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Tax Court to 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 case dealing with the mechanics of the branch rule and potentially at stake are important issues related to its application, 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 foreign base company sales income ("FBCSI") and (2) whether income that is not, consistent with local law, allocated to the branch by the controlled foreign corporation ("CFC") and that is not allocable to the branch under the arm's length standard of Treas. Reg. § 1.482-1 can be allocated to it by the IRS for purposes of determining FBCSI.

Resolving these issues is fundamental to the application of 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 the issues could be of significant importance. In addition, regardless of whether the case is ultimately decided or the result, the case presents an opportunity to gain insights about the IRS position on these issues.

Insight. Although no case has addressed the mechanics of the application of the branch rule, two cases have been decided that addressed the definition of a branch 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

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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 so the rule was not applicable.

Summary of Issues

One category of subpart F income is FBCSI. Section 954(d)(1) defines FBCSI to mean income derived in connection with 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 but only if the property is 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. Disparity generally exists if a sales branch is taxed at 5 percentage points less than the rate that would apply to a permanent establishment ("PE") in the country of organization of the CFC or if a manufacturing branch is taxed at 5 percentage points higher than the rate that would apply to a PE in the country of organization of the CFC. There is also a rule in that treats a purchase/sales branch as the remainder of the CFC for purposes of determining disparity where a CFC has both a manufacturing branch and a purchase/sales branch.

Insight. The branch rule applies to a sales branch if the branch performs sales activities. At issue in this case is therefore the question of whether the branch rule can apply when the branch has no employees that perform any sales activities. In addition, even if the branch rule can apply under such circumstances and there is determined to be tax rate disparity such that the branch is treated as a separate corporation for purposes of determining FBCSI, there remains the question of how much income is attributable to the branch.

In this case, the IRS issued a Notice of Deficiency determining that, for 2005 and 2006, the Barbados office of a CFC, CooperVision International Holding Company LP ("CVIHCo") (a U.K. partnership treated as a corporation for U.S. tax purposes), was a branch or similar establishment of CVIHCo and that the carrying on of activities by the Barbados office had substantially the same effect as if the Barbados office was a wholly owned subsidiary corporation. The Notice of Deficiency 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 of Deficiency determined the additional subpart F income attributable to the Barbados office to be $52,812,000. The Notice of Deficiency does not provide further analysis of 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 ("U.K.") and Australia, and products manufactured in the U.S. by CVIHCo's general partner for UK law purposes. The petition indicates that the adjustment in the Notice of Deficiency does not relate to the sale of products manufactured in CVIHCo's facility in Puerto Rico. The answer to the petition clarifies this fact by

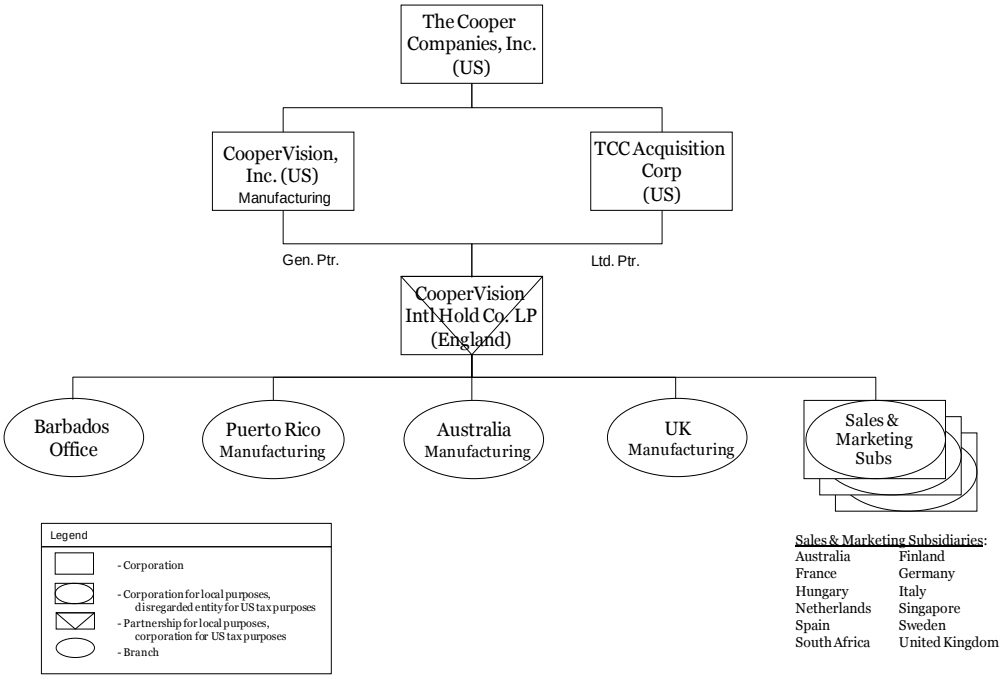
admitting that the $52,812,000 that the IRS treats as FBCSI attributable to the carrying on of activities of the Barbados office represents sales income attributable to the sale of products manufactured outside Puerto Rico. However, there is no indication as to the nature of the arrangement between CVIHCo and its general partner or how CVIHCO's income from the sale of products manufactured by the general partner was treated for U.S. federal tax purposes, nor is there any indication of how income from the sale of products manufactured in Australia was specifically treated.

