2018

Effects of the New Sourcing Rule: ECI and Profit Sharing

David L. Koontz

Jeffery M. Kadet
University of Washington School of Law

taxnotes®

Volume 159, Number 8 ■ May 21, 2018

Effects of the New Sourcing Rule: ECI and Profit Shifting

by David L. Koontz and Jeffery M. Kadet

Reprinted from *Tax Notes*, May 21, 2018, p. 1119

Effects of the New Sourcing Rule: ECI and Profit Shifting

by David L. Koontz and Jeffery M. Kadet

David L. Koontz is a retired CPA who spent 25 years working in offices in the United States and Asia as a tax partner in a major accounting firm. Later he was involved with international transactions, including raising capital from multiple sources and using it in public and private companies worldwide. Jeffery M. Kadet was in private practice for over 32 years, working in international taxation for several major international accounting firms. He now teaches international tax courses in the LLM program at the University of Washington School of Law in Seattle.

In this article, Koontz and Kadet discuss the Tax Cuts and Jobs Act's new sourcing rule for sales of manufactured inventory property, which states that gross income from the sale or exchange of property produced by the taxpayer will be sourced at the place of manufacture. That is a departure from the old rule, which assigned gross income partially to the place of sale (the old title passage rule) and partially to the place of manufacture. They explain that in addition to closing a long-standing foreign tax credit loophole, this change gives foreign-based entities selling manufactured products in the United States a clear roadmap for avoiding U.S. tax on those sales. Also, it profoundly affects the many multinational profit-shifting structures that involve groups with manufacturing management, decision-making, and related functions within the United States, but which often use contract manufacturers outside the United States. When effectively connected income taxation applies, more gross income will be sourced within the United States and be taxable ECI. The authors argue that Treasury and the IRS should modernize reg. section 1.863-3 and related rules to reflect not only this TCJA change, but also the business models using contract manufacturers that did not exist when the current regulations were issued.

For the first time in eons, Congress has seen fit to change a basic rule for the sourcing of income. The Tax Cuts and Jobs Act (P.L. 115-97) minced few words in its addition of a single sentence to section 863(b) that applies to sales or exchanges of inventory property (1) produced in whole or in part by the taxpayer in one country, and (2) sold or exchanged in another country. The United States can either be the country where the inventory property is produced or the country where it is sold.

The new sentence reads:

> Gains, profits, and income from the sale or exchange of inventory property described in paragraph (2) shall be allocated and apportioned between sources within and without the United States *solely on the basis of the production activities with respect to the property*. [Emphasis added.]

With this change, income from the sale of inventory produced by a taxpayer will no longer be sourced at the location where any sales activities take place. Rather, the location, or locations, of production activities will be the sole determining factor. This change is effective for tax years beginning after December 31, 2017.

I. Why Was the Rule Changed?

Under the U.S. tax system, sourcing of income within or outside the United States has been, and will remain, important for two principal reasons. First, income source is the basis for the vitally important foreign tax credit limitation formula, which specifies the maximum foreign income taxes that may be used by a U.S. taxpayer to offset U.S. income tax. Second, a non-U.S. taxpayer will be subject to tax in the United States only on income that is either U.S. source or is effectively connected with the conduct of a trade or business within the United States. The determination of effectively connected income is very much dependent on sourcing rules.

Despite those two principal reasons for the importance of sourcing rules, the committee reports explaining this change in law do not focus on how the change could affect either the FTC or the taxation of non-U.S. taxpayers. Rather, the House committee report merely says:

> The Committee acknowledges that current administrative guidance, which sources sales income, in part, based on the place of destination rather than the place of production, may be appropriate in the context of our current tax system. However, the Committee believes this approach is not appropriate under a participation exemption system with lower tax rates. Rather than providing targeted relief to particular kinds of income, the Committee is instead reducing tax rates for all taxpayers, while also modernizing the U.S. system for taxing cross-border income. Therefore, the Committee believes changing present law in this area will more accurately measure foreign-source taxable income as part of providing a flatter, fairer, and simpler tax system.[1]

The committee is saying that the sourcing change is consistent with two of the TCJA's fundamental changes: (1) the significant reduction of corporate rates, and (2) the participation exemption. But the committee leaves it to the reader to speculate why that might be so.

While the above reflects Congress's explanation of good tax policy, we suspect that the amendment most likely reflects a desire to eliminate a long-standing loophole for artificially increasing a U.S. taxpayer's ability to use foreign taxes to offset U.S. taxes. In brief, under the old rule and the long-standing regulations interpreting it, it was often possible for a U.S. taxpayer that is manufacturing products within the United States and selling them overseas to treat half of the gross profit as foreign source, thereby artificially increasing the available FTC limitation and using otherwise excess FTCs to reduce current U.S. tax payable. That result was allowed even if the taxpayer had no overseas branch or other foreign activities that contributed to the sale. By eliminating sales activities as a factor and sourcing income at the place of production, that loophole has been closed.[2]

II. Effect on Profit-Shifting Structures

A. ECI Taxation and Profit-Shifting Structures

The authors have written several articles focused on the application of ECI taxation to specific profit-shifting structures involving worldwide businesses that are centrally managed and conducted from the United States.[3] Those structures typically exhibit three economic and operational factors:

1. value drivers in the United States;
2. control and decision-making in United States; and
3. lack of a foreign group member CEO and management outside the United States that are capable of operating an independent stand-alone business.

