

The Foreign Base Company Sales Income of Controlled Foreign Corporations

Eric T. Laity

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The Foreign Base Company Sales Income of Controlled Foreign Corporations*

Eric T. Laity**

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Introduction

At one time, a U.S. multinational corporation could realize substantial tax savings by using a subsidiary organized in a tax haven as a base for its foreign operations. For example, by using the tax haven subsidiary as an intermediary in its import and export transactions, the multinational corporation could isolate part of its income within the subsidiary, freeing the income from the tax imposed by either the country of origin or the country of destination. With the addition of the Subpart F rules to the Internal Revenue Code (the "Code"), the United States now taxes its multinational corporations on much of the income derived by their foreign subsidiaries through base company operations in tax havens.¹

This Article is a detailed study of the sales income of base companies that arises through their use as intermediaries in export and import transactions. This type of income is more formally known as the foreign base company sales income of controlled foreign corporations.² Foreign base company sales income is defined by reference to a class of transactions in a specific category of personal property between controlled foreign corporations and related persons. This Article first discusses the class of transac-

1. Subpart F comprises sections 951-964 of the Internal Revenue Code.

2. For purposes of this Article, it suffices to say that the term, "controlled foreign corporation," includes the foreign subsidiaries of U.S. parent corporations. The exact definition includes more within its sweep and can be found in section 957(a) of the Internal Revenue Code.

tions, then defines the category of relevant personal property, and, lastly, delineates the income taxable to the U.S. shareholder of the controlled foreign corporation. Throughout the Article, a number of specific changes to the Code's definition of foreign base company sales income and the supporting administrative law are recommended. Most of the changes would enlarge the definition of base company income subject to U.S. taxation in order to assure the integrity of the U.S. tax regime for multinational activity. The other changes would improve the administration of that tax regime.

I. The Types of Transactions

A controlled foreign corporation may derive foreign base company sales income from any one of four types of transactions involving related persons.

A. Related Person Defined

For purposes of foreign base company sales income, a related person is any entity that controls, is controlled by, or is under common control with the controlled foreign corporation.³ The status of related persons is not reserved for corporations; even individuals, partnerships, trusts, and estates may be related persons.⁴ The definition of "related person" is not limited to domestic persons; foreign persons may also fall within the definition. Hence, a purely foreign transaction can give rise to foreign base company sales income. Finally, a related person may be found within the controlled foreign corporation itself; under the branch rule, which is discussed later in this Article, a segment of a controlled foreign corporation

3. I.R.C. § 954(d)(3) (1997).

4. *Id.* Control of a partnership, trust, or estate is defined as the ownership, directly or indirectly, of more than fifty percent by value of the beneficial interests in the entity. *Id.* The qualifying control of a corporation, on the other hand, may be achieved through either voting power or value. Control of a corporation is defined as the ownership, directly or indirectly, of more than fifty percent of either the total voting power or the total value of all classes of the corporation's stock. *Id.* Rules similar to those of Code section 958 apply to determine indirect and constructive ownership of interests in a corporation or other entity. *Id.* The indirect ownership principles of section 958(a) are to be applied without regard to whether an entity is foreign or domestic and without regard to whether an individual is a citizen or resident of the United States. Treas. Reg. § 1.954-1(f)(2)(iv) (1997). Prior to the amendment of section 954(d)(3) of the Code by the Tax Reform Act of 1986, P.L. No. 99-514, § 1221(e), 100 Stat. 2085, 2553-54, reprinted in 1986-3 (v. 1) C.B. 1, 470-71, the definition of related person did not fully include partnerships. This failure led to arrangements by which controlled foreign corporations would receive income from related partnerships without subjecting their U.S. shareholders to immediate taxation under Subpart F under circumstances in which the same income received from related corporations would have caused immediate taxation to their U.S. shareholders. See *MCA, Inc. v. United States*, 685 F.2d 1099 (9th Cir. 1982) (holding that foreign entities were partnerships and not corporations for tax purposes, and thus, under pre-1987 law, rents and royalties received from the entities by a related controlled foreign corporation were not foreign personal holding company income and, therefore, not Subpart F income).

may be deemed a person related to the remainder of the corporation.⁵

B. The Four Types of Transactions

Entering into any one of four types of transactions with a related person can result in foreign base company sales income for a controlled foreign corporation. Outright purchases and sales of personal property from or to a related person may cause the controlled foreign corporation to realize foreign base company sales income. In addition, acting as a sales or purchasing agent for a related person may cause the controlled foreign corporation to realize foreign base company sales income. Thus, the class of transactions that might generate foreign base company sales income includes those transactions through which personal property originates with a related person and comes to rest with another person or originates with another person and comes to rest with a related person, whether or not the controlled foreign corporation takes title to the property in the interim. If the personal property is either consumed or created by the controlled foreign corporation, the corporation's transactions in the property generally will not give rise to foreign base company sales income.⁶ Hence, the personal property must pass both into and out of the controlled foreign corporation's sphere of operations, even if only on behalf of a client of the corporation's purchasing or marketing services. In this sense, each tainted transaction can be seen as a composite of an inbound and an outbound transaction for the controlled foreign corporation.

1. *The Controlled Foreign Corporation as Distributor*

The purchase by a controlled foreign corporation of personal property from a related person and its sale to any person, whether related or not, is the first type of transaction that may give rise to foreign base company sales income for the controlled foreign corporation.⁷ The controlled foreign corporation derives sales income from such a transaction.

2. *The Controlled Foreign Corporation as Sales Agent*

The sale of personal property to any person by the controlled foreign corporation on behalf of a related person is the second type of transaction that may give rise to foreign base company sales income for the controlled foreign corporation.⁸ The related person serves as a client for the marketing services of the controlled foreign corporation; the controlled foreign corporation, in turn, is the recipient of fee or commission income for its marketing services.

5. The additional related persons created by the branch rule are identified and discussed in Parts I.C.3. and 4 of this Article. The branch rule treats certain foreign branches of controlled foreign corporations as controlled foreign corporations in their own right, in order to prevent the branches' use as foreign base companies. The branch rule is discussed *infra* in Part I.C. of this Article.

6. The exception to this general rule lies with the branch rule, which is discussed in Part I.C. of this Article.

7. See I.R.C. § 954(d)(1) (1997).

8. See *id.*

3. *The Controlled Foreign Corporation as Supplier*

The purchase by the controlled foreign corporation of personal property from any person, whether related or not, and its subsequent sale to a related person is the third type of transaction that may give rise to foreign base company sales income for the controlled foreign corporation.⁹ The controlled foreign corporation derives sales income from this type of transaction.

4. *The Controlled Foreign Corporation as Purchasing Agent*

The purchase of personal property from any person, whether related or not, by the controlled foreign corporation on behalf of a related person is the fourth type of transaction that may give rise to foreign base company sales income for the controlled foreign corporation.¹⁰ The related person serves as a client for the controlled foreign corporation's purchasing or procurement services; the controlled foreign corporation is the recipient of fee or commission income for its purchasing services.

5. *Imputing Partnership Transactions to the Controlled Foreign Corporation*

Only controlled foreign corporations can derive foreign base company sales income.¹¹ Partnerships cannot. This dichotomy holds out the possibility of a U.S. multinational corporation avoiding current tax liability under Subpart F simply by its controlled foreign corporation conducting tainted transactions through a foreign partnership. The income derived by the partnership is not legally considered foreign base company sales income, and the controlled foreign corporation's distributive share of partnership income is sheltered in the tax haven from U.S. income tax liability. Consider the following example:

EXAMPLE ONE: Foreign Partnership as Intermediary. Parent Corporation, incorporated in Delaware, owns all of the stock of Base Company, a Cayman Islands corporation. The Cayman Islands levies no income tax. Base Company

9. *See id.*

10. *See id.*

11. *See* *Brown Group, Inc. v. Comm'r*, 77 F.3d 217, 221 n.5 (8th Cir. 1996) ("Furthermore, even if we were to accept the IRS's broad interpretation of 'related person,' it is irrelevant to the present inquiry because Brinco [a partnership] is not a controlled foreign corporation, and therefore its income, whether earned on behalf of a 'related person' or not, cannot be characterized as Subpart F income"). *Brown Group* contains a second and contradictory line of reasoning, which assumes that a partnership can indeed derive foreign base company sales income. *See id.* at 222 ("[O]ur holding may result in a tax windfall to the Brown Group due to the particularized definition of 'related person' under the pre-1987 version of section 954(d)(3) of the Internal Revenue Code"). Of the two lines of reasoning, the first is preferable. Foreign base company sales income is a component of Subpart F income. *See* I.R.C. §§ 952(a)(2), 954(a)(2) (1997). Subpart F income is defined, in turn, only with reference to controlled foreign corporations and not with reference to partnerships. *See* I.R.C. § 952(a) (1997). The definition of a related person requires that the person in question is related with respect to a controlled foreign corporation and not with respect to a partnership. *See* I.R.C. § 954(d)(3) (1997).

enters into a Cayman Islands partnership with two individuals experienced in procurement. The partnership purchases inventory abroad on behalf of Parent Corporation and in return receives a commission based on the cost of the inventory. If Base Company had rendered the procurement services directly, its purchasing transactions on behalf of Parent Corporation would have given rise to foreign base company sales income, absent an exclusion. Base Company's distributive share of the partnership's income is not foreign base company sales income.¹²

The Internal Revenue Service (IRS) attempted to combat this abuse by revenue ruling and by litigation based on the regulations under Subchapter K of the Code.¹³ The IRS argued that the controlled foreign corporation's distributive share of partnership income was foreign base company sales income itself.

The IRS based its argument on Treasury Regulations section 1.702-1(a)(8)(ii), which provides that a partner must take into account separately its distributive share of any item of partnership income that, if taken into account separately, results in an income tax liability for any partner that is different from the income tax liability resulting when the item is not taken into account separately. The IRS argued that the regulation requires the isolation of partnership income that would be foreign base company sales income if it had been earned by the controlled foreign corporation under identical circumstances.¹⁴ Treasury Regulations section 1.702-1(b) in turn provides that the character of a separately-stated item in the hands of the partner is determined as if such item were realized directly by the partner from the source from which the partnership realized the item of income. Hence, the IRS concluded, the controlled foreign corporation's distributive share of the separately-stated income is foreign base company sales income.¹⁵ The IRS's efforts proved fruitless.¹⁶ According to the U.S. Court of Appeals for the Eighth Circuit, Treasury Regulations section 1.702-1(a)(8)(ii) does not in fact require the separate statement of the partnership's income that would constitute foreign base company sales income if it were derived by the controlled foreign corporation under identical circumstances. The isolation of such income is not required since its separate statement does not affect the income tax liability of a partner; only the income tax liability of the U.S. shareholders of a partner is affected.¹⁷

12. See *Brown Group, Inc. v. Comm'r*, 77 F.3d 217, 221 (8th Cir. 1996). The Eighth Circuit suggests that the outcome might be different for periods after December 28, 1994, the effective date for the Treasury Department's partnership anti-abuse regulations, Treas. Reg. § 1.701-2. *Id.* at 222.

13. See *id.* at 222; Rev. Rul. 89-72, 1989-1 C.B. 257.

14. See *Brown Group, Inc. v. Comm'r*, 104 T.C. 105, 113 (1995), *vacated*, 77 F.3d 217 (8th Cir. 1996); Rev. Rul. 89-72, 1989-1 C.B. 257-8.

15. See *Brown Group*, 104 T.C. at 113-14; Rev. Rul. 89-72, 1989-1 C.B. 257-8.

16. See *Brown Group, Inc. v. Comm'r*, 77 F.3d 217, 217, 222 (8th Cir. 1996) (holding that a controlled foreign corporation's distributive share of partnership income cannot be considered foreign base company sales income prior to December 29, 1994, and possibly not even after that date).

17. See *Brown Group*, 104 T.C. at 122-23 (Ruwe, J., concurring).

Thus, the question of the proper characterization of the isolated items of partnership income is moot.

The Eighth Circuit has invited the IRS to address the issue through the Treasury Department's partnership anti-abuse regulations, citing, in particular, Treasury Regulations section 1.701-2(e).¹⁸ This regulation permits the IRS to treat a partnership as an aggregate of its partners as appropriate to carry out the purpose of the provisions of Subpart F and its regulations.¹⁹ However, those interested in furthering the rule of law might prefer something more specific in this context. Similarly, those familiar with the paucity of legislative history for Subpart F might come to the same conclusion.

A rule is needed providing that a controlled foreign corporation's distributive share of income from a partnership is deemed, for purposes of calculating the corporation's Subpart F income, to be income derived directly by the corporation in circumstances identical to those in which the partnership derived the income. One way of accomplishing this is to correct the flaw in the IRS's argument, while taking into account the concern of those who argue that the IRS does not have a bridge from Subpart F to Treasury Regulation section 1.702-1(a)(8)(ii) in the first place.²⁰

RECOMMENDATION ONE: Amend Treasury Regulations sections 1.952-2(a)(1) and 1.952-2(b)(1) to provide that, for the purpose of determining the amount of any category of a controlled foreign corporation's Subpart F income, the controlled foreign corporation's distributive share of income from a partnership is deemed to be income derived directly by the corporation in circumstances identical to those in which the partnership derived the income; and amend Treasury Regulations 1.702-1(a)(8)(ii) to provide that a partner must take into account separately its distributive share of any item of partnership income or expense that, if taken into account separately, results in an income tax liability for any partner or a U.S. shareholder of a partner different from the income tax liability resulting when the item is not taken into account separately.

Once Treasury Regulation 1.702-1(a)(8)(ii) is amended, the partnership will be required to state such items separately.²¹ Because the identity of related persons will change from partner to partner, separately stating the relevant partnership items can be difficult for the partnership. In order to state separately the necessary items of its income, the partnership must know the identity of all persons related to each of its partners that are a controlled foreign corporation. Once the relevant portion of a controlled foreign corporation's distributive share of partnership income is separately stated, the portion will be characterized as foreign base company sales income by virtue of Treasury Regulations section 1.702-1(b).

18. See *Brown Group*, 77 F.3d at 222.

19. Treas. Reg. § 1.701-2(e)(1) (1997).

20. See *Brown Group*, 104 T.C. at 127-28 (Beghe, J. concurring), (arguing that Code section 702(a) applies only to the determination of the U.S. income tax liability of a partner).

21. See I.R.C. § 703(a)(1) (1997).

6. The Requirement of a Related Person

Each of the four types of tainted transactions requires the participation of a related person. This requirement produces three apparent anomalies that help to define the boundaries of Subpart F's concern for tax haven operations.

(a) Independent Offshore Sales Operations

The first of the apparent anomalies is that import and export transactions conducted by a controlled foreign corporation for the benefit of an unrelated U.S. corporation are without consequence under Subpart F. Compare the following two examples.

EXAMPLE TWO: Base Company Exporting Parent's Products. Parent Corporation, a Delaware corporation, manufactures personal computers in the United States. Parent Corporation incorporates Base Company, a wholly-owned Bermuda corporation. Base Company is a controlled foreign corporation. Furthermore, Bermuda has no income tax. Base Company purchases personal computers from Parent Corporation and resells the computers to users in France. The income that Base Company derives from those transactions is foreign base company sales income and, subject to exclusions and limitations, is taxable to Parent Corporation.

EXAMPLE THREE: Base Company Exporting Unrelated Person's Products. Base Company, from the preceding example, purchases cellular telephones from an unrelated U.S. manufacturer and resells the telephones to unrelated users in France. The income that Base Company derives from the transactions is not foreign base company sales income and is not taxable to Parent Corporation. The income derived by Base Company from the sale of telephones is free of local income tax, as is the income Base Company derives from its sale of computers. Parent Corporation enjoys the benefit of the deferral of U.S. income tax on the income derived by Base Company from sales of telephones until such time, if ever, that Base Company repatriates the income to Parent Corporation in the form of a dividend or other payment. Yet, Parent Corporation generally is subject to U.S. income tax on the income derived by Base Company on sales of computers manufactured by Parent Corporation. The Internal Revenue Code tolerates Parent Corporation's tax haven operation as long as Base Company deals in property acquired from and sold to unrelated persons.

More generally, a controlled foreign corporation may buy and sell goods between jurisdictions from its tax haven base, sheltering its income from the income tax regimes of the countries of origin and the countries of destination, as long as its transactions do not involve related persons. This is illustrated by the following example:

EXAMPLE FOUR: Base Company Selling Foreign Products to Foreign Markets. Base Company from the preceding examples purchases photocopiers from an unrelated manufacturer in the Netherlands and resells them to unrelated users in Argentina. The income derived by Base Company from the transactions is not foreign base company sales income, and Parent Corporation enjoys the benefit of U.S. tax deferral through its tax haven operation on the income it derives from its distribution activities.

One claimed justification for including the income from related person transactions in foreign base company sales income is to prevent the

separation of a U.S. corporation's sales income from its manufacturing income and the consequent sheltering of the sales income in a tax haven.²² This justification is actually a specific example of the general policy of capital export neutrality. Under that policy, the Code should not give incentives to U.S. businesses to move their operations offshore to seek a lower tax burden. As a result, the U.S. tax base is diminished, and U.S. competitors who do not move their operations offshore are placed at a disadvantage.²³ The inclusion of a controlled foreign corporation's foreign base company sales income in the income of its U.S. parent corporation removes the incentive to move sales operations offshore and preserves the tax base of the United States. Thus, under the policy of capital export neutrality, scrutiny of the offshore operations of U.S. distributors at the same level as the offshore sales operations of U.S. manufacturers is justified. Moreover, transactions by controlled foreign corporations with unrelated persons should be scrutinized, in the absence of considerations competing with the policy of export neutrality.

Should there be a difference in result for Parent Corporation in Examples Two and Three depending on whether Base Company has dealt with a related person? The exclusion from foreign base company sales income of income from transactions with unrelated persons is puzzling, because all the transactions of Base Company arguably erode the U.S. tax base. The traditional justification lies with the goal of capital import neutrality: because the exclusion of some transactions between a base company and unrelated persons might permit U.S. multinational corporations to operate abroad under the same overall tax burden as their foreign competitors, the exclusion of all transactions by base companies with unrelated persons is sure to cover the needy cases.²⁴ Capital import neutrality in this case is an incomplete justification. To achieve capital import neutrality, one would exclude only the income from base company sales transactions with unrelated persons that otherwise would bear a heavier total tax burden than that existing in the foreign market in which the U.S. affiliate competes.

If capital import neutrality justifies a departure from the policy of capital export neutrality in the case of income derived from transactions with unrelated persons, does it also justify a departure for the benefit of income derived from transactions with related persons? In order to achieve true equality with foreign competitors, it would be necessary to define the tax burden of foreign competitors as the burden that exists after the foreign competitors have also taken advantage of a tax haven arrangement. As this Article points out elsewhere,²⁵ section 954(d) of the Code usually examines only the tax burden in the country of origin or destination of goods

22. See S. Rep. No. 87-1881, at 84 (1962), reprinted in 1962-3 C.B. 703, 790.

23. For a brief account of capital export neutrality as an element of international tax policy, see CHARLES H. GUSTAFSON & RICHARD C. PUGH, *TAXATION OF INTERNATIONAL TRANSACTIONS* ¶ 1091 (1991).

