IRS Chief Counsel treats intercompany referral fee as foreign base company sales income and allocates expenses to non-subpart F income

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In brief

The IRS released CCM 20153301F (the CCM) on August 14, 2015, challenging a taxpayer's characterization of intercompany referral fees as part sales income and part services income. The CCM concludes that the taxpayer erred in splitting the income between sales and services income, because all of the activities, if actually performed by the controlled foreign corporation (CFC), related to sales and should be classified as foreign base company sales income (FBCSI), and the taxpayer did not properly substantiate the portion of the referral fees attributable to the services. The CCM also concludes that the taxpayer erred in allocating and apportioning the intercompany referral fee expense (referral expense) to all income when that expense was definitely related only to third-party customer sales that were not subpart F income.

In detail

Facts

CCM 20153301F sets forth the following facts:

USP is a US corporation with a consolidated group and several wholly-owned (CFCs). USP sold to third parties and also had a network of employee-brokers who referred business internally, resulting in the payment of intercompany referral fees from one legal entity to another. In certain segments, a single salesperson, termed the Customer Broker, was responsible for developing and maintaining the business relationship globally with each customer in such segments.

Customer Brokers would satisfy certain customer requests through a Supply Broker that could be employed by another affiliate. The taxpayer represented that the Customer Broker would negotiate with the customer regarding the specifications and coordinate with a centralized credit function on the sales terms. The Customer Broker would also be responsible for tracking customer purchases from all affiliates and managing exposure to the particular customer. The Supply Broker would have the responsibility for identifying and negotiating the price with the direct supplier, arranging the product delivery to the customer, receiving the signed documents showing that the product met the specifications, and recording the sales revenue.

The Supply Broker affiliate would pay the Customer Broker a portion of the sales gross margin associated with the transaction. In Segment A, the intercompany referral fee was 50% of the gross margin earned by the seller. In Segment B, the referral fee was 10% of gross margin. USP and its CFCs did not enter into written contracts regarding the referral fee but simply operated based on verbal agreements.

Taxpayer's position

Referral income

According to the CCM, the taxpayer contended that 70% of the intercompany referral fee (referral income) earned by its CFCs was income derived in connection with the performance of services on behalf of a related person. USP characterized the remaining 30% of the referral income earned by its CFCs as FBCSI because it was income earned from sales on behalf of a related party.

The taxpayer represented that a majority of the post-sale services were performed within the country that US federal income tax law would consider the employing CFC's country of incorporation. Accordingly, the taxpayer argued that that referral income should not be foreign base company services income (FBCSvI), but rather non-subpart F income meeting the same-country exception. To the extent that the post-sale services were performed outside the country of incorporation, the taxpayer treated the services portion of the referral fees as FBCSvI. With respect to the remaining 30% of the referral income, which the taxpayer characterized as sales income, it treated most, if not all, of that income as FBCSI because the product was neither produced nor sold for use or consumption in the Customer Broker CFC's country of organization.

The taxpayer cited Treas. Reg. sec. 1.954-1(e)(1) to support its bifurcation of the referral income between sales income and services income. That regulation provides that income is characterized in accordance with the substance of the transaction and not in accordance with the designation applied by the parties. The taxpayer also cited Treas. Reg. sec. 1.954-4(b)(3), Examples 1, 8, and 10, for the proposition that compensation for certain services performed when property is sold may be characterized as income other than 'in connection with' such sale.

USP's position was that Customer Brokers received referral income for services in the following categories:

1. Performing the sales function (i.e., the functions performed by a typical, unrelated sales broker), including the sale solicitation;

2. Post-sale services, including: (i) responding to shortages, issues with quality and damages resulting from delivery delays; (ii) handling billing disputes and negotiating claim settlement with customers; (iii) managing credit risk exposure by tracking customers' overall purchase volume, pattern, and collecting formal and informal information about a customer's credit risk; (iv) tracking outstanding invoices and collecting payment on behalf of affiliates; and (v) keeping the customer up-to-date on current price trends, market dynamics and other factors impacting supply and prices. Of these functions, the taxpayer viewed assisting with collections as the only one an independent sales broker might conduct.

