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Government Reneges on Subpart F Application of "Check-the-Box"

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On January 16, 1998, the Internal Revenue Service ("IRS") released Notice 98-11, announcing that regulations would be proposed that would vitiate the "check-the-box" single member entity rules for purposes of subpart F of the Internal Revenue Code and that such regulations, when adopted, would be effective January 16, 1998.

Background

The "check-the-box" regulations, adopted in December of 1996, drastically changed the rules governing the classification of entities for U.S. federal tax purposes as partnerships or as associations taxable as corporations.[1] In the international arena, except for certain listed forms of organizations in various countries which are always classified as corporations,[2] a foreign entity can elect whether to be treated as a partnership (*i.e.*, a pass-through entity) or a corporation for U.S. federal tax purposes.[3] Moreover, an eligible entity which has but one owner and which elects partnership (*i.e.*, pass-through) treatment is disregarded as a separate entity for U.S. federal tax purposes;[4] rather, its activities are treated as a sole proprietorship, branch or division of its owner.[5]

1 For a discussion of the "check-the-box" regulations see our December 1996 Partnership Tax Bulletin available on the world wide web at www.pmstax.com/part/bull9612.html or at www.pmstax.com/ftp/part/bull9612.pdf in printed Adobe Acrobat form. The text of Treasury Decision 8697 can be found at www.pmstax.com/ftp/part/td8697.pdf, again in Adobe Acrobat format from the Federal Register. An October 1997 Notice of Proposed Rulemaking, proposing essentially clarifying amendments to the "check-the-box" regulations, is available at www.pmstax.com/ftp/part/preg7701-9710.pdf.

2 See *Proc.& Admin.Regs. § 301.7701-2(b)(8)* for the so-called "*per se* list" of foreign entities always classified as corporations, including, for example, United Kingdom public limited companies and German Aktiengesellschafts.

3 *Proc.& Admin.Regs. § 301.7701-3(a)*. The regulations call an entity which is permitted to elect its classification an "eligible entity." *Id.*

4 *Proc.& Admin.Regs. § 301.7701-3(a)*.

5 *Proc.& Admin.Regs. § 301.7701-2(a)*.

Government Concerns

Treasury and the IRS are concerned that the "check-the-box" regulations facilitate the use of what they refer to as "hybrid branches" to circumvent the anti-deferral regime of subpart F. In the words of Notice 98-11:–

> "These arrangements generally involve the use of deductible payments to reduce the taxable income of a controlled foreign corporation (CFC) under foreign law, thereby reducing the CFC's foreign tax and, also under foreign law, the corresponding creation in another entity of low-taxed, passive income of the type to which subpart F was intended to apply."

Also in this Bulletin

Notice 98-11 illustrates the type of arrangements giving rise to concern in the following two examples:–

> "Example 1. CFC1 owns all of the stock of CFC2. CFC1 and CFC2 are both incorporated in Country A. CFC1 also has a branch (BR1) in Country B. The tax laws of Country A and Country B classify CFC1, CFC2 and BR1 as separate, non-fiscally transparent entities. CFC2 earns only non-subpart F income and

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uses a substantial part of its assets in a trade or business in Country A. BR1 makes a transfer to CFC2 that the tax laws of both Country A and Country B recognize as a loan from BR1 to CFC2. CFC2 pays interest to BR1. Country A allows CFC2 to deduct the interest from taxable income. Little or no tax is paid by BR1 to Country B on the receipt of interest.

"If BR1 is disregarded, then for U.S. tax purposes the loan would be regarded as being made by CFC1 to CFC2 and the interest as being paid by CFC2 to CFC1. While interest received by a CFC is normally subpart F income under section 954(c) (foreign personal holding company income), in this case, if BR1 is disregarded, the "same country" exception of section 954(c)(3) would apply to exclude the interest from subpart F income. If BR1 instead were considered to be a CFC, however, this payment would be between two CFCs located in different countries. In that case, subpart F income would arise because the same-country exception would not apply. Thus, if BR1 is disregarded CFC1 will have lowered its foreign tax on deferred income and created a significant tax incentive to invest abroad rather than in the United States. As this arrangement creates income intended to be subpart F income which is not subject to subpart F in this case, the result of the arrangement is inconsistent with the policies and rules of subpart F.

