US Outbound Tax Newsalert

A Washington National Tax Services (WNTS) Publication

January 10, 2012

Tax Court may address certain important Subpart F sales income issues for the first time

The Cooper Companies, Inc. and Subsidiaries v. Comm'r could be the first court case dealing with the mechanics for applying the branch rule. The Tax Court could address important issues, including: (1) whether a branch without any employees performing sales activities can be treated as a separate corporation under the branch rule; and (2) whether income that is not allocated to the branch by the controlled foreign corporation ("CFC"), consistent with local law, or allocable to the branch under the arm's length standard can nevertheless be allocated to it by the IRS for purposes of determining foreign base company sales income ("FBCSI").

Resolving these issues is fundamental to applying the branch rule, but to date no court case or IRS ruling has directly addressed them. Therefore, the manner in which the Court analyzes and decides these issues could be significant. Regardless of the outcome, this case could provide insights into the IRS's branch rule positions.

Observation. Although no case has addressed the mechanics for applying the branch rule, two previous cases addressed the branch definition for purposes of the branch rule: *Ashland Oil v. Comm'r*, 95 T.C. 348 (1990) and *Vetco Inc. and Subsidiaries v. Comm'r*, 95 T.C. 579. At issue in the cases was whether, under the authority of Rev. Rul. 75-7, a separate unrelated (in *Ashland*) or related (in *Vetco*) manufacturing corporation could be treated as a branch of a CFC for purposes of applying the branch rule. In both cases the court held that a separate corporation was not a branch or similar establishment under the branch rule. Although these cases generally addressed the branch rule, the court did not apply the rule because the corporations in question were held not to be branches of the relevant CFC.

Summary of Issues

One category of subpart F income is FBCSI. FBCSI is generally income from the purchase and sale of personal property where there is a related party on at least one side of the transaction or where personal property is purchased or sold on behalf of a related party. Note that the property must be both manufactured and purchased/sold for use outside the CFC's country of organization. Section 954(d)(2) provides a branch rule pursuant to which a branch of a CFC is treated as a separate corporation for purposes of determining FBCSI if the use of the branch has substantially the same effect as if such branch were a wholly owned subsidiary.

The Treasury Regulations clarify that a branch is treated as a separate corporation when it performs purchasing, selling or manufacturing activities and there is tax rate disparity between the branch and the "remainder" of the CFC under the "sales branch" rule. Disparity generally exists if a sales branch is taxed at five percentage points less than the rate applicable to a permanent establishment ("PE") in the CFC's country of organization, or under the manufacturing branch rule, if a manufacturing branch is taxed at least five percentage points higher than the rate applicable to a PE in the CFC's country of organization. In addition, under the manufacturing branch rule, a purchase/sales branch is treated as the remainder of the CFC for purposes of determining disparity where a CFC has both a manufacturing branch and a purchase/sales branch.

Observation. The branch rule applies to a sales branch if it performs sales activities. The issue in this case is whether the branch rule applies when the branch has no employees that perform any sales activities. In addition, even if the branch rule applies under such circumstances and tax rate disparity exists such that the branch is treated as a separate corporation for purposes of determining FBCSI, the amount of income attributable to the branch must still be determined.

In this case, the IRS issued a Notice of Deficiency ("the notice") determining that, for 2005 and 2006, the Barbados office of a CFC, CooperVision International Holding Company LP ("CVIHCo") (a UK partnership treated as a corporation for US tax purposes), was a branch or similar establishment of CVIHCo and that the Barbados office's carrying on of activities had substantially the same effect as if the Barbados office was a wholly owned subsidiary corporation. The notice concluded that the income attributable to the carrying on of such activities is treated as income derived by a wholly owned subsidiary of CVIHCo and constitutes FBCSI of CVIHCo. For 2005 (the only year under dispute in the petition), the notice determined that the additional subpart F income attributable to the Barbados office was$52,812,000. The notice does not describe how the IRS determined the amount of income attributable to the Barbados office's activities or why the Barbados office is treated as a separate corporation for purposes of determining FBCSI.