The taxpayer argued that compensation for a service should be considered a sales function (giving rise to sales income) only if it was provided to the seller and necessary for the sale to occur. If the sale could be made whether or not the service is provided to the seller, compensation for that service should not be considered sales income. The taxpayer contended that income received for services related to the performance of the sales function (category 1 above) was derived in connection with the sale of property, and should be considered foreign base company income or not based on whether it fit the definition of FBCSI. The taxpayer argued that the referral income attributable to the performance of post-sale services (category 2 above) compensated CFCs for services that were not necessary to consummate sales, and therefore constituted foreign base company income only if they fit the definition of FBCSvI.

The taxpayer further explained its position that Customer Brokers' post-sale services were not sales functions by pointing out that they occurred after a sale has been closed. Moreover, some of the services were not tied to any particular sale, including (a) negotiating credit terms, a service provided by the Customer Broker in connection with a credit function rather than a sales function; (b) managing risk exposure, an ongoing process and not necessary for any particular sale; and (c) ensuring customer satisfaction, which was independent of any specific sale. Finally, the taxpayer argued that post-sale collection and invoice tracking was not necessary for the sale to occur, since those services occurred only once the sale had already taken place.

The CCM notes that the taxpayer engaged an unrelated third party to substantiate its characterization of referral fees. That third party issued a memorandum on the amounts attributable to the sales and post-sales functions. With respect to market

Segment A, the memorandum analogized the Customer Broker and Supply Broker relationship to co-brokerage transactions between unrelated brokers to identify similar functions and risks. That analysis found that the Customer Broker undertook all of the sales functions that a sales broker in such transactions would undertake, as well as other post-sales functions. The memorandum then identified benchmark fees per metric ton for each of the two types of services the Customer Brokers performed (sales and post-sales), and compared them to the total compensation received by the Customer Broker for the segment. The memorandum issued to the taxpayer also used information on the fees charged by uncontrolled third parties acting as sales brokers to establish an interquartile range for Segment A. The analysis determined that the most reasonable method to benchmark the appropriate fee for the alleged post-sale functions was to allocate the remaining charge not included in the sales function benchmark to those post-sale services. The third party confirmed its analysis by asking the Customer Brokers to estimate the amount of time spent on sales functions.

For USP's market Segment B, the analysis in the third-party memorandum relied solely on time estimates provided by the Customer Brokers. The CCM comments that USP sought to substantiate Customer Brokers' provision of post-sale services to the Supply Broker's CFC using documentation prepared for a transfer pricing study. That documentation included interview notes and a sample Sales Agreement involving certain CFCs and a third party customer. While the Sales Agreement included provisions relating to quality and damages, billing disputes, credit terms, and invoicing (i.e., the first four Category 2 post-sale functions), the Sales Agreement did not specify the entity responsible for providing these services or include a provision for keeping customers up-to-date on current price trends, market dynamics, and other factors. The Sales Agreement also did not reference the intercompany referral fee.

Referral expense

The taxpayer relied on general rules of Treas. Reg. sec. 1.861-8 and Temp. Treas. Reg. sec. 1.861-8T to allocate and apportion the Supply Brokers' referral expense to all classes of income in determining subpart F income. Each CFC paying referral fees had the following categories of income: (i) income from sales to its own customers (as employer of the Customer Broker); (ii) income from sales to customers on referral from other CFCs (as employer of the Supply Broker); (iii) intercompany referral fees received from referral of customers to other CFCs (as employer of the Customer Broker); and (iv) foreign personal holding company income. The taxpayer's position was that all of the income in the four categories of income was derived from a single activity: the purchase and subsequent sale to customers of certain materials and products.

USP argued that all of the CFCs' deductions -- including referral expenses -- were incurred as a result of, or incident to, the global group's sale activity, and were definitely related to each of the three categories of income. The taxpayer stated that a CFC's liability for a referral fee owed to a member of the Group was triggered only if and when the CFC generated income in category (ii) above. The CFC could generate income in the categories (i) and (iii) only by virtue of being part of the Group, acting as Supply Broker for its fellow Group members' customers and thus incurring referral fee liabilities.

The taxpayer's view was thus that membership in the Group made it possible for each CFC to produce income in all three categories, not just the second, as customers purchased worldwide and preferred to transact with a single group able to provide on a worldwide basis. Thus, the referral expenses were incurred as a result of activity generating all three categories of sale income described above, and each CFC's 'class of gross income' to which its referral expense deductions were definitely related included all three income categories.