24. See *id.*

25. See the discussion of the branch rule in Part II.C.1 of this Article. The branch rule views as irrelevant the possibility that a local competitor to a controlled foreign corporation can establish an extra-territorial branch for local tax savings.

and not the tax burden that might exist by the use of international tax-saving arrangements by foreign competitors. The Code implicitly trusts that other nations will adopt analogues of Subpart F. Without a harmonization of world tax rates, the general conflict between capital export neutrality and capital import neutrality will be suspended only by uneasy compromises.²⁶ Regardless of the justification, the result is clear: independent tax haven sales transactions are outside the scope of the provisions of Subpart F. A related person must be involved before the tax haven sales transaction is of consequence under U.S. tax policy.²⁷

(b) Transactions Affecting Foreign Tax Bases

The second apparent anomaly arises from the fact that the related person need not be a domestic person. Thus, purely foreign import and export transactions can generate tainted income if they involve a foreign person related to the controlled foreign corporation. Consider the following example:

EXAMPLE FIVE: Tainted Transactions That Produce Foreign Tax Savings. Parent Corporation incorporates Manufacturing Subsidiary, a wholly-owned Netherlands corporation. Manufacturing Subsidiary manufactures photocopiers and distributes them throughout the European Union. Base Company purchases photocopiers from Manufacturing Subsidiary and resells them to unrelated users in Argentina. The income Base Company derives from the sales in Argentina is foreign base company sales income, because the photocopiers were purchased from a related person.

The second apparent anomaly is the difference between Example Four and Example Five in the treatment of Base Company's sales income. In Example Four, Base Company does not derive any foreign base company sales income from selling Dutch photocopiers to customers in Argentina. In Example Five, however, Base Company does derive foreign base company

26. Two inchoate reasons might also lie behind the inclusion of income derived from transactions with related persons. First, Section 954(d) might owe its existence, in part, to a generalized fear that section 482 is insufficient to cope with transfer-pricing abuses between related persons in base company operations. Including a base company's sales transactions with related persons within the company's foreign base company sales income is one way to address that concern, albeit an overly broad one. Second, the participation by a related person in a base company's transaction might serve as a proxy for the base company's lack of economic substance. The related person may be providing all staff and fulfilling all operational functions required for what is nominally the controlled foreign corporation's sales operation. If the base company transacts business with unrelated persons, so this approach might reason, it likely has the staff and resources necessary to conduct a sales operation itself. This raises the possibility of excluding the income from related-person transactions from a controlled foreign corporation's foreign base company sales income, if the corporation conducts a substantial volume of transactions with unrelated persons. Section 482 would be available to counter any transfer-pricing abuses in the related-person transactions.

27. The U.S. parent corporation is not entirely immune from Subpart F considerations if its controlled foreign corporation conducts tax-haven transactions only with unrelated persons. The gain recognized by a U.S. parent corporation from selling its stock in the controlled foreign corporation generally is recharacterized as a dividend. See I.R.C. § 1248(a) (1997).

sales income from selling Dutch copiers to customers in Argentina. The difference in treatment does not protect U.S. tax revenue, since Manufacturing Subsidiary could have sold the photocopiers to unrelated users in Argentina itself without deriving foreign base company sales income.

However, the difference protects the tax revenue of the Netherlands. In Example Five, the concern of Dutch tax policy is that Manufacturing Subsidiary is diverting its sales income to Base Company. Nonetheless, any Dutch analogue to Subpart F could not reach Base Company's foreign base company sales income, because Base Company is not a Netherlands corporation, is not owned directly or indirectly by Dutch shareholders, and is not managed from the Netherlands. Thus, it is beyond the reach of the Netherlands' prescriptive jurisdiction under international law.²⁸ Any Dutch analogue to Subpart F could reach only the base company income of Manufacturing Subsidiary's own subsidiaries. The use of a sibling foreign corporation as a base company can be attacked in those circumstances only by the U.S. Subpart F, or more generally by the state that has prescriptive jurisdiction over the shareholders, direct or indirect, of the sibling foreign corporation.²⁹ In Example Five, Subpart F protects Dutch income tax revenues by penalizing the transaction.³⁰ In sum, Subpart F reaches transactions that are unrelated to U.S. markets and that would otherwise generate income completely foreign to the U.S. tax base. Taxing such foreign base company sales income to the U.S. parent corporation can be viewed as a measure to protect foreign tax revenue.

(c) Substantial Assistance by a Related Person

The four types of tainted transactions envision the controlled foreign corporation as an entity assisting the related person in its operations. If, on the other hand, the situation is reversed and the related person assists the controlled foreign corporation with its own activities, the controlled foreign corporation's transactions do not fall within the four tainted categories. This is the third apparent anomaly. Transactions in which title to personal property begins or ends in the controlled foreign corporation generally trigger no adverse effect under section 954(d). Hence, a related person who provides procurement or marketing services to a controlled foreign corporation does not cause the controlled foreign corporation's transactions to generate foreign base company sales income. Compare the following two examples:

28. See RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 402 (1986).

29. This structure works in reverse. A foreign multinational corporation may create a base company in a tax haven through which it can market the products manufactured by its U.S. subsidiary. The United States must depend on the Subpart F analogue, if any, of the multinational's home jurisdiction to protect its tax base from the erosion caused by the base company sales operations.

30. The sales income recaptured for a foreign nation's tax base, of course, becomes part of the U.S. tax base rather than being returned to the foreign tax base. But, the primary effect of Subpart F is to discourage the tainted transaction from taking place, so when Subpart F is successful as a preventive device, the tax revenue never leaves the foreign tax base.

EXAMPLE SIX: Procurement Services by Base Company. Base Company purchases circuit boards on behalf of Parent Corporation from an unrelated source in Germany. In payment for its procurement services, Base Company is paid a fee by Parent Corporation. Base Company's fee is foreign base company sales income and, subject to exclusions and limitations, is taxable to Parent Corporation under Subpart F.

EXAMPLE SEVEN: Procurement Services by Related Person. Parent Corporation purchases cellular telephones from an unrelated U.S. manufacturer on behalf of Base Company, who then resells the telephones to unrelated users in Kazakhstan. Despite Parent Corporation's assistance in the transactions, the income derived by Base Company is not foreign base company sales income. Although Parent Corporation's fee income from providing purchasing services to Base Company is taxable to Parent Corporation, it gains the benefit of tax deferral with regard to the sales income derived by its tax haven operation.³¹

Parent Corporation may also render marketing services to Base Company without causing Base Company's income from the sales transactions to be classified as foreign base company sales income. The assistance may be rendered by a foreign related person. In such a case, the fee income of the related person is not subject to U.S. taxation if the related person is not a controlled foreign corporation itself and the fee income is not connected to the conduct of a trade or business in the United States. The third anomaly demonstrates that the Code's concern with foreign base company sales income is primarily with the sales income of manufacturers and not with the sales income of distributors. A U.S. parent corporation engaged in the distribution of products generally is subject to Subpart F if it sells products to a controlled foreign corporation but not if it purchases goods on behalf of the controlled foreign corporation.

Contract manufacturing is among the services that a related person might perform for a controlled foreign corporation. If the related person provides only a service to the controlled foreign corporation and has a financial interest only in the fee it receives for the service, while the controlled foreign corporation bears the risk of loss throughout the manufacturing process, the controlled foreign corporation may be deemed to be the manufacturer of the goods produced.³² The assistance of the related person does not bring the subsequent sales transactions of the controlled foreign corporation within the four types of tainted transactions because, instead of distributing goods purchased from a related person, the controlled foreign corporation is selling goods it has manufactured itself.

The IRS has indirectly challenged contract manufacturing by a related person, but its challenge was not successful.³³ Consider the following

31. The American Law Institute also makes this point. See AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION 266-68 (1987).

32. For a discussion of contract manufacturing and the relevant authorities, see *infra* Part II.A.4 of this Article.

33. *Vetco, Inc. v. Commissioner*, 95 T.C. 579 (1990). In *Vetco*, the alleged contract manufacturing was performed by a wholly-owned subsidiary of the controlled foreign corporation. The controlled foreign corporation was incorporated in Switzerland, and its subsidiary both operated and was incorporated in the United Kingdom. The alleged

examples:

EXAMPLE EIGHT: Contract Manufacturing by Domestic Related Person. *Contract Manufacturer, a Texas corporation, manufactures personal computers for four well-known U.S. computer companies. None of computer companies is related to Contract Manufacturer. Contract Manufacturer manufactures the computers according to each client's specifications and packages the assembled computers in cartons specified by the client and bearing the client's trademarks. Contract Manufacturer's principal business consists of its contract manufacturing of computers. Contract Manufacturer now decides to engage in retail sales of computers in foreign markets not addressed by its contract manufacturing clients. Contract Manufacturer incorporates Base Company in Bermuda with an employee trust as a minority shareholder. Contract Manufacturer then enters into a contract manufacturing arrangement with Base Company under which Contract Manufacturer is to manufacture computers for Base Company. Under the contract, Base Company bears all risk of loss during the manufacturing process. Base Company sells its computers in several smaller South American markets. Base Company's sales income arguably is not foreign base company sales income under the Internal Revenue Code.*

contract manufacturing process consisted of the precision welding of a pipe connector to oilfield pipe. The IRS unsuccessfully argued that the British subsidiary should be treated as a branch for purposes of the branch rule. *See id.* at 589-91. The branch rule is discussed in Part I.C of this Article.

The IRS's strategy in making this argument is unclear. The strategy required that the welding operation of the subsidiary constitute manufacturing and that the subsidiary be characterized as a manufacturing branch for purposes of the branch rule. *See id.* at 587. If the welding operations of the subsidiary were not manufacturing, then the controlled foreign corporation derived no foreign base company sales income from the sale of the pipe connector assemblies because the two components of the assemblies were purchased by the controlled foreign corporation from unrelated persons. If the subsidiary was not characterized as a branch, the welding operations conducted by the subsidiary, a related person, under contract with the controlled foreign corporation would be deemed to be conducted by the controlled foreign corporation itself (or so the IRS seems to have assumed). Under these circumstances, the controlled foreign corporation's sales income would fall outside the definition of foreign base company sales income.

Thus, apparently, the IRS had the following four-step strategy in mind: (i) establish that the subsidiary was a branch for purposes of the branch rule; (ii) the controlled foreign corporation and its subsidiary could therefore be seen as a single entity; (iii) the contract manufacturing of the subsidiary, which is deemed to be manufacturing by the controlled foreign corporation, could then be reattributed to the branch; and (iv) by the operation of the branch rule, the sales income of the controlled foreign corporation would be on behalf of the branch, a related person, and would therefore fall within the definition of foreign base company sales income. Yet, because of the way in which the IRS presented its case, the court did not address the issue of whether the subsidiary's welding operations qualified as manufacturing. The IRS did not raise directly the issue of whether contract manufacturing by a related person is deemed to be manufacturing by the controlled foreign corporation.

In fact, there were two sources of foreign base company sales income in *Vetco*. The IRS did not raise either source as an issue. First, the controlled foreign corporation, as a separate matter, purchased pipe connectors manufactured by the subsidiary and resold them to unrelated persons. The income derived by the controlled foreign corporation from such sales constituted foreign base company sales income. Second, the subsidiary purchased pipe connectors on behalf of the controlled foreign corporation from an unrelated person. The income derived by the subsidiary from such procurement services was foreign base company sales income.

EXAMPLE NINE: Contract Manufacturing by Foreign Related Person. Base Company from the preceding example organizes Subsidiary in the Republic of Ireland with Contract Manufacturer's employee trust as minority shareholder. Subsidiary is also a controlled foreign corporation. Base Company contracts with Subsidiary to conduct manufacturing operations on behalf of Base Company. Under the contract, Base Company bears all risk of loss during the manufacturing process. Subsidiary is paid an arms-length fee for its service. Base Company arguably is the manufacturer of the products produced by Subsidiary under contract with Base Company and the income Base Company derives from selling those products arguably is not foreign base company sales income.

The third anomaly demonstrates a shortcoming in the requirement of a related person. The requirement can be circumvented by changing the role of the related person from that of a title holder to that of a service provider.

Thus, a U.S. parent corporation in the distribution business can use a base company in its sales operations by substituting the rendering of procurement services to its base company for the reselling of purchased goods to the company. Similarly, a U.S. parent corporation engaged in manufacturing can use a base company in its sales operations by the careful arrangement of contract manufacturing for the benefit of the base company. In such a case, the base company also becomes an offshore absorber of the risk associated with the manufacturing process.

Hence, the related-person requirement should be expanded to include the rendering of substantial assistance by a related person. However, an exclusion should be provided for any assistance rendered in the controlled foreign corporation's country of incorporation by a related person also incorporated in that country. There are valid non-tax reasons for a multinational to operate in a single foreign jurisdiction through several subsidiaries. For example, local law may require that operations subject to regulation be conducted in a separate entity. Business considerations may dictate the conduct of financial activity in a separate subsidiary from operations. The following recommendation can, therefore, be made:

RECOMMENDATION TWO: Amend Code section 954(d)(1) to provide that foreign base company sales income generally includes sales income derived by a controlled foreign corporation with the substantial assistance of a related person; however, the income derived by a controlled foreign corporation with substantial assistance rendered in its country of incorporation by a related person also incorporated in that country should be excluded from foreign base company sales income. The regulations under the new provision generally should provide that purchasing services, marketing services, and contract manufacturing by a related person fall within the definition of substantial assistance.

7. The Effect of Transforming the Property

The four types of tainted transactions do not include the transformation of property by a controlled foreign corporation. If the controlled foreign corporation substantially transforms personal property it has purchased and then sells the transformed property, the corporation may have succeeded in dividing a tainted transaction into two separate transactions neither of which produces foreign base company sales income. The transformed

property is considered to be distinct from the antecedent property.³⁴ This distinction permits the use of the tax haven arrangements, illustrated by the following two examples, in which a controlled foreign corporation intermediates between a U.S. parent corporation and foreign persons.

EXAMPLE TEN: Outbound Manufacturing and Distribution. Parent Corporation, a Delaware corporation, incorporates Base Company in the Republic of Ireland. Base Company enjoys a ten-year income tax holiday in Ireland. Base Company purchases raw materials from Parent Corporation and manufactures capacitors. Base Company then sells the capacitors to personal computer manufacturers in France. None of the income derived by Base Company from its manufacture and sale of capacitors is foreign base company sales income. If Base Company sells finished capacitors to Parent Corporation, a related person, it still does not derive foreign base company sales income. The purchase of the raw materials from a related person and the sale of the manufactured products are not linked together into a single, tainted transaction for purposes of determining Base Company's foreign base company sales income.

EXAMPLE ELEVEN: Inbound Manufacturing and Supply. Base Company from the preceding example purchases raw materials from an unrelated supplier in Brazil and manufactures capacitors for sale to Parent Corporation. Base Company derives no foreign base company sales income from its sales of the capacitors. Once again, the purchase of raw materials from an unrelated person and the sale of manufactured products to a related person are not linked together into a single, tainted transaction for purposes of determining Base Company's foreign base company sales income.

In each example, Base Company has derived both manufacturing and sales income from its operations. However, Subpart F does not reach foreign base company manufacturing income.³⁵ Nor does Subpart F reach the sales income derived by a foreign base company from the products it has manufactured.³⁶ The base company's manufacturing operations in effect shelter its sales income from inclusion as in foreign base company sales income. In each example, the U.S. parent is able to segregate income from export or import transactions within the tax haven entity and escape the brunt of Subpart F by moving the manufacturing operation to the tax haven as well.

To some extent, this sheltering of income is justified by capital import neutrality. The goal of permitting the U.S. multinational to operate in foreign markets under the same income tax burden as its foreign competitors would justify the exclusion from foreign base company income of a controlled foreign corporation's income derived from the manufacturing and sale of products within its own country of incorporation. However, capital import neutrality does not necessarily justify sheltering income derived from all third-country manufacturing and sales operations. As it is, the definition of the four tainted transactions creates, in effect, a blanket exclusion for the income derived by a controlled foreign corporation from sell-

34. See Treas. Reg. § 1.954-3(a)(4)(i) (1997). Parts II.A.3 and 4 of this Article discuss the transformation of property by a controlled foreign corporation.

35. See I.R.C. § 954(a) (1997).

36. See Treas. Reg. § 1.954-3(a)(4)(i) (1997).

ing anything it has manufactured, regardless of the identity, location, or competitive structure of the market ultimately served.

A blanket exclusion leads to several abuses. First, a U.S. multinational can divert its import and export income to a tax haven if the tax haven entity adds sufficient value to the imported or exported item for the item to be considered as manufactured by the entity.³⁷ Second, the tax haven entity can conduct its manufacturing operations through a branch anywhere in the world and shelter its sales income from the manufactured product. In effect, the tax haven entity simply reproduces at its own level the behavior of its parent against which Subpart F is aimed. The branch rule targets this abuse, but it is not wholly successful. The branch rule cannot reach the manufacturing activity of a branch if the branch also sells the products it has manufactured. Nor can the branch rule reach the abuse if the manufacturing branch's effective income tax rate is lower than the effective tax rate of the controlled foreign corporation's country of incorporation. Third, the U.S. multinational can shelter its foreign base company sales income if its tax haven entity contracts for manufacturing by another entity.³⁸ At the price of assuming the risk of loss from the manufacturing process, the tax haven entity can shelter the sales income of the U.S. multinational.

A more satisfactory approach would provide for a general inclusion of the sales income of a controlled foreign corporation that is derived from selling products it has manufactured, with specific exclusions tailored to the goal of capital import neutrality. To provide for a general inclusion of a controlled foreign corporation's sales income derived from products it has manufactured, the set of tainted transactions must be expanded. The set should generally include the sale of manufactured goods by a controlled foreign corporation to related persons and the sale of manufactured products to unrelated persons that have been manufactured with inputs from related persons. Such inputs might take the form of either materials or services. An appropriate exclusion would be that discussed in Part II.A.1 of this Article as amended by Recommendation Ten. In brief, an exclusion should be provided for income derived from the sale by the controlled foreign corporation to any person anywhere of property manufactured by the controlled foreign corporation in its country of incorporation. The following recommendation reflects this approach:

RECOMMENDATION THREE: Amend section 954(d)(1) of the Code to include as foreign base company sales income, the sales income derived by a controlled foreign corporation in connection with: (i) the sale to a related person of personal property manufactured, produced, constructed, grown, or extracted by the controlled foreign corporation outside its country of incorporation; (ii) the sale to any person of personal property manufactured, produced, or constructed by the controlled foreign corporation outside its country of incorporation from per-

37. Third-country manufacturing can sometimes be justified by economies of scale. See Example Fifteen in Part II.A.1(a) of this Article.

38. Recommendation Two addresses contract manufacturing by a related person. See *supra* Part I.B.6(c).

sonal property purchased from a related person; and (iii) the sale to any person of personal property manufactured, produced, constructed, grown, or extracted by the controlled foreign corporation outside its country of incorporation with substantial assistance from a related person.