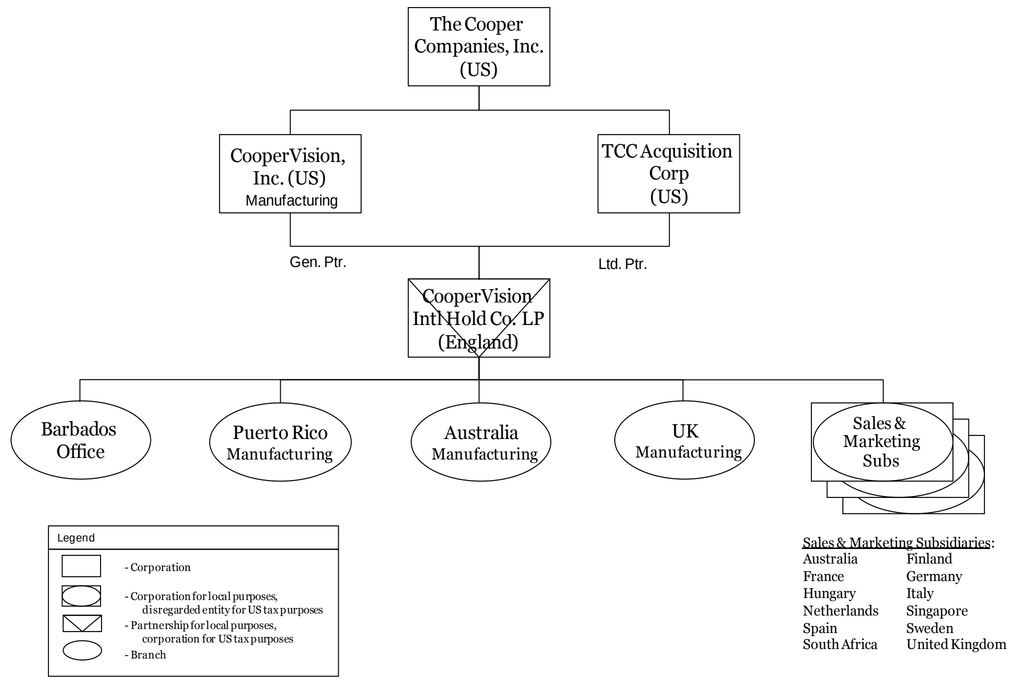
CVIHCo sold products manufactured at its facilities in Puerto Rico, the United Kingdom and Australia, and products manufactured in the United States by CVIHCo's general partner for UK law purposes. The petition indicates that the notice's adjustment does not relate to the sale of products manufactured in CVIHCo's Puerto Rico facility. The answer to the petition admits that the $52,812,000 that the IRS treats as FBCSI attributable to the Barbados office's carrying on of activities represents sales income attributable to the sale of products manufactured outside Puerto Rico. However, neither the notice, nor the answer describes the arrangement between CVIHCo and its general partner or how CVIHCO's income from the sale of products manufactured by the general partner was treated for US federal tax purposes. Furthermore, there is no indication of how income from the sale of products manufactured in Australia was specifically treated.

Observation. The adjustment does not include income from sales of products manufactured at CVIHCo's Puerto Rico facility since tax rate disparity between Barbados and Puerto Rico may not have existed under the branch rule regulations. If there is no tax rate disparity between the place of manufacture and the place of sale, then the branch rule does not apply to treat the branches as separate corporations for purposes of determining FBCSI. As noted above, income from sales of products manufactured by CVIHCO's general partner or by the Australian facility is not discussed so its treatment is unclear. Since only the sales branch rule is mentioned in the petition and admitted to in the answer, perhaps the only income at issue is the income from property manufactured in the United Kingdom.

The petition asserts that the Commissioner erred in: (1) treating income attributable to the Barbados office's activities as income derived by a wholly-owned subsidiary; (2) treating income attributable to the Barbados office's activities as FBCSI; and (3) treating the CFC's sales income as attributable to the Barbados office. To support these assertions, the petition: (1) assumes "on information and belief" that the sales branch rule applies to treat the Barbados office as a separate CFC in the notice and argues that the sales branch rule is inapplicable because the Barbados office's activities are not purchasing or selling activities; and (2) argues that, even if the Barbados office were treated as performing purchasing or selling activities, the income attributable to such activities would be determined under the arm's length standard.

