a variety of countries. Sales terms, transportation, insurance, and all other logistical matters are covered by contracts with KC negotiated by Kumquat headquarters personnel. The paliographs are not transported to or through the Caribbean nation and never touch its soil. Purchasers resell the paliographs to stores and other consumer outlets in the countries where they are located or in neighboring countries. Manufacturing and transportation costs are small relative to the sales price of the paliograph, and the result is a substantial profit stream for KC.

KC has no employees. Its office in the Caribbean nation is in the office of a local law firm. Personnel at Kumquat's headquarters closely supervise the manufacturing process, perform quality control, and handle all issues that may arise concerning KC's contracts. KC has never filed a U.S. tax return or a U.S. information return of any kind.

In some cases, employees at offices of disregarded KC entities outside the Caribbean nation help distribute paliographs. There is no pattern to this assistance. Its extent and duration vary from country to country, from year to year, and even from sale to sale.

U.S. Tax Issues?

A question has been raised whether there are any U.S. tax issues embedded in these facts.

Since no treaty applies, any conceivable U.S. issues would depend entirely on application of the IRC. Personnel at the headquarters of Kumquat, who contract in the name of KC and engage in all activities necessary for implementation of KC's contracts, are plainly agents of KC. The activities of these agents suffice for a finding that KC is engaged in a trade or business in the United States.

Paliographs sold by KC are for use, consumption, or disposition outside the United States. Such sales of inventory property by a foreign corporation have a foreign source under section 865(e), unless the foreign corporation maintains an office or fixed place of business in the United States and the income in question is attributable to that office or fixed place of business. Even in such a case, foreign sourcing is retained if an office or other fixed place of business of the taxpayer in a foreign country materially participates in the sales.

Whether KC maintains an office or other fixed place of business in the United States and whether a particular sale is attributable to that office or other fixed place of business are questions determined under the principles of section 864(c)(5). The office or other fixed place of business of an agent is disregarded unless the agent has authority to conclude contracts in the name of the foreign taxpayer and regularly does so, and the agent is not an agent of independent status acting in the ordinary course of its business. Personnel at Kumquat headquarters have the necessary authority, and regularly use it. It would be difficult to characterize such personnel as agents of independent status acting in the ordinary course. Thus, KC almost certainly has an office or other fixed place of business in the United States.

It is possible that an office or other fixed place of business of KC in one or more foreign countries — that is, an office of one of KC's disregarded subsidiaries — materially participates in some or all of KC's paliograph sales. However, disregarded entities do not exist in all countries where the paliograph is sold and, in any event, the more important aspects of sales are always handled exclusively by Kumquat headquarters personnel. Thus, participation by foreign offices of KC may not extend to all sales and, even if it does, the participation may not amount to material participation.

With KC having a U.S. office or fixed place of business, income from any sale attributable to KC's U.S. office or fixed place of business and not involving material participation by a KC office in a foreign country would have a U.S. source. The income, gain, or loss attributable to the office or fixed place of business is the amount properly allocable thereto but not in excess of the income that would be derived from sources in the United States if the sales were made in the United States. U.S.-source income from inventory sales is conclusively presumed to be effectively connected with the seller's U.S. trade or business.

It is questionable whether a U.S. source should be assigned to the entirety of KC's income from sales of the paliograph without material participation of a foreign office of KC, since actual physical manufacture of the paliographs is outside the United States. Under the principles of section 863(b), dealing with income partly from within and partly from without the United States, some portion of KC's income might have a foreign source. On the other hand, section 865(e)(2)(A) states that all income from sales attributable to a U.S. office has a U.S. source "notwithstanding any other provisions of this part," which includes the section 863 "special rules for determining source."

To the extent the income in question is sourced in the United States, it is hard to escape the conclusion that it is effectively connected.

If there was U.S. tax liability on an effectively connected analysis, KC would be exposed to the branch tax under section 884. There would be no applicable statute of limitations because KC has never filed a U.S. tax return. Moreover, KC might not be entitled to deductions because of Treas. reg. section 1.882-4, again because no U.S. return has ever been filed. Conceivably, KC could invoke the nondiscrimination provisions of the income tax treaty between the Caribbean nation where it was organized and the United States, to defeat application of reg. section 1.882-4. Denial of deductions under that regulation, which derives from section 882(c), is plainly discriminatory, since no such denial applies to U.S. corporations. Although KC is not a tax resident of the Caribbean nation, it is a national because it was formed there.