Recommendations Two and Three address the following problem:

EXAMPLE TWELVE: Contract Manufacturing by Sibling. Parent Corporation, a California corporation, incorporates Base Company in Vanuatu. Base Company purchases raw materials from Parent Corporation and contracts with its sibling controlled foreign corporation in South Korea to manufacture finished products on behalf of Base Company. Base Company sells the finished goods to unrelated persons throughout East Asia and Southeast Asia, but to no one in Vanuatu. The finished goods are deemed to be manufactured by Base Company. The income derived by Base Company from selling those goods to unrelated persons arguably is not foreign base company sales income under current law.

If either Recommendation Two or Three is implemented, the sales income derived by Base Company would be foreign base company sales income to Base Company. Under Recommendation Two, the related person in South Korea would have rendered substantial assistance to Base Company outside Base Company's country of incorporation. Thus, Base Company's sales income would fall within foreign base company sales income. Under Recommendation Three, Base Company would be deemed to have manufactured the goods, but to have done so outside Vanuatu, its country of incorporation, from personal property purchased from a related person and with the substantial assistance of a related person. Again, the income derived by Base Company from its sales would fall within foreign base company sales income.

Part of the solution also lies with generally adding foreign base company manufacturing income to the scope of Subpart F. Again, a specific exclusion can be tailored to the requirements of the goal of capital import neutrality. Thus, an exclusion for income arising from manufacturing operations conducted by the controlled foreign corporation within its own country of incorporation is justified. The local investment required for manufacturing operations gives sufficient economic substance to the corporation's presence, rendering application of the policy of capital import neutrality more convincing. In addition, the controlled foreign corporation's competitors under the policy are those who are active in its own jurisdiction. If these suggestions are applied to Examples Ten and Eleven, the manufacturing income of Base Company in those examples would escape current U.S. income taxation. With this in mind, the following amendment should be adopted:

RECOMMENDATION FOUR: Amend section 954(a) of the Code to include foreign base company manufacturing income within the definition of foreign base company income. Add a new section 954(h) to the Code to define foreign base company manufacturing income. The definition of manufacturing would include the processes of producing, constructing, growing, and extracting personal property, either for the controlled foreign corporation's own account or for the account of others. Income derived by a controlled foreign corporation from manufacturing property within its country of incorporation for its own account

or for others would be excluded from foreign base company manufacturing income.

C. The Branch Rule

In some instances, a foreign branch of a controlled foreign corporation can mimic a foreign base company. For that reason, the branch rule treats certain foreign branches as controlled foreign corporations in their own right.³⁹ If the branch rule transforms a branch into a separate corporation, the rule may then recharacterize transactions in which either the branch or the remainder of the controlled foreign corporation engages as transactions conducted on behalf of related persons. The branch rule expands the class of tainted transactions.

1. *The Perceived Abuse*

If a controlled foreign corporation is incorporated in a country with a territorial income tax system, a foreign branch of the corporation can simulate a foreign base company. A jurisdiction with a territorial income tax system is one that does not levy tax on a taxpayer's income derived from sources outside its territory. A controlled foreign corporation operating under a territorial tax system can create a foreign base company for its own use without incorporating a separate subsidiary. Selling its products through a sales branch in a tax haven produces the same effect as selling through a subsidiary in a tax haven: the income derived by the controlled foreign corporation from the sales activity, being derived from sources outside the corporation's home jurisdiction, is not taxable by that jurisdiction.

The same result can be achieved by reversing the place of incorporation. The controlled foreign corporation incorporates in the tax haven, the location of its sales operations, and conducts its manufacturing operations in the higher-tax jurisdiction. The controlled foreign corporation is then a foreign taxpayer relative to the higher-tax jurisdiction. The corporation pays tax to that jurisdiction only on the income it derives from its manufacturing branch. This second arrangement is also useful with regard to jurisdictions that impose a worldwide income tax on domestic taxpayers but only a territorial tax on the income of foreign taxpayers. The controlled foreign corporation incorporates elsewhere and conducts operations in the jurisdiction with a worldwide tax system through a local branch.

Either arrangement separates a controlled foreign corporation's manufacturing income from its income from sales operations and places the sales income within a tax haven. Depending on the structure of the applicable territorial tax system, the two arrangements can also separate a controlled foreign corporation's purchasing activities from its manufacturing activities and shelter the income that the corporation derives from its purchasing activities. The controlled foreign corporation conducts its purchasing activities in a tax haven for the benefit of its manufacturing operations in a jurisdiction with a territorial tax system. The purchasing

39. I.R.C. § 954(d)(2) (1997).

activities would consist either of rendering procurement services or of taking delivery of raw materials and reshipping them to the manufacturing operation. As a result, the tax haven operation would have either imputed services income or imputed sales income. If the territorial jurisdiction recognizes the tax haven branch's sales or services income as being distinct from the income of the domestic operation and being of foreign source, the controlled foreign corporation has succeeded in sheltering the income attributable to the tax haven branch's activities from income tax levied by the territorial jurisdiction.⁴⁰

The use of these strategies is not limited to manufacturers. Distributors can use the combination of a jurisdiction with a territorial tax system and a tax haven jurisdiction to realize foreign tax savings. The controlled foreign corporation purchases inventory in the territorial jurisdiction and conducts its distribution operations in the tax haven. If the markets of the territorial jurisdiction are the objective, the controlled foreign corporation conducts its distribution operations in the territorial jurisdiction and conducts its purchasing operations in the tax haven. The applicable territorial tax system may treat the tax haven branch as a separate taxpayer and not subject to taxation.⁴¹ As this Article will discuss, the regulations promulgated under the branch rule deal primarily with manufacturers. The regulations fail to address some of the arrangements beneficial to distributors.

In a sense, the branch rule is a departure from the policy of capital import neutrality.⁴² The controlled foreign corporation's local competitors in the territorial jurisdiction are free to establish foreign branches in tax havens and can thus take advantage of these strategies. Local competition to the American affiliate is recognized by the policy of capital import neutrality for purposes of the branch rule only to the extent that the competitors' activities take place in the controlled foreign corporation's country of incorporation.

2. *The Requirement of an Establishment*

The branch rule does not seek out income of a controlled foreign corporation that merely arises in a tax haven; the income must be attributable to the activities of a branch or similar establishment.⁴³ Furthermore, the

40. The U.S. income tax system would attribute all of the income from a sale by the U.S. branch of a foreign taxpayer to the selling branch and none to a foreign branch conducting purchasing activities. See AMERICAN LAW INSTITUTE, *supra* note 31, at 261, n.143. Hence, the arrangement described in the text would not be effective in removing from the scope of U.S. income taxation the income of a foreign branch of a foreign taxpayer attributable to purchasing activities conducted on behalf of the taxpayer's U.S. branch. More generally, the arrangement described in the text will not be available to a controlled foreign corporation with a sales branch located in a foreign jurisdiction with a worldwide system of taxation that follows the U.S. rule.

41. Such an arrangement would not necessarily be helpful to a controlled foreign corporation with a sales branch located in a foreign jurisdiction with a worldwide system of taxation. See *supra* note 40 and accompanying text.

42. The policy of capital import neutrality is discussed in Part II.B.6(a) of this Article.

43. See I.R.C. § 954(d)(2) (1997).

branch or other establishment must be located outside the controlled foreign corporation's country of incorporation.⁴⁴ This condition raises the question of the presence required before a branch or other establishment will be considered as existing outside the corporation's country of incorporation.

The required presence must be a presence of the controlled foreign corporation itself. A corporate entity distinct from the controlled foreign corporation cannot be a branch. The IRS has attempted to categorize an unrelated corporation that serves as a contract manufacturer for a controlled foreign corporation as a branch of the controlled foreign corporation.⁴⁵ The IRS met with defeat.⁴⁶ The IRS also met with defeat when it attempted to categorize a subsidiary as a branch.⁴⁷ The Tax Court has concluded that the term "branch" should be given its ordinary meaning in the context of business and accounting.⁴⁸ The Tax Court interprets the phrase, "or similar establishment," to mean a branch that is given a different name for accounting, financial reporting, local law, or other purposes.⁴⁹ The concern of the IRS is that a controlled foreign corporation can avoid the branch rule simply by using a contract manufacturer in the desired jurisdiction instead of establishing a manufacturing branch in the jurisdiction.⁵⁰ The problem identified by the IRS is real in the context of a related person serving as a contract manufacturer and must be addressed in another manner. Recommendation Two, which proposes tainting sales transactions for which a related person renders substantial assistance, would answer the IRS's concern over when a related person is involved.⁵¹

44. See *id.*

45. See Rev. Rul. 75-7, 1975-1 C.B. 244. But see *Ashland Oil, Inc. v. Commissioner*, 95 T.C. 348, 363 (1990).

46. See *Ashland Oil*, 95 T.C. at 363.

47. See *Vetco, Inc. v. Commissioner*, 95 T.C. 579 (1990).

48. See *Ashland Oil*, 95 T.C. at 356. The Tax Court has rejected the argument that a branch can be defined by the tax rate disparity test alone. *Id.* at 358-60. The tax rate disparity test is discussed in Part II.C.3(b) of this Article.

49. See *Ashland Oil*, 95 T.C. at 357. The Tax Court states in dicta that the IRS does not have statutory authority to define a branch or similar establishment for purposes of the branch rule. See *id.* at 357-58. If the statement is true, any definition would be an interpretive regulation rather than a legislative regulation. At one time, it could have been argued that a separate corporation may constitute a permanent establishment of a controlled foreign corporation and thus be a branch or that a separate but related corporation may constitute an agent of a controlled foreign corporation under the *National Carbide* factors, see *National Carbide Corp. v. Commissioner*, 336 U.S. 422, 437 (1948), and consequently be a branch. See Howard J. Levine & Allen J. Littman, *Contracting Out, Not Branching Out: Manufacturing Revisited*, 22 TAX MGMT. INT'L J. 343, 350-53 (1993). The Tax Court's holdings in *Ashland Oil* and *Vetco* have foreclosed those arguments.

50. See Gen. Couns. Mem. 35,961 (August 23, 1974). The IRS is also concerned that contract manufacturing expands the manufacturing exclusion unduly. Gen. Couns. Mem. 33,357 (Oct. 24, 1966). (The manufacturing exclusion is discussed in Parts III.A.3 and 4 of this Article and is the subject of Recommendations Three and Four.) These general counsel memoranda discuss drafts of what later became Revenue Ruling 75-7, 1975-1 C.B. 244. Further background for the revenue ruling can be found in Priv. Ltr. Rul. 64-12-105700A (Dec. 10, 1964).

51. See the discussion in Part II.A.6(c) of this Article.

When the contract manufacturer is an unrelated person, the IRS's concern is misplaced. Because tax haven sales operations independent of any related person are permitted without consequence under section 954(d),⁵² contract manufacturing by an unrelated person should also be so permitted.⁵³

Nonetheless, the Tax Court's statements about the definition of a branch are overbroad in the context of operations internal to a controlled foreign corporation. In such a context, U.S. tax jurisprudence offers two alternative possibilities for the definition of a branch or other establishment: first, the definition of a permanent establishment under U.S. tax treaties; and, second, the definition of a trade or business developed under the Internal Revenue Code. Borrowing the treaty concept of a permanent establishment has two drawbacks.⁵⁴ The definition of a permanent establishment in U.S. tax treaties varies from treaty to treaty, making a general definition difficult to formulate. Moreover, using the permanent establishment concept misses the opportunity to join the shift in the Code itself from the concept of a permanent establishment to the concept of income effectively connected with the conduct of a trade or business. The language in Code section 954(d)(2), added by the Revenue Act of 1962,⁵⁵ predates the shift in Code sections 871(b) and 882 to the concept of effectively-connected income enacted in the Foreign Investors Tax Act of 1966.⁵⁶ Reviving or creating a general definition of a permanent establishment seems anachronistic.

52. See Part II.B.6(a) of this Article for a discussion of this point.

53. If the IRS had prevailed on the issue of a contract manufacturer constituting a branch for purposes of the branch rule, a controlled foreign corporation would have faced the odd incentive to choose contract manufacturers operating in low-tax jurisdictions over those operating in higher-tax jurisdictions. This odd incentive is illustrated by the facts of Private Letter Ruling 87-49-060 (Sept. 8, 1987). Under those facts and if the bids from potential contract manufacturers were equal, the controlled foreign corporation, F2, ought to accept the bids of contract manufacturers operating in the Shenzhen zone of the People's Republic of China over those operating in Korea or Taiwan. Choosing contract manufacturers in higher-tax Korea or Taiwan would cause the controlled foreign corporation's sales income to be classified as foreign base company sales income.

In the context of certain related-person transactions, contract manufacturing outside a controlled foreign corporation's country of incorporation by an unrelated person falls within the scope of Recommendation Three. The recommendation would cause certain sales income derived by a controlled foreign corporation from manufacturing goods outside its country of incorporation to fall within foreign base company sales income. See Part II.B.7 of this Article for a discussion of this proposal.

54. One writer, who apparently observed the enactment of Subpart F, suggests that Congress had permanent establishments in mind when it created the branch rule. See Stanley R. Fimberg, *The Foreign Base Company Engaged in Selling Activities: A Reappraisal of the Conduct of Foreign Business*, 17 *Major Tax Planning* 237, 260-61 (1965), quoted in *Vetco, Inc. v. Commissioner*, 95 T.C. 579, 592-93 (1990).

55. Section 954(d)(2) was added to the Code by the Revenue Act of 1962, Pub. L. No. 87-834, § 12(a), reprinted in 1962-3 C.B. 111, 157.

56. The concept of effectively-connected income was introduced into section 871(b) of the Code by the Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, § 103(a), reprinted in 1966-2 C.B. 656, 664, and into section 882 of the Code by the same act, § 104(b), reprinted in 1966-2 C.B. 656, 671.

Using the trade or business concept has the advantage of consistency with the current approach for analyzing the U.S. operations of foreign corporations, including the application of the branch profits tax.⁵⁷ Under this approach, a controlled foreign corporation would be deemed to have a branch or other establishment in any country in which the corporation conducts a trade or business as understood by U.S. tax law. The location of such a trade or business is an issue addressed elsewhere in Subpart F, where a definition of location is needed to define exclusions from a controlled foreign corporation's foreign personal holding company income. A cross-reference would be appropriate.

RECOMMENDATION FIVE: Amend Treasury Regulations section 1.954-3(b) to provide that (i) a controlled foreign corporation is deemed to have a branch or other establishment in a country other than its country of incorporation if the corporation conducts a trade or business in that other country; and (ii) the location of a trade or business is to be determined by the rules given in Treasury Regulations section 1.954-2(b)(4)(iii).

3. The Determination to Treat a Branch as a Separate Corporation

The branch rule treats a branch as a separate corporation if the use of the branch by the controlled foreign corporation has substantially the same tax effect as the use of a wholly-owned subsidiary.⁵⁸ To determine whether using a branch has the same effect as using a wholly-owned subsidiary, the branch rule first isolates a portion of the income of the controlled foreign corporation. The branch rule then compares the effective rates of tax on such income in the jurisdiction in which the income arose and in the other jurisdictions in which the controlled foreign corporation conducts its operations.

(a) Isolating the Relevant Income

The branch rule begins its analysis by isolating certain income derived by particular segments of the controlled foreign corporation. The relevant segments are the units of the controlled foreign corporation that engage in sales or purchasing activities. If a branch conducts sales or purchasing activities, then the branch is one of the pertinent segments.⁵⁹ If the controlled foreign corporation conducts sales or purchasing activities through its principal office, then the office is a pertinent segment.⁶⁰ The branches in a single jurisdiction may be aggregated for purposes of the branch rule if the relative tax effect of operating in the jurisdiction will be the same for all of the branches.⁶¹ The fact that a branch conducts manufacturing operations in addition to sales or purchasing operations does not preclude its scrutiny under the branch rule.

57. See I.R.C. § 884 (1997).

58. See Treas. Reg. §§ 1.954-3(b)(1)(i)(a), (ii)(a) (1997).

59. See Treas. Reg. §§ 1.954-3(b)(1)(i)(b),(c) (1997).

60. See Treas. Reg. §§ 1.954-3(b)(1)(ii)(b),(c) (1997).

61. See Treas. Reg. § 1.954-3(b)(4) Ex. 2 (1997) (all sales offices in the home jurisdiction are aggregated for purposes of the branch rule).

The income to be isolated for a segment is that income derived by the segment falling within a specialized definition of income.⁶² Hence, the isolated income must fall both within the class of income derived by the segment and within a specialized subclass of that income. The words, "derived by," take their meaning from U.S. tax principles, since the regulations do not provide that the words are defined by foreign tax law.⁶³ Thus, only income derived by the segment under U.S. income tax principles can be considered for the specialized subclass of income.⁶⁴

This conclusion raises the question of the proper order of application to the segment of the U.S. concept of income derivation and Treasury Regulations section 1.954-3(b)(2)(i)(a). This section of the Treasury Regulations requires the specialized income of the segment to be determined on the assumption that the branch is a corporation separate from the remainder of the controlled foreign corporation and incorporated in the country of its location. As a result, one first determines the income derived by the segment under U.S. tax principles and then applies the assumption of separate incorporation while narrowing that category of income. This methodology unnecessarily restricts the range of tax abuses that the branch rule can pursue. Consider the following example:

EXAMPLE THIRTEEN: Intra-Company Sales by Branch. Parent Corporation, a Delaware corporation, sells cellular phones to the Bermuda branch of its Argentine subsidiary, Base Company, S.A. Bermuda levies no income tax. The Bermuda branch then resells the telephones, at a markup that reflects the value of the Bermuda branch's purchasing activity, to the distribution branch in northwestern Argentina of Base Company for local sale. Suppose that Argentina recognizes the sale by the Bermuda branch to the Argentine branch for tax purposes and that the income derived by the Bermuda branch from its intra-entity sale is not included within Argentina's tax base. Base Company has succeeded in sheltering the income allocable to its purchasing activity in Bermuda. The branch rule is powerless to respond to this arrangement, since only income derived by the Bermuda branch under U.S. tax principles can be considered in the branch rule's determination of whether the Bermuda branch should be treated as a separate corporation from Base Company. Under U.S. income tax principles, the Bermuda branch has derived no income from its intra-entity sales. The Argentine branch, when it resells the phones, is considered to have derived the entire income arising from Base Company's purchasing and selling of phones; the income allocable to the activities of the Bermuda branch is reallocated under U.S. principles to the Argentine branch.⁶⁵ (The income of the Argentine branch does not constitute foreign base company sales income by vir-

62. See Treas. Reg. §§ 1.954-3(b)(1)(i)(b),(ii)(b) (1997).

63. See *Biddle v. Commissioner*, 302 U.S. 573, 578 (1938).

64. The American Law Institute tentatively agrees with this conclusion. See AMERICAN LAW INSTITUTE, *supra* note 31, at 261, n.143. The Institute does not address Treasury Regulations section 1.954-3(b)(2)(i)(a) or whether the rule of that section should affect the income derived by a segment of a controlled foreign corporation under U.S. income tax principles.

65. This example draws upon an example of the American Law Institute. See AMERICAN LAW INSTITUTE, *supra* note 31, at 260-61. A similar example would have the Argentine branch pay a commission to the Bermuda branch for acting as a purchasing agent for the Argentine branch in dealing with unrelated suppliers in the United States. Under present law, the branch rule does not reach the Bermuda branch's commission income.