"Example 2. CFC3 is incorporated in Country A. CFC3 has a branch (BR2) in Country B. The tax laws of Country A and Country B classify CFC3 and BR2 as separate, non-fiscally transparent entities. BR2 makes a transfer to CFC3 that the tax laws of both Country A and Country B recognize as a loan from BR2 to CFC3. CFC3, which earns only non-subpart F income, pays interest to BR2 that Country A allows as a deduction against taxable income. Little or no tax is paid by BR2 on the receipt of interest.

"If BR2 is disregarded, then U.S. tax law would not recognize the income flows (neither the loan nor the interest payment) between the CFC and its branch and, therefore, subpart F would not apply. If this transaction were between two CFCs, however, the interest would be subpart F income under section 954(c) and no exception would apply. Thus, if BR2 is disregarded, by use of this arrangement the CFC will have lowered its foreign tax on deferred income in a manner inconsistent with the policies and rules of subpart F."

Treasury and IRS Response

Notice 98-11 states that regulations will be proposed to prevent taxpayers from utilizing hybrid branch arrangements to reduce foreign tax while avoiding the corresponding creation of subpart F income. The regulations will provide that in cases to which they apply, a controlled corporation and its hybrid branch will be regarded as separate corporations for purposes of subpart F. The regulations will be effective not only to hybrid branch arrangements entered into or substantially modified on or after January 16, 1998, but will also apply to such arrangements entered into before that date beginning July 1, 1998.

Subsequent informal pronouncements by IRS and Treasury personnel have been inconsistent and confusing as to the scope of the impending regulations. Some comments suggest a narrow scope dealing only with fact patterns identical or nearly identical to the examples in Notice 98-11, while other comments suggest a broader view. In addition, Notice 98-11 itself states that Treasury and the IRS are aware that similar, and apparently equally undesirable results can be obtained utilizing partnerships and trusts and notes ominously that Treasury and the IRS will address the issues raised in those contexts in separate ongoing regulation projects.

Observations

What Treasury and the IRS seek to achieve appears to be a pervasive extension of the so-called "branch rule" of Internal Revenue Code section 954(d)(2), which currently only applies in the context of the foreign base company sales income rules.[6] If the branch rule is to be extended beyond its statutory scope, a credible argument can certainly be made that it's up to Congress to do it. In addition, the reliance by the government in Notice 98-11 on the reservation of regulatory authority in the check-the-box regulations with regard to international transactions is somewhat disingenuous. The results which seem to be of such concern arose long before adoption of the check-the-box regulations, although admittedly those regulations make it less burdensome to structure arrangements to reach those results. Even Notice 98-11 itself admits that comparable results can be achieved

6 For a more complete discussion of the section 954(d)(2) branch rule in the context of contract manufacturing, see *Contract Manufacturing and Subpart F: IRS Revokes Revenue Ruling 75-7,* at page 3 of this bulletin.

through partnerships and trusts without regard to the "check-the-box" single member entity rules.

Notice 98-11 is an example of *in terrorem* tax administration which seems to have as its motto, "Better to thwart 1,000 legitimate transactions than to permit one abusive one." The notice is written so ambiguously and could be interpretted so broadly that it raises a host of questions. For example, in addition to partnership and trust structures, what about "real" branches treated as separate taxpayers under foreign law? In those cases, the offensive result arises because there is no separate entity for U.S. tax purposes, without regard to the check-the-box regulations. And what is a deductible payment? Some suggestion has been made that a dividend could be such a payment where under the foreign tax system (*e.g.*, Germany), the payor is entitled to a reduced rate of tax on earnings paid out to shareholders.

It will be interesting to see what the reaction will be to any proposed regulations and what success Treasury will have if it ultimately decides, as has been suggested, that a legislative solution would be the wiser course.

Contract Manufacturing and Subpart F: IRS Revokes Revenue Ruling 75-7

Kerne Matsubara

One of the concepts underlying the anti-deferral regime of subpart F of the Internal Revenue Code is that U.S. taxpayers should be precluded from deferring U.S. tax on certain categories of income (so-called "subpart F income") earned by their foreign subsidiaries. Subpart F applies to controlled foreign corporations ("CFCs"); a CFC is any foreign corporation more than 50 percent of the stock of which, by vote or value, is owned by "United States shareholders," U.S. persons holding at least ten percent of the total voting power of the stock of the foreign corporation.[1] Among the categories of "subpart F income" is "foreign base company income," which in turn includes "foreign base company sales income."[2]

Foreign Base Company Sales Income

Foreign base company sales income is defined as income derived in connection with (i) the purchase of personal property from a related person and its sale to any person, (ii) the sale of personal property to any person on behalf of a related person, (iii) the purchase of personal property from any person and its sale to a related person or (iv) the purchase of personal property from any person on behalf of a related person where:–

