2018

Letter from Jeffery M. Kadet and David L. Koontz to the Internal Revenue Serv. (June 5, 2018) on Notice 2018-43, 2018-2019 Priority Guidance Plan Regulatory and Ruling Guidance Concerning Various International Tax Issues

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Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2018-43) Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Notice 2018-43, 2018-2019 Priority Guidance Plan

Dear Sir or Madam:

The undersigned, Jeff Kadet and David Koontz, are both retired CPAs who have worked internationally for many years. Based on our prior working experience and in connection with some recent articles we have written, we have identified several projects that should be considered a *high priority* for the Treasury and the IRS. These projects, which are attached as appendices to this letter, cover a number of areas.

Notice 2018-43 lists factors that the Treasury and the IRS consider in selecting projects for inclusion in its 2018-2019 Priority Guidance Plan. They include, for example, whether a project (i) involves significant issues relevant to many taxpayers, (ii) will reduce controversy and lessen the burden on taxpayers or the IRS, and (iii) promotes sound tax administration. *All of the suggestions for projects that we are submitting more than satisfy all of these factors. More specifically, the effect of issuing new and/or* *amended regulations as well as publishing guidance in these areas could result in hundreds of billions of dollars of additional tax revenues through:*

- *Encouraging MNCs to unwind existing profit shifting structures that violate not only the spirit of the tax law but also its letter, as well as discouraging the formation of new profit shifting structures, and*
- *Enabling the government to effectively and efficiently contest such aggressive profit shifting structures.*

A principal focus of our suggestions is the modernization and updating of regulations as well as providing guidance that will affect the many multinational corporations (MNCs) whose operations take place partially or wholly within the U.S. Many of these MNCs have embarked on complicated and legalistic schemes whose primary purpose is to shift profits without any real operational changes and to record those profits within zero- and low-taxed foreign members. Importantly, this includes not only U.S.-based MNCs, but also the many inverted MNCs that structured their inversions to remain untouched by the §7874 anti-inversion rules.

The government has expended efforts and significant resources attempting to attack a multitude of MNC profit shifting structures. These efforts are labor intensive, time consuming, and have uncertain outcomes. Such attacks have relied on either transfer pricing (e.g. Microsoft, Amazon, Facebook, etc.) or re-characterization adjustments (e.g. Caterpillar, Perrigo, etc.). *These approaches, which have high costs for the government and taxpayers alike, are so subjective in nature and application that litigated decisions are little better than a toss-up.* Edward Kleinbard, a noted tax law professor at the University of Southern California, commented the following after the Amazon Tax Court decision:

> Regardless of the correctness of the decision on the merits, cases like this -- costing millions of dollars to litigate, featuring 30 expert witnesses battling one another, and decided through a 200 page opinion -- are symptomatic of an unadministrable international tax system.[1]

The recent Tax Cuts and Jobs Act has made few improvements in this regard because it still provides an up to ten-percentage point or higher incentive to shift profits out of the U.S. (often a 21% benefit for foreign-owned MNCs). Included in the attached appendices are suggestions that the IRS use the Code's existing effectively connected income (ECI) rules as a tool in combating profit shifting and base erosion. Today, the Treasury and the IRS already have the full authority to modernize and focus the relevant regulations in a manner that would support application of the ECI rules to many MNC profit shifting schemes, thereby giving the IRS another and more effective means to tax this shifted income. Where the facts support it, imposition of ECI taxation may prove to be more objective and easier to sustain than either transfer pricing or re-characterization adjustments.

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[1] Richard Rubin and Laura Stevens, "Banking & Finance: Amazon Defeats IRS in Tax Case", *Wall Street Journal, Eastern edition*, New York, N.Y., March 24, 2017.

The issuance by the Treasury and the IRS of modernized sourcing and ECI regulations along with our entity classification and other suggestions focused on profit shifting structures would provide clarity for both MNC taxpayers and the IRS.[2] In addition, clear guidance would force outside audit firms to require their clients to make more meaningful disclosures of their potential tax liabilities or to actually accrue tax, interest, and penalties where some clients have inappropriately pushed the envelope in their profit shifting structures. This would be further helped by the IRS designating tax motivated structures having relevant factual, profit shifting characteristics as a "listed transaction".