Given the similarity (identity) between the language of section 865(e)(2) and that of section 864(c)(4)(B)(iii), it is not normally possible for a foreign person to have foreign-source income from inventory sales that is effectively connected with a U.S. trade or business. If income from foreign sales of the paliographs did not have a U.S. source, it would escape the effectively connected rules if KC did not fall into the (small) gap between the definition of "nonresident" under section 865(e) and the definition of a "foreign" person under section 7701(a)(5). KC does not fall within that gap.

More Considerations

There is, however, another set of issues to consider, regardless of whether there was material participation by a foreign office of KC in sales of the paliograph. Those issues arise under subpart F. KC is, of course, a controlled foreign corporation.

Under section 952(b), U.S.-source income that is effectively connected with a U.S. trade or business and not exempt or subject to a reduced rate of taxation because of a U.S. income tax treaty or other treaty obligation, is not subpart F income. Under section 864(c)(4)(D), foreign-source income covered by subpart F cannot be effectively connected. This latter provision is superfluous, however, because, as just noted, it is generally impossible for a foreign corporation to have effectively connected foreign-source income from sales of inventory. Thus, any U.S.-source income that is effectively connected with a U.S. trade or business is not covered by subpart F, and any sales income that has a foreign source will be taxable by the United States only under subpart F, if at all.

Income of KC from sales of the paliograph that cannot be shown to have benefited from material participation by a foreign office of KC will have a U.S. source. It does not appear to matter, for purposes of the exclusion from subpart F, whether U.S. tax has actually been paid on such income. Sales income for which material participation by a foreign office of KC can be demonstrated must be analyzed only under subpart F.

KC purchases components from unrelated persons, assembles them into paliographs, and sells the completed products to unrelated persons. There would appear to be no related persons in this picture and therefore no room for application of the foreign base company sales income rules of subpart F. The branch rule of section 954(d)(2), however, is designed to supply the related person that is required for those rules to apply. The branch rule applies to "situations in which the carrying on of activities by a controlled foreign corporation through a branch or similar establishment outside the country of incorporation of the controlled foreign corporation has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income." It authorizes regulations providing that "the income attributable to the carrying on of such activities of such branch or similar establishment shall be treated as income derived by a wholly owned subsidiary of the controlled foreign corporation and shall constitute foreign base company sales income of the controlled foreign corporation." In effect, a branch of a CFC may be deemed to be acting as a separate corporation on behalf of the remainder of the CFC, thereby invoking the foreign base company sales income rules.

The branch rule is of 1962 vintage and operates on the basis of certain assumptions: that the sales function of a controlled foreign corporation is relatively mobile and may be taxed at a lower rate than the manufacturing function; that the manufacturing function is not mobile and not likely to be taxed abroad at an especially low rate; that a separation of the sales function from the manufacturing function can result in a significantly lower tax on the controlled foreign corporation than the tax that would apply if all its income were subject to tax in the jurisdiction where it was incorporated; and that the country of incorporation (presumed to be the country of residence) is a useful reference point. Some of these assumptions seem quaint in the modern world.

Activity of personnel at Kumquat's headquarters appears to amount to either a "sales branch" or a "manufacturing branch" of KC, or both. Headquarters personnel orchestrate all KC's paliograph sales and engage in the types of activities that taxpayers successfully advanced as "manufacturing" for purposes of avoiding a finding of foreign base company sales income under section 954(d)(1). Regulations first issued in 2008 added a "substantial contribution" test to the concept of "manufacturing." Substantial contribution includes a variety of activities spelled out in reg. section 1.954-3(a)(4)(iv), including "oversight and direction of the activities and process pursuant to which the property is manufactured," "material selection, vendor selection, or control of the raw materials, work-in-process or finished goods," "control of manufacturing related logistics," and "quality control." In response to comments from the public, the IRS stated that the same broad definition of "manufacturing" would be used not only for purposes of section 954(d)(1) but for the branch rule of section 954(d)(2) as well.