Summary of Facts

The Cooper Companies, Inc. is a US corporation and the parent company of an affiliated group of corporations (collectively the "Cooper Group") that filed a consolidated tax return for 2005. CooperVision, Inc. ("CV") and TCC Acquisition Corp. are US corporation members of the Cooper Group and are the general and limited partner, respectively, of CVIHCo. CVIHCo is a limited partnership organized under the laws of England that is treated as a corporation, and therefore a CFC, for US federal tax purposes. In 2005, CVIHCo had manufacturing plants in Puerto Rico, the United Kingdom and Australia, as well as selling and marketing subsidiaries in various countries that were disregarded entities ("DEs") for US federal tax purposes ("Sales DEs"). The petition does not indicate whether the manufacturing plants were branches or DEs of CVIHCO.



In 2005, CVIHCo sold contact lens products to resellers and distributors. The products were manufactured at CVIHCo's manufacturing facilities in Puerto Rico, the United Kingdom and Australia, and at CV's manufacturing facilities in the United States. The products were sold through the Sales DEs whose sales staff performed sales activities. The Barbados office's sole employees were the chartered secretary and two administrative/clerical secretaries whose activities were limited to clerical and administrative functions pertaining to the Barbados office's operations. The Barbados employees did not perform any of the types of sales activities performed by the local country distributors.

Consistent with local law, CVIHCo filed a Barbados return for 2005 reporting only its Barbados-sourced income of $31,765. This amount, determined in a transfer pricing study, was attributable to the activities of the Barbados office. Neither the petition nor the notice explains the allocation or reporting for the rest of CVIHCo's income.

Observation. The local country distributors may have been limited risk distributors compensated on a cost-plus basis consistent with local transfer pricing laws. CVIHCo, perhaps because it was a partnership for UK purposes and/or because it was managed and controlled outside of the United Kingdom from Barbados, may not have been taxed on its income. If so, since only income attributable to activities performed in Barbados was reported and taxed in Barbados, the remainder of the income may have been allocated for accounting purposes to the UK home office and not taxed.

Discussion

Since there is no indication to the contrary, presumably the relevant regulations are those that were in effect in 2005. The petition assumes "on information and belief", and the answer to the petition admits, that the Commissioner is applying the sales branch rule in Treas. Reg. § 1.954-3(b)(1)(i). This appears to be the correct rule with respect to income from the sale of products manufactured in the United Kingdom. However, with respect to income from the sale of products manufactured by CVIHCo in its Australian facilities, the applicable rule is the manufacturing branch rule in Treas. Reg. § 1.954-3(b)(1)(ii)(c), specifically as it relates to the use of a sales branch and a manufacturing branch. Therefore, if any of the $52,812,000 adjustment is attributable to income from the sale of products manufactured by CVIHCo's Australian facility, this latter rule, rather than the sales branch rule, would apply in determining the treatment of that income.

The fact that different rules may apply with respect to different portions of the adjustment may have little impact on the overall analysis. Under the sales branch rule in Treas. Reg. § 1.954-3(b)(1)(i), the sales branch is treated as a separate CFC for purposes of determining whether its income is FBCSI if the effective rate applied to the sales income derived by the sales branch is taxed at an effective rate that is less than 90% of, and at least five percentage points fewer than, the rate that would apply to that income if it were derived by a PE in the CFC's country organization. The manufacturing branch tax rate disparity test treats the sales branch as the remainder of the corporation, and then as a separate CFC, for purposes of determining whether its income is FBCSI if the effective rate applied to the sales income derived by the sales branch is taxed at an effective rate that is less than 90% of, and at least five percentage points fewer than, the rate that would apply to that income if it were derived by a PE in the manufacturing branch's country. Therefore, both rules would apply a tax rate disparity test by comparing the effective rate of tax on the income attributed to the Barbados office to the rate that would apply to that income if it were earned by a PE in a high-tax country, either the UK or Australia.

It is unclear whether any of the $52,812,000 was subject to tax in any jurisdiction and whether it includes the $31,765 reported in Barbados. All, or all but $31,765, of the $52,812,000 may not have been taxed anywhere such that the effective tax rate on the sales income allocated to the Barbados office by the IRS may have been zero or close to zero percent. The tax rates on UK and Australia income are significantly higher than zero. Therefore, if the branch rule applies, tax rate disparity would exist in both cases and the Barbados office would be a separate corporation for purposes of determining whether income attributed to it is FBCSI. However, both branch rule regulations apply when "purchasing or selling activities are carried on, by, or through" the sales branch. In this case, the Barbados office does not appear to have performed any purchasing or selling activities as it only performed clerical and administrative functions pertaining to the Barbados office's operations. If the Barbados office did not perform any purchasing or selling activities, the branch regulations arguably do not apply to treat the Barbados office as a separate CFC.