When applicable, ECI taxation would impose U.S. corporation tax at normal corporate rates[4] on some portion of the shifted profits that multinational groups have recorded within their foreign group members established in zero- or low-taxed foreign jurisdictions (low-taxed foreign members). Note that this imposition of U.S. corporate tax on ECI is a direct tax on the low-taxed foreign member. This contrasts with the indirect taxation that arises under the subpart F controlled foreign corporation rules or through

[1] H.R. Rep. No. 115-409, at 384.

[2] For further discussion of this rule change, see Jasper L. Cummings, Jr., "Selective Tax Act Analysis: Subpart F and Foreign Tax Credits," *Tax Notes*, Jan. 29, 2018, p. 653.

[3] Jeffery M. Kadet, "Attacking Profit Shifting: The Approach Everyone Forgets," *Tax Notes*, July 13, 2015, p. 193; Thomas J. Kelley, David L. Koontz, and Kadet, "Profit Shifting: Effectively Connected Income and Financial Statement Risks," 221 *J. Acct.* 48 (Feb. 2016); Kadet and Koontz, "Profit-Shifting Structures and Unexpected Partnership Status," *Tax Notes*, Apr. 18, 2016, p. 335; Kadet and Koontz, "Profit-Shifting Structures: Making Ethical Judgments Objectively, Part 1," *Tax Notes*, June 27, 2016, p. 1831; and Kadet and Koontz, "Profit-Shifting Structures: Making Ethical Judgments Objectively, Part 2," *Tax Notes*, July 4, 2016, p. 85.

[4] The rates are currently 21 percent (up to 35 percent before the TCJA), plus the 30 percent section 884 branch profits tax when not reduced or eliminated under an applicable tax treaty.

transfer pricing adjustments when the taxpayer is a U.S. person.

A common feature of many profit-shifting structures is that a low-taxed foreign member sources its inventory directly from one or more contract manufacturers, whether related or unrelated, and sells it to customers around the world. As explained below, the low-taxed foreign member, despite the lack of its own manufacturing facilities, is economically the manufacturer, with this manufacturer status normally reflected contractually through the following mechanisms:

i. *Holding intellectual property rights.* The low-taxed foreign member will be a licensee or a participant in, respectively, a license or cost-sharing agreement that defines the IP rights held.

ii. *Agreements with contract manufacturers.* These agreements are typically more in the nature of service agreements. The party holding the intangibles (that is, the IP that allows production and trademarking of a specific product) directs the other party, which has the necessary plant, equipment, and personnel, to use those intangibles to produce the specified products. In the absence of such an agreement, the contract manufacturer would not be allowed to produce the product.[5]

iii. *Intercompany agreements.* Under intercompany agreements, other group members (typically located primarily within the United States) perform production activities for the low-taxed foreign member. Usually structured as service agreements, the service provider group member contractually purports to act as an independent contractor and not as a partner, agent, or in a joint venture with the low-taxed foreign member. Despite this contractual approach, the service provider often performs crucial business functions and makes business decisions for the low-taxed foreign member. These are functions and decision-making that the low-taxed foreign member typically has neither the capacity nor the personnel to either conduct itself or competently direct service providers to perform.

In short, under these arrangements, the low-taxed foreign member is not simply purchasing a product for resale. Rather, directly or indirectly, it conducts manufacturing and assumes most of the same production and commercial risks that any manufacturer assumes, and is, in fact, the manufacturer. Because these low-taxed foreign members are both producing and selling, section 863(b) is relevant when two jurisdictions are involved and either the production or selling activities occur within the United States.

Profit-shifting structures often involve a low-taxed foreign member (including its disregarded entity subsidiaries[6]) that is taxed either nowhere or at low effective tax rates in the countries where it conducts operations. These structures also conveniently sidestep the CFC rules by avoiding purchases from and sales to related group members.[7] Thus, before the effective date of the TCJA, and ignoring any potential ECI taxation, no U.S. tax would have been paid currently on the low-taxed foreign member's profits.[8]

[5] As an example of a contract manufacturing arrangement, see Facebook's 2017 Form 10-K at 24. The Form 10-K sets out clearly the group's use of third parties to manufacture its Oculus products, as well as the various production and other commercial risks the group faces.