"Material participation" by an office of KC in a foreign country is not relevant to either variety of the branch rule (sales branch or manufacturing branch). Furthermore there is nothing in section 954(d)(2) and the pertinent regulations that precludes the existence of a manufacturing branch or a sales branch in the United States.

If activities of Kumquat's headquarters personnel are sufficient to constitute both a sales branch and a manufacturing branch, the sales branch designation appears to take precedence and the jurisdiction where the manufacturing branch is located is substituted for the place of incorporation. This is reflected in reg. section 1.954-3(b)(1)(ii)*(c)(1)*.

If there were foreign base company sales income taxable to Kumquat under subpart F, the statute of limitations would apply because Kumquat regularly files U.S. corporate income tax returns. However, section 6501(e)(1)(C) provides for a six-year statute.

Rate Disparity Test

To determine whether the carrying on of activities by a "branch or similar establishment" has "substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income," the regulations use a "rate disparity test." This involves an allocation of income between the branch and the remainder of the corporation and a comparison of tax rates. The preamble to regulations issued in 2008 states: "the tax rate disparity tests should take into account the *actual* tax rate paid with respect to the sales income by the selling branch or remainder and the *hypothetical* effective tax rate that would be paid by the manufacturing branch (or remainder) on that sales income under the laws of the country in which the manufacturing branch is located (or, in the case of a remainder, the country of organization of the CFC)" (emphasis added).

In the case of a sales branch the question is whether the income of the branch is taxed at an effective rate that is less than 90 percent of, and at least 5 percentage points less than, the effective rate that would hypothetically apply to that income under the laws of the country in which the corporation is created if the entire income of the corporation were considered derived by the corporation from sources within that country from doing business in that country through a permanent establishment, the income was received in that country and allocable to the PE, and the corporation was managed and controlled in that county. On a sales branch analysis the comparison would be between the U.S. rate on the income of KC's U.S. sales branch — zero — and the 25 percent rate that would apply to the income in the Caribbean nation.

In the case of a manufacturing branch, the question is somewhat less clear. One approach would be to ask whether the income allocated to the remainder of the corporation is actually taxed at a rate that is less than 90 percent of, and at least 5 percentage points less than, the rate that would hypothetically apply to the income under the laws of the country where the manufacturing branch or similar establishment is located if the entire income of the corporation were considered derived from sources within the country doing business through a permanent establishment, if the income were received there and allocated to the PE, the corporation was created or organized under the laws of that country, and it was managed and controlled there. This approach tracks the sentence quoted above from the preamble to the regulations. The comparison would then be between the tax actually imposed by the Caribbean nation on the remainder of KC — zero — and the rate that would apply in the United States, where the manufacturing branch is located, if KC's sales income were fully subject to taxation there.

On the other hand, since there is no sales activity in the Caribbean nation, it may not be consistent with the manufacturing branch rule to use the rate of tax in that jurisdiction as a reference point. Given that the actual rate of tax on KC is zero in both the United States and the Caribbean nation, and that both the United States and the Caribbean nation have a corporate income tax that applies a positive rate of tax to all types of income, the rate disparity test should be met by a comparison of the actual rate of taxation applied to KC in either country (zero) and the hypothetical rate in either country (positive). But since the branch rule focuses on a separation of the sales function from the manufacturing function, there may be a question whether the rule applies at all if, as in KC's case, no such separation exists. That interpretation of section 954(d)(2) would convert the branch rule into a potent tax planning tool for avoiding subpart F. It is not obviously mandated by the statute or the pertinent regulations.

In the case of KC, with actual manufacture undertaken by unrelated persons on a contract basis, and compensated on an arm's-length basis, it would seem that profits are largely attributable to the sales function. That would potentially subject most of those profits to exposure as foreign base company sales income. However, there may be room for dispute regarding the proper amount to be allocated to the sales function, and therefore subject to inclusion in Kumquat's income under subpart F.

Along with the effectively connected and subpart F analyses, Kumquat seems vulnerable to a substantial reallocation of income from KC under standard transfer pricing principles. It is true that valuable intangibles have been migrated to KC, but their economic utilization lies entirely in the hands of Kumquat personnel. At a minimum, there is the possibility of an allocation under section 482 for the valuable services rendered by Kumquat headquarters personnel.

In sum, there are a few U.S. tax issues presented by Kumquat's circumstances. ■