The undersigned either together or separately have authored six articles covering how various MNC profit-shifting structures may well be subject to U.S. taxation under the effectively connected income (ECI) rules.[3] The third of these articles details how such structures often create an unanticipated partnership for U.S. tax purposes that includes two or more MNC group members as partners in a partnership that conducts the joint business of the group members. An unanticipated partnership is important not only due to the applicable tax return filing obligations and §1446 withholding, but also due to the fact that a partnership simply makes the application of ECI taxation much easier. The sixth article notes how the manufacturing branch rule included in the Subpart F regulations may often apply to cause some gross income not caught by the ECI rules to be subpart F income. Additional background and issues relevant to suggestions made within this letter and its appendices are covered in detail in those articles.

Although not specifically related to the profit shifting structures that the six articles deal with, many MNCs erode the U.S. tax base through deductible payments by U.S. group

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[2] These high priority regulation projects (with perhaps the sole exception of the TCJA change to the §863(b) sourcing rule) represent only modernization and clarification of *existing* rules that are already sufficiently broad to apply ECI taxation and partnership status to many profit shifting structures. Importantly, the Treasury and IRS should make clear that these rules will apply where the facts support them to any tax year whether before or after the issuance of new or amended regulations.

[3] **1.** Jeffery M. Kadet, "Attacking Profit Shifting: The Approach Everyone Forgets", 148 Tax Notes 193 (July 13, 2015), available at http://ssrn.com/abstract=2636073.
2. Thomas J. Kelley, David L. Koontz, and Jeffery Kadet, "Profit Shifting: Effectively Connected Income and Financial Statement Risks", 221(2) Journal of Accountancy 48 (February 2016), available at http://ssrn.com/abstract=2728157.
3. Jeffery M. Kadet and David L. Koontz, "Profit-Shifting Structures and Unexpected Partnership Status", 151 Tax Notes 335 (April 18, 2016), available at http://ssrn.com/abstract=2773574.
4. Jeffery M. Kadet and David L. Koontz, "Profit-Shifting Structures: Making Ethical Judgments Objectively," Part 1 at 151 Tax Notes 1831 (June 27, 2016) and Part 2 at 152 Tax Notes 85 (July 4, 2016), available at http://ssrn.com/abstract=2811267 and http://ssrn.com/abstract=2811280.
5. Jeffery M. Kadet and David L. Koontz, "Internet Platform Companies and Base Erosion--Issue and Solution," *Tax Notes*, Dec. 4, 2017, p. 1435, available at http://ssrn.com/abstract=3096925.
6. Jeffery M. Kadet and David L. Koontz, "Effects of New Sourcing Rule: ECI and Profit Shifting", *Tax Notes,* May 21, 2018, p. 1119, copy attached as Appendix G.

members to foreign group members, including DRE subsidiaries. Often, these payments would be subject to the 30% U.S. withholding tax, but this tax is most typically reduced or eliminated by the claimed coverage of a tax treaty. The same is true for non-withholding tax claims such as a claim by a foreign group member that it has no permanent establishment under an applicable tax treaty. Appendix F provides specific guidance for needed regulatory amendments that would prevent the inappropriate use of tax treaties to achieve double non-taxation.

As a final comment, we believe that if the Treasury and the IRS were to make clear their intentions to pursue profit shifting structures through Notices, revenue rulings, or regulations, as appropriate, that would undoubtedly put all MNCs and their legal and tax advisors on “notice" to take potential partnership status and ECI taxation seriously. Also, if the IRS were to find as a part of its audit of just one MNC an unanticipated partnership for U.S. tax purposes, and impose significant ECI taxation, interest, and penalties, that information would undoubtedly be disclosed in the MNCs public SEC filings.[4] From the moment of this "notice" becoming public (or an official notice from the IRS or Treasury), many MNCs, which have fact patterns under which it is “more likely than not" that partnership status and ECI taxation apply, would be required by their auditors to reflect additional disclosures and taxes in their financial statements. Further, some of these MNCs will determine that they must file Form 1120-F for the current and certain prior years and will voluntarily pay tax on their ECI.[5]

Perhaps more importantly, any such “notice” will cause many MNC boards of directors and managements to re-think their aggressive profit-shifting structures and should result in significantly increased corporate tax payments with less profits ending up in tax havens.