[6] Reg. section 301.7701-2(c)(2). Unless otherwise noted, any reference in this article to the low-taxed foreign member includes the assets, personnel, and activities of any disregarded entity subsidiaries that are treated as divisions or branches for U.S. tax purposes.

[7] More than just U.S.-based multinational groups are involved in profit-shifting structures. When, for example, an inverted multinational based in Ireland uses a low-taxed foreign member that records sales of inventory property as part of a profit-shifting structure, that low-taxed foreign member will often be owned directly or indirectly by the Irish parent. In that case, no income will be created under either sections 951 or 951A, meaning that the subpart F and GILTI rules will be irrelevant. For an example of planning using non-CFCs by an inverted group, see the discussion of Valeant Pharmaceuticals International Inc.'s acquisitions and subsequent internal operations concerning Medicis Pharmaceutical Corp., Bausch & Lomb Holding Inc., and Salix Pharmaceuticals Ltd. from pages 19*ff* of the majority staff report prepared for hearings before the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, "Impact of the U.S. Tax Code on the Market for Corporate Control and Jobs" (July 30, 2015).

[8] Of course, if a dividend were paid to a U.S. shareholder before the effective date of the TCJA, U.S. tax would be paid.

After the TCJA's effective date (and again ignoring any potential ECI taxation), the global intangible low-taxed income[9] provisions could result in current U.S. tax at an effective rate of roughly half the domestic 21 percent corporate tax rate. That lower effective tax rate will cause many, if not most, multinationals to continue existing profit-shifting structures and will likely encourage many new ones. Even the Congressional Budget Office in its April 2018 Budget and Economic Outlook concluded that the TCJA will have only a minor effect on the approximate $300 billion of profits it estimates are shifted each year out of the U.S. tax base. The CBO estimates that the TCJA will reduce this $300 billion by only $65 billion, with a third of that reduction (say $20 billion to $25 billion) relating to IP transfers into zero- and low-taxed countries. These IP transfers are integral to the profit shifting that is a focus of this article. (Note that about half of this $65 billion estimated reduction arises from TCJA provisions focused on profit shifting that involves debt and its related interest charges.[10])

Multinationals that have created profit-shifting structures include:

1. U.S. multinationals;

2. former U.S. multinationals that have inverted;

3. former U.S. multinationals acquired by private equity and other investment funds through foreign acquisition vehicles; and

4. former U.S. multinationals acquired by foreign multinationals that leave U.S. management intact.

The low-taxed foreign members of multinationals in the first category will almost always be CFCs and subject to the CFC rules as well as the new GILTI rules. However, for the other three categories, the low-taxed foreign members will normally be owned by foreign group members so that there is no coverage by the CFC and GILTI rules.[11] Because of this, for the other three categories, the new GILTI rules will not at all discourage these profit-shifting structures in the future. Further, these structures will seldom, if ever, involve any outbound related-party payments from U.S. group members, meaning that the new base erosion minimum tax[12] will have no effect.

In summary, aside from potential ECI taxation, most multinationals will have no reason to either discontinue existing profit-shifting structures or refrain from initiating new ones.

B. Basis for ECI Taxation

As noted above, a low-taxed foreign member within a profit-shifting structure may hold IP rights allowing it to manufacture products or to rely on others, such as contract manufacturers, to do so. Often, the low-taxed foreign member has neither the physical assets (for example, plants and equipment) nor knowledgeable personnel that would make it capable of either manufacturing the products on its own or directing a contract manufacturer to produce them. So without either physical assets or personnel, how does such a low-taxed foreign member operate? How does it acquire the products that it will sell to its distributors and customers around the world?

[9] Detailed discussion of GILTI is beyond the scope of this article. *See* sections 951A and 250.

[10] *See* the CBO's April 2018 Budget and Economic Outlook, at 124-127. This report makes clear the CBO's doubt that there will be any significant reduction of profit shifting. From page 125:

> CBO estimates that the reduction in the U.S. corporate tax rate, combined with the new [GILTI] rules governing the treatment of income from high-return investments (much of which is derived from IP), will reduce corporations' incentives to shift profits by transferring IP outside the United States. However, that effect is expected to be modest. IP is especially easy to relocate, so MNCs are typically able to locate it in whichever affiliates face the lowest tax rate on the income that it generates. *Because tax havens outside the United States will continue to have relatively low tax rates, CBO projects that most IP currently located will remain there. For newly created or future IP, the changes resulting from the tax act and the fixed costs of transferring IP to foreign affiliates will probably deter some small amount of profit shifting.* [Emphasis added.]

[11] For the other three categories, there will be situations where a low-taxed foreign member is partially owned by one or more U.S. group members. Even where the U.S. ownership is less than 50 percent, the TCJA's repeal of section 958(b)(4) may have the effect of causing those group members to be CFCs. Despite such a CFC classification, the directly foreign-owned portion should remain protected from any subpart F or GILTI taxation.