Observation. The IRS could argue that the booking of sales income and the taking and passing of title to property constitute sales activities even if the CFC or branch that books income or takes and passes title to property has no employees engaged in those activities. However, in this case, because the CFC is a UK partnership that could be managed and controlled from Barbados, the sales income may be booked, and title may flow through the UK partnership and simply not be subject to tax there. If so, the IRS cannot argue that the Barbados office performs sales activities by virtue of booking the sales income or taking and passing title to the property.

Even if the branch rule treated the Barbados office as a separate corporation that was considered to have performed purchasing or selling activities on behalf of the manufacturing branches, the amount of income attributable to the Barbados office and considered FBCSI remains an issue. Apparently, the CFC only allocated $31,765 of income to the Barbados office for local law purposes; this appears to follow the arm's length standard. Which theory the notice used to allocate $52,812,000 to the Barbados office is not clear.

If the income that the IRS is seeking to allocate to the Barbados office and treat as FBCSI was not allocated to the Barbados office by the CFC, consistent with local law, and the income is not allocable to the Barbados office under the arm's length standard, then, arguably, that income should not be allocated to the Barbados office and should be considered income derived either by the remainder of the CFC (the UK home office) or by the Sales DEs. Any income allocated to the remainder of the CFC from the sale of products manufactured in the United Kingdom would not be FBCSI because CVIHCo manufactures those products in its country of organization and would qualify for the manufacturing exception in Treas. Reg. § 1.954-3(a)(4) (which excepts from FBCSI income from the sale of property manufactured by the CFC). Any income allocated to a Sales DE would not be FBCSI to the extent the income was derived from the sale of products for use, consumption, or disposition in the Sales DE's country, because even if that Sales DE were treated as a separate CFC under the branch rule, it would qualify for the "same country" sales exception under Treas. Reg. § 1.954-3(a)(3) (which excepts from FBCSI income from the sale of property for use, consumption, or disposition in the CFC's country of organization).

Observation. The branch rule regulations do not address whether local transfer pricing principles or US transfer pricing principles should apply in allocating income to a branch for purposes of determining the amount of FBCSI. Although the CFC in this case may have allocated an amount of income to Barbados that is consistent with both Barbados and US transfer pricing principles, the Tax Court could address which set of transfer pricing principles apply.

CVIHCo also sells property manufactured by CV, a related party. Unless CVIHCo also manufactures that property, income from the sale of that property would be FBCSI under the general rules of section 954(d)(1) if the property is either purchased from CV and resold for use outside of the United Kingdom or sold on CV's behalf for use outside of the United Kingdom.

Conclusion

The Cooper Companies, Inc. and Subsidiaries v. Comm'r, could be the first court decision on the application of the FBCSI branch rule to a branch with no sales activities. At stake are important issues related to the application of the branch rule including: (1) whether a branch without any employees that perform sales activities can be treated as a separate corporation under the branch rule for purposes of determining whether sales income attributed to that branch is FBCSI; and (2) whether income that is not, consistent with local law, allocated to the branch by the CFC and that is not allocable to the branch under the arm's length standard can nevertheless be allocated to it by the IRS for purposes of determining FBCSI.

Based on the information available in the Notice of Deficiency, petition, and answer, and making certain presumptions, the petitioner appears to have a strong case that the branch rule should not apply to the Barbados office and that allocating more than $31,765 income to the Barbados office is not appropriate. A decision in this case would be the first time that the United States Tax Court, or any court for that matter, has opined on the issues raised in this case. Therefore, the manner in which the Court analyzes and decides the issues could be significant.

In addition, regardless of the outcome, the case provides insights into the IRS's branch rule positions. Although the IRS and Treasury recently finalized portions of the branch rule regulations (See US Outbound Tax Newsalert dated December 22, 2011) without addressing the issues raised in the Cooper case, the preamble to the final regulations states that the IRS and Treasury continue to study the issues under the FBCSI rules and are considering whether to issue additional guidance such as the circumstances in which "a branch should be treated as a separate corporation" (See above Newsalert). Additionally, positions taken by the IRS in the case may be indicative of the positions it will take in other audit examinations.

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