> "(A) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and (B) the property is sold for use, consumption, or disposition outside such foreign country, or, in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country."[3]

The foreign base company sales rules are intended to prevent the artificial shifting of sales income among related parties. Sales income is not considered to have been shifted artificially where that income is earned by a CFC incorporated in the same country as the country in which

1 *I.R.C. §§ 957(a), 951(b).*

2 *I.R.C. §§ 952, 954.* Foreign base company income also includes "foreign personal holding company income," "foreign base company services income," "foreign base company shipping income" and "foreign base company oil related income." *I.R.C. § 954(a).*

3 *I.R.C. § 954(d)(1).*

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the relevant property is either manufactured or consumed; hence the so-called "same country" exclusions from foreign base company sales income.

The Manufacturing Exception

Consistent with the underlying rationale, the implementing regulations provide that foreign base company sales income does not include income from the sale of personal property manufactured, produced or constructed by a CFC in whole or in part from personal property which it has purchased, that is, if the property sold by the CFC is in effect not the property which it purchased.[4] A CFC is considered to manufacture, produce or construct property if the purchased property is substantially transformed prior to its sale by the CFC.[5] This "manufacturing exception" is distinct from the "same country" exclusions described above and means that the U.S. parent of a CFC can defer U.S. tax on the CFC's "manufacturing income," even if all the CFC's products are sold to related parties.

The Branch Rule

Internal Revenue Code section 954(d)(2), the so-called "branch rule," contains a significant limitation on the manufacturing exception. It provides:–

> "For purposes of determining foreign base company sales income in situations in which the carrying on of activities by a controlled foreign corporation through a branch or similar establishment outside the country of incorporation of the controlled foreign corporation has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income, under regulations prescribed by the Secretary, the income attributable to the carrying on of such activities of such branch or similar establishment shall be treated as income derived by a wholly owned subsidiary of the controlled foreign corporation and shall constitute foreign base company sales income of the controlled foreign corporation."

Without a branch rule, a manufacturing CFC could be incorporated in any tax haven jurisdiction and could in turn establish a branch in some other jurisdiction in which the actual manufacturing operations would be conducted. If the branch happens to be located in a high tax jurisdiction and recognized as a separate taxpayer in that jurisdiction, transfer pricing and other techniques could be utilized to shift income from the branch jurisdiction to the CFC's "home" jurisdiction. What the branch rule does in those types of situations is treat the CFC and its branch as if they were separate corporations; the CFC is then no longer a manufacturer and realizes foreign base company sales income from the purchase of property from a related person (its branch now treated as a wholly owned corporation).

Because the concern behind the branch rule is the shifting of income from a high tax branch jurisdiction to a low or non-tax CFC "home" jurisdiction, regulations provide that the branch rule does not apply where the tax rate in the CFC's "home" jurisdiction is 90 percent or more of (or no less than five percentage points below) the tax rate in the branch's jurisdiction.[6]

Contract Manufacturing

How are these rules applied when a CFC (the "Sponsor") itself does not conduct manufacturing activities, but instead engages a contract manufacturer (the "Contractor")? In a typical contract manufacturing arrangement:

- The Sponsor bears all risk of loss;
- The Sponsor controls the production (quality and quantity);
- The Sponsor owns and provides the raw materials;
- The Sponsor provides any trade secrets, technology or other intellectual property; and
- The Contractor receives a fee and does not share in any profits or losses.

The Service addressed the foreign base company sales income issues raised by contract manufacturing in Revenue Ruling 75-7.[7]

Revenue Ruling 75-7

In Revenue Ruling 75-7, corporation X, a CFC, was incorporated in country M. X contracted with unrelated corporation Y, which was incorporated in country O. Under the contract, X paid Y a fee for processing ore into a metal alloy. X bore the risk of loss and completely

4 *Income Tax Regs. § 1.954-3(a)(4)(i).*

5 *Income Tax Regs. § 1.954-3(a)(4)(ii).*

6 *Income Tax Regs. § 1.954-3(b)(1)(ii)(b).*

7 1975-1 C.B. 244.

controlled the time and quantity of production. X had the sole responsibility for arranging the sale of the finished product to third parties. Y was paid a conversion fee and did not share in profits or losses. The effective tax rate in country M was 46 percent and in country O was 38.5 percent.