Note that any such “notice” would achieve one of the stated goals of the "Form 1120-F Non-Filer Campaign” released on January 31, 2017. That campaign states, in part:

> … The goal is to increase voluntary compliance by foreign corporations with a U.S. business nexus.

*   *   *   *   *

[4] Public companies such as Microsoft, Caterpillar, Coca Cola, and Facebook have included in their SEC filings disclosures of IRS transfer pricing and re-characterization adjustments. See, for example, page A-30 of the Caterpillar Inc. Form 10-K for its year ended December 31, 2014, filed February 17, 2015.

[5] See in particular the article “Profit Shifting: Effectively Connected Income and Financial Statement Risks”, which is included as article 2 in the listing within footnote 3.

We hope that the above information is useful to the Treasury and the IRS. Either of us would be glad to speak by telephone with you or to respond to emailed questions if that would be helpful.

Very truly yours,

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Attached Appendices

Appendix A – Modernization of Sourcing of Income and Effectively Connected Income Regulations (Regulations under §§861 - 864)

Appendix B – Amendment of Reg §301.7701-1(a)(2) and/or Issuance of Revenue Ruling on Partnership Status for Certain Profit-Shifting Structures

Appendix C – Designate Certain MNC Profit-Shifting Structures as Listed Transactions

Appendix D – Profit-Shifting Structures Implemented Following Inversions and Acquisitions by Foreign Acquirers

Appendix E – Addition of Examples to the Manufacturing Branch Rule

Appendix F – Regulatory and Ruling Guidance Concerning Tax Treaties

Appendix G - Jeffery M. Kadet and David L. Koontz, "Effects of New Sourcing Rule: ECI and Profit Shifting", *Tax Notes,* May 21, 2018, p. 1119.

APPENDIX A

Modernization of Sourcing of Income and Effectively Connected Income (ECI) Regulations (Regulations under §§861 - 864)

Problem: Existing income sourcing and ECI regulations are sufficient to determine, calculate, and impose ECI taxation for traditional (old) businesses but lack clarity when applied to new business models prevalent in the 21st century. These include large MNCs that depend on the use of digital and internet tools in their centrally managed worldwide business models (e.g. high-tech manufacturers, pharmaceutical companies, internet-based companies earning advertising and commission income, etc.). The existing regulations need modernization to provide the IRS with another and even more effective tool to use against profit-shifting structures. Currently, the IRS's primary tools to reverse profit-shifting structures have been transfer pricing and re-characterization, both tools that are very subjective to apply and uncertain of success in the complex litigation that inevitably follows. Modernizing the rules for applying ECI taxation would hopefully encourage taxpayers to avoid aggressive structures and effectively add another enforcement tool for the IRS to apply and sustain due to ECI's more objective, fact-based criteria.

Solution: It is critical that sourcing and ECI regulations be updated to reflect modern-day business models such as supply chains, contract manufacturers, etc. Moreover, updating these regulations and making them consistent with other parts of the Code and regulations would make ECI taxation easier for both taxpayers and the IRS to apply. Failing to up-date these regulations will likely result in situations where ECI taxation should apply but which may go unrecognized by taxpayers, outside auditors, and the IRS.

Regarding specific regulations to be modernized, the Reg. §1.864-6 rules (regarding sales of goods or merchandise through a U.S. office of a foreign taxpayer) focus closely on the sales contract and not on the many critical activities, often performed within the United States by related persons, that strongly support not only consummated sales but critical purchase and/or production functions. For example, many profit shifting structures start with the transfer of production intangibles to a zero- or low-taxed foreign group member that itself has no personnel or capacity to:

- Conduct production through its own facilities;
- Direct production physically performed by a contract manufacturer;
- Control the risks associated with production or the holding of the production intangibles.