[12] *See* section 59A and Kadet and Koontz, "Internet Platform Companies and Base Erosion — Issue and Solution," *Tax Notes*, Dec. 4, 2017, p. 1435.

Over the past few decades, technological and other digital developments[13] have allowed many multinational groups with worldwide businesses centrally managed from the United States to create supply chains that include important production and sales functions conducted in multiple countries. In some cases, although physical manufacturing may be conducted in plants and facilities around the world (with those plants and facilities often being owned and operated by unrelated contract manufacturers), almost by necessity, many if not all significant production activities (short of the physical production) are carried out by U.S.-based personnel. In those situations, U.S.-based personnel are responsible for and actually conduct production activities for the group's worldwide operations — that is, they plan, manage, and carry out production activities for all group members that hold IP exploitation rights for various geographic regions. For example, personnel based within the United States make business decisions and conduct production activities that directly allow (1) one or more U.S. group members to manufacture or have manufactured the products that they sell to U.S. customers, and (2) one or more low-taxed foreign members to manufacture or have manufactured the products that they sell to customers in non-U.S. geographic territories.

Most importantly, this means that the activities of these personnel directly benefit, and are carried out for and on behalf of, multiple group members, thereby representing the joint production of products by these multiple group members. Also, in many cases the products being physically produced by contract manufacturers will not be identified as being produced for, or owned by, any specific group member until either late in the production process or until they've been packed for shipment to a customer.

What are these joint production activities and functions that are short of actual physical production?[14] They include, for example:

1. oversight and direction of production activities;

2. material selection, vendor selection, control of raw materials, work-in-process, or finished goods;

3. management of manufacturing costs or capacities;

4. control of manufacturing-related logistics; and

5. quality control.

With two or more group members involved in joint production, the IRC's partnership rules, regulations, and a litany of case law come into play. In short, joint production activities are more than enough to create a partnership for U.S. tax purposes. This finding of a partnership will be even more obvious when there is a central management function (including product sales management) that presents the group's business to customers, distributors, and others as one seamless worldwide business and that makes innumerable business decisions affecting that business (for example, determining production quantities, terms for transactions with third parties, and product pricing).

Interested readers may refer to our previously cited article for an explanation of how a profit-shifting structure may create a partnership for U.S. tax purposes.[15] In short, that article notes that many profit-shifting structures involve one worldwide, centrally managed and conducted business, the operations and transactions of which have been separated into multiple group members with each member conducting defined portions of that business. The article explains how in many cases the group members are partners in an unacknowledged partnership for U.S. tax

[13]For considerable discussion of these developments and their effects on cross-border commerce, see OECD, "Tax Challenges Arising From Digitalisation – Interim Report 2018: Inclusive Framework on BEPS," in *OECD/G20 Base Erosion and Profit Shifting Project* (OECD Publishing, Paris). *See also* Section II of Kadet, "BEPS: A Primer on Where It Came From and Where It's Going," *Tax Notes*, Feb. 15, 2016, p. 793.

[14]*See* reg. section 1.954-3(a)(4)(iv)(b), which is the source for this listing. While in some cases there will be overlap with research and development work, these production activities and functions are in fact separate from R&D. Thus, special rules governing R&D such as the cost-sharing agreement regulations and the entity classification rules do not apply. *See* reg. sections 1.482-7(j)(2)(iii) and 301.7701-1(c).

[15]*See* Kadet and Koontz, "Profit-Shifting Structures and Unexpected Partnership Status," *supra* note 3.

purposes. Suffice it to say that the existence of a partnership, while not a necessity, simply makes the application by the IRS of ECI taxation more certain and considerably easier to implement.[16]

Once there is a partnership with the relevant U.S. and foreign group members as partners, all joint activities and related revenue and expenses are considered to be conducted, earned, and incurred within the partnership and no longer conducted, earned, and incurred by any of the partners.[17] This means that the relevant low-taxed foreign member or members are partners in a partnership that is conducting a trade or business within the United States that is partially or wholly producing inventory property in the United States for sale outside the United States.[18] Under these circumstances, low-taxed foreign member partners will be treated as engaging in a trade or business within the United States[19] and will have some amount of ECI, for which they must file Form 1120-F (U.S. Income Tax Return of a Foreign Corporation) and pay applicable U.S. corporate income tax. The partnership must apply section 1446 withholding tax.

It will often be the case that U.S. group members, acting independently on a regular and continuing basis, make business decisions and negotiate and conclude important terms of contracts on behalf of their low-taxed foreign members. These independent actions cover matters such as component and raw material sourcing, contract manufacturing agreements, production planning, overseeing the manufacturing process, and quality control. Thus, even if no partnership exists for tax purposes, the facts may establish that U.S. group members are de facto agents acting on behalf of their low-taxed foreign members, thereby creating a trade or business within the United States with some amount of ECI. De facto agency status is sufficient to meet the "trade or business in the United States" test for application of the ECI rules.