The Service first ruled that the manufacturing exception applied to the arrangement, reasoning that the ore processing done by Y should be considered as performed by X. In general, under a contract manufacturing arrangement, Y's manufacturing activities can be attributed to X.

The Service also ruled that the activities of Y, the contract manufacturer, gave rise to a branch or similar establishment of X in country O. However, because the effective tax rate in Y's country O (38.5 percent) was actually less than the rate in X's county M (46 percent), the branch rule of Internal Revenue Code section 954(d)(2) did not apply.

Ashland Oil and Vetco

The application of the branch rule to contract manufacturing arrangements was at issue in a pair of companion 1990 Tax Court cases, *Ashland Oil, Inc. v. Commissioner*[8] and *Vetco, Inc. v. Commissioner.*[9]

In *Ashland Oil*, a U.S. corporation organized a wholly owned Liberian subsidiary, which entered into a typical contract manufacturing arrangement with an unrelated Belgian corporation. The Belgian corporation would manufacture certain marine chemical products and the Liberian subsidiary would sell the products to third parties. At issue was whether the Belgian corporation should be treated as a "branch or similar establishment" of the Liberian corporation for purposes of the branch rule.

The Court held that the Belgian corporation was not a "branch" under the branch rule because the ordinary meaning of a "branch" does not include an unrelated corporation operating under an arm's-length contractual arrangement. In addition, the Court held that the Belgian corporation was not a "similar establishment." Here the Court looked to tax treaty concepts of "permanent establishment." The Court reasoned that a contract manufacturer could not be a "branch or similar establishment" of the contracting CFC, because an independent contractor cannot constitute a permanent establishment of its contracting party. The Court reached a similar result in *Vetco*, which involved a contract manufacturer that was related to the CFC (a wholly owned subsidiary).

The combination of *Ashland Oil* and particularly *Vetco* with the first holding in Revenue Ruling 75-7 (*i.e.,* the Sponsor in a contract manufacturing arrangement is a manufacturer) created an extremely favorable planning opportunity: a CFC could be established in a tax haven jurisdiction and could arrange to have its products manufactured under contract by a related contract manufacturer in virtually any jurisdiction. The bulk of the profit from the overall activity could be, and indeed, under the transfer pricing rules of Internal Revenue Code section 482 would be required to be, allocated to the CFC.

Revenue Ruling 97-48

As one would expect, the Service expressed dissatisfaction with the holdings in *Ashland Oil* and *Vetco* and indicated in its business plan that it intended to take action to limit the contract manufacturing exception. The Service was relatively quiet for seven years until November 1997 when it issued Revenue Ruling 97-48,[10] revoking Revenue Ruling 75-7 effective December 8, 1997. The Service, without much explanation, said that it was following the nonattribution principle established in *Ashland Oil* and *Vetco*. Because the Court refused to attribute activities of a contract manufacturer to a sponsoring CFC for branch rule purposes, the Service felt it was inappropriate to attribute such activities to a sponsoring CFC for manufacturing exception purposes. Revenue Ruling 97-48 also states that for taxable years beginning before December 8, 1997, a CFC may continue to rely on Revenue Ruling 75-7 to attribute contract manufacturer activities to the CFC, but only if the CFC treats the contract manufacturer as a "branch or similar establishment" of the CFC for purposes of the branch rule of Internal Revenue Code section 954(d)(2).

Observations

There is some surface logical appeal to the IRS proposition that if contract manufacturer activities cannot be attributed for branch purposes then they should not be attributed for manufacturing exception purposes. Unfortunately, this argument ignores one important

[8] 95 T.C. 348 (1990).

[9] 95 T.C. 579 (1990).

[10] 1997-49 I.R.B. 5.

factor: the reasons for and analysis behind "attribution" are fundamentally different in the two contexts. The reason a Sponsor in a contract manufacturing arrangement can be considered a manufacturer is that the Sponsor, and the Sponsor alone, bears all economic risk associated with the manufacturing endeavor. On the other hand, the branch analysis of *Ashland Oil* and *Vetco* turns on traditional income tax treaty notions of permanent establishment. As noted in *Ashland Oil*, an independent agent is ordinarily not considered a permanent establishment of an offshore party contracting with that independent agent. But it is equally true that the presence of a dependent agent can constitute a permanent establishment of the principal.