Capacity to carry out these functions remains within one or more U.S. group members that act on behalf of the foreign group member. These U.S. group members conduct production operations, make day-to-day business decisions, and manage production risk for that foreign member. Such operations and decisions can include the contractual terms of agreements signed by the foreign member with component suppliers, raw material vendors, and contract manufacturers. It also includes decisions on production processes, production quantities, quality control, etc. Such functions and activities, and the commercial risks that arise from them, are a crucial and critical part of any manufacturing business.

This sort of profit shifting structure, voluntarily created by many MNCs seeking to shift profits into zero- or low-taxed foreign group members, creates solely *in legal form* an independent company that produces products and sells them. Most or all production functions (short of the physical manufacture that is performed by a usually unrelated contract manufacturer) are performed by group members in the U.S., which are ostensibly acting as independent contractors under a service agreement and not as an agent, joint venturer, or partner.

Modernization of the §§861-864 regulations is needed to reflect the reality that U.S. group members are performing critical production functions and making day-to-day business decisions that control the potential profitability of and commercial risks borne by the foreign group member. Such modernization could include:[6]

- **Meaning of "Produced"**

  Reg §1.864-1 should be amended to read:

  > For purposes of sections 1.861-1 through 1.864-7, the word "sale" includes "exchange"; the word "sold" includes "exchanged"; the word "produced" includes "created", "fabricated", "manufactured", "extracted", "processed", "cured", "aged", and activities that constitute a substantial contribution (within the meaning of section 1.954-3(a)(4)(iv)) to the manufacture, production, or construction of personal property through the activities of a taxpayer's employees, agents, and related persons (within the meaning of section 1.954-1(f)).

- **Clarity of Engaged in Trade or Business within the United States**

  Reg §1.864-2 should be amended to clarify that a foreign taxpayer having no capacity or personnel to conduct all or any material portion of its business or to manage the commercial risks of all or any material portion of its business will be engaged in trade or business within the U.S. when those functions or management of risks are conducted by one or more persons within the U.S. Such persons include not only agents of the foreign taxpayer, but also putative independent contractors (whether related or not) acting under a service or similar agreement. The following should be added at the end of paragraph (a) of Reg §1.864-2:

  > The term also includes the performance of activities within the United States (for example the purchasing or production of products, the substantial contribution to the manufacturing of personal property within the meaning of section 1.954-3(a)(4)(iv)(*b*), the sale of products, the maintenance and management of an internet-based platform through

[6] The suggested modernizations included below assume the present regulation structure under §864 that have not yet been updated to reflect the addition of §865 and, in particular, §865(e)(2), which causes relevant sales of personal property to be U.S. source and therefore ECI under §864(c)(3) rather than foreign source and, as a result, covered by §864(c)(4)(B)(iii).

> which sales are made or advertising or other internet based service revenues are earned, the rental or licensing of intangibles, etc.) by another person (whether related or not and including activities performed under any independent contractor service agreement or agency) who conducts all or any material portion of these activities or manages the commercial risks thereof for or on behalf of any taxpayer when the taxpayer itself has insufficient personnel or capacity to conduct all or any material portion of its business or manage the commercial risks thereof. The actual conduct and activities of the persons will control rather than any contractual label or description that provides, for example, that the person conducting the activities or managing the commercial risk is an independent contractor providing a service.

- **Gross Income from Internet-Based Platforms**

Many MNCs and other taxpayers conduct centrally managed worldwide businesses that involve the provision of digital goods and services. At the core of these businesses are the central ongoing decision-making concerning the business being conducted and the day-to-day maintenance and management of the internet platforms that are accessed by users globally. For many MNCs, these platforms were not only developed primarily within the U.S., but both the ongoing decision-making and the platform maintenance and management are also conducted mostly, if not wholly, within the U.S. While users (including advertisers) from a particular country, territory, or region may access a platform presented in their local language with some localization of the products or services offered, the platform and the digital goods and services offered are virtually the same worldwide. It is MNC personnel located in the U.S. who maintain and manage these worldwide platforms and are the decision makers with regard to matters such as the products or services to be offered, the terms on which they will be offered including pricing, etc.