*tue of an exclusion discussed later in this article.*⁶⁶⁾

In Example Thirteen, applying the assumption of separate incorporation to the segment only after one has determined that the income derived by the segment under U.S. income tax principles forestalls the use of the branch rule. The U.S. concept of income derivation allocates all income realized from a sale of personal property to the segment making the sale to a purchaser outside the controlled foreign corporation. The U.S. concept fails to allocate any of that income to segments that have performed intra-entity services in connection with the sale. The segments performing intra-entity services may include the purchasing segment and segments acting as intra-entity purchasing or selling agents. Yet, it is the splitting of income among segments possible under a territorial tax system that enables the controlled foreign corporation to engage in the abuses targeted by the branch rule. The branch rule must follow the splitting of income among segments in order to reach its target.⁶⁷ Hence, measuring the income derived by a segment should be done only on the assumption that the branch is a separately-incorporated corporation. This measurement can be accomplished by applying the assumption of Treasury Regulations section 1.954-3(b)(2)(i)(a) prior to determining the income derived by a segment.⁶⁸

66. See Part III.B of this Article for the exclusion from foreign base company sales income based on the location of the use of the property sold by a controlled foreign corporation. The exclusion for income derived by the Argentine branch on its local sales should not extend to exclude the income of Base Company, S.A. allocable to the purchasing activities of its Bermuda branch if Argentina does not tax that income. See Recommendation Eleven in Part III.B of this Article.

67. The regulations partly recognize this fact since they provide for a branch's purchasing activity to be deemed to be conducted on behalf of a home office and, thus, allow for the income derived by the branch from such activity to be recharacterized as additional foreign base company sales income of the controlled foreign corporation. See Treas. Reg. § 1.954-3(b)(2)(ii)(b) (1997). Transaction categories one, three, four, and five of Part II.C.4 of this Article describe the treatment of a branch's purchasing income. The stipulation by the regulations, however, occurs only after the branch rule determines that the purchasing branch is to be treated as a separate corporation. If the branch rule does not treat the purchasing branch as a separate corporation, the question of the branch's income from purchasing activities is never reached. Oddly enough, if the branch rule treats the purchasing branch as a separate corporation by virtue of some other type of income that U.S. tax principles recognize as being derived by the branch (i.e., sales income), then both the branch's purchasing income and its sales income can be recharacterized as additional foreign base company sales income of the controlled foreign corporation.

68. An alternate solution would be to use the principles of income derivation adopted by the pertinent foreign jurisdiction instead of the U.S. principles of income derivation. This approach has the virtue of closely following the income-splitting possible under the income tax law of the controlled foreign corporation's country of incorporation. However, this approach has the drawback of requiring IRS personnel to master foreign income tax law. If this approach is adopted, the first sentence of Treasury Regulations section 1.954-3(b)(1)(i)(b) should read as follows: "The determination as to whether such use of the branch or similar establishment has the same tax effect as if it were a wholly owned subsidiary corporation of the controlled foreign corporation shall be made by allocating to such branch or similar establishment only that income derived by the *controlled foreign corporation that is allocable to the activities of the branch or other establishment under the income tax law of the controlled foreign corporation's country of incorporation and that*, when the special rules of subparagraph (2)(i) of this paragraph

Treasury Regulation section 1.954-3(b)(2)(i)(a) stipulates, in effect, that the branch is to be viewed as a separate taxpayer. Such a stipulation should be in force even as the income derived by the segment under U.S. income tax principles is being determined. The following amendment is needed:

RECOMMENDATION SIX: Amend Treasury Regulations sections 1.954-3(b)(1)(i)(b) and (ii)(b) to provide that the determination of whether a segment will be treated as a separate corporation is to be made by allocating to the segment only that income derived by the controlled foreign corporation that is: (i) derived by the segment after applying the rule of Treasury Regulations section 1.954-3(b)(2)(i)(a); and (ii) described in Treasury Regulations section 1.954-3(a) (but determined without applying subparagraphs (2), (3), and (4) of that paragraph) after the special rules of Treasury Regulations section 1.954-3(b)(2)(i) are applied.

The specific income to be isolated for each pertinent segment is determined by an adjusted definition of foreign base company sales income. For this purpose, the definition of foreign base company sales income is adjusted by suppressing three exclusions otherwise available. The exclusions are those for income derived from transactions in goods manufactured by the controlled foreign corporation, in goods that originated in the corporation's country of incorporation, and in goods that ultimately are used in the corporation's country of incorporation.⁶⁹ The exclusion of income derived from the sale or purchase of agricultural commodities not grown in commercial quantities in the United States applies for the purpose of this determination.⁷⁰

The branch rule employs a number of assumptions in isolating the adjusted foreign base company sales income of the pertinent segment of the controlled foreign corporation. If a foreign branch is the pertinent segment, then the branch is assumed to be a separately incorporated subsidiary of the controlled foreign corporation and the jurisdiction in which the branch operates is deemed to be its place of incorporation.⁷¹ In addition, the branch's sales or purchasing activities are deemed to be conducted on behalf of another segment of the controlled foreign corporation if the personal property involved was manufactured, bought, or sold by the other segment.⁷² If, on the other hand, the controlled foreign corporation's office in its country of incorporation is the pertinent segment, then the sales or purchasing activities conducted in the jurisdiction of incorporation with respect to personal property that was manufactured by a branch are

are applied, is described in paragraph (a) of this section (but determined without applying subparagraphs (2), (3), and (4) of such paragraph)." The new language is italicized. The first sentence of Treasury Regulations section 1.954-3(b)(1)(i)(b) would read as above, except that the last two references to a branch or similar establishment would be references to the remainder of the corporation.

69. See Treas. Reg. §§ 1.954-3(b)(1)(i)(b), (ii)(b) (1997). See Parts III.A and III.B of this Article for discussions of these exclusions.

70. This exclusion is discussed in Part III.C of this Article.

71. See Treas. Reg. § 1.954-3(b)(2)(i)(a) (1997).

72. See Treas. Reg. §§ 1.954-3(b)(1)(i)(c), (2)(i)(b), (4) Exs. 6, 7 (1997).

deemed to be conducted on behalf of the branch.⁷³ Oddly enough, sales or purchasing activities conducted in the home jurisdiction with respect to personal property that was bought or sold by a branch are not deemed to be conducted on behalf of the branch.⁷⁴ This oversight fails to curb abuses of tax havens by distributors. Part I.C.5 of this Article discusses those abuses.

RECOMMENDATION SEVEN: Amend Treasury Regulations section 1.954-3(b)(2)(i)(c) to deem sales or purchasing activities conducted by the remainder of the controlled foreign corporation with respect to personal property bought, sold, or bought and sold by a branch to be performed on behalf of the branch.

The adjusted foreign base company sales income determined through the application of these assumptions is used only to determine whether a branch is to be treated as a separate corporation. The figure does not represent the additional foreign base company sales income realized by the controlled foreign corporation if the branch is, in fact, treated as a separate corporation.⁷⁵ The calculation of the additional foreign base company sales income repeats some of the steps taken to determine whether the branch will be treated as a separate corporation. The calculations are not, however, identical. First, the initial sum of income taken into account when calculating the additional income realized by the controlled foreign corporation is potentially larger than the income taken into account when determining whether the branch is to be treated as a separate corporation. When the issue is separation, arguably only the income derived by the branch under U.S. income tax principles is included.⁷⁶ When the issue is the additional base company income realized, however, the relevant income is the potentially greater sum of income derived by the branch under U.S. tax principles when the branch is treated as a separate taxpayer.⁷⁷ Second, the sum isolated for the purpose of determining whether the branch is to be treated as a separate corporation neither takes into account several of the exclusions based on the types of property in which the transactions dealt⁷⁸ nor the specialized exclusions discussed in Part III.A of this Article. Third, the handling of deductions differs. The sum used to determine whether the branch will be treated as a separate corporation takes deductions into account, while the calculation of additional income does not. In the latter case, deductions attributable to the additional income will not be taken into account until the U.S. shareholders of the controlled foreign corporation calculate the corporation's aggregate foreign base company income.⁷⁹

73. See Treas. Reg. § 1.954-3(b)(2)(i)(c) (1997).

74. See *id.*

75. The calculation of the additional income realized by the controlled foreign corporation is discussed in Part IV.A of this Article.

76. See *supra* notes 62-68 and accompanying text.

77. See Treas. Reg. § 1.954-3(b)(2)(ii)(a) (1997).

78. See *supra* note 69 and accompanying text.

79. See I.R.C. § 952(b)(5) (1997).

If the pertinent segment has no adjusted foreign base company sales income, the branch rule's analysis comes to an end, and the branch is not treated as a separate corporation. Hence, a controlled foreign corporation can maintain a manufacturing branch in a higher-tax jurisdiction without running afoul of the branch rule if the home office conducts no purchasing or sales activities with regard to the property manufactured by the branch.⁸⁰

(b) Comparing the Effective Tax Rates

Once the branch rule has isolated the relevant income, the rule compares the effective tax rates on that income in pairs of jurisdictions.⁸¹ The pairings permit the comparison of the effective tax rate on the adjusted foreign base company income in the suspected tax haven with the effective tax rate in each of the other jurisdictions in which the controlled foreign corporation operates. Hence, one member of each pair is the jurisdiction in which the controlled foreign corporation conducts the sales or purchasing activities under scrutiny. The second member of the pair is determined by the other jurisdictions in which the controlled foreign corporation operates. In the event that the controlled foreign corporation has only one foreign branch, the branch rule will test only a single pairing of jurisdictions: the corporation's country of incorporation and the jurisdiction in which the branch conducts its operations. The pairing serves the purposes of the branch rule regardless of whether the branch's jurisdiction or the corporation's home jurisdiction is the suspected tax haven. At the other extreme, a controlled foreign corporation that conducts sales or purchasing activities in numerous jurisdictions presents the branch rule with the necessity of testing numerous series of pairings, one series for each jurisdiction in which the controlled foreign corporation conducts sales or purchasing activities.

In order for a branch to be treated as a separate corporation, the effective tax rate on the isolated income in the jurisdiction in which the controlled foreign corporation conducts its sales or purchasing activities must be sufficiently less than what the effective tax rate would be on such income in a paired jurisdiction. The sufficiency of the difference is measured by two different criteria. First, the effective tax rate in the sales or purchasing jurisdiction must be less than ninety percent of the paired jurisdiction.⁸² Second, the effective tax rate of the sales or purchasing jurisdiction must also be at least five percentage points less than the effective tax rate of the paired jurisdiction.⁸³ Both criteria must be satisfied in order for a branch to be treated as a separate corporation. If the difference satisfies both criteria, the branch rule deems the segments of the controlled foreign corporation operating in the paired jurisdictions to be separate cor-

80. This is the scenario of Technical Advice Memorandum 85-09-004 (Nov. 23, 1984).

81. See Treas. Reg. §§ 1.954-3(b)(1)(c),(2)(c), (4) Exs. 6, 7 (1997).

82. See Treas. Reg. §§ 1.954-3(b)(1)(i)(b),(ii)(b) (1997).

83. See *id.*

porations relative to one another.⁸⁴ If both segments are foreign branches of the controlled foreign corporation, the two segments will also be deemed corporations separate from the controlled foreign corporation.⁸⁵ In each case, separateness is a relative concept: a foreign branch attains the status of a separate corporation only relative to other specific jurisdictions. In the simple case of a controlled foreign corporation with a single foreign branch, the separate status of the branch looks absolute since there is just one pairing of jurisdictions to test.

The effective tax rate in a paired jurisdiction is measured under hypothetical conditions. The conditions generally assure that the effective rate of tax is that applicable to domestic-source business income derived by a domestic taxpayer and reflects the appropriate tax bracket. Specifically, the corporation's combined income from operations in the two jurisdictions being compared is used for the measurement.⁸⁶ In addition, the combined income is assumed to be derived by a corporation incorporated, managed, and controlled within the paired jurisdiction, to be derived from sources within that jurisdiction, to be derived from conducting business through a permanent establishment in that jurisdiction, to be allocable to the permanent establishment, and to be received in that jurisdiction.⁸⁷ In determining the effective rate of tax in the paired jurisdiction, the isolated income is reduced by specified deductions.⁸⁸ Only income taxes are taken into account in computing the effective tax rates.⁸⁹

84. See Treas. Reg. §§ 1.954-3(b)(1)(ii)(a), (4) Ex. 6 (1997).

85. See *id.*

86. See Treas. Reg. §§ 1.954-3(b)(1)(c), (2)(c), (4) Exs. 5, 6, 7 (1997). The references elsewhere in the regulations to the controlled foreign corporation's "entire income" as the relevant quantity to be used in the comparison of effective tax rates are made in the context of the simple case in which the controlled foreign corporation has only one foreign branch. See Treas. Reg. §§ 1.954-3(b)(1)(i)(b), (ii)(b). If the controlled foreign corporation has more than one branch being scrutinized under the branch rule, the corporation's income for purposes of calculating the hypothetical effective tax rate consists only of the combined income derived in the two jurisdictions being compared in a particular pairing. The income derived from the other jurisdictions in which the controlled foreign corporation operates is not included in the comparison. See Treas. Reg. §§ 1.954-3(b)(1)(c), (2)(c), (4) Exs. 5, 6, 7 (1997). Hence, the income derived in other jurisdictions does not lift the income from the specific jurisdiction being analyzed into a higher tax bracket in the paired jurisdiction. As the income of each suspect jurisdiction is subjected to the hypothetical conditions, the hypothetical tax bracket is determined only by the sum of the paired jurisdictions' income. Note that Example Five of the regulations assumes that the home jurisdiction (country X) has a single tax bracket for its corporate income tax. As the example analyzes each of branches B and C under the branch rule, the hypothetical effective tax rate in country X should be determined on \$300,000 of income (the sum of the corporation's income from its home office and the branch in question each time). The example does not expressly include this step and simply relies on the effective tax rate on the \$200,000 of income derived by the home office for its comparison of tax rates. Note, too, that one does not use the sum of \$400,000 to determine the hypothetical effective tax rate (or the total income of the corporation if both branches are taken into account simultaneously). See Treas. Reg. § 1.954-3(b)(1)(i)(c) (1997). Examples Six and Seven make similar assumptions.

87. See Treas. Reg. §§ 1.954-3(b)(1)(i)(b), (c) (1997).

88. See Treas. Reg. § 1.954-3(b)(2)(i)(d) (1997).

89. See Treas. Reg. § 1.954-3(b)(2)(i)(e) (1997).

Even though a comparison of effective tax rates would otherwise lead the branch rule to treat a branch as a separate corporation, there is an exception. A sales or purchasing branch will continue to be treated as an integral part of the controlled foreign corporation if two conditions are satisfied. First, the corporation's operations in the paired jurisdiction (the home office in the simple case) must operate under a lower effective tax rate than the branch.⁹⁰ Second, the operations of the branch must consist of sales or purchasing activities, rather than manufacturing.⁹¹ If the operations of the branch include manufacturing as well as sales or purchasing activity, the branch will be treated by the branch rule as a separate corporation with respect to the manufacturing but not with regard to the sales or purchasing activity. The exception is unwarranted. Consider the following example:

EXAMPLE FOURTEEN: Arrangement by Distributor. Parent Corporation, a Delaware corporation, incorporates Base Company, Ltd., in Bermuda. Bermuda has no income tax. Base Company establishes a branch in Buenos Aires, Argentina to sell cellular phones in the local market. The home office purchases the phones from an unrelated manufacturer in Finland and resells them to the Argentine branch. Assume that Argentina has a territorial income tax system and recognizes the intra-entity sale of phones between the home office and the branch so that Argentina does not tax the income attributable to the home office's purchasing activities. The branch rule does not treat the branch as a corporation separate from the Base Company and does not reach the income shifted to Bermuda by the tax haven arrangement.

The exception is created by the interplay of two subsets of rules within the branch rule.⁹² Removing the exception requires that the relationship of those two sets of rules be addressed. The regulations composing the branch rule distinguish between purchasing or sales branches on the one hand, and manufacturing branches on the other, and then provide substantially the same set of rules for each type of branch regarding the isolation of income and tax rate differentials.⁹³ Between them, however, the two sets of rules fail to cover the arrangements that fall within the stated exception.⁹⁴ The rules for purchasing or sales branches recognize that branches can be organized in tax havens and that such branches can deal in property that is either manufactured or bought or sold by the home office in a higher-tax jurisdiction.⁹⁵ The rules for manufacturing branches recognize that the place of incorporation can be reversed, with the home office being organized in the tax haven and conducting purchasing or selling activities in a tax haven with regard to property manufactured by the branch in a higher-tax jurisdiction.⁹⁶ The two sets of rules fail to cover, however, the arrangement by which the controlled foreign corporation is incorporated in a tax

90. See Treas. Reg. § 1.954-3(b)(1)(i)(b) (1997).

91. See Treas. Reg. § 1.954-3(b)(1)(ii)(a) (1997).

92. See Treas. Reg. §§ 1.954-3(b)(1)(i), (ii) (1997).

93. See Treas. Reg. §§ 1.954-3(b)(1)(i)(6), (ii)(6) (1997).

94. See Treas. Reg. §§ 1.954-3(b)(1)(i), (ii) (1997).

95. See Treas. Reg. § 1.954-3(b)(1)(i) (1997).

96. See Treas. Reg. § 1.954-3(b)(1)(ii) (1997).

haven and the home office conducts sales or purchasing activities with regard to property purchased or sold by a branch in the higher-tax jurisdiction.⁹⁷ With regard to Example Fourteen, the rules governing the treatment of manufacturing branches as separate corporations do not apply to the arrangement, since the Argentine branch conducts no manufacturing operations.⁹⁸ Nor do the rules governing the treatment of sales or purchasing branches apply to the arrangement, because those rules require the branch to be located in a jurisdiction with an effective tax rate lower than the tax rate in the home office's jurisdiction.⁹⁹

The distinction between the two types of branches should be removed, and the two sets of rules should be combined into a single set of more general rules. The more general rules should simply focus on the identification of segments of the controlled foreign corporation, without regard to whether they might be branches or home offices and especially without regard to the nature of the segment in the jurisdiction with the higher effective tax rate. A second improvement can be made as the rules are unified. Treasury Regulations section 1.954-3(b)(2)(i) states additional rules that apply to the determination of whether to treat a branch as a separate corporation. The additional rules already are phrased to apply to both types of branches. Those additional rules should now join the unified rules to make a comprehensive set of regulations. The remaining rules of subparagraph 1.954-3(b)(2) address the separate determination of the additional foreign base company sales income that arises if a branch is indeed treated as a separate corporation. The purpose of those remaining rules will be clarified by their new-found isolation. Altering the law in the following manner can address these problems:

RECOMMENDATION EIGHT: Merge Treasury Regulations sections 1.954-3(b)(1)(i) and (ii) and 1.954-3(b)(2)(i) into a single section 1.954-3(b)(1) entitled 'The Determination to Treat a Branch as a Separate Corporation.' In that unified section, state the rules given in this Part of this Article and do not create an exception from the branch rule for a sales or purchasing branch in a jurisdiction with a higher tax rate than that in its home office's jurisdiction. Renumber Treasury Regulations section 1.954-3(b)(2)(ii) as section 1.954-3(b)(2) and entitle the subparagraph 'The Determination of Additional Foreign Base Company Sales Income.'