The branch analysis should turn on the nature of the relationship between the Sponsor and the Contractor. If that relationship is merely one of dependent agent and principal, then the contract manufacturer should be regarded as a "branch or similar establishment" of the Sponsor. But if the contract manufacturer is truly an independent agent, then it should not be so regarded. Perhaps this approach can offer a way out of the thicket; after all, a contract manufacturer may find it difficult to establish independent agent status in situations where it is related to the Sponsor and does not provide contract manufacturing services to others in the ordinary course of its business.[11]

[11] See *InverWorld, Inc. v. Commissioner*, T.C.Memo. 1996-301 (1996), *supplemented* T.C.Memo. 1997-226 (1997), where a foreign corporation was unable to insulate itself from U.S. effectively connected income because its U.S. affiliates were considered its agents.

IRS Finally Releases Foreign Trust Reporting Form for 1996

The Small Business Job Protection Act of 1996 (P.L. 104-188, the "Act") brought about substantial changes in the United States federal tax treatment of foreign trusts and their grantors and beneficiaries. Included among the Act's provisions were increased information reporting requirements and related penalties, many of which became effective on August 20, 1996. In Notice 97-34, the Internal Revenue Service ("IRS") provided interim guidance on the new information reporting requirements as applicable for 1996.[1]

Under the Act and Notice 97-34, information reporting on IRS Form 3520 is required on an annual basis by U.S. persons making certain transfers to foreign trusts. Information on transfers to foreign trusts was previously reportable by the 90th day after a transfer. Form 3520 is also to be used by U.S. persons to provide information regarding (i) foreign trusts any portion of which are treated as owned by such persons for U.S. federal income tax purposes under the grantor trust rules, (ii) distributions from foreign trusts and (iii) certain gifts received from foreign persons.

Unfortunately, Notice 97-34 announced that the IRS was redesigning Form 3520 and that persons required to provide information would not be considered to have complied with the various requirements if they used the old form. Notice 97-34 also provided that the due date for information for 1996 had been extended to November 15, 1997, but that a taxpayer could also comply by attaching the new Form 3520 to the taxpayer's U.S. federal income tax return for the first taxable year beginning on or after January 1, 1997. For calendar year individual taxpayers, the due date for a 1997 U.S. federal income tax return is generally April 15, 1998.

A few days before November 15, 1997, the IRS released its 1996 Form 3520 and related instructions. See "Materials Available On-Line" for links to the form and instructions.

[1] For a complete discussion of the Act and related IRS guidance, see our July 1997 International Tax Bulletin, available on the world wide web as part of the **Pillsbury Madison & Sutro LLP Tax Page** at www.pmstax.com/intl/bull9707.html or at www.pmstax.com/ftp/intl/bull9707.pdf in printed, Adobe Acrobat format.

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U.S. Treasury Announces Entry into Force of Several Income Tax Treaties

On January 6, 1998 the United States Treasury Department announced the entry into force and effective dates of income tax treaties and protocols ratified by the United States Senate on October 31, 1997. New treaties, and in some cases related protocols, have entered into force with South Africa, Thailand, Ireland, Switzerland, Austria and Turkey. The treaties replaced by and effective dates of these new treaties are set forth in the following table:–

Country	*History or Date of Prior Treaty*	*Effective for Taxes Withheld at Source (amounts paid or accrued on or after)*	*Effective for Other Tax Matters (taxable periods beginning on or after)*
South Africa	Prior treaty terminated in 1987 under the U.S. Anti-Apartheid Act.	January 1, 1998	January 1, 1998
Thailand	First tax treaty between the two countries.	June 1, 1998	January 1, 1998
Ireland	1949	January 1, 1998	January 1, 1998
Switzerland	1951	February 1, 1998	January 1, 1998
Austria	1957	April 1, 1998	January 1, 1998
Turkey	First tax treaty between the two countries.	January 1, 1998	January 1, 1998

In addition, a fourth protocol to the U.S. income tax treaty with Canada is retroactively effective to April 26, 1995 with respect to certain real property gains and to amounts paid or credited after December 31, 1995 with respect to the taxation of social security benefits.

This article also appears on the world wide web at www.pmstax.com/intl/treaty9801.html as part of the ***Pillsbury Madison & Sutro LLP Tax Page****.*

Materials Available On-Line

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- Notice 98-11 [irb/n9811.pdf, 12K].
- Revenue Ruling 97-48 [irb/rr9748.pdf, 21K].
- Revenue Ruling 75-7 [irb/rr757.pdf, 54K].
- IRS 1996 Form 3520 [forms/1996/f3520-96.pdf, 60K].
- IRS 1996 Form 3520 Instructions [forms/1996/i3520-96.pdf, 93K].