These digital goods and services include providing advertisers and others with access to the MNC's user base and information about users. They also include without limitation providing platforms for gig economy workers (e.g. ride sharing), acting as agents selling the products of others (e.g. software and non-physical products like ebooks, music, movies, etc.), and providing cloud services.

For some years now, the regularly issued Priority Guidance Plan has included a project focused on the sourcing and character of income related to digital goods and services. The most recent quarterly update issued on May 9, 2018, of the 2017-2018 Priority Guidance Plan in the International section on page 23 at F.2. states:

> Regulations under §861 on the character of income, including income arising in transactions involving intellectual property and the provision of digital goods and services.

The authors of this submission have no information of what is being considered for these future regulations. However, we believe that where an internet platform and the business being conducted are primarily maintained and managed from within the U.S., future regulations will likely provide that some material portion of the revenue generated will be U.S. source gross income, irrespective of where in the world the user, advertiser, or customer may be.

For prior and current years until these contemplated regulations are issued, source of income will be based on the existing regulations, IRS rulings, other IRS pronouncements, and case law. While there of course can be arguments made for specific taxpayer situations regarding the character of income and the source rule to be used, it seems that often the facts and circumstances approach of Reg §1.861-4(b)(1) will be the most appropriate sourcing rule to apply. Where this is the case, the day-to-day U.S.-based maintenance and management of the group's business and internet platform will cause material amounts of U.S. source income, again irrespective of where in the world the user, advertiser, or other customer may be.

Many MNC profit shifting structures involve the license or transfer of IP created primarily within the U.S. to zero- or low-taxed foreign group members. Such transactions provide the basis for the foreign group members to record revenues generated by the internet platform from digital goods and services. A transfer often involves first an ownership transfer of existing IP along with a cost sharing agreement that allows the group member participants to own their respective shares of future IP development for exploitation within their respective geographic areas.

The foreign group member licenses or owns its IP, but it participates minimally, if at all, in the actual operation of the internet platform through which it earns its revenues from digital goods and services. Rather, one or more U.S. group members conduct within the U.S. the bulk or all of the maintenance and management of the business and platform for foreign group members (including management of risk of the group's investment in the platform), presumably under a service or similar agreement. The foreign group member's personnel (including the employees of any disregarded entity subsidiaries) are typically involved in marketing, customer support, logistics, and similar activities. They normally have neither the knowledge nor the capacity to participate in maintaining and managing the platform or in managing the risk of the IP they license or own. Further, they do not have the capability of directing an independent service provider to perform these functions and manage these risks.

In these circumstances, note that under Reg §1.482-7(j)(3)(i), cost sharing transaction payments will be considered the payor's costs of developing intangibles at the location where such development is conducted. Reg §1.482-7(j)(2)(ii) provides that a foreign participant in a cost sharing agreement will not be treated as engaged in trade or business within the U.S. solely by reason of its participation in a CSA. However, if other factors create a trade or business within the U.S., the paragraph (j)(3)(i) characterization rule means that the foreign participant is considered to directly own a share of an intangible asset (the internet platform) that is maintained and managed on a day-to-day basis within the U.S. This means that the existing regulations characterize the foreign participant as earning gross income from "directly-owned" assets that are part of an active business being managed and conducted within the U.S. This characterization further supports that there must be some material amount of U.S. source income.

Under the first bullet point above, we have suggested a change to Reg §1.864-2(a) that would make clear that a foreign group member earning gross income from digital goods and services through an internet platform that is maintained and managed within the U.S. as described within this bullet point will be engaged in trade or business within the United States. We suggest that the following **Example (4)** be added to Reg §1.864-4(b) to make clear that any U.S. source income earned by such a foreign group member would be effectively connected income.