4. The Additional Transactions

If the branch rule concludes that a branch is to be treated as a separate corporation, the branch rule then recharacterizes some of the transactions of the controlled foreign corporation as being conducted on behalf of related persons. The branch rule accomplishes the recharacterization by applying three conclusive presumptions. These presumptions are identical to the assumptions under which the branch rule isolates a segment's adjusted foreign base company sales income for purposes of determining

97. See Treas. Reg. §§ 1.954-3(b)(1)(i), (ii) (1997).

98. See Treas. Reg. § 1.954-3(b)(1)(ii) (1997).

99. See Treas. Reg. § 1.954-3(b)(1)(i)(b) (1997).

whether a branch is to be treated as a separate corporation. First, a separated branch is deemed to be a wholly-owned subsidiary of the controlled foreign corporation.¹⁰⁰ The branch is, thus, a controlled foreign corporation in its own right. The branch takes as its place of incorporation the jurisdiction in which it operates.¹⁰¹ Second, some of the sales or purchasing activities conducted by the branch are deemed to be conducted on behalf of a related person. If such activities are performed with respect to personal property that either was manufactured or is bought or sold by another segment of the corporation with respect to which the branch has been determined to be a separate entity, the transactions are deemed conducted by the branch on behalf of a related person.¹⁰² Hence, sales by one foreign branch of personal property manufactured by another foreign branch are deemed conducted on behalf of a related person if the two branches are determined to be separate corporations relative to one another by the branch rule. Third, some of the sales or purchasing activities conducted by the corporation in its country of incorporation will be deemed conducted on behalf of a related person. If those activities are performed with respect to property that was manufactured by the separated branch, the transactions are deemed conducted on behalf of a related person.¹⁰³ These additional transactions on behalf of related persons produce additional foreign base company sales income for the controlled foreign corporation, subject to the exclusions and qualifications stated in Parts II and III of this Article.¹⁰⁴

Through these conclusive presumptions, the branch rule recharacterizes ten categories of transactions as being conducted on behalf of a related person. The problem addressed by Recommendation Six is not of concern here. Since the branch rule at this point has concluded that the branch is to be treated as a corporation separate from the controlled foreign corporation, the branch is now a separate taxpayer. Therefore, it can derive income under U.S. income tax principles from purchasing activities or when acting as a purchasing or sales agent. The ten transactions are as follows:

A TAX-HAVEN BRANCH CONDUCTING SALES OR PURCHASING ACTIVITIES

FACTS COMMON TO CATEGORIES ONE THROUGH EIGHT: The controlled foreign corporation is incorporated in a high-tax jurisdiction. The corporation establishes a sales or purchasing branch in a low-tax jurisdiction; the effective tax rate in that jurisdiction is such that the branch rule deems the branch to be a

100. See Treas. Reg. § 1.954-3(b)(2)(ii)(a) (1997).

101. See *id.*

102. See Treas. Reg. § 1.954-3(b)(2)(ii)(b) (1997). Although Treasury Regulations section 1.954-3(b)(2)(ii) contains no express rule dealing with multiple branches similar to that contained in sections 1.954-3(b)(1)(i)(c) and (ii)(c), examples six and seven of section 1.954-3(b)(4) demonstrate that differences in effective tax rates between branches can give rise to recharacterized transactions.

103. See Treas. Reg. § 1.954-3(b)(2)(ii)(c) (1997).

104. The additional foreign base company sales income derived by the controlled foreign corporation as a result of the application of the branch rule is discussed in Part IV.A of this Article.

separate corporation. (In the transactions below, the controlled foreign corporation's establishment in its jurisdiction of incorporation is referred to as the "home office," regardless of whether the establishment is the corporation's place of management and control.)

CATEGORY ONE: The branch engages in purchasing activities with respect to personal property that is consumed by the home office in manufacturing. The manufactured product is then sold either by the home office or by another branch of the corporation. Under the branch rule, the branch's purchasing activities are deemed to be conducted on behalf of the home office.¹⁰⁵ The income derived by the branch from its purchasing activities is in effect fee income realized in its role as a deemed purchasing agent for the home office.

CATEGORY TWO: The branch engages in selling activities with respect to personal property manufactured by the home office. Under the branch rule, the branch's selling activities are deemed to be conducted on behalf of the home office.¹⁰⁶ Although the branch is thus deemed to be a sales agent for the home office, in functional terms the branch derives either fee income as a deemed sales agent for the home office (if the home office sells the personal property) or sales income as a constructive distributor for the home office (if the branch sells the personal property).

CATEGORY THREE: The branch engages in purchasing activities with respect to personal property that is sold by the home office. Under the branch rule, the branch's purchasing activities are deemed to be conducted on behalf of the home office.¹⁰⁷ Although the branch is thus deemed to be a purchasing agent for the home office, in functional terms the branch derives either sales income as a constructive supplier of the home office (if the branch purchased the personal property) or fee income as a deemed purchasing agent (if the personal property was purchased by another branch).

CATEGORY FOUR: The branch engages in purchasing activities with respect to personal property that is purchased by the home office. The personal property is then either sold by any segment of the controlled foreign corporation other than the home office or consumed by any segment of the controlled foreign corporation. Under the branch rule, the branch's purchasing activities are deemed to be conducted on behalf of the home office.¹⁰⁸ The branch's income from the purchasing activities is fee income derived as a deemed purchasing agent of the home office.

CATEGORY FIVE: The branch engages in purchasing activities with respect to personal property that is purchased and sold by the home office. Under the branch rule, the branch's purchasing activities are deemed to be conducted on behalf of the home office.¹⁰⁹ The branch derives fee income as a deemed purchasing agent of the home office.

105. See Treas. Reg. § 1.954-3(b)(2)(ii)(b) (1997). The income derived by the branch from such activities is not excluded from foreign base company sales income by the exclusion for manufacturing. The components the branch purchases on behalf of the home office have not been manufactured by any segment of the controlled foreign corporation. The exclusion for manufactured goods is discussed in Part III.A of this Article.

106. *Id.* If the personal property is sold by another branch, the first branch may realize fee income as a deemed sales agent of the other branch. Such possible recharacterization of the first branch's selling activity, however, would fall within the analysis of the two branches as separate corporations as to one another, rather than within the analysis of the first branch and the home office as separate corporations as to one another.

107. See *id.*

108. See *id.*

109. See *id.*

CATEGORY SIX: *The branch engages in selling activities with respect to personal property sold by the home office that either was purchased by any segment of the corporation other than the home office or was manufactured by any segment of the corporation other than the branch or the home office. Under the branch rule, the branch's selling activities are deemed to be conducted on behalf of the home office.*¹¹⁰ *The branch derives fee income as a deemed sales agent of the home office.*

CATEGORY SEVEN: *The branch engages in selling activities with respect to personal property purchased (but not sold) by the home office. Under the branch rule, the branch's selling activities are deemed to be conducted on behalf of the home office.*¹¹¹ *Although the branch is deemed to be a sales agent for the home office, in functional terms the branch derives either sales income as a constructive distributor for the home office (if the branch sells the property) or fee income as a deemed sales agent (if another branch sells the property).*

CATEGORY EIGHT: *The branch engages in selling activities with respect to personal property purchased and sold by the home office. Under the branch rule, the branch's selling activities are deemed to be conducted on behalf of the home office.*¹¹² *The branch derives fee income as a deemed sales agent of the home office.*

A TAX-HAVEN HOME OFFICE CONDUCTING SALES OR PURCHASING ACTIVITIES

FACTS COMMON TO CATEGORIES NINE AND TEN: *The controlled foreign corporation is incorporated in a low-tax jurisdiction. The controlled foreign corporation establishes a manufacturing branch in a high-tax foreign jurisdiction the effective tax rate of which is such that the branch rule deems the branch to be a separate corporation. (In the transactions below, the controlled foreign corporation's establishment in its jurisdiction of incorporation is referred to as the "home office," regardless of whether the establishment is the corporation's place of management and control.)*

CATEGORY NINE: *The home office engages in purchasing activities with respect to personal property manufactured by the branch. Under the branch rule, the home office's purchasing activities are deemed to be conducted on behalf of the branch.*¹¹³ *Although the home office is deemed to be a purchasing agent of the branch, the home office in functional terms derives either fee income as a deemed purchasing agent of the branch (if a branch purchases the raw materials) or sales income as a constructive supplier to the branch (if the home office purchases the raw materials).*

CATEGORY TEN: *The home office engages in selling activities with respect to personal property manufactured by the branch. Under the branch rule, the home office's selling activities are deemed to be conducted on behalf of the branch.*¹¹⁴ *Although the home office is deemed to be a sales agent of the branch, the home office in functional terms derives either fee income as a deemed sales agent of the branch (if a branch sells the manufactured personal property) or sales income as a constructive distributor for the branch (if the home office sells the manufactured personal property).*

The branch rule may deem a single transaction of a branch to be conducted on behalf of two other segments of the corporation simultaneously. For

110. See *id.*

111. See *id.*

112. See *id.*

113. See Treas. Reg. § 1.954-3(b)(2)(ii)(c) (1997).

114. See *id.*

example, the branch may conduct purchasing activity that is deemed to be performed on behalf of both another branch that purchases property and the home office that sells the same property. This assumes that the branch rule treats the two branches as separate corporations relative to each other. Either characterization is sufficient to make the income realized by the branch eligible for inclusion in the controlled foreign corporation's foreign base company sales income.

5. *The Missing Transactions*

Even when the branch rule determines that a branch is to be treated as a separate corporation, there are a number of tax haven transactions that the branch rule fails to recharacterize as being conducted on behalf of related persons. Sales or purchasing activities conducted by a home office with respect to personal property that was bought or sold by a separated branch are not deemed to be conducted on behalf of the branch.¹¹⁵ This is unjustified. There is no reason to distinguish between a separated branch and the home office as a distributor, purchasing agent, or selling agent. Nor should a distinction be made between the home office and a foreign branch when recharacterizing their transactions in personal property purchased or sold by a second foreign branch. The authority for recharacterizing the home office's purchasing or sales activities with respect to personal property manufactured by a branch can also serve as the authority allowing the recharacterization of the home office's purchasing or sales activities with respect to personal property purchased or sold by a branch.¹¹⁶ The following six categories of transactions should be recharacterized as being conducted on behalf of a related person:

FACTS COMMON TO THE SIX CATEGORIES: The controlled foreign corporation is incorporated in a low-tax jurisdiction. The controlled foreign corporation establishes a sales or purchasing branch in a high-tax foreign jurisdiction with a territorial income tax system the effective tax rate of which is such that the branch rule, amended per Recommendations Six, Seven, and Eight, deems the branch to be a separate corporation. The controlled foreign corporation's establishment in its jurisdiction of incorporation is referred to as the home office in the transactions below.

PURCHASING ACTIVITY LOCALIZED IN THE TAX HAVEN

CATEGORY ELEVEN: The home office engages in purchasing activity with respect to personal property that is purchased (but not sold) by the branch. The property is then sold by a segment of the controlled foreign corporation other than the branch or the home office or is consumed either by the branch or by another segment of the controlled foreign corporation. The home office derives fee income as purchasing agent for the branch. The home office's purchasing activity should be deemed to be conducted on behalf of the branch.

CATEGORY TWELVE: The home office engages in purchasing activity with respect to personal property that is sold (but not purchased) by the branch. The home office derives sales income as a constructive supplier to the branch (if the home office purchases the property) or fee income as purchasing agent for another branch (if another branch purchased the property). The home office's

115. See *id.*

116. See I.R.C. § 954(d)(2) (1997).

purchasing activity should be deemed to be conducted on behalf of a related person. If the home office acts as purchasing agent for another branch, its purchasing activities are conducted on behalf of two related persons simultaneously.

CATEGORY THIRTEEN: The home office engages in purchasing activity with respect to personal property that is both purchased and sold by the branch. The home office derives fee income as purchasing agent for the branch. The home office's purchasing activity should be deemed to be conducted on behalf of a related person.

SELLING ACTIVITY LOCALIZED IN THE TAX HAVEN

CATEGORY FOURTEEN: The home office engages in selling activity with respect to personal property that is purchased (but not sold) by the branch. The home office derives sales income as a distributor for the branch (if the home office sells the property) or fee income as a selling agent for another branch (if another branch sells the property). The home office's selling activity should be deemed to be conducted on behalf of a related person. If the home office is a selling agent for another branch, its selling activities are conducted on behalf of two related persons simultaneously.

CATEGORY FIFTEEN: The home office engages in selling activity with respect to personal property that is sold (but not purchased) by the branch. The property was purchased or manufactured by another segment of the controlled foreign corporation. The home office derives fee income as selling agent for the branch. The home office's selling activity should be deemed to be conducted on behalf of a related person.

CATEGORY SIXTEEN: The home office engages in selling activity with respect to personal property that is both purchased and sold by the branch. The home office derives fee income as selling agent for the branch. The home office's selling activity should be deemed to be conducted on behalf of a related person.

These six categories of activity by the home office should be recharacterized by the branch rule as transactions with related persons so that income from these transactions will be considered foreign base company sales income. Hence, the following recommendation can be made:

RECOMMENDATION NINE: Amend Treasury Regulations section 1.954-3(b)(2)(ii)(c) to deem sales or purchasing activities conducted by the remainder of the controlled foreign corporation with respect to personal property bought or sold by a branch to be performed on behalf of the branch.¹¹⁷

D. Transactions in Certain Timber Products

The income from transactions in certain timber products is deemed to be foreign base company sales income, regardless of whether the specific transaction falls within one of the four types of tainted transactions with related persons. Foreign base company sales income includes the income derived from the sale anywhere in the world of unprocessed softwood tim-

¹¹⁷ Recommendation Nine should not be confused with Recommendation Seven. Recommendation Seven addresses the issue of when a branch should be treated as a separate corporation. Recommendation Nine treats the separate issue of the proper characterization of the branch's transactions in the event that the branch is treated as a separate corporation.

ber cut from an area of the United States.¹¹⁸ Such foreign base company sales income has its source in the United States for U.S. tax purposes.¹¹⁹ Hence, the controlled foreign corporation itself may be subject to U.S. income tax on the income, wholly apart from the U.S. income tax liability of its U.S. shareholders due to the income's characterization as foreign base company sales income. Foreign base sales company income also includes the income derived from the milling of such timber outside the United States.¹²⁰ This is true irrespective of the exclusion for property manufactured by a controlled foreign corporation. The exclusion makes no distinction between softwood grown on privately-owned land and softwood grown on public lands. The inclusion reinforces the recharacterization of the income as U.S.-source under section 865(b).¹²¹

II. The Kinds of Property

In order for a transaction in personal property to give rise to foreign base company sales income, generally both the origin and the ultimate use of the property must be outside the controlled foreign corporation's country of incorporation.¹²² Moreover, the property must not have been manufactured by the controlled foreign corporation, regardless of the place of manufacture.¹²³ These general rules indirectly create several exclusions, which are discussed below. In addition, there is an explicit exclusion for transactions in certain agricultural commodities.¹²⁴ That exclusion is discussed below, as well.

Other possible exclusions should be mentioned in passing. First, there is no general exclusion for transactions in non-inventory property. In order for a transaction in personal property to give rise to foreign base company sales income, the property need not be purchased or sold by the controlled foreign corporation in the ordinary course of business.¹²⁵ Property sold after substantial use by the controlled foreign corporation, however, is excluded from this category.¹²⁶ The non-inventory property of the

118. See I.R.C. §§ 865(b), 954(d)(4) (1997). Unprocessed timber is defined as any log, cant, or similar form of timber. See I.R.C. § 865(b) (1997). The rules of Subpart G, dealing with export trade corporations, do not apply to such Subpart F income. See I.R.C. § 954(d)(4) (1997).

119. See I.R.C. § 865(b) (1997).

120. See I.R.C. §§ 865(b), 954(d)(4) (1997).

121. Section 954(d)(4) was added to the Code by the Omnibus Budget Reconciliation Act of 1993, P.L. No. 103-66, § 13239(d), 107 Stat. 312, 509 [1993], reprinted in 1993-3 C.B. 1, 97. The committee reports on the Act are silent as to the reason for adding section 954(d)(4) to the Code. The Conference Committee Report states that the provision was an amendment added by the Senate to the House bill and that the conference agreement followed the Senate amendment to the bill. H.R. Rep. No. 213, 103d Cong., 1st Sess. at 658 (1993), reprinted in 1993-3 C.B. 393, 536.

122. See I.R.C. § 954(d)(1) (1997). The branch rule provides the exceptions to this general rule. For discussions of the exceptions, see Parts II.A.1(c) and B.3 of this Article.

123. See Treas. Reg. § 1.954-3(a)(4)(i) (1997).

124. See I.R.C. § 954(d)(1) (1997).

125. See Treas. Reg. § 1.954-3(a)(1)(i) (1997).

126. See *id.*

controlled foreign corporation in the event that substantially all of the controlled foreign corporation's property is sold as part of the liquidation of a trade or business of the controlled foreign corporation is also excluded.¹²⁷ Second, transactions in intangible personal property do not give rise to foreign base company sales income. The Code refers only to personal property that is manufactured, produced, grown, or extracted, a category that does not include intangible property.¹²⁸ Third, income is excluded from foreign base company sales income if it also constitutes foreign personal holding company income.¹²⁹ Hence, transactions in commodities do not give rise to foreign base company sales income if the income from those transactions qualifies as foreign personal holding company income.¹³⁰

A. Exclusions Based on the Origin of Property

In order for a transaction in personal property to give rise to foreign base company sales income, the property must have been manufactured, produced, constructed, grown, or extracted outside the controlled foreign corporation's country of incorporation.¹³¹ In addition, the property must not have been manufactured, produced, or constructed by the controlled foreign corporation from materials purchased by the corporation.¹³²

1. *Property Originating Within the Controlled Foreign Corporation's Country of Incorporation*

Income derived by a controlled foreign corporation from transactions in personal property originating within the corporation's country of incorporation generally is excluded from the corporation's foreign base company

127. *See id.*

128. *See* I.R.C. § 954(d)(1)(A) (1997). Transactions by a controlled foreign corporation in intangible personal property can give rise to foreign personal holding company income, another type of base company income. *See* I.R.C. §§ 954(a)(1), (c)(1)(B) (1997) (classifying as foreign personal holding company income the net gain from transactions in property that gives rise to dividends or interest, among other items of income).

129. *See* Treas. Reg. § 1.954-1(e)(4)(i)(D) (1997).

130. *See id.* Foreign personal holding company income includes, among other items, a controlled foreign corporation's excess of gains over losses from transactions in commodities. *See* I.R.C. § 954(c)(1)(C) (1997).

131. *See* I.R.C. § 954(d)(1)(A) (1997); Treas. Reg. §§ 1.954-3(a)(2), (4) (1997).