C. Before TCJA

Section 863(b) and relevant regulations in effect before the TCJA provide for sourcing of applicable gross income from production and sales by attributing one portion to production activity and the remainder to sales activity. While not the only method set out in the regulations,[20] a commonly used approach is the 50/50 method, under which gross income is apportioned one-half to production activity and one-half to sales activity. While the production activity portion is sourced based on the location of production assets,[21] the sales activity portion is governed by the long-standing sourcing rule that looks to the country in which the sale occurs — the title passage rule.[22] Under those rules, even if a product was wholly produced within the United States and no actual sales activities were performed by the taxpayer outside the United States, one-half of the gross income was treated as foreign source as long as the sale was foreign source under the title passage rule. This is the costly loophole that the TCJA section 863(b) amendment closes.

Consider a profit-shifting structure in which a low-taxed foreign member and one or more other group members are partners in a partnership that manufactures and sells inventory property. Most likely the structure was created, of course, with the group's management and its advisers either ignoring or overlooking the very real possibility that their jointly conducted business activities have created a partnership for U.S. tax purposes. (Even if no partnership was found to exist for tax purposes, there would likely be a de facto agency relationship between the low-taxed foreign member and one or more U.S. group members

[16] The authors are unaware of any IRS attempt to assert an unintended partnership in a profit-shifting structure. However, the actual facts regarding how members of some groups operate joint businesses might be so strong that those groups may, after a careful review, conclude that a partnership exists for tax purposes and act accordingly.

[17] *See* LTR 201305006.

[18] Note that under the code, regulations, and case law, there will still be a partnership with production occurring within the United States even when the partnership activities are limited to joint production with each partner taking its share of production as a distribution in kind for sale by that partner. Thus, although many centrally managed groups conducting joint production also direct and conduct sales activities centrally, the performance of these centrally directed sales activities are not necessary for the results described in this article.

[19] *See* section 875(1). Activities conducted within the United States will usually be more than sufficient to cause a permanent establishment when a tax treaty applies.

[20] *See* reg. section 1.863-3(b) and (g)(2).

[21] *See* reg. section 1.863-3(c)(1) and (g)(2).

[22] *See* reg. sections 1.863-3(c)(2), (g)(2), and 1.861-7(c).

acting on its behalf.) Except as noted in the below discussion, this partnership conducts all production activities within the United States and sells the inventory property both within and outside the United States. Assume also that physical production of the inventory property is performed by an unrelated contract manufacturer outside the United States.

Under the pre-TCJA sourcing rules, and using the 50/50 method, the gross income from foreign sales would result in 50 percent of the gross profit being U.S. source and 50 percent being foreign source.[23] This has the following consequences for the low-taxed foreign member partner:

1. Because the U.S.-source income is ECI at the partnership level,[24] the portion of ECI allocable under section 704 to the low-taxed foreign member partner is subject to both section 1446 withholding and normal corporate taxation at a rate of up to 35 percent.[25] The 30 percent section 884 branch profits tax would also apply if not reduced or eliminated under an applicable tax treaty.

2. When the low-taxed foreign member partner is a CFC, the manufacturing branch rule[26] will likely apply to cause some portion of the partnership's foreign-source income allocable to that partner to be currently taxable under subpart F to the U.S. shareholder.[27]

D. After TCJA

Once the TCJA is effective, changes that will affect the above-described profit-shifting structure include:

1. sourcing of income from covered inventory property transactions solely to the location or locations of production (section 863(b) amendment);

2. taxation of GILTI; and

3. reduction of the corporate tax rate to a flat 21 percent rate from its previous rates of up to 35 percent.

These changes result in the following consequences for the low-taxed foreign member partner:

1. With a finding that all the partnership's production activities are conducted within the United States (the related contract manufacturer's assets and activities outside the United States are ignored for this purpose because they are not assets of the partnership, but rather assets of the contract manufacturer), the full gross income from product sales will be U.S.-source income[28] and ECI at the partnership level. As with the pre-TCJA situation described above, the portion of ECI allocable under section 704 to the low-taxed foreign member partner will be subject to section 1446 withholding;

[23] Note that the assets of the contract manufacturer outside the United States do not affect the source of income from production activities. Thus, under these assumed facts, all 50 percent of the gross profits from production activities are U.S. source.

[24] *See* section 864(c)(3).

[25] See discussion in prior articles listed in *supra* note 3, covering both the potential loss of deductions and credits under section 882(c)(2) and open statute of limitations under section 6501(c)(3) when the low-taxed foreign member has not filed a tax return for a prior year.

[26] *See* reg. section 1.954-3(b)(1)(ii).