> **Example (4).** In 2005, U.S. Parent (USP) and its wholly owned Foreign Subsidiary (FS) execute a cost sharing agreement (CSA) to develop digital goods and services, an internet platform, related software, and business processes for earning revenues worldwide from the sale, exchange, rental, lease, or similar transactions related to such digital goods and services. Under the CSA, each of USP and FS owns a share of the internet platform and holds the economic rights for exploitation of the developed IP within its respective geographic territory (for USP, North America, and for FS, the rest of the world). FS (including its disregarded entity subsidiaries) conducts marketing, customer service, logistics, and related activities within its territory. Under a service agreement, FS contracts with USP for USP to maintain and manage the internet platform that USP and FS jointly own. It is determined that the facts and circumstances of USP and FS cause FS to be engaged in trade or business within the United States under the provisions of section 1.864-2. FS's income or loss from sources within the United States is treated as effectively connected for 2005 with the conduct of a business in the United States.

- **Office or Other Fixed Place of Business Within the United States**

Amend Reg §1.864-7(c) by adding the following sentence at the end of this paragraph.

> However, where the officers or other personnel of the domestic parent corporation are not only responsible for policy decisions affecting the related foreign sales corporation, but also conduct activities that represent the business of that foreign sales corporation (for example, officers or other personnel are involved in negotiations with major customers, approve the terms of specific sales contracts, manage or control the purchasing and sourcing of inventory property from vendors or from contract manufacturers, etc.) or manage its commercial risks, then that foreign sales corporation will be considered to have an office or other fixed place of business in the United States.

Amend Reg §1.864-7(g) by adding the following new Example (7) at the end of this paragraph.

> **Example (7).** S, a foreign corporation, is engaged in the business of manufacturing a microphone and selling it to customers within its territory, which is all countries outside North America. S is a wholly owned subsidiary of P, a domestic corporation engaged in the business of manufacturing the same microphone and selling it to customers in North America. The physical manufacture of the microphone is performed by an unrelated contract manufacturer under separate contract manufacturing agreements that each of P and S have executed with the contract manufacturer. P and S have executed a cost sharing agreement (CSA) for the development of the microphone and the production processes to produce it.
>
> Employees of P conduct the bulk of the development work under the CSA. They also conduct virtually all functions described in section 1.954-3(a)(4)(iv)(*b*), which represent a substantial contribution to the manufacture of the microphones. The performance of these functions is integral and necessary for both P and S to source their respective microphones from the contract manufacturer.
>
> S does not have a fixed facility in the United States, and none of its employees are stationed in the United States. Officers and employees of P are generally responsible for the policies followed by S and are directors of S. S has a chief executive officer in Country A who, from its office therein, handles the day-to-day conduct of S's business. However, the chief executive officer does not have the knowledge or capability to perform the functions described in section 1.954-3(a)(4)(iv)(*b*) or to direct another person to do so. If P did not perform these functions, S would be incapable of either manufacturing, or having manufactured, the microphones for which it holds IP rights under the CSA.
>
> Based upon the facts presented, S is considered to have an office or other fixed place of business in the United States for purposes of this section.

- **Income, Gain, or Loss Attributable to an Office or Other Fixed Place of Business in the United States**

Reg. §1.864-6, which in part concerns sales of goods or merchandise through a U.S. office of a foreign taxpayer, focus closely on the sales contract and not on the many critical activities, often performed within the United States by related persons, that strongly support not only consummated sales but critical purchase and production functions. We recommend amending the first sentence of Reg §1.864-6(b)(2)(iii) to read as follows:

> Income, gain, or loss from sales of goods or merchandise specified in paragraph (b)(3) of section 1.864-5, if the office or other fixed place of business is involved in purchasing such goods or merchandise, conducts production activities with respect to such goods or merchandise (within

> the meaning of section 1.954-3(a)(4)(i), including activities described in paragraph (4)(iv)*(b)*), or actively participates in soliciting the order, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale which are not the subject of a separate agreement between the seller and the buyer.

The effect of this amendment is best illustrated by an example. Say that a zero- or low-taxed foreign group member sells products through an internet platform that is maintained and managed by a U.S. group member. The U.S. group member could also conduct certain product purchasing functions for the foreign group member. Assume that the foreign group member does not have any foreign office that is a material factor in the realization of income (see Reg §1.864-6(b)(3)(i)). Assume also that the foreign group member through its own employees (including the employees of any disregarded entity subsidiary) does not perform any product purchasing functions.

Under the current regulation, the foreign group member takes the