132. *See* Treas. Reg. § 1.954-3(a)(4)(i) (1997). Property that the controlled foreign corporation has grown or extracted outside its country of incorporation is also excluded, even though such property does not come within the terms of the manufacturing exclusion, as long as the corporation has not previously sold such property to a third party. Transactions in property that was grown or extracted by the controlled foreign corporation and that has not previously been alienated by the corporation do not fall within the four types of tainted transactions. The only types of tainted transactions available to a controlled foreign corporation when it has not previously purchased the property in question are those of a sales agent and a purchasing agent. *See* I.R.C. § 954(d)(1) (1997). Neither type is relevant to dealing in property that has been grown or extracted by the corporation and that has not previously been alienated by the corporation. *See* Part I.B for a discussion of the types of tainted transactions.

sales income.¹³³ The Code excludes this income regardless of whether the property was produced by the controlled foreign corporation or by another person. Moreover, the income is excluded even though the property originates in the controlled foreign corporation's country of incorporation through the corporation's own manufacturing processes from raw materials imported by the corporation.¹³⁴

(a) The Exclusion Evaluated

The exclusion permits a U.S. multinational to establish a regional manufacturing subsidiary and to export the production of that subsidiary to other markets in the region. Consider the following example:

EXAMPLE FIFTEEN: Regional Manufacturing and Distribution. Parent Corporation, a Delaware corporation, manufactures and distributes automobiles. To serve the markets of Southeast Asia, Parent Corporation establishes Manufacturing Subsidiary, a wholly-owned Thailand corporation. Manufacturing Subsidiary constructs a plant in Thailand to manufacture and assemble automobiles. Part of the output of Manufacturing Subsidiary is intended for the local Thai market. The majority of Manufacturing Subsidiary's output is destined for export to Malaysia, Indonesia, the Philippines, and, as political conditions permit, the other nations of Southeast Asia. No single market in Southeast Asia is large enough to justify building the size of manufacturing plant required to take advantage of the economies of scale now inherent in automobile manufacturing. With the fall in customs duties throughout the region, automobile manufacturers generally, including those based in Europe and Japan, are choosing a single jurisdiction in the region for their manufacturing operations and establishing sales subsidiaries in the other countries to absorb the production beyond that needed for the local market. The nations of Southeast Asia are competing among themselves for the new manufacturing plants. Thailand won Parent Corporation's new facility in competition with the Philippines.

In this example, the exclusion permits Manufacturing Subsidiary to take advantage of economies of scale and to export part of its production to related sales corporations serving other markets in Southeast Asia without having its income classified as foreign base company sales income. Eliminating the exclusion would mean that Manufacturing Subsidiary could export manufactured products only to unrelated persons.¹³⁵ More generally, the exclusion permits a controlled foreign corporation to conduct business under the same income tax burden as its local competitors, which may be subsidiaries of the U.S. parent corporation's global competitors, insofar as its business consists of selling locally produced products to the local or worldwide markets. In this sense, the exclusion bases its justification upon capital import neutrality.¹³⁶

133. See I.R.C. § 954(d)(1)(A) (1997). The branch rule provides the exception to this generalization. The effect of the branch rule is discussed in Part II.A.1(c) of this Article.

134. See Treas. Reg. § 1.954-3(a)(2), Ex. 2 (1997).

135. Congress should eliminate the general manufacturing exclusion. See *supra* Part I.B.7. If the manufacturing exclusion remains, it will still permit export sales by Manufacturing Subsidiary to related persons even if Congress repealed the origin exclusion.

136. See GUSTAFSON & PUGH, *supra* note 23, ¶ 1091.

The origin exclusion is, however, overly broad in two ways. First, the exclusion is available to a controlled foreign corporation regardless of whether its income from the transactions is subject to taxation by its country of incorporation. Some countries tax on the basis of residence only those corporations that are managed and controlled from within their territory. The exclusion permits the controlled foreign corporation to be managed from another foreign jurisdiction, to conduct its business operations in its country of incorporation in such a manner as to be free of local income tax on the basis of source, and to exclude from foreign base company sales income its income derived from transactions in property originating in its country of incorporation. When this occurs, the controlled foreign corporation has used the management and control test to obtain a lower tax burden than that of its local competitors and the policy of capital import neutrality is no longer applicable. The exclusion based on the property originating in the controlled foreign corporation's country of incorporation should be available only to controlled foreign corporations that are subject to income taxation on the basis of residence by their countries of incorporation. If the country of incorporation has no income tax, the exclusion would not discriminate against local competitors and should be available to the controlled foreign corporation.

Second, the exclusion is overly broad because it permits a U.S. parent corporation to shelter its foreign procurement income by incorporating purchasing offices in those foreign jurisdictions in which the parent corporation purchases its requirements. Such controlled foreign corporations are engaged neither in production nor in serving their local markets. The exclusion ought to apply only to income arising from the controlled foreign corporation's sale of property produced by the corporation or a related person.¹³⁷ Only two categories of transactions are relevant here because of the separate exclusion available for property sold for use in a controlled foreign corporation's country of incorporation.¹³⁸ The first category consists of sales by the controlled foreign corporation of locally-purchased property to related persons outside the corporation's country of incorporation. The second category consists of local purchases of property by the controlled foreign corporation on behalf of related persons outside the jurisdiction. The policy of capital import neutrality does not apply to either category. The controlled foreign corporation is not conducting business in competition with local businesses. Instead, the controlled foreign corporation is buying from those businesses and sheltering the related person's procurement income. Property produced by a related person is properly excluded since a multinational group should have the flexibility to operate through multiple entities in a single jurisdiction. There are valid

137. The American Law Institute makes a similar recommendation. See AMERICAN LAW INSTITUTE, *supra* note 31, at 283. The Institute would in effect limit the exclusion to property produced by the controlled foreign corporation or a related person. See *id.* The Institute's recommendation does not address the question of whether the controlled foreign corporation's income is taxable by its country of incorporation. See *id.*

138. For an account of this exclusion, see *supra* Part II.B.

nontax reasons for multiple entities in a single jurisdiction. For example, local authorities may require certain activities to be segregated in a separate entity for regulatory purposes.

If the exclusion is limited to the income derived from transactions in property produced locally by the controlled foreign corporation itself or a related person, there seems little reason to also subject the corporation to tax on the basis of residence in the corporation's country of incorporation. Manufacturing operations will likely be sufficient to make the controlled foreign corporation taxable by its country of incorporation in a manner similar to its local competitors. The following recommendation can now be made:¹³⁹

*RECOMMENDATION TEN: Amend Code section 954(d)(1) by narrowing the exclusion to exclude from foreign base company sales income only the income derived by a controlled foreign corporation from the sale of property that has been manufactured, produced, constructed, grown, or extracted within the corporation's country of incorporation by either the corporation or a related person incorporated in that country.*¹⁴⁰

(b) Effect of Partnership Operations

If the partnership anti-abuse rule causes a partnership transaction to be imputed to a controlled foreign corporation, the relevant country for purposes of the exclusion remains the corporation's country of incorporation and not the country under the laws of which the partnership is organized.¹⁴¹

(c) Effect of the Branch Rule

If the branch rule causes a branch of the controlled foreign corporation to be treated as a separate corporation, the exclusion applies separately to the

139. One possible criticism of the recommendation offered here is that it burdens the outsourcing of parts. Consider Example Fifteen. Suppose Manufacturing Subsidiary manufactures its automobiles partly from components produced by unrelated suppliers operating in Thailand. Under Recommendation Ten, if Manufacturing Subsidiary exports those components as spare parts to Parent Corporation's sales subsidiaries in the other markets of Southeast Asia, Manufacturing Subsidiary's income from those exports would be foreign base company sales income. Under Recommendation Ten, however, there is an alternative. The sales subsidiaries in the export markets can purchase their inventory of replacement parts directly from the suppliers in Thailand.

140. If foreign procurement subsidiaries cannot be attacked, Recommendation Ten must address the first concern and would read as follows:

ALTERNATE RECOMMENDATION TEN: Amend Code section 954(d)(1) by narrowing the exclusion to exclude from foreign base company sales income only the income derived, by a controlled foreign corporation subject to income taxation by its country of incorporation on the basis of residence, from the sale of property that has been manufactured, produced, constructed, grown, or extracted within the controlled foreign corporation's country of incorporation.

141. See Rev. Rul. 89-72, 1989-1 C.B. 257, overruled on other grounds by *Brown Group, Inc. v. Commissioner*, 77 F.3d 217 (8th Cir. 1996). The partnership anti-abuse rule in this context appears at Treasury Regulations section 1.701-2(e) and is discussed *supra* in Part I.B.5 of this Article. The consideration in the text also would be relevant if Recommendation One is adopted.

transactions in which the branch is deemed to engage. The exclusion is available for those transactions only if the property originates in the country in which the branch is located.¹⁴² The branch rule cannot, however, decrease the controlled foreign corporation's foreign base company sales income.¹⁴³ Hence, the exclusion is not available for transactions in personal property that originate in the country in which the branch is located if the income derived from those transactions falls within foreign base company sales income before the application of the branch rule. As a result, the exclusion can only exclude a branch's income if, prior to the application of the branch rule, the income was already excluded from the foreign base company sales income of the controlled foreign corporation. These rules are illustrated by the following examples:

EXAMPLE SIXTEEN: Branch Rule Removing Exclusion. Parent Corporation, a New York corporation, incorporates a wholly-owned subsidiary, Base Company, in Austria. Base Company in turn establishes a branch, Local Branch, in Liechtenstein. Assume that the income tax regimes of Austria and Liechtenstein are such that the branch rule treats Local Branch as a separate corporation. The Vienna office of Base Company purchases personal property manufactured in Austria by an unrelated person and resells the property to Local Branch. Local Branch in turn sells the property to Parent Corporation for use in the United States. Before the application of the branch rule, the income derived by Base Company through the activities of Local Branch is not foreign base company sales income since the personal property originated in Base Company's country of incorporation. When the branch rule is taken into account, the income deemed to have been derived by Local Branch is foreign base company sales income since the property originated outside Liechtenstein, the country in which Local Branch is located.

EXAMPLE SEVENTEEN: Branch Rule Blocked from Offering Exclusion. The Vienna office of Base Company from the preceding example now purchases personal property that originates in Liechtenstein and resells that property to Local Branch. Local Branch in turn sells the property to Parent Corporation for use in the United States. Before the application of the branch rule, the income derived by Base Company through the activities of Local Branch is foreign base company sales income of Base Company because the property did not originate in Base Company's country of incorporation. After the application of the branch rule, the income allocable to Local Branch's activities continues to be foreign base company sales income despite the fact that the property originated in Local Branch's country of location. The shift in the country relevant to the exclusion is ignored, since the branch rule cannot remove an item of income from Base Company's foreign base company sales income. The branch rule can only increase Base Company's foreign base company sales income.

2. Property of Mixed Origin

Property that is not of local origin might be combined by the controlled foreign corporation with property of local origin in an assembly process that does not rise to the status of manufacturing. In such a case, part of

142. See Treas. Reg. §§ 1.954-3(b)(2)(ii)(a), (4) Ex. 3 (1997).

143. See Treas. Reg. §§ 1.954-3(b)(2)(ii)(f), (4) Ex. 4 (1997). For a discussion of the proper construction of the first of these provisions, see *infra* Part III.A of this Article.

the income derived from the sale of the assembled product may be foreign base company sales income, while part is not so classified.¹⁴⁴ Part III.C of this Article discusses the allocation of income arising from the sale of such composite property.

3. *Property Manufactured Anywhere by the Controlled Foreign Corporation*

Income derived by a controlled foreign corporation from the sale of personal property it has manufactured, produced, or constructed from property it has purchased is excluded from its foreign base company sales income.¹⁴⁵ To the extent that the exclusion applies to property manufactured within the controlled foreign corporation's country of incorporation, the rule is simply an application of the more general rule that income derived from transactions in property originating within the controlled foreign corporation's country of incorporation is excluded from foreign base company sales income; the manufacturing activity has given a new origin to the transformed property. The exclusion applies, however, even to income derived from the sale of property manufactured by the controlled foreign corporation outside its country of incorporation.¹⁴⁶ Under those circumstances, the exclusion is justified only by the fact that the manufactured property was not purchased by its manufacturer, and such a purchase transaction is a necessary element of each of the four types of transactions that generate foreign base company sales income.¹⁴⁷ No separate Code authority excludes property manufactured by the controlled foreign corporation outside the controlled foreign corporation's country of incorporation.

The broad manufacturing exclusion leads to abuses by controlled foreign corporations incorporated in jurisdictions with territorial income tax systems or in jurisdictions that tax on the basis of residence only those corporations that are controlled and managed from within their territory. The exclusion allows a controlled foreign corporation to manufacture products at a branch located outside its country of incorporation without necessarily incurring tax on the income it derives from selling the products comparable to the tax being borne by competing operations in the country of destination. The branch rule only partially addresses the problem. For example, the branch rule will not reach the foreign branch's sales income if the branch both manufactures and sells the property itself. Nor will the branch rule apply if the effective tax rate in the controlled foreign corpora-

144. See Treas. Reg. § 1.954-3(a)(5) (1997). For a discussion of the definition of manufacturing applicable to foreign base company sales income, see *infra* Part II.A.4 of this Article.

145. See Treas. Reg. § 1.954-3(a)(4)(i) (1997). The exclusion extends to income derived by the controlled foreign corporation from the sale of goods manufactured by another entity under contract with the controlled foreign corporation. For a discussion of contract manufacturing, see *infra* Part II.A.4 of this Article.

146. See Treas. Reg. § 1.954-3(a)(4)(ii), Ex. 1 (1997).

147. See H.R. Rep. No. 1447, 87th Cong., 2d Sess. (1962), reprinted in 1962-3 C.B. 592-593. For a discussion of the four types of transactions, see *supra* Part I.B of this Article.

tion's country of incorporation is the same as or higher than the effective tax rate in the manufacturing branch's country of location. Hence, a controlled foreign corporation can avoid all local income tax and still qualify for the exclusion if it is incorporated in a territorial tax jurisdiction and its manufacturing branch is located in a jurisdiction with no income tax.

These abuses are addressed by Recommendation Three, which would eliminate the general manufacturing exclusion.¹⁴⁸ The recommendation would achieve its aim by redefining the underlying transactions that otherwise give rise to the exclusion. The exclusion from foreign base company sales income for income derived from transactions in property originating in the controlled foreign corporation's country of incorporation would still be available for the portion of sales income derived from transactions in property manufactured by the controlled foreign corporation within its country of incorporation. Under that exclusion as amended by Recommendation Ten, the sale of property manufactured in a controlled foreign corporation's country of incorporation by either the corporation or a related person also incorporated within that country would not give rise to foreign base company sales income. The elimination of the general manufacturing exclusion would avoid some of the complexity of the branch rule.¹⁴⁹

4. Manufacturing Defined

A controlled foreign corporation has manufactured, produced, or constructed property if it is not the same as the property the controlled foreign corporation purchased.¹⁵⁰ There are two explicit ways to meet this general test: either by satisfying the criterion of substantial transformation or by satisfying the combined criterion of substantial activity coupled with social convention.¹⁵¹ It is possible to meet the general test without satisfying either of those criteria, but the difficulty of predicting the outcome of an attempt to do so will lead most controlled foreign corporations to rely on the two explicit criteria. Certain activities of a controlled foreign corporation are ineligible for use in meeting the general test, regardless of the two criteria and any safe harbors. Those activities are packaging, repackaging, labeling, and minor assembly operations.¹⁵²

The first criterion for manufacturing is that of substantial transformation. If a controlled foreign corporation substantially transforms personal property it has purchased, the property as sold will be deemed to have

148. See *supra* Part I.B.7.

149. The branch rule would continue to be required to counter abuses of purchase or sales branches operating in tax havens. See *supra* parts I.C.1, 4, and 5.

150. See Treas. Reg. § 1.954-3(a)(4)(i) (1997). The IRS will not ordinarily issue private letter rulings on the question of what constitutes manufacturing. See Rev. Proc. 96-7, 1996 IRB LEXIS 8, at *10. The only private letter ruling issued prior to the current ban that describes the product and processes involved is Private Letter Ruling 81-46-058 (August 20, 1981) (finding the making of glass flow cells, coils, and fittings and connectors for the medical and electronics industries to be manufacturing).

151. See Treas. Reg. § 1.954-3(a)(4)(ii) (1997).

152. See Treas. Reg. § 1.954-3(a)(4)(iii) (1997).

been manufactured, produced, or constructed by the controlled foreign corporation.¹⁵³ Whether property has been substantially transformed apparently is a question of fact, but examples of substantial transformation include the transformation of wood pulp into paper, of steel rods into bolts and screws, and of tuna caught on the high seas into canned fish.¹⁵⁴

The second criterion grants substantial assembly operations the status of manufacturing if social convention holds those operations to be manufacturing. Even if the property purchased by a controlled foreign corporation has not been substantially transformed, the property will still be deemed to be manufactured, produced, or constructed by the controlled foreign corporation if the property meets the criterion's requirements. The property must be a component used in assembly operations conducted by the controlled foreign corporation, and those assembly operations must be substantial in nature and generally be considered to constitute the manufacturing, production, or construction of property.¹⁵⁵ Whether the controlled foreign corporation's assembly operations are substantial in nature and are generally considered to constitute the manufacturing, production, or construction of property is a question of fact.¹⁵⁶ However, the con-

153. See Treas. Reg. § 1.954-3(a)(4)(ii) (1997).

154. See Treas. Reg. § 1.954-3(a)(4)(ii), Exs. 1, 2, & 3 (1997).

155. See Treas. Reg. § 1.954-3(a)(4)(iii) (1997). The most important factor in determining whether substantial assembly operations are considered by social convention as manufacturing is the general attitude of the controlled foreign corporation's industry on the question. See *Bausch & Lomb Inc. v. Commissioner*, 1996 Tax Ct. Memo LEXIS 64, at *105 (1996). A definition of manufacturing that adapts to changing industrial convention is probably wise as traditional manufacturers outsource entire subassembly operations.