[27] In brief, with the manufacturing branch being in the United States, the manufacturing branch rule (reg. section 1.954-3(b)(1)(ii)(b)) is applied comparing the effective tax rate on the relevant foreign-source sales income with 30 percent. This 30 percent is the lower of 90 percent of, or 5 percentage points less than, the 35 percent U.S. tax rate. With the profit-shifting structure minimizing the imposition of foreign taxes to very low rates, the manufacturing branch rule should apply to relevant foreign sales that are otherwise caught by the section 954(d)(1) definition of foreign base company sales income (FBCSI). Note also that not all foreign-source income will be FBCSI. For example, if the partnership or the low-taxed foreign member partner has a sales office in Singapore, inventory property sold for use, consumption, or disposition within Singapore would not be caught by the section 954(d)(1) FBCSI definition. However, sales into nearby Malaysia where there is no sales office would be caught.

[28] The facts in this example assume that 100 percent of production activities occur within the United States. When the partnership conducts production activities and holds production assets outside the United States, some portion would be foreign source and avoid ECI taxation.

normal corporate taxation, though now at the 21 percent flat rate; and the 30 percent section 884 branch profits tax if applicable.

2. Because all gross income in this example is caught by the new section 863(b) sourcing rule and is therefore ECI, none of that income will be subject to the new GILTI rules[29] when they would otherwise apply to a U.S. shareholder because the low-taxed foreign member is a CFC. The GILTI rules (as well as the subpart F rules), of course, recognize that when a CFC is taxable on ECI, there is no need to include that already taxed income in the income of any U.S. shareholder.

The above consequences assume that 100 percent of the production activities occurred in the United States. Say instead that 25 percent of the partnership's production assets are located outside the United States, thereby causing 25 percent of the gross income from product sales to be foreign source.[30] That would cause that portion of gross income to escape ECI taxation.

Assuming the low-taxed foreign member is a CFC, either the above-mentioned subpart F manufacturing branch rule or the GILTI rules would apply to its U.S. shareholders regarding the 25 percent of gross income that is foreign source. In short, the manufacturing branch rule could conceivably apply, with its application depending on the tax rate in the country where the partial manufacturing takes place and the effective tax rate paid on that income. When the manufacturing branch rule doesn't apply, the income would be included in the U.S. shareholder's GILTI computation. As for the applicable U.S. tax rate, when subpart F applies, it would be the flat 21 percent rate. When GILTI applies, the flat 21 percent rate is cut roughly in half. In either case, if foreign taxes have been paid, there would be some amount of FTC.[31]

III. Foreign Producer Sales Into the United States

The above sections of this article have focused on profit shifting conducted by groups having one or more low-taxed foreign members that partially or wholly produce products within the United States. The new section 863(b) sourcing rule will also affect legitimate foreign producers that sell their fully foreign-manufactured products into the United States.

Traditional tax planning wisdom has typically discouraged producers from setting up sales branches to sell their manufactured products within other countries. This has been true for various nontax reasons, including the desire to secure limited liability protection that shields the group from excessive legal risks arising from local operations. Thus, when a producer from one country desires to set up its own distribution or other sales support network that goes beyond some limited functions such as market research (in which case the foreign producer might establish a representative office), it will most commonly establish a local subsidiary. One important tax reason for this traditional planning is to establish a more secure transfer price that will better delineate the income attributable to the local sales and distribution functions. The foreign producer wants to minimize the risk that the local country will claim that some portion of the income attributable to production intangibles and the production process itself becomes a part of that local country's tax base.

In brief, the use of a local subsidiary for the sale and distribution of products results in intercompany transactions that are reflected in legally enforceable contracts and other documents between group members. In contrast, when a foreign producer maintains a sales branch, there is an intracompany home office/branch transfer value that has only internally generated management documentation for support. Despite the self-serving nature of these legally enforceable contracts and

[29] *See* sections 951A(c)(2)(A)(i)(I) and 952(b).

[30] *See* reg. section 1.863-3(c)(1) and (g)(2). Current regulations provide that the adjusted basis of production assets located within and outside the United States shall be used to determine U.S.-source and foreign-source income from production activities. New regulations under section 863(b) that may be issued could set out other factors to determine source.

[31] *See* section 960, including new section 960(d) added by the TCJA to allow a partial FTC for GILTI.

documents, tax authorities understandably give them more credibility than the internally generated documentation.

For purposes of illustration, assume that a foreign widget producer has manufacturing and related administration costs of $50. It then sells the widget at a price of $80 to its U.S. sales subsidiary, which in turn sells the widget to a customer for $100, incurring $10 of local expenses in the process. This leaves groupwide profit of $40 with $30 of profit in the foreign producer, which reflects the value of production including production intangibles; and $10 of profit in the U.S. sales subsidiary, which reflects the value of sales and distribution functions including local marketing intangibles. Assume that title transfers from the foreign producer to the U.S. subsidiary when the products are physically within the United States.