Insight. Income from sales of products manufactured at CVIHCo's facility in Puerto Rico may not be included because there may not have been tax rate disparity between Barbados and Puerto Rico 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. Income from sales of products manufactured by CVIHCO's general partner or by the Australian facility is not discussed and it is therefore unclear how this income was specifically treated. Because only the sales branch rule is mentioned in the petition and admitted to in the answer, it may be that only income from property manufactured in the U.K. is at issue.

The petition asserts that the Commissioner erred in: (1) treating income attributable to the activities of the Barbados office as income derived by a wholly-owned subsidiary; (2) treating income attributable to the activities of the Barbados office as FBCSI; and (3) treating sales income of the CFC as attributable to the Barbados office. To support these assertions, the petition: (1) assumes "on information and belief" that treatment of the Barbados office as a separate CFC in the Notice of Deficiency is based on the application of the sales branch rule and argues that the sales branch rule is inapplicable because the activities of the Barbados office 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 the amount determined under the arm's length standard of Treas. Reg. § 1.482-1.

Summary of Facts

The Cooper Companies, Inc. is a U.S. corporation and the parent company of an affiliated group of corporations (collectively the "Cooper Group") that filed a consolidated return for 2005. CooperVision, Inc. ("CV") and TCC Acquisition Corp. are U.S. corporations that are members of the Cooper Group and they 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 U.S. federal tax purposes. In 2005, CVIHCo had manufacturing plants in Puerto Rico, the U.K. and Australia as well as selling and marketing subsidiaries in various countries that were disregarded entities ("DEs") for U.S. federal tax purposes ("Sales DEs"). There is no indication in the petition as to whether the manufacturing plants were branches or DEs of CVIHCO.



In 2005, CVIHCo derived sales income from the sale of contact lens products to resellers and distributors. The products were manufactured at CVIHCo's manufacturing facilities in Puerto Rico, the U.K. and Australia, and at CV's manufacturing facilities in the United States, and sold through the Sales DEs. The Sales DEs employed their own staffs of sales personnel who performed sales activities. The sole employees of the Barbados office were the chartered secretary and two administrative/clerical secretaries whose activities were limited to clerical and administrative functions pertaining to the operations of the Barbados office. 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, which was determined pursuant to a transfer pricing study to be the amount of income attributable to the activities of the Barbados office under the arm's length standard of Treas. Reg. § 1.482-1. Neither the petition nor the Notice of Deficiency explains how the rest of the income of CVIHCo was allocated or reported.

Insight. The local country distributors may have been limited risk distributors compensated on a cost plus basis consistent with local transfer pricing laws. CVIHCo may, perhaps because it was a partnership for U.K. purposes and/or because it was managed and controlled outside of the U.K. from Barbados, not have been taxed on its income in the U.K. 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 U.K. home office and not been taxed.