156. See *Bausch & Lomb*, 1996 Tax Ct. Memo LEXIS at *105. One example of substantial assembly operations that social convention holds as manufacturing is the assembly of automobiles from purchased components where the controlled foreign corporation conducts stamping, machining, and subassembly operations and has a substantial investment in the equipment used in the assembly operations. See Treas. Reg. § 1.954-3(a)(4)(iii), Ex. 2 (1997). Another example is the assembly of bag-closing machines when the controlled foreign corporation (i) must tailor some of its purchased components before they can be used; (ii) assembles 283 tailored and other components of 198 different types into a completed machine in a six-hour, fifty-eight step process through the efforts of trained and experienced mechanics using skill and judgment; and (iii) possesses in its plant all of the tools and equipment necessary for its tailoring and assembling processes. See *Dave Fischbein Mfg. Co. v. Commissioner*, 59 T.C. 338, 360-61 (1972), *action on decision*, 1973-422 (Jan. 30, 1973) (concluding that the court's factual determination was not clearly erroneous and that no basis for appeal existed and recommending acquiescence in the Tax Court's decision). In *Fischbein*, assembly operations constituted manufacturing even though the controlled foreign operation purchased most of the components from a related person, some of the components remained recognizable in the finished machine, and the controlled foreign corporation's operations did not account for twenty percent or more of the total cost of the machine it sold. See *id.* at 350, 352. Consider a third, unusual example. The assembly by hand of nonprescription sunglasses from five pieces (a front, two temples, and two lenses) with the necessary screws has been found to be manufacturing. See *Bausch & Lomb*, 1996 Tax Ct. Memo LEXIS at *118-19. In *Bausch & Lomb*, the Tax Court found the assembly of the sunglasses to be substantial in nature, turning down the IRS's arguments that the assembly operations (i) did not require sufficient skill and judgment, capital, or time to be substantial; and (ii) were not substantial when compared to the manufacturing of the parts used in the assembly process. See *id.* at *103-04. Although the assembly of a

trolled foreign corporation may take advantage of a safe harbor. The controlled foreign corporation's operations will be deemed to be manufacturing, even though the operations do not substantially transform the property purchased by the controlled foreign corporation, if the conversion costs (limited to direct labor and factory burden) of the controlled foreign corporation account for twenty percent or more of the total cost of the goods sold.¹⁵⁷

The operations need not be conducted by the controlled foreign corporation itself in order for the operations to count as manufacturing by the corporation. The operations may be conducted by a contract manufacturer on behalf of the controlled foreign corporation.¹⁵⁸ Yet, contract manufacturing has potential for abuse. The potential lies in the difference between a controlled foreign corporation manufacturing the goods it sells, which produces no foreign base company sales income, and the controlled foreign corporation purchasing goods for resale from a related person who has manufactured the goods outside the controlled foreign corporation's country of incorporation, which does generate foreign base company sales income for the controlled foreign corporation. Rather than purchasing

single pair of eyeglasses apparently was a comparatively simple affair, the court was impressed by the substantial training and supervision required by the assemblers to become proficient in producing a large volume of sunglasses within a limited time. See *id.* at *116-17. Largely, the case turned on the measures instituted by the controlled foreign corporation to produce the volume of defect-free, high-end sunglasses needed to make the assembly operations economic. In response to the IRS's argument that the assembly operation was not substantial when compared to the manufacturing of the necessary components, the Tax Court ruled that the regulations do not permit the comparison of a questioned assembly operation with the operations of the related person. See *id.* at *104. The Tax Court also found that the assembly of the sunglasses was generally considered to constitute manufacturing. See *id.* at *114. The most important factor for the court was the view that the sunglasses industry held of the assembly operations. The court cited in particular the testimony of two former employees of a competing sunglasses manufacturer with a similar assembly operation (one of whom had served as president of a trade association for the industry). *Bausch & Lomb* is a tour de force by the taxpayer's counsel.

157. See Treas. Reg. § 1.954-3(a)(4)(iii) (1997).

158. See Rev. Rul. 75-7, 1975-1 C.B. 244. The ruling assumes that the controlled foreign corporation furnishes all necessary raw materials, retains title to the materials throughout the operation, bears the risk of loss during the operation, and controls the timing and manner of production. The ruling also assumes that the contract manufacturer's only financial interest in the arrangement is the fee it receives for its services and that the contract manufacturer is not related to the controlled foreign corporation. The ruling's conclusion that the branch rule must be applied to the contract manufacturing arrangement is incorrect. See *Ashland Oil, Inc. v. Commissioner*, 95 T.C. 348, 363 (1990). The IRS has ruled informally that a controlled foreign corporation need not hold title to the materials as long as the corporation bears the economic risk of loss. See Priv. Ltr. Rul. 87-49-060 (Sept. 8, 1987). In that private letter ruling, the contract manufacturers were to purchase many of the needed materials themselves and were to be reimbursed for the expense by the controlled foreign corporation. Technical Advice Memorandum 87-39-003 (June 17, 1987) reaches the same conclusion on the matter of title and the economic risk of loss. The issue of imputing manufacturing activity from a contractor to a taxpayer also arises in the context of Code section 263A(g)(2) and the manufacturer's excise tax. The factors considered in addressing the issue in those two areas may be useful here. See *Levine & Littman*, *supra* note 49, at 348-50.

goods manufactured by a related person, the controlled foreign corporation instead has the related person act as an arm's-length contract manufacturer. This abuse is discussed in Part I.B.6(c) of this Article and is the subject of Recommendation Two.¹⁵⁹ Contract manufacturing by an unrelated person expands the scope of the manufacturing exclusion for foreign base company sales income. To the extent that the exclusion is based on the controlled foreign corporation's investment in substantial manufacturing assets complementing or anchoring its otherwise freely-transferrable sales operations, contract manufacturing reduces the justification for the exclusion.¹⁶⁰ This result troubled the IRS¹⁶¹ and led the IRS to make an ill-fated attempt to bring contract manufacturing within the branch rule.¹⁶²

B. Exclusion Based on the Use of Property

In order for a transaction in personal property to give rise to foreign base company sales income, the property must be sold for use, consumption, or disposition outside the controlled foreign corporation's country of incorporation.¹⁶³ If the property is purchased by the controlled foreign corporation on behalf of a related person, that is, if the controlled foreign corporation is acting as a purchasing agent for a related person, the property must have been purchased for use, consumption, or disposition outside the controlled foreign corporation's country of incorporation.¹⁶⁴ This exclusion encourages the U.S. multinational to incorporate a separate subsidiary in each of its markets, rather than rely on a handful of subsidiaries with extensive branch operations. In determining a product's country of use, the controlled foreign corporation has the option of using an assumption and must use three presumptions. In addition, there is available to the controlled foreign corporation a rule for the simplified tracing of fungible goods to their country of consumption.

The assumption is useful to a controlled foreign corporation when it sells products to retailers. The controlled foreign corporation may assume conclusively at the time of sale that personal property it sells to a purchaser, all of whose business consists of selling from inventory to retail customers at retail outlets within a single country, will be used within such

159. A related person should be able to act as a contract manufacturer for a controlled foreign corporation if the related person is incorporated in the same country as the controlled foreign corporation and conducts its manufacturing operations there. In that case, the incorporation of two entities in the same country, rather than a single entity, is a matter of nontax considerations for the U.S. parent corporation and should not attract a tax penalty.

160. Recommendation Three would require, in the context of certain related-person transactions, that contract manufacturing by an unrelated person take place within the controlled foreign corporation's country of incorporation. For a discussion of this recommendation, see Part I.B.7 of this Article.

161. See Gen. Couns. Mem. 33,357 (Oct. 24, 1966).

162. See Rev. Rul. 75-7, 1975-1 C.B. 244. *But see* *Ashland Oil, Inc. v. Commissioner*, 95 T.C. 348, 363 (1990) (holding that a contract manufacturer does not fall within the definition of a branch for purposes of the branch rule).

163. See I.R.C. § 954(d)(1)(B) (1997).

164. See *id.*

country.¹⁶⁵ The assumption may be used even when the controlled foreign corporation sells to a retailer who is a related person.¹⁶⁶ This assumption may be used even if the controlled foreign corporation knows or has reason to know that the property probably will not be used in the country where the purchaser's retail operations are located.¹⁶⁷ The controlled foreign corporation always has the option of ignoring the assumption and tracing individual sales by such a purchaser.

The three presumptions apply to other situations, either when the purchaser is not a retailer or when the purchaser has retail outlets in more than one country. Two of the presumptions apply to sales made to persons unrelated to the controlled foreign corporation, and the third applies to sales made to related persons. If the controlled foreign corporation sells personal property to an unrelated person, the property is presumed to be sold for use, consumption, or disposition in the property's country of destination.¹⁶⁸ The first presumption is discarded, and the property is presumed to be sold for use outside the controlled foreign corporation's country of incorporation, if the controlled foreign corporation knows or should know that the property probably will not be used, consumed, or disposed of in its country of destination.¹⁶⁹ The controlled foreign corporation may rebut the second presumption by tracing the property to the corporation's country of incorporation.¹⁷⁰

If a controlled foreign corporation sells property to a related person, the property is presumed to be sold for use outside the controlled foreign corporation's country of incorporation.¹⁷¹ Once again, the controlled foreign corporation may rebut the presumption by tracing the property to the corporation's country of incorporation.¹⁷² If the related purchaser disposes of the property, the controlled foreign corporation must continue its tracing or reapply the presumptions.¹⁷³ Purchases by a controlled foreign corporation on behalf of a related person no doubt are subject to the same presumptions as a sale of property to a related person.

When tracing is used and the goods are fungible, a specialized rule may come into play. The rule may be used when the controlled foreign corporation knows or has reason to know the manner in which its first

165. See Treas. Reg. § 1.954-3(a)(3)(ii) (1997). The presumption is available to the controlled foreign corporation even if a part of the purchaser's business consists of an activity other than the retail sales described in the text, so long as that part is insubstantial. See *id.*

166. See *id.*

167. See *id.*

168. See Treas. Reg. § 1.954-3(a)(3)(ii) (1997). A definition of the country of destination is not given in the regulations. The country in which a temporary interruption in shipment of the goods takes place is not the goods' country of destination. See *id.*

169. See *id.* The purchaser, for example, might require the controlled foreign corporation to include assembly instructions in a language not spoken in the country of destination.

170. See *id.*

171. See *id.*

172. See *id.*

173. See *id.*

purchaser disposes of the goods from a fungible mass. Under those circumstances, the controlled foreign corporation may treat its property as being sold for ultimate use in those countries and to those purchasers in the same proportions in which property from the fungible mass is sold by the first purchaser in the regular course of business.¹⁷⁴ The controlled foreign corporation may use the tracing rule regardless of whether the first purchaser is a related person or not. The three presumptions no doubt are applicable to the secondary purchasers once those purchasers are identified. The controlled foreign corporation may trace the shipment rather than employ the rule if it so chooses.¹⁷⁵ The rule also need not be used if the controlled foreign corporation has no reason to know the manner in which its first purchaser disposes of its goods, even though the goods are fungible. The mandatory tone enveloping the tracing rule is misleading and is dispelled by a careful reading of the rule.

1. *The Use Exclusion Evaluated*

The use exclusion facilitates the establishment by a U.S. multinational of a regional manufacturing subsidiary and the export of its production to other nations in the region. The exclusion permits the individual sales subsidiaries in the region's markets to purchase the manufactured product from the regional manufacturing subsidiary in order to sell it in their own markets.¹⁷⁶ Eliminating the exclusion would require each sales subsidiary to manufacture its own inventory, regardless of whether its market could sustain a facility large enough to capture economies of scale. More generally, this exclusion permits a controlled foreign corporation to conduct import operations in its local market under the same tax burden as its local competitors, which may be subsidiaries of the parent corporation's global competitors. In this sense, the exclusion is based on the policy of capital import neutrality.

The use exclusion is overbroad, however. The exclusion is available to a controlled foreign corporation regardless of whether its income from the sale of goods for use within its country of incorporation is subject to taxation by that country.¹⁷⁷ Depending on the jurisdiction involved, the income might not be subject to taxation on the basis of either source or residence. When the corporation is not subject to taxation, it is in a preferred position with regard to its local competitors and should not be entitled to the benefit of the exclusion. The policy of capital import neutrality is no longer being advanced.

There are at least two sets of circumstances in which a foreign jurisdiction might not tax sales income of a corporation incorporated under its

174. See Treas. Reg. § 1.954-3(a)(3)(iii) (1997).

175. See Treas. Reg. § 1.954-3(a)(3)(iv), Ex. 3 (1997).

176. Example Fifteen in Part II.A.1 of this Article illustrates such an arrangement. The use exclusion shelters the sales subsidiaries' sales income from Subpart F, and either the origin exclusion or the general manufacturing exclusion shelters the manufacturing subsidiary's sales income from Subpart F.

177. The American Law Institute makes a similar criticism. See AMERICAN LAW INSTITUTE, *supra* note 31, at 263.

laws. First, some countries tax on the basis of residence only those corporations that are managed and controlled from within their territory. Under these circumstances, the exclusion permits a controlled foreign corporation to be managed from another foreign jurisdiction, to conduct its business operations in its country of incorporation in such a manner as to be free of local income tax, and to exclude from foreign base company sales income the income it derives from the sale of goods for use within its country of incorporation. The controlled foreign corporation has used the management and control test to gain preferential treatment compared to its local competitors and still qualify for the exclusion.

Second, some countries maintain territorial income tax systems. Depending on the source rules used by such a jurisdiction, the income derived by a foreign sales branch of a controlled foreign corporation by importing goods into the corporation's country of incorporation may not be subject to income tax by that jurisdiction. The branch rule is not able to counter this arrangement if a second segment of the corporation has not acted with regard to the property sold. The exclusion should apply only to income that is subject to the income tax of the corporation's country of incorporation on the basis of residence.

RECOMMENDATION ELEVEN: Amend Code section 954(d)(1) by narrowing the exclusion to exclude from foreign base company sales income the income derived by a controlled foreign corporation from the sale of personal property for use in its country of incorporation only if the corporation is subject to tax in that country on such income on the basis of residence.

2. Effect of Partnership Operations

If the partnership anti-abuse rule causes a partnership transaction to be attributed to a controlled foreign corporation, the relevant country for purposes of the exclusion remains the corporation's country of incorporation and not the country under the laws of which the partnership is organized.¹⁷⁸

3. Effect of the Branch Rule

If the branch rule treats a branch of the controlled foreign corporation as a separate corporation, the exclusion applies separately to the transactions in which the branch is deemed to engage. The exclusion is available for those transactions only if the property is sold for use within the country in which the branch is located.¹⁷⁹ The controlled foreign corporation's country of incorporation remains the relevant country for applying the exclusion with respect to personal property sold by the home office of the corporation.¹⁸⁰

178. See Rev. Rul. 89-72, 1989-1 C.B. 257, *rev'd on other grounds* by *Brown Group, Inc. v. Commissioner*, 77 F.3d 217 (8th Cir. 1996); Treas. Reg. § 1.701-2(e) (1997) (providing the partnership anti-abuse rule in this context). See also discussion *supra* Part I.B.5. The consideration mentioned in the text also would be relevant if Recommendation One is accepted.

179. See Treas. Reg. §§ 1.954-3(b)(2)(ii)(a), (4) Ex. 1 (1997).

180. See Treas. Reg. § 1.954-3(b)(4) Ex. 2 (1997).

The branch rule cannot, however, decrease the controlled foreign corporation's foreign base company sales income.¹⁸¹ Hence, the exclusion is not available for personal property that is sold for use in the country in which the branch conducts its operations if the income derived from those transactions falls within foreign base company sales income before the application of the branch rule. As a result, the exclusion can only exclude income of a branch if, prior to the application of the branch rule, the income was already excluded from the foreign base company sales income of the controlled foreign corporation. These rules are illustrated by the following examples:

EXAMPLE EIGHTEEN: Branch Rule Removing Exclusion. Parent Corporation, a New York corporation, incorporates a wholly-owned subsidiary, Base Company, in Germany. Base Company then establishes a branch, Local Branch, in Luxembourg. Assume that the income tax regimes of Germany and Luxembourg are such that the branch rule treats Local Branch as a separate corporation. Base Company purchases personal property from Parent Corporation and resells the property to Local Branch. Local Branch in turn resells the property to an unrelated person for use in Germany. Before the application of the branch rule, the income derived by Base Company through the activities of Local Branch is not foreign base company sales income since the property was sold for use in Base Company's country of incorporation. When the branch rule is taken into account, the income deemed to have been derived by Local Branch is foreign base company sales income, since the property was sold for use outside Luxembourg, the country in which Local Branch is located.

EXAMPLE NINETEEN: Branch Rule Blocked from Offering Exclusion. Base Company from the preceding example again purchases personal property from Parent Corporation and resells the property to Local Branch. Local Branch now resells the property to an unrelated person for use in Luxembourg. Before the application of the branch rule, the income derived by Local Branch from the transaction is foreign base company sales income of Base Company; the property was not sold for use in Germany, Base Company's country of incorporation. After the branch rule is taken into account, the income continues to be foreign base company sales income despite the fact that the property was sold for use in Local Branch's country of location. The shift in country relevant to the use exclusion is ignored, since the branch rule cannot remove an item of income from Base Company's foreign base company sales income.

C. Exclusion for Certain Agricultural Commodities

Transactions in agricultural commodities that are not grown in the United States in commercially marketable quantities do not give rise to foreign base company sales income.¹⁸² The regulations provide a list of agricultural commodities that are deemed to be grown in the United States in commercially marketable quantities and a list of agricultural commodities that are deemed not to be grown in the United States in commercially mar-

181. See Treas. Reg. §§ 1.954-3(b)(2)(ii)(f), (4) Ex. 4 (1997). For a discussion of the proper construction of the first of these provisions, see *infra* Part III.A of this Article and Recommendation Eleven.

182. See I.R.C. § 954(d)(1) (1997).

ketable quantities.¹⁸³ The status of all other agricultural commodities is a question of fact.¹⁸⁴ The exclusion is not available for timber.¹⁸⁵ Nor is the exclusion available for any processed items if the cost of processing represents at least fifty percent of their fair market value.¹⁸⁶ If the controlled foreign corporation processes the commodities to the extent that the commodities lose the cover of the agricultural exclusion, the corporation may well be said to have engaged in manufacturing, and thus the products may simply be moving from one exclusion to another.¹⁸⁷ The exclusion based on the origin of property is also available; this provision excludes transactions in agricultural products grown or produced in the controlled foreign corporation's country of incorporation.¹⁸⁸

The justification for the exclusion is not apparent. The committee reports for the Tax Reduction Act of 1975, which added the exclusion to the Code, give no reason for the addition.¹⁸⁹ Two commenters on the proposed regulations are reported to have claimed that the exclusion was necessary to permit U.S. owned companies to participate in wholly-offshore international transactions in agricultural commodities.¹⁹⁰ Contrary to the comments attributed to those persons, a controlled foreign corporation may engage in foreign-to-foreign transactions without deriving foreign base company sales income regardless of the exclusion; there must be a related person involved in the transaction before any of the income of the controlled foreign corporation will be classified as foreign base company sales income.¹⁹¹ Hence, a controlled foreign corporation may participate in

183. See Treas. Reg. § 1.954-3(a)(1)(ii)(a) (1997).

184. See *id.* The United States, for this purpose, consists only of the fifty states and the District of Columbia. Agricultural commodities include both livestock and produce. See *id.*

185. See *id.* At the time the regulation was promulgated, the IRS was simply striving for consistency with regulations unrelated to Subpart F that excluded forestry from the definition of farming activities. See *Memorandum of Transmittal dated December 18, 1975 to the Assistant Secretary of the Treasury from the Commissioner of Internal Revenue*, 1975 TM LEXIS 5, at *5, available in LEXIS, Genfed Library, Memos File. The exclusion for timber now serves to coordinate in a very rough way the exclusion for agricultural commodities not grown in the United States in commercial quantities with the inclusion of certain timber products. For a discussion of the inclusion for certain timber products, see *supra* Part I.D of this Article.

186. See Treas. Reg. § 1.954-3(a)(1)(ii)(a) (1997).

187. For a discussion of the exclusion for property manufactured by the controlled foreign corporation, see *supra* Part II.A.3 of this Article.

188. See I.R.C. § 954(d)(1) (1997). See *supra* Part II.A.1 of this Article for a discussion of this exclusion.

189. The exclusion was added to the proposed tax act in conference committee. See S. Rep. No. 120, 94th Cong., 1st Sess., at 70 (1975), reprinted in 1975-1 C.B. 624, 631. The exclusion was added at the same time that the repeal of the minimum distribution exception was included in the proposed act. See *id.* Perhaps the exclusion for agricultural commodities was introduced through the lobbying of private industry and its cost was rationalized by the increased revenue brought about by the repeal of the minimum distribution exception.