Before the new section 863(b) amendment, the title passage rule would govern the source of the foreign widget producer's gross income that is attributable to its sales activity. Thus, some portion of the producer's gross income would be U.S. source. Despite this U.S.-source status, the producer would under normal circumstances avoid any U.S. tax because the producer has neither a trade or business in the United States nor a permanent establishment under any tax treaty that might be applicable. This means that the United States would only tax the $10 of profit recorded within the sales subsidiary, allowing the foreign widget producer to protect its $30 of manufacturing profit from U.S. taxation (ignoring of course the potential for transfer pricing adjustments).

With the new section 863(b) sourcing rule for manufactured inventory property, 100 percent of the gross income from sales into the United States by foreign-based manufacturers will now be foreign source. For our foreign widget producer selling to its U.S. sales subsidiary at $80, this means that none of its $30 of profits would be ECI, even if the producer were found to be conducting a trade or business in the United States or to have a PE under an applicable tax treaty.

Say that before the section 863(b) amendment, the foreign widget producer had been selling into the United States through a U.S. sales branch rather than the assumed local subsidiary. With this conduct of a trade or business within the United States and some amount of U.S.-source gross income as determined under the section 863(b) regulations, it would have been taxable in the United States on some portion of its $40 of groupwide profits.

Now, with the section 863(b) amendment, the foreign widget producer will have zero U.S.-source gross income, meaning that all the profit of $40 will escape ECI taxation. As a corollary, of course, with all gross income being foreign source, the expenses of the sales branch attributable to it could not be attributed to and deductible against any other ECI that the widget producer might have from other activities it conducts in the United States.

Given the foregoing, traditional tax planning may no longer apply to foreign producers that wish to set up their own sales and distribution operations in the United States. For example, when a foreign producer's home country exempts from taxation or taxes the profits of a foreign sales branch at very reduced rates, there will be an incentive to sell into the United States through such a branch — that incentive being little or no home country tax and no U.S. tax.

What other incentive might there be? Say that a foreign producer with a U.S. sales subsidiary has material intercompany sales that it believes are at some risk of a transfer pricing adjustment.[32] If it were to transition in some manner to a sales branch structure, the sourcing based solely on location of production would cause complete nontaxability, thereby sidestepping for the future any ongoing transfer pricing risk.

Needless to say, when an existing sales or distribution subsidiary holds marketing rights and intangibles, any restructuring may have significant transfer pricing, legal ramifications, and other consequences from their transfer, all of which are outside the scope of this article. However, when a foreign producer is initiating its own sales or distribution operations for the first time or is initiating separate operations for a new product line so that there is no transfer of exiting

[32]An excellent example of a foreign producer that received IRS attention is GlaxoSmithKline Holdings (Americas) Inc. *See* IR-2006-142.

marketing rights or intangibles, establishing a sales branch should carry little or no U.S. tax risk.

U.S. groups in their profit-shifting structures have made aggressive use of the check-the-box rules[33] to create hybrid entities that avoid or minimize tax in the foreign countries in which they operate. Also, the simple check-the-box rules allow foreign producers to create hybrid entities for U.S. sales and distribution operations that would be separate taxpayers under their home country tax rules and disregarded entity (DRE) subsidiaries under the U.S. tax rules. With DRE status and the new section 863(b) source rule, foreign producers would be able to easily avoid both their home country tax and U.S. tax. Treasury may need to consider issuing future antiabuse rules that would override such structures.

The above discussion covers only domestic U.S. rules. When a foreign producer is covered by a tax treaty with the United States, there could potentially be treaty terms that define source, though in general, treaties do not act to increase the tax that would be due in excess of amounts otherwise owed under domestic law. The potential applicability of any sourcing rule as well as the implications of having a PE under a treaty would require separate investigation.

IV. Intangible Products

This article has been written primarily with the production and sale of tangible products in mind. There are, however, many intangible products sold with one multinational group both producing and selling the product. An obvious example of such a product is software, which under the terms of reg. section 1.861-18 can be treated as the sale or exchange of a product when provided to customers.[34] Any other intangible products included within the section 865(i)(1) definition of inventory property would also fall into this category.

V. Effect on Transition Tax

With the transition from the former deferral system to the new territorial participation exemption system mandated by the TCJA, section 965 imposes a one-time tax on accumulated post-1986 deferred foreign income on U.S. shareholders, payable at the election of the taxpayer in eight annual installments. Say that a U.S. shareholder of a zero- or low-taxed CFC has been making installment payments regarding that CFC's accumulated post-1986 deferred foreign income. Later, it is determined that for specific pre-TCJA years the CFC conducted a trade or business within the United States and had ECI subject to normal U.S. taxation.