After allocation, USP apportioned each CFC's referral expenses between the CFC's statutory and residual groupings of gross income. The taxpayer argued that gross income reflected, to a reasonably close extent, the factual relationship between the deduction and the gross income in the relevant groupings. The argument was based on the position that the benefit of being a group member, which necessitated referral fee payments, was realized by earning income in all gross income groupings in the class, and in no one grouping more than any other. Accordingly, the taxpayer's allocation and apportionment of each CFC's referral expenses to each of the CFC's classes of income resulted in reducing subpart F income as well as non-subpart F sales and services income.

The CCM's analysis

Referral income

The CCM concludes that the predominant character of the transaction at issue was sales, and that the post-sale services rendered by Customer Brokers were all incident to the sales function and would not have occurred without a sale. The CCM notes that the taxpayer calculated and paid referral fees solely on the basis of the seller's gross margins, and did not use some measure of efficacy for the non-sales services, which supported the conclusion that the predominant character of the transaction was sales. Thus, the CCM further concludes that the taxpayer should have included all of its referral income for the year at issue in FBCSI.

The analysis underlying the CCM's conclusions begins with descriptions of subpart F income generally and FBCSI specifically. The CCM identifies the issue in the case as whether the taxpayer had appropriately characterized certain income as either sales income or services income. The conclusion that no portion of the referral fees should be characterized as services income is based on the following factors, as viewed by the IRS: (1) the taxpayer did not substantiate that a portion of the referral fee was paid for the post-sale functions; (2) the referral fee was derived in connection with the purchase and sale of personal property to a person on behalf of a related person (i.e., the fee income was the type that would constitute FBCSI); and (3) the transaction did not meet the requirements for the referral income to be considered FBCSvI (rather than FBCSI).

Observation: Note that this last point raises questions about the analysis, since the services income would not necessarily be subject to subpart F at all.

With respect to lack of evidence regarding post-sale functions, the CCM emphasizes that there was no written agreement between the CFCs employing the Customer Broker and Supply Broker, respectively, regarding the referral fee. The Sales Agreement did not establish that any of the referral fee relates to post-sale functions or designate the specific CFC responsible for providing those functions. The IRS questioned whether some of the cited post-sales functions were actually performed by the Customer Brokers. The CCM noted that interview notes included no statements that part of the referral fee related to post-sale functions, and there were no interviews of customers, who could have offered an independent viewpoint as to the CFC that provided the post-sale services. In the IRS' view, all of the objective evidence indicated that the referral income was derived solely in connection with the purchase and sale of personal property on behalf of a related person. Thus, the income would be FBCSI to the extent the sale was for use or consumption outside the selling CFC's country.

As noted above, the CCM also focuses on the taxpayer's use of the seller's gross margins as the basis for 'services' compensation, pointing out that those gross margins were based solely on sales. In addition, the referral fee was awarded solely as a result of successful sales activities, with no contingency for the completion or efficacy of the non-sales services. The CCM argues that, if the Customer Broker were actually earning a fee predominantly for non-sales services, it is doubtful that the fee for such services would be contingent on sales activities.

The CCM also contends that, even if the Customer Brokers did provide post-sale services (which the CCM argues was not substantiated), such services would need to be provided with respect to the sales by the Customer Brokers' CFCs, calling into question whether the Supply Broker would pay for such services. In the IRS' view, each post-sale function was part and parcel of the product sale. The CCM spends a few pages detailing arguments as to why each of the post-sale services was actually sale-related. These arguments include extensive rebuttals to the unrelated third party's analysis of the CFCs' functions.

Observation: Some of the IRS' assertions on this point might surprise taxpayers, such as the CCM's statement that handling billing disputes and negotiating claim settlements constitute sales activity.

Referral expense

The CCM concludes that the intercompany referral fee expense was properly allocable only to income from sales to customers on referral from other affiliates (as employer of the Supply Broker). That income generated by the CFC employing the Supply Broker was non-subpart F income.

The CCM's discussion underlying that conclusion begins with a general discussion of calculating a CFC's subpart F base company income. It notes that the term 'foreign base company income,' as used in the Code and Regulations generally means 'adjusted net foreign base company income,' which requires determining the amount of deductions properly allocable or apportionable to foreign personal holding company income, FBCSI, and FBCSvI.

The CCM cites to Treas. Reg. sec. 1.954-1(c)(1)(i) in stating that computations of a CFC's net foreign base company income take into account deductions as follows:

(A) first, determining the gross amount of each item of income described in Treas. Reg. sec. 1.954-1(c)(1)(iii) (including foreign personal holding company income, FBCSI, and FBCSvI)

(B) second, any expenses definitely related to less than all gross income as a class are allocated and apportioned to the gross income described in Treas. Reg. sec. 1.954-1(c)(1)(i)(A)

(C) third, foreign personal holding company income that is passive under Section 904 (regardless of the high-tax kick out) is reduced by related-person interest expense allocable to passive income and must be further allocated and apportioned to items described in Treas. Reg. sec. 1.954-1(c)(1)(iii)(B)

(D) fourth, the amount of each item of income described in Treas. Reg. sec. 1.954-1(c)(1)(iii) is reduced by other expenses properly allocable and apportionable to such income.

The CCM explains the mechanics of allocating deductions to a class of gross income under Treas. Reg. sec. 1.861-8, and, then, if necessary to make the determination required by the operative section of the Code (in this case, governing foreign base company income). As the CCM states, each deduction is allocated to the class of gross income to which it is definitely related; that is, where the deduction was incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived.

The CCM asserts that each CFC had four categories of income to which deductions could be allocated: (1) income from sales to its own customers (as employer of the Customer Broker); (2) income from sales to customers on referral from other affiliates (as employer of the Supply Broker); (3) intercompany referral fee income received from referrals of customers to other affiliates (as employer of the Customer Broker); and (4) foreign personal holding company income. Although the taxpayer took the position that its referral expense was definitely related to all of its categories of income, the CCM concludes that the referral expenses were definitely related only to category (2) above -- income from sales to customers on referral from other affiliates (as employer of the Supply Broker).

The CCM goes on to reiterate some of its arguments about the connection between the sales income and the referral expense. Its analysis finishes with further attacks on the taxpayer's 'tenuous' position, as illustrated by the allocation of referral expenses to foreign personal holding company income. The CCM states categorically that "[t]here is absolutely no basis for concluding that there is a definite relationship between the expense and foreign personal holding company income."

Observation: Much of the CCM is devoted to challenging the taxpayer's position with respect to the income characterization of the referral fee, more as a matter of fact than of law. The challenge appears primarily aimed at the taxpayer's lack of documentation, and in some instances, whether the Customer Brokers actually performed stated functions to a significant extent. Treas. Reg. sec. 1.954-1(e)(2) provides that if a single transaction gives rise by definition to more than one category of foreign base company income, the income will be so characterized. Treas. Reg. sec. 1954-1(e)(3) provides a predominant character test as an exception to that rule. The predominant character test applies in unusual circumstances to income (other than FPHCI) from a transaction if the portion of income that would meet a particular definition of foreign base company income is not separately determinable. The taxpayer took the position that the sales income and the service income were separately determinable. The IRS rejected this approach and applied the predominant character rule of Treas. Reg. section 1.954-1(e)(3), which is only supposed to apply in unusual circumstances, and concluded that the service income, if any, was not separately determinable. If the taxpayer had the Customer Brokers and Supply Brokers enter into separate service contracts in addition to the sales agreements, and if the fees for those services had been computed based upon the value of their services (i.e., time spent) rather than gross margin, the IRS might have had more difficulty challenging the taxpayer's position based on a predominant character test. Nonetheless, the CCM's apparent attempt to expand the boundaries of sales activities may be concerning to some taxpayers. Taxpayers seeking to bifurcate income among sales and services should consider the need for strong documentation to substantiate allocations of income and expense. If the taxpayer has a transfer pricing study, the information used to substantiate bifurcation should be consistent with that study.

The takeaway

CCM 20153301F signals that the IRS may take a strong position with respect to taxpayers seeking to bifurcate income between sales and services. Good documentation is likely to be essential in substantiating such a bifurcation but may not prevent the IRS from pursuing the issue.

Let's talk

For a deeper discussion of how this may affect your business, please contact:

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