Discussion

As 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 would appear to be the correct rule

with respect to income from the sale of products manufactured in the U.K. However, with respect to income from the sale of products manufactured by CVIHCo in its facilities in Australia, the applicable rule would be the rule in Treas. Reg. § 1.954-3(b)(1)(ii)(c) which addresses 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 5 percentage points less than the rate that would apply to that income if it were derived by a PE in the country where the CFC is organized. Under the manufacturing and sales branch rule in Treas. Reg. § 1.954-3(b)(1)(ii)(c), the manufacturing branch tax rate disparity test in Treas. Reg. § 1.954-3(b)(1)(ii)(b) is applied by treating the sales branch as the remainder of the corporation. Under the manufacturing branch tax rate disparity test, 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 5 percentage points less than the rate that would apply to that income if it were derived by a PE in the country where the manufacturing branch is located. Therefore, under both rules, a tax rate disparity test would be applied 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 U.K. 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 rates on income in the U.K. and Australia are significantly higher than zero. Therefore, if the branch rule is applicable, there would be tax rate disparity in both cases and the Barbados office would be treated as 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, it does not appear that the Barbados office performed any purchasing or selling activities as it only performed clerical and administrative functions pertaining to the operations of the Barbados office. 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.

Insight. 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 does not have any employees engaged in those activities. However, in this case, because the CFC is a U.K. partnership that could be managed and controlled from Barbados, the sales income may be booked, and title may flow through the U.K. 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 Barbados office were treated as a separate corporation under the branch rule and considered to have performed purchasing or selling activities on behalf of the manufacturing branches, there remains the issue of how much income is

attributable to the Barbados office and considered FBCSI. It appears that the CFC only allocated $31,765 of income to the Barbados office for local law purposes and that this is consistent with the amount determined under the arm's length standard of Treas. Reg. § 1.482-1. It is unclear under what theory the Notice of Deficiency has allocated $52,812,000 to the Barbados office.

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 of Treas. Reg. § 1.482-1, 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 U.K. home office) or by the Sales DEs. Any income allocated to the remainder of the CFC from the sale of products manufactured in the U.K. 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 that the income was derived from the sale of products for use, consumption, or disposition in the country of the Sales DE 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 country of organization of the CFC).

Insight. The branch rule regulations do not address whether local transfer pricing principles or U.S. 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 U.S. transfer pricing principles, it is possible that 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 U.K. or sold on CV's behalf for use outside of the U.K.

Conclusion

The Cooper Companies, Inc. and Subsidiaries v. Commissioner, if decided, would be the first decision rendered by a court on the application of the foreign base company sales income ("FBCSI") branch rule contained in section 954(d)(2) to a branch with no sales activities. Potentially 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 of Treas. Reg. § 1.482-1 can 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, it appears that the petitioner has a strong case that the branch rule should not apply to the Barbados office and that it is inappropriate to allocate more than $31,765 income to the Barbados office. If this case is decided rather than settled, it will 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 whether the case is ultimately decided or the result, the case presents an opportunity to gain insights about the IRS position on these issues. A portion of the branch rule regulations are currently in temporary and proposed form and the temporary regulations are set to expire on December 23, 2011. Positions taken by the IRS in this case could therefore be incorporated into those regulations when they are finalized or in future guidance. Additionally, positions taken by the IRS in the case may be indicative of the positions it will take in other audit examinations.

Finally the case highlights a structure that could be very effective in avoiding FBCSI. Some supply change structures utilize a CFC or a branch that is a disregarded entity ("DEB") located in a low or no tax jurisdiction that books income and passes title and relies upon the argument that the CFC or DEB has no employees that perform any activities in concluding that there is no FBCSI. In the case of these structures, the IRS could argue that the booking of income and the passing of title by the CFC or DEB constitute sales activities. Furthermore, where income is actually booked in a jurisdiction the IRS could argue that the CFC is bound by its allocation of income even if the allocation is in excess of the amount determined under foreign or domestic transfer pricing principles. A supply chain structure that utilizes a reverse hybrid CFC organized in the country where the property is manufactured (a potentially high tax country) but set up and operated in a manner that avoids local taxation does not appear to be susceptible to challenge on these grounds because the CFC will qualify for either the manufacturing or "same country" manufacturing exceptions and if a branch is used to establish management and control outside of the country the branch may not actually book any sales income or pass title to any property.

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