In that event, with the determination that some portion of the CFC's accumulated post-1986 deferred foreign income is attributable to ECI, the tax base for the one-time transition tax would be adjusted downward.[35]

VI. Needed Amendment of Regulations

The amendment of section 863(b) requires at a minimum that changes be made to reg. section 1.863-3 to explain and define how the new law is to be applied. This will provide an opportunity to modernize this regulation and others to reflect the business models now commonly used that did not exist many decades ago when the existing regulations were issued.[36]

Reg. section 1.863-3 now uses the adjusted basis and location of production assets owned by a taxpayer to determine the source of income from production activities. New business models have centralized production activities as well as production decision-making and management functions in the United States while relying on third-party contract manufacturers often located outside the United States. This creates an urgent need to update the section 863(b) sourcing rules. This update could both more fully define what should be considered as inventory property produced by a taxpayer and identify the factor or factors that would determine source. Any new rules that address business models using contract

[33] Reg. section 301.7701-1 to -3.

[34] *See* reg. section 1.861-18(f)(2), which provides that section 863 will apply when appropriate to determine the source of income from transactions classified as sales or exchanges of copyrighted articles. *See also* examples 3, 5, 6, and 7 and the related discussion in Kadet, *supra* note 3.

[35] *See* section 965(d)(2)(A).

[36] Several specific suggestions for updating existing regulations were included in Kadet and Koontz, *supra* note 12.

manufacturers should be consistent with reg. section 1.954-3(a)(4)(iv), which was amended effective from 2009 to focus on such business models for purposes of subpart F.[37] Because contract manufacturing has been an important part of business models and profit-shifting structures for several decades now, it is long past the time to make similar changes to the ECI and sourcing rules. Modernization should include the production and sale of intangibles such as software. Antiabuse rules could also be amended to reflect today's profit-shifting structures as well as to cover possible new structures such as those mentioned in the above section on foreign producer sales into the United States.

VII. Concluding Comments

In addition to the new sourcing rule applicable to both domestic and foreign taxpayers, the above discussion has highlighted several significant TCJA changes to the code, including a lower corporate tax rate, the participation exemption, and the GILTI provisions. But much has not changed. In short, although an oversimplification, it's fair to say that much of the code and its myriad rules have remained basically intact while some new complicated layers have been added. This lack of change means that the existing ECI provisions are very much a constant for all years, whether pre- or post-TCJA.[38] The move from the prior deferral system to the new territorial participation exemption system does not change this one iota, except for the new sourcing of income rule.

The IRS has made clear over the past few years that it does not like and is willing to challenge many profit-shifting structures now used by multinational companies. In doing so it has primarily used as tools either transfer pricing or recharacterization, both of which are subjective and carry considerable uncertainty of success in the inevitable litigation process.[39] In contrast, when the facts support it, the existence of a partnership for tax purposes and the determination of ECI are relatively objective.

The authors have seen no evidence to date that the IRS has attempted to counter the effects of profit-shifting structures through application of the ECI rules. If the IRS should decide to apply ECI in the future, taxpayers are unlikely to be able to rely on the statute of limitations to prevent application of the ECI rules to prior tax years. This is because for any tax years that the low-taxed foreign member failed to file its own separate tax return, those years remain open to examination. Low-taxed foreign members would not, of course, have been eligible to join with their U.S. affiliated group in the filing of a consolidated tax return. This means that when the facts justify it, the IRS has the authority to look back many years and assess tax, interest, and penalties. Unless a low-taxed foreign member actually filed Form 1120-F for a prior year that started the running of the statute of limitations for that year, that prior year will still be open. That is true even if that year has already closed for the U.S. affiliated group.[40]

Despite no apparent evidence of the application of ECI taxation to multinational profit-shifting structures, there is evidence that the IRS believes that ECI taxation is relevant and worth an increased investment in manpower and training. This is supported by the Form 1120-F nonfiler campaign included in the January 31, 2017, rollout of the IRS Large Business and International Division's initial 13 campaigns.

Considering the above, we recommend that multinationals using the types of profit-shifting structures discussed in this article and our previous articles reassess their facts and circumstances and consider whether such structures should be continued, modified to better align profits with value creation, or unwound.[41] ■

---

[37]In brief, reg. section 1.954-3(a)(4)(iv) provides rules for determining whether personal property sold by a CFC will be considered to have been manufactured, produced, or constructed by that CFC when the physical manufacturing, producing, and construction activities are not performed by the CFC. *See also* T.D. 9438.

[38]The TCJA affects ECI taxation through the section 863(b) change discussed herein and even expanded it through the addition of section 864(c)(8) concerning the sale or exchange of some partnership interests.

[39]Over the past several years, *Tax Notes* has included numerous articles and documents concerning ongoing IRS and taxpayer disputes, including those with Microsoft, Facebook, and Caterpillar.

[40]*See* section 6501(c)(3).

[41]For the discussion and recommendations provided for groups and their outside auditors, see Kelly, Koontz, and Kadet, "Profit Shifting: Effectively Connected Income and Financial Statement Risks," *supra* note 3, and Kadet and Koontz, "Profit-Shifting Structures: Making Ethical Judgments Objectively, Part 1," *supra* note 3. The latter article proposes an ethical benchmark that multinationals can use to objectively test the propriety of their profit-shifting structures.