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The FBCSI Branch Rules: Parsing Example 3

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Income derived by a controlled foreign corporation (CFC) from selling products generally 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).¹

A CFC's income generally is FBCSI under §954(d)(1)² if the income is derived in connection with: (1) the purchase of personal property from a related person and its sale to any person; (2) the sale of personal property to any person on behalf of a related person; (3) the purchase of personal property from

any person and its sale to a related person; or (4) the purchase of personal property from any person on behalf of a related person.³ Under this definition, a CFC's sales income is not FBCSI if it sells to an unrelated person property that it did not purchase from a related person.⁴

The transactions described in (2) and (4) refer to agency arrangements where a CFC performs the same purchasing or selling functions that would be performed in (1) and (3), but does not take title to the products. The legislative history explains that FBCSI "is income from the purchase and sale of personal property if the property is either purchased from a related person or sold to a related person" or income from "similar cases where the controlled foreign corporation does not take title to the property but acts on a fee or commission basis."⁵

Several exceptions are provided. A CFC's income is not FBCSI if the property is sold for use in, or manufactured in, the CFC's country of organization.⁶ In addition, a CFC's sales income is not FBCSI if the CFC manufactured the products resulting in the sales income.⁷ A CFC qualifies for the manufacturing exception if the CFC through its employees physically manufactures the property, or substantially contributes to the manufacture of the property that is physically manufactured on its behalf by a contract manufacturer. These exceptions apply both to income derived by a CFC from purchasing and selling property, and to commissions received for purchasing or selling property on behalf of a related person.

If a CFC carries on purchasing, selling or manufacturing activities in a foreign branch and its income is

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** I am pleased to inform you that Dave Noren will be writing Leading Practitioner Commentaries for the Tax Management International Tax Journal, stepping in for me. Dave is an international tax partner and the leader of McDermott Will & Emery's Washington D.C. tax practice, and co-leader of the firm's international tax practice group. He has written a number of articles and is co-author of three Bloomberg Tax & Accounting's Portfolios on Subpart F. Dave has reviewed many of the commentaries I have submitted — correcting, editing, and providing unparalleled insightful, eloquent additions. I am very grateful to Bloomberg Tax & Accounting for having provided me with the opportunity to write commentaries for the TMIJ, and am thankful for the support from the Bloomberg staff, in particular the invaluable guidance and encouragement provided by Soni Manickam, Managing Editor, and the outstanding editorial assistance provided by Larry Frank.

¹ Income derived by a CFC from selling products that is not Subpart F income is taken into account for purposes of the global intangible low-taxed income rules. §951A.

² All section references are to the Internal Revenue Code, as amended, or the Treasury regulations thereunder, unless otherwise indicated.

³ See Reg. §1.954-3(a)(1)(i).

⁴ See Yoder, *No Subpart F Income if No Related Person Purchase or Sale*, 40 Int'l Tax J. 3 (July-Aug. 2014).

⁵ S. Rep. No. 1881, 87th Cong. 2d Sess. 84 (1962) at 790.

⁶ §954(d)(1)(A), §954(d)(1)(B); Reg. §1.954-3(a)(2), §1.954-3(a)(3).

⁷ Reg. §1.954-3(a)(4).

not FBCSI under §954(d)(1), then under §954(d)(2) and the underlying regulations the FBCSI rules may be reapplied to determine if a portion of the CFC's income is FBCSI by treating the CFC's head office (remainder) and its branch as separate CFCs.⁸ This branch rule applies, however, only to certain described structures and if a tax rate disparity test is met. There are different operating rules depending on whether the foreign branch carries on purchasing or selling activities (selling branch rule) or manufacturing activities (manufacturing branch rule).

EXAMPLE 3: THE FACTS

Reg. §1.954-3(b)(4) *Example 3*, illustrates the application of the selling branch rule to income derived by a CFC from purchasing and selling products through a foreign branch. It considers three scenarios and concludes that under one scenario the income derived by the branch is FBCSI, and under the other two scenarios the branch's income is not FBCSI under the selling branch rule.

The organizational structure addressed in *Example 3* is as follows: CFC-D owns CFC-E, and both CFCs are organized under the laws of Country X. CFC-E carries on its sole activity through a branch in Country Y ("Branch-Y").

CFC-D manufactures products in Country X. CFC-E purchases products from CFC-D and sells the products to unrelated customers. CFC-E's purchasing and selling activities are carried on through Branch-Y. All of the products are sold to customers for use outside of Country X, and 90% are sold to customers for use outside of Country Y.

Branch-Y's income from sales to customers within Country Y is subject to a 50% tax rate and its income from sales to customers outside Country Y is not subject to tax. To illustrate, assume Branch-Y derives \$100 of income from selling the products, 10% of which is from sources within Country Y. Country Y would impose \$5 of tax on the income (i.e., \$100 x 10% x 50%). If instead the income had been earned in Country X, CFC-E would have been subject to a 40% tax rate on the income (\$40 of tax), but because the income is earned through Branch-Y, it was not subject to taxation in Country X under that country's territorial tax system.

Scenario One

The first analytical step in determining CFC-E's FBCSI is to apply the general definition in §954(d)(1)

⁸ Reg. §1.954-3(b). The regulations provide additional rules that apply when a CFC operates through more than one branch. Reg. §1.954-3(b)(1)(i)(c), §1.954-3(b)(1)(ii)(c).

to the sales income derived by CFC-E.⁹ CFC-E's income generally would be FBCSI because the income is derived from selling products that CFC-E purchased from a related person (i.e., CFC-D). Nevertheless, because the products are manufactured by CFC-D in Country X, the country under the laws of which CFC-E is organized, the same country of manufacture exception applies, and thus CFC-E's sales income is not FBCSI under the general definition in §954(d)(1).¹⁰

The example addresses the application of the selling branch rule under §954(d)(2) and the underlying regulations. That rule applies when a CFC carries on purchasing or selling activities by or through a branch located outside the country in which the CFC is organized and a tax rate disparity test is met.¹¹ CFC-E was organized under the laws of Country X, and the example provides as a fact that CFC-E carries on purchasing and selling activities through a branch in Country Y. Thus, the first requirement is met for the selling branch rule to apply.

The selling branch rule applies to Branch-Y only if a tax rate disparity test is met. That test is met if the income derived by the selling branch, *that would be FBCSI* by applying "special rules," is taxed in the year when earned at an effective tax rate that is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income under the laws of the country in which the CFC is organized.¹² The regulations provide that only the income derived by a foreign branch that would be FBCSI by application of the special rules is allocated to the branch for purpose of applying the tax rate disparity test, and thus, if none of the income of the branch would be FBCSI under the special rules, the tax rate disparity test would not be met.¹³

The special rules are necessary to determine the income of a branch that would be FBCSI because a

⁹ Branch-Y generally is ignored for U.S. tax purposes, including for purposes of applying Subpart F. Reg. §301.7701-2(a), §301.7701-2(c)(2).

¹⁰ The example does not contain this analysis of the application of the general definition of FBCSI provided by §954(d)(1); however, this analysis and conclusion is necessary because the branch rule of §954(d)(2) can apply only if CFC-E's income is *not* FBCSI under §954(d)(1). See Reg. §1.954-3(b)(4) *Ex. 4* (branch rules did not apply where a CFC purchased products through its foreign branch because the CFC's income was FBCSI under §954(d)(1)).

¹¹ Reg. §1.954-3(b)(1)(i)(a).

¹² Reg. §1.954-3(b)(1)(i)(b).

¹³ The regulations state that whether the tax rate disparity test is met is determined "by allocating to such branch or similar establishment *only* that income derived by the branch or similar establishment which, when the special rules of subparagraph (2)(i) are applied, is described in paragraph (a) of this section," i.e., would be FBCSI under the general definition of §954(d)(1). *Id.* (emphasis added).

branch does not have legal personality and is not separate from the CFC itself. In relevant part, the special rules would treat Branch-Y as a wholly owned subsidiary of CFC-E.¹⁴ The purchasing and selling activities performed by Branch-Y are treated as performed “on behalf of” the remainder of CFC-E, a deemed related person, but only with respect to personal property “purchased or sold, or purchased and sold, by the remainder of the controlled foreign corporation” (i.e., by the head office of CFC-E).¹⁵

As described above, commission or fee income derived by a CFC that does not take title to products, but that purchases or sells products on behalf of a related person as an agent, generally is FBCSI. Thus, if under this special rule Branch-Y, treated as a separate CFC, were treated as deriving its income from performing its purchasing and selling activities on behalf of CFC-E, treated as a separate related CFC, its income generally would be FBCSI, because Branch-Y would be treated as selling the products as an agent on behalf of a related person (i.e., its deemed parent).

Under the facts of *Example 3*, however, the property is not purchased or sold through the remainder of CFC-E. The facts state that CFC-E’s sole activity is conducted through Branch-Y. Thus, under the above special rule, Branch-Y is not treated as deriving its income from selling the property on behalf of a related person.

The example agrees that, under its facts, the products are not purchased or sold through the remainder of CFC-E. Branch-Y, treated as a separate CFC, is not treated as selling the products on behalf of CFC-E. Thus, the example does not treat Branch-Y’s income as FBCSI under the above special rule.¹⁶

The example, however, treats Branch-Y’s income as FBCSI. For purposes of determining Branch-Y’s FBCSI to be taken into account in applying the tax rate disparity test, the example deems Branch-Y, treated as a separated CFC, as if it had purchased the products from CFC-D and sold the products to the unrelated customers. In other words, the example attributes the contractual relationships (buy-sell transactions) of CFC-E’s head office to Branch-Y, treated as a separate CFC.¹⁷ By the example treating Branch-Y (a separate CFC) as purchasing the products from

CFC-D, a related person, and selling the products to the customers, Branch-Y’s sales income would be FBCSI under §954(d)(1) for purposes of determining whether the tax rate disparity test is met.¹⁸

Once the example determined that Branch-Y’s income would be FBCSI for purposes of applying the tax rate disparity test, the example concludes that the test is met. Under the above illustration, Branch-Y is treated as deriving \$100 of income that is subject to a 5% tax rate, i.e., \$5 of tax. Even though the nominal tax rate in Country Y is 50%, only 10% of the income is subject to tax, because Country Y does not tax the income from the sale of 90% of the products which are sold to customers for use outside of Country Y. If the income were taxed in Country X, it would be subject to a 40% tax rate, i.e., \$40 of tax.¹⁹ Because \$5 is less than 90% of, and 5 percentage points less than, \$40, the example concludes that the tax rate disparity test is met.

Assuming the tax rate disparity test is met, then the amount of income derived by the branch that is FBCSI under the selling branch rule is determined by reapplying §954(d)(1), again under special rules.²⁰ In relevant part, the same special rules discussed above apply for this purpose, treating CFC-E and Branch-Y as separate CFCs, and Branch-Y as a wholly owned subsidiary of CFC-E. Branch-Y is treated as selling the products on behalf of CFC-E with respect to products that are purchased or sold through the remainder. As discussed above, because the products are not purchased or sold through the remainder, the special rules

Branch-Y’s income, treated as a separate CFC, is FBCSI, the special rules do not treat Branch-Y as buying and reselling the property, but as carrying on its purchasing or selling activities as an agent on behalf of the remainder CFC. Reg. §1.954-3(b)(2)(i)(b)(2). See also Reg. §1.954-3(b)(2)(i)(b)(1) (branch treated as selling products on behalf of the CFC remainder that manufactures the products); AM 2015-002 (Feb. 9, 2015), n. 15 (“Treas. Reg. §1.954-3(b)(2)(i) treats the branch as selling on behalf of the CFC, notwithstanding the fact that the branch may be a hybrid entity that, in its country of incorporation, is treated as a separate corporation that purchases property from the CFC and sells the property to customers, or purchases property from suppliers, contracts with the CFC to manufacture the property, and then sells the property to customers.”).

¹⁸ The determination of the amount of a branch’s income that is treated as FBCSI for purposes of the tax rate disparity test does not take into account the exceptions for the same country of use or manufacture, or for manufacturing the products. Reg. §1.954-3(b)(1)(i)(b).

¹⁹ The effective rate of tax on such income in the CFC’s country is determined as if the entire income of the CFC were considered as derived by such corporation from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the corporation were managed and controlled in such country. Reg. §1.954-3(b)(1)(i)(b).

²⁰ Reg. §1.954-3(b)(2)(ii).

¹⁴ Reg. §1.954-3(b)(2)(i)(a).

¹⁵ Reg. §1.954-3(b)(2)(i)(b)(2).

¹⁶ See REG-124590-07, 73 Fed. Reg. 10,716 at 10,722 (Feb. 28, 2008) (Discussing *Example 3*, the Treasury and IRS in the preamble to proposed regulations state: “[T]he branch is not selling on behalf of the second-tier CFC [CFC-E] because the remainder of the second-tier CFC does not manufacture, purchase, or sell the personal property. Therefore, §1.954-3(b)(2)(i)(b) and (ii)(b) [special rules] do not apply.”).

¹⁷ As described above, for purposes of determining whether

would not apply to treat Branch-Y's income as FBCSI under §954(d)(1).²¹

While the example agrees that the above special rule does not result in Branch-Y's income being FBCSI, again the example deems Branch-Y (treated as a separate CFC) to have purchased the products from CFC-D (a related person) and as selling the products to the unrelated customers. As a result, the example concludes that Branch-Y's \$100 of income generally is FBCSI by reapplying §954(d)(1).

For purposes of determining Branch-Y's income that is FBCSI under the selling branch rule, the exceptions to FBCSI apply.²² The special rules treat Branch-Y as a separate CFC incorporated in the country in which it is located, i.e., in Country Y. Thus, the same country of manufacture exception would not apply, because the products are manufactured by CFC-D in Country X. Nevertheless, 10% of the products are sold to customers for use in Country Y, and thus \$10 of Branch-Y's income would *not* be FBCSI under the selling branch rule. The example concludes that \$90 of Branch-Y's income is FBCSI because Branch-Y is treated as purchasing products from a related person and selling 90% of the products for use outside of Country Y.²³

Scenario Two

Under the second scenario in *Example 3*, CFC-D is instead assumed to be unrelated to CFC-E. The example concludes that CFC-E's sales income is not FBCSI under the selling branch rule.

Under this scenario, CFC-E's income is not FBCSI under the general definition contained in §954(d)(1) because it purchases the products from an unrelated person and sells the products to unrelated customers. Nevertheless, because CFC-E carries on purchasing and selling activities in a foreign branch, the selling branch rule in §954(d)(2) and the underlying regulations must be addressed.

The above analysis for determining whether the tax rate disparity test is met under the special rules applies equally to scenario two. As discussed above, under the special rules the income derived by Branch-Y would not be FBCSI because the products are not purchased or sold through the remainder of CFC-E. Thus,

under the special rules the tax rate disparity test would not be met, and the income derived by Branch-Y would not be FBCSI under the selling branch rule.

The example agrees that the special rules in the regulations do not result in Branch-Y's income being treated as FBCSI. That determination would seem to be sufficient for the example to reach its conclusion that CFC-E's income is not FBCSI under the selling branch rule.

Nevertheless, the reason given by the example for its conclusion that Branch-Y's income, where Branch-Y is treated as a separate CFC, is not FBCSI is that: "[CFC-E] would be purchasing from and selling to unrelated persons and if [Branch-Y] were treated as a separate corporation, it would likewise be purchasing from and selling to unrelated persons." As in scenario one, the example deems Branch-Y as purchasing the products from CFC-D (assumed to be an unrelated person) and as selling the products to unrelated customers. Under this construct, the example concludes that CFC-E does not have FBCSI under the selling branch rule.

The conclusion for this scenario requires an interpretation that the special rules in the regulations do not treat the products as purchased or sold through the remainder of CFC-E. If instead the special rule had applied, Branch-Y would have been treated as selling the products on behalf of a related person (CFC-E), and \$90 of its income would have been FBCSI. Thus, CFC-E being the contracting party for the purchasing and selling transactions, and reporting all of the income from selling the products through its branch, does not cause CFC-E to be treated as purchasing or selling the product for purposes of the selling branch rule.²⁴

Scenario Three

Selling Branch Rule. Example 3's third scenario, like the first scenario, treats CFC-E as purchasing the products from a related person (i.e., CFC-D) and selling the products to unrelated customers. The additional fact is that CFC-E substantially contributes to the manufacture of the products that it sells. The substantial contribution manufacturing activities are carried on by CFC-E through Branch-Y in Country Y.

As with scenario one, CFC-E's income is FBCSI under the general definition in §954(d)(1) because the income is derived from selling products purchased from a related person. Again, like scenario one, the same country of manufacture exception applies because the products are manufactured by CFC-D in Country X, the country under the laws of which

²¹ The regulations state that "the determination of whether such branch or similar establishment has foreign base company sales income shall be made by applying the following [special] rules..." *Id.* This language indicates that the special rules are the exclusive rules for determining whether Branch-Y's income is FBCSI under the selling branch rule.

²² Reg. §1.954-3(b)(2)(ii)(e).

²³ If income from the sale of products purchased from CFC-D is the only income of CFC-E, then the other \$10 would be foreign base company income under the full inclusion rule. §954(b)(3)(B); Reg. §1.954-1(b)(1)(ii).

²⁴ This interpretation is expressly stated in the preamble to proposed regulations quoted above at note 16.

CFC-E is organized.²⁵ In addition, CFC-E's income should not be FBCSI under the manufacturing exception because it manufactures the products that it sells.²⁶

Because CFC-E carries on purchasing and selling activities outside of its country of organization in a branch, it is necessary to consider the application of the selling branch rule. The analysis in scenario one for applying the tax rate disparity test applies in the same manner to scenario three. While the special rules would not cause Branch-Y's income to be FBCSI, and therefore the tax rate disparity test would not be met under the special rules, the example treats Branch-Y, treated as a separate CFC, as purchasing the products from a related person (CFC-D), and thus treats Branch-Y's income as FBCSI under the general definition in §954(d)(1). While Branch-Y manufactures the products it sells, the manufacturing exception is not applied at this stage of the analysis. Thus, the example concludes that the tax rate disparity test is met for Branch-Y as described above for scenario one.

The next step is to determine the amount of CFC-E's FBCSI under the selling branch rule. Again, as discussed above, CFC-E would not have any FBCSI under §954(d)(1) by applying the special rules, because the products are not purchased or sold through the remainder of CFC-E. The example, however, deems Branch-Y, treated as a separate CFC, as purchasing the products from a related person (CFC-D) and selling the products to the unrelated customers. Thus, as discussed above in scenario one, the example would conclude that Branch-Y's income is FBCSI by reapplying §954(d)(1) to Branch-Y, treated as a separate CFC, before applying any exceptions.

At this stage of the analysis, however, under the special rules in the regulations the exceptions to FBCSI are applied to determine the FBCSI of Branch-Y under the selling branch rule. The regulations state that income derived by a branch will not be FBCSI if the income would not be FBCSI if it were derived by a separate CFC under like circumstances.²⁷

The example concludes that the income derived by Branch-Y is not FBCSI because, treated as a separate

²⁵ The fact that the products are physically manufactured in Country X and also treated as manufactured in Country Y because Branch-Y substantially contributes to the manufacture of the products should not prevent the same country of manufacture exception from applying. See Yoder, *Subpart F Same-Country-of-Manufacture Exception Applied to Products Manufactured in Two Countries*, 41 Tax Mgmt. Int'l J. 302 (June 8, 2010).

²⁶ Reg. §1.954-3(a)(4). Again, the example does not expressly address the application of the general definition of FBCSI in §954(d)(1), but that is a necessary step in the analysis before addressing the application of the selling branch rule in scenario three.

²⁷ Reg. §1.954-3(b)(2)(ii)(e).

CFC, Branch-Y manufactures the products that it sells (i.e., it substantially contributes to the physical manufacture of the products by CFC-D). Therefore, Branch-Y's income qualifies for the manufacturing exception.²⁸ This exception applies to the \$10 of income subject to tax in Country Y as well as the \$90 of income that is not subject to tax in any country.

Manufacturing Branch Rule. Because CFC-E manufactures the products it sells in a foreign branch, the potential application of the manufacturing branch rule provided by regulations must be addressed.²⁹ When a CFC manufactures products in a foreign branch, the regulatory manufacturing branch rule applies if the products: (1) "are purchased or sold by or through the remainder of the controlled foreign corporation. . . ." ³⁰ and (2) a tax rate disparity test is met.³¹

Example 3 does not address the manufacturing branch rule.³² Presumably, it was concluded that the first requirement was not met and therefore the manufacturing branch rule did not apply.³³

²⁸ The manufacturing exception would apply whether Branch-Y, treated as a separate CFC, were treated as earning a commission for selling products as an agent on behalf of CFC-E, or Branch-Y were treated as purchasing the products from CFC-D and selling the products to the unrelated customers. See PLR 201325005 (June 21, 2013) (manufacturing exception applied to sales commissions); PLR 201332007 (Aug. 9, 2013) (manufacturing exception applied to procurement commissions). For an analysis of these rulings, see Yoder, *Subpart F Manufacturing Exception Applies to Sales Commissions*, 42 Tax Mgmt. Int'l J. 633 (Oct. 11, 2013); Yoder, *Subpart F Manufacturing Exception Applies to Procurement Commissions*, 42 Tax Mgmt. Int'l J. 762 (Dec. 13, 2013).

²⁹ The manufacturing branch rule is provided in the regulations. While the language of §954(d)(2) does not provide a manufacturing branch rule, the Tax Court in *Whirlpool v. Commissioner*, 154 T.C. 142, 174-79 (2020), upheld the validity of the regulations providing a manufacturing branch rule. The taxpayer has appealed the Tax Court's decision to the U.S. Circuit Court of Appeals for the Sixth Circuit.

³⁰ Reg. §1.954-3(b)(1)(ii)(a).

³¹ Reg. §1.954-3(b)(1)(ii)(b). The manufacturing branch rule also applies to another branch of a CFC that carries on purchasing or selling activities with respect to the products manufactured in a branch. Reg. §1.954-3(b)(1)(ii)(c)(1).

³² If the manufacturing branch rule were addressed in *Example 3*, it would be necessary to determine whether the tax rate disparity test was met with respect to the tax rate in Country Y, whereas with the selling branch rule the test is determined with respect to the tax rate in Country X. Reg. §1.954-3(b)(1)(ii)(b). The example only considers the tax rate disparity test with respect to the tax rate in Country X. See 73 Fed. Reg. 10,716 at 10,722 ("*Example 3* is further revised to add two alternative factual scenarios (purchase from an unrelated person, and manufacture within the meaning of proposed §1.954-1(a)(4)(iv) by the *selling branch*). . . ." (emphasis added)).

³³ If the manufacturing branch rule applies to a purchasing or selling branch, then the selling branch rule does not apply to that purchasing or selling branch. Reg. §1.954-3(b)(1)(ii)(c)(1).

Specifically, as discussed above, the Treasury and IRS in *Example 3* determined that, for purposes of the selling branch rule, the products were not “purchased or sold, or purchased and sold, by the remainder of the controlled foreign corporation.”³⁴ Based on that determination, the manufacturing branch rule would not apply because it applies only if the products manufactured in a branch are “purchased or sold by or through the remainder” of the CFC.³⁵

A conclusion that the manufacturing branch rule did not apply in the third scenario of *Example 3* would be consistent with the IRS’s analysis and conclusion in TAM 8509004. That TAM concluded that the manufacturing branch rule did not apply to income derived by a CFC from selling products manufactured and sold in a foreign branch because the products were not purchased or sold through the remainder.

Under the facts of TAM 8509004, F1, a CFC, entered into a contract manufacturing agreement with a related CFC, F2, pursuant to which F2 manufactured Product Z in Country Y under the direction and control of F1. The CFC sold the products through related and unrelated commission agents. F1’s head office staff consisted of management personnel who were charged with the responsibility of supervising the various aspects of F1’s business, including supervising the commission agents.

F1 established a branch in Country Y. Branch Y purchased the materials needed to manufacture Product Z and provided them to F2 to manufacture the products. Branch Y paid F2 a service fee for manufacturing the products. Branch Y sold the product to the customers. The TAM states that title to and ownership of the unfinished and finished goods, and risk of loss, were in Branch Y until the products were sold. The branch also was treated as manufacturing the products that were manufactured on its behalf by F2.

The IRS in TAM 8509004 concluded that the CFC’s income was not FBCSI under §954(d)(1) because it manufactured the products that it sold. Furthermore, while the products were manufactured in a foreign branch of the CFC, the IRS concluded that the

manufacturing branch rule did not apply. The TAM states that manufacturing branch rule did not apply to the CFC’s remainder because the products were not “purchased or sold by or through the remainder” of the CFC.

Thus, *Example 3*’s not addressing the manufacturing branch rule is consistent with TAM 8509004’s analysis and conclusion of not treating products as purchased or sold through the remainder for purposes of the manufacturing branch rule where the purchasing and selling activities are carried on in a foreign branch. This conclusion was reached even though in both situations the CFC would be the legal party to the purchasing and selling contracts. While in *Example 3* the sole activities of CFC-E were conducted through Branch-Y, the TAM concludes that products were not treated as purchased or sold through the remainder — and the manufacturing branch rule did not apply — where personnel at the remainder carried on oversight and supply chain related activities, but Branch-Y carried on the purchasing and selling activities.³⁶

SOME OBSERVATIONS

Example 3 interprets the regulations as providing that, where a CFC carries on its purchasing and selling activities in a foreign branch, the products are not treated as purchased or sold through the home office for purposes of the selling branch rule. This is the case even though the head office would be the party to the purchasing or selling agreements (a branch does not have legal personality), and would have reported all of the sales income of its branch.

This determination apparently was the basis for *Example 3* not addressing the manufacturing branch rule in scenario three, which would have applied only if the products manufactured in Branch-Y were purchased or sold through CFC-E’s head office. TAM 8509004 explicitly determined that the manufacturing branch rule did not apply where a manufacturing branch carried on the purchasing and selling activities and the employees of the head office provided supply chain oversight and support activities, because the products were not treated as purchased or sold through the head office (and the Tax Court distinguished the facts of the TAM from the facts in the *Whirlpool* case).

Finally, it is noteworthy that *Example 3* concludes under scenario two (unrelated-to-unrelated) and sce-

³⁴ See 73 Fed. Reg. 10,716 at 10,722 (“[T]he remainder of [CFC-E] (not including the branch) does not manufacture, purchase, or sell the personal property.”).

³⁵ While the CFC-E remainder apparently did not have income that would be subject to the manufacturing branch rule, that fact is not given as a reason for the example not applying the manufacturing branch rule. Furthermore, when the manufacturing branch rule applies, the examples in the regulations also apply the special rules to determine whether the income derived by the manufacturing branch itself would be FBCSI. See Reg. §1.954-3(b)(4) Ex. 2 (“Branch B, treated as a separate corporation, derives no foreign base company sales income since it produces the product that is sold.”).

³⁶ The Tax Court in *Whirlpool* distinguished the facts of TAM 8509004 from the facts in that case. The Tax Court states: “There (unlike here) the remainder of the CFC was treated as having made no sales because ‘[t]itle to, and ownership of, all work in process, as well as finished goods, was clearly in the branch.’ ” *Whirlpool*, 154 T.C. at 173, n. 12 (emphasis added).

nario three (manufacturing exception) that CFC-E had *no* FBCSI under the selling branch rule or the manufacturing branch rule even though only 10% of the income was subject to tax in Country Y where the branch was located, and 90% was not subject to tax in any country. This conclusion was reached even though the sales income would have been subject to a 50% tax rate if fully taxable in Country Y, and a 40% tax rate if derived by CFC-E in Country X.

The Editorial Board of the Tax Management International Journal would like to thank Lowell D. Yoder for his long service as a contributing author for the Leading Practitioner Commentary column. As a thought leader, his dedication and commitment to writing for the journal has enhanced the journal and contributed to the discussion of important tax issues in the tax practitioner community.