190. See *Memorandum of Transmittal dated August 21, 1977 to the Acting Assistant Secretary of the Treasury from the Commissioner of Internal Revenue*, 1977 TM LEXIS 24, at *7-8, available in LEXIS, Genfed Library, Memos File.

191. For a discussion of the related-person requirement, see *supra* Part II.B.6.

wholly-foreign transactions — even in agricultural commodities that are grown in commercial quantities in the United States — without deriving foreign base company sales income. The exclusion benefits controlled foreign corporations that act as suppliers or purchasing agents for U.S. parent corporations or other related persons in foreign agricultural commodities. The inclusion of the net gains from commodities transactions in the foreign personal holding company income of the controlled foreign corporation does not ameliorate the impact of this tax expenditure, since the net gains from commodities transactions of producers, processors, merchants, and handlers of commodities are excluded from foreign personal holding company income.¹⁹² The exclusion should be repealed.

RECOMMENDATION TWELVE: Delete the last sentence of Code section 954(d)(1).

III. The Income Derived

The income derived by a controlled foreign corporation from transactions of the types described in Part II of this Article in property described in Part III of this Article generally constitutes foreign base company sales income.¹⁹³ The computation and characterization of such income raises a number of problems. First, several rules are required to ensure that the branch rule functions properly, neither relieving tax haven operations from the burden of U.S. income taxation nor imposing that burden twice. Second, income incidental to foreign base company sales transactions may be characterized as foreign base company sales income. The income derived by a controlled foreign corporation from financing its sales of property is an important example of such incidental income. Such incidental income also raises the question of coordinating overlapping categories of base company income.¹⁹⁴ Third, the sale of composite property, partly manufactured by the controlled foreign corporation and partly purchased by the corporation, may require the apportionment of income between tainted and untainted categories. Last, the rate of foreign tax borne by the sales income may remove the income entirely from the controlled foreign corporation's base company income. If the effective rate of foreign tax is comparable to the U.S. rate, no tax savings inhere in the base company sales transactions and accordingly the income is excluded.¹⁹⁵

192. See I.R.C. § 954(c)(1)(C)(ii) (1997).

193. See I.R.C. § 954(d)(1) (1997).

194. Other inclusions under Subpart F may accompany the foreign base company sales income inclusion. For example, the purchase of U.S. property under section 956 by the controlled foreign corporation causes the principal amount of the purchase to be included in the incomes of the corporation's U.S. shareholders, subject to limitations, in addition to any foreign base company sales income derived by the controlled foreign corporation when reselling the property. See I.R.C. §§ 951(a)(1)(B), 956 (1997).

195. See I.R.C. § 954(b)(4) (1997). This last problem raises a number of points common to all of the various categories of foreign base company income and must await a separate article dealing with the overall computation of a controlled foreign corporation's foreign base company income. The allocation of deductions to foreign base company sales income is one of those points that must await the separate article.

A. The Additional Income Arising Under the Branch Rule

If the branch rule treats a branch of the controlled foreign corporation as a separate corporation, the controlled foreign corporation realizes additional foreign base company sales income. The additional income arises through the branch rule's recharacterization of some of the transactions of the controlled foreign corporation with third persons as having been conducted on behalf of related persons.¹⁹⁶ When computing this additional foreign base company sales income, the U.S. shareholders may use the exclusions discussed in Part II of this Article.¹⁹⁷ In addition, the branch rule provides for two specialized exclusions. The two specialized exclusions attempt to ensure that an item of income is not included in foreign base company sales income twice. The branch rule makes no demands as to the jurisdiction in which the additional income has its source. The income must only be attributable to the conduct of activities by the pertinent segment of the controlled foreign corporation, regardless of the income's source.¹⁹⁸

1. No Reduction in Tainted Income by Operation of the Branch Rule

The branch rule can only operate to increase a controlled foreign corporation's foreign base company sales income; the branch rule cannot decrease it. This is a consequence of the rule that the branch rule is not to be applied to any item of income that is classified as foreign base company sales income of the controlled foreign corporation without the application of the branch rule.¹⁹⁹

2. Exclusion for Income Already Included in Tainted Income

If income constitutes foreign base company sales income before the application of the branch rule, such income is not included a second time in the tainted income of the controlled foreign corporation by operation of the branch rule.²⁰⁰ This is a second consequence of the rule that the branch rule is not to be applied to any item of income that is classified as foreign base company sales income of the controlled foreign corporation prior to the application of the branch rule.²⁰¹ The somewhat opaque language of the underlying rule is as follows:

(f) Priority of Application. If income derived by the branch or similar establishment, or by the remainder of the controlled foreign corporation, from a transaction would be classified as foreign base company sales income of such controlled foreign corporation under section 954(d)(1) and paragraph (a) of this section, the income shall, notwithstanding this paragraph, be treated as foreign

196. For the transactions that are recharacterized as being conducted on behalf of related persons, see *supra* Part I.C.4.

197. See Treas. Reg. § 1.954-3(b)(2)(ii)(e) (1997). Moreover, the first sentence of Treasury Regulations section 1.954-3(b)(2)(ii) does not contain the parenthetical phrase, "but determined without applying subparagraphs (2), (3), and (4) of [paragraph (a)]," found in Treasury Regulations sections 1.954-3(b)(1)(i)(b) and (ii)(b).

198. See I.R.C. § 954(d)(2) (1997).

199. See Treas. Reg. §§ 1.954-3(b)(2)(ii)(f), (4) Ex. 4 (1997).

200. See Treas. Reg. § 1.954-3(b)(2)(ii)(f) (1997).

201. See Treas. Reg. § 1.954-3(b)(2)(ii)(f),(4) Ex. 4 (1997).

base company sales income under paragraph (a) of this section and the branch or similar establishment shall not be treated as a separate corporation with respect to such income.

Both consequences that flow from this rule may not be apparent immediately. The opacity of the rule derives, in part, from the intermittent nature that the rule's phrasing ascribes to a branch's separateness: a branch's attribute of separateness varies from item to item of income. Under the branch rule, however, the separateness of a branch is primarily a function of a differential in effective tax rates between jurisdictions and thus remains constant relative to another segment of the corporation. Administration of the branch rule might be eased if the regulation were simply rewritten to state that the branch rule can only increase a controlled foreign corporation's foreign base company sales income and cannot include an item of income a second time in that tainted income.

RECOMMENDATION THIRTEEN: Delete Treasury Regulations section 1.954-3(b)(2)(ii)(f) and add the following immediately after Treasury Regulations section 1.954-3(b)(2)(ii)(e):

(f) Exclusion Under Branch Rule for Income Already Included. If income derived by the branch or similar establishment, or by the remainder of the controlled foreign corporation, from a transaction is classified as foreign base company sales income of such controlled foreign corporation under paragraph (a) of this section, such income shall not be included a second time in the foreign base company sales income of the controlled foreign corporation by the operation of this paragraph (b).

(g) Branch Rule Not to Diminish Foreign Base Company Sales Income. If income derived by the branch or similar establishment, or by the remainder of the controlled foreign corporation, from a transaction is classified as foreign base company sales income of such controlled foreign corporation under paragraph (a) of this section, such income shall be classified as foreign base company sales income of such controlled foreign corporation notwithstanding anything to the contrary in this paragraph (b).

3. Branch Rule Itself Not to Include Income Twice

The second specialized exclusion addresses the possible double inclusion of an item of income by the branch rule itself. When the branch rule itself would otherwise include an item more than once in the controlled foreign corporation's foreign base company sales income, priority is given to (i) the item's inclusion based on the fact that a sales or purchasing branch is treated as a separate corporation under the branch rule, over (ii) its inclusion based on the fact that a manufacturing branch is treated as a separate corporation under the branch rule.²⁰²

The second exclusion is ill-conceived. A single item of income cannot be included twice in the controlled foreign corporation's foreign base company sales income by application of the branch rule alone. The rule can only recharacterize an existing transaction as having been conducted on behalf of a related person. The branch rule cannot cause an item of income

202. See Treas. Reg. § 1.954-3(b)(2)(ii)(d) (1997).

to be derived more than once by a separated segment of the controlled foreign corporation. Nor can the identity of the separated segment deriving the item of income be disturbed by the workings of the branch rule. It is true that the operation of the branch rule can result in a single transaction being characterized as having been conducted on behalf of more than one related person.²⁰³ But such a characterization does not replicate the item of income derived from the transaction, nor cause the income to be derived by more than one segment of the controlled foreign corporation.

Example Seven of the branch rule regulations purports to illustrate the second exclusion. In this example, a sales branch of a controlled foreign corporation is determined under the branch rule to be a separate corporation from a sibling manufacturing branch. In addition, the sales branch is determined to be a separate corporation from its home office. Both the sales branch and the home office sell personal property manufactured by the manufacturing branch. The second exclusion is invoked to support the proposition that only the separateness of the sales branch from its home office is to be recognized with regard to the branch's income. Yet, the application of the exclusion turns out to be superfluous: the result in Example Seven is exactly the same as in Example Six, the preceding example in which the sales branch is deemed a separate corporation from the manufacturing branch and is not independently a separate corporation from the home office.²⁰⁴ The second exclusion has had no effect on the outcome of Example Seven.

It should be noted that Example Seven misstates the second exclusion. Example Seven states that the second exclusion requires that only the classification of the sales branch as a separate corporation from the home office, and not the classification of the sales branch as a separate corporation from the manufacturing branch, is to be applied to the sales branch's income. This is misleading. The second exclusion is to be applied separately to each item of income derived by the sales branch, and not to the sales branch's entire income as a common pool. If the sales branch conducts no business other than the sale of articles manufactured by its sibling branch, the misstatement is harmless. But consider the situation in which the sales branch also engages in reselling property purchased by the home office. Income from both activities should be eligible for inclusion in the controlled foreign corporation's additional foreign base company sales income. Both the sales branch's separateness from the home office and its

203. See *supra* Part I.C.4 of this Article.

204. Both Example Six and Example Seven of the regulations are faulty in their statement of their results. The penultimate sentence of each example should read as follows:

The income derived by the home office and branch C, respectively, each treated as a separate corporation, from the sale by or through each of them for use, consumption, or disposition outside country X and country Z, respectively, of *personal property manufactured by branch B* is treated as income from the sale of personal property on behalf of branch B, a related person, and constitutes foreign base company sales income for 1963.

The italicized language is missing from the original text of the two examples. See Treas. Reg. § 1.954-3(b)(2)(ii)(b)(1) (1997).

separateness from the manufacturing branch need to be recognized, if only in connection with different items of income. The second exclusion does not permit the sales branch's income derived from reselling personal property purchased by the home office to escape from the reach of the branch rule.

As a general matter, having an exclusion that prevents double inclusion is not objectionable, even if such double inclusion is not possible. However, the statement of the exclusion should be improved. As the exclusion is written now, it preserves a distinction between a sales or purchasing branch on the one hand and a manufacturing branch on the other. Such a distinction is not required and leads to the confusion, illustrated by Example Seven, about the proper object of the exclusion's application. The exclusion applies to individual items of income, not to a branch's income in its entirety.

RECOMMENDATION FOURTEEN: Amend Treasury Regulations section 1.954-3(b)(2)(ii)(d) to read in its entirety as follows: "(d) Items Not to be Twice Included in Income. An item of income shall be included in the controlled foreign corporation's foreign base company sales income only once as a result of the application of this paragraph (b)."

B. Incidental Income

Part of the income that a controlled foreign corporation derives from its sales activities may be attributable to services it performs in connection with the sale. One of those services may be the financing of the sale. If the income attributable to incidental services also falls within another category of foreign base company income, a question of priority between the two categories of income is raised. If the income from incidental services does not fall within another category of foreign base company income, apparently the income comes within foreign base company sales income.²⁰⁵ When the incidental income falls within another category of foreign base company income, the choice between the two categories is made first by reference to a partial list of priorities,²⁰⁶ then by separately determining the components of the income,²⁰⁷ and as a last resort by judging the predominant character of the transaction giving rise to the incidental income.²⁰⁸ The categories of foreign base company income most likely to overlap with foreign base company sales income are foreign personal holding company income and foreign base company services income.

205. See Treas. Reg. § 1.954-3(a)(1)(iii), Ex. 5 (1997). Note that Treasury Regulations section 1.954-3 was promulgated prior to Treasury Regulations sections 1.954-1(e)(3), (4) and is subject to the later provisions. As a result, the interest income described in Example 5 of Treasury Regulations section 1.954-3(a)(1)(iii) now falls within foreign personal holding company income.

206. See Treas. Reg. § 1.954-1(e)(4)(i) (1997).

207. See Treas. Reg. § 1.954-1(e)(2) (1997).

208. See Treas. Reg. § 1.954-1(e)(3) (1997).

1. *Financing the Sale of Property*

The interest income that a controlled foreign corporation derives from financing its sales of personal property usually constitutes foreign personal holding company income, another category of foreign base company income.²⁰⁹ Foreign personal holding company income also includes the corporation's income equivalent to interest, including much of the corporation's factoring income.²¹⁰ The inclusion of an item of income in a controlled foreign corporation's foreign personal holding company income takes precedence over its inclusion in foreign base company sales income.²¹¹ The regulations state, with admirable faith, that foreign personal holding company income is always separately determinable from the remainder of the foreign base company sales income that a controlled foreign corporation derives from a tainted sales transaction.²¹² The regulations, as a result, believe that no analysis is ever necessary of the predominant character of an ostensible sales transaction when the income in question is foreign personal holding company income.²¹³ There are several exclusions from foreign personal holding company income, and, when one applies, the interest income may fall back into foreign base company sales income.²¹⁴

2. *Other Incidental Services*

The incidental income derived by a controlled foreign corporation from a tainted sales transaction may also fall within the definition of foreign base company services income. In general terms, a controlled foreign corporation derives foreign base company services income when it renders services outside its country of incorporation for the benefit of a related person.²¹⁵ The income from the tainted sales transaction that qualifies as foreign base company services income may be separately determinable. If so, the income so determined is classified as foreign base company services income rather than as foreign base company sales income.²¹⁶ If the services income cannot be separately determined, all of the income from the sales transaction is classified according to the transaction's predominant character.²¹⁷ Hence, when the services rendered are incidental to a tainted sales transaction and give rise to income that cannot be separately determined, all income derived from the transaction is classified as foreign base company sales income.

209. See I.R.C. § 954(c)(1)(A) (1997).

210. See I.R.C. § 954(c)(1)(E) (1997); Treas. Reg. § 1.954-2(h)(2)(i)(D) (1997). Factoring income consists of the income derived by a controlled foreign corporation from purchasing accounts receivable at a discount and collecting them at maturity.

211. See Treas. Reg. § 1.954-1(e)(4)(i)(D) (1997).

212. See Treas. Reg. § 1.954-1(e)(3) (1997).

213. See *id.*

214. See Treas. Reg. § 1.954-1(e)(4)(ii) (1997).

215. See I.R.C. § 954(e)(1) (1997).

216. See Treas. Reg. §§ 1.954-1(e)(2), (3) (1997).

217. See Treas. Reg. § 1.954-1(e)(3) (1997).

C. Income from Property of Mixed Origin

A controlled foreign corporation might purchase components from various sources and assemble them into a product by a process that does not qualify as manufacturing. If the corporation then sells the assembled product, the sale may complete a tainted transaction as to some or all of the components. Consequently, the corporation may need to apportion its income from selling such a composite product between foreign base company sales income and other income. The controlled foreign corporation might also assemble a product in part from components it has manufactured and in part from components it has purchased. If the corporation then sells the assembled product, the sale again may complete a tainted transaction as to some or all of the purchased components. Again, the corporation may need to apportion its income derived from selling a composite product between foreign base company sales income and other income. In either case, no apportionment is necessary for the income derived from sales of assembled goods for use within the controlled foreign corporation's country of incorporation, since such sales are excluded from the class of transactions that produce foreign base company sales income.

The controlled foreign corporation has three options in apportioning the income from the sale of assembled products. First, the controlled foreign corporation may classify all of the income as foreign base company sales income.²¹⁸ Second, the controlled foreign corporation may apportion the income in the manner, if any, that its records show is proper.²¹⁹ Third, the controlled foreign corporation may apportion the income on the basis of the cost of the components.²²⁰ Under the third option, the choice of the relevant ratio for apportioning the income depends on whether a sale is made to a related person or to an unrelated person. The pertinent ratio for apportioning the income derived from sales to related persons for use outside the controlled foreign corporation's country of incorporation is the ratio of the cost of all purchased components produced outside that country, whether purchased from related or unrelated persons, to the aggregate cost of all components.²²¹ The pertinent ratio for apportioning income derived from sales to unrelated persons for use outside the controlled foreign corporation's country of incorporation is the ratio of the cost of components produced outside the controlled foreign corporation's country of incorporation and purchased from related persons to the aggregate cost of all components.²²² When the controlled foreign corporation has manufactured some of the components itself, the corporation apparently must cre-

218. See Treas. Reg. § 1.954-3(a)(5) (1997).

219. See *id.* The second method of apportionment takes priority over the third: if the allocation shown to be proper by the corporation's records differs from the allocation produced by the third method, the third method may not be used. See *id.* The corporation always has the option of using the first method of apportionment. See *id.*

220. See *id.*

221. See *id.*

222. See *id.*

ate an arms-length selling price for the manufactured component in order to assign it a cost for purposes of the allocation ratios.

Conclusion

This Article has recommended a number of changes in the U.S. taxation of foreign base company sales income. Most of the recommendations would enlarge the definition of base company income subject to U.S. taxation in order to assure the integrity of the U.S. tax regime for multinational activity. Recommendation One would prevent the use of a partnership to shield base company sales transactions from U.S. taxation. Recommendation Two would add to foreign base company sales income the income derived by a controlled foreign corporation from sales transactions carried out with the substantial assistance of a related person. Recommendation Three would add the income from sales transactions in products manufactured by a controlled foreign corporation to the corporation's foreign base company sales income if those transactions are with related persons or if the product reflects substantial assistance or inputs from a related person. Recommendation Four would add foreign base company manufacturing income to the categories of foreign base company income under the Code, subject to an exclusion tailored to the requirements of the policy of capital import neutrality. Recommendation Six would recognize intra-entity transactions for purposes of the branch rule, to the extent that such transactions are not already recognized. Recommendations Seven, Eight, and Nine would include certain arrangements by distributors within the scope of the branch rule. Recommendation Ten would narrow the exclusion for property originating within the controlled foreign corporation's country of incorporation. Recommendation Eleven would narrow the exclusion for property sold for use within the controlled foreign corporation's country of incorporation. Recommendation Twelve would repeal the exclusion for agricultural commodities not grown in commercial quantities within the United States. Recommendation Five would define a branch or other establishment of a controlled foreign corporation by the existence of a trade or business conducted in a country outside the corporation's country of incorporation. Recommendations Thirteen and Fourteen would amend the regulations to provide more clearly that the branch rule can neither diminish foreign base company sales income nor cause an item of income to be included twice. Finally, the remaining recommendations would assist with the administration of the rules governing the taxation of foreign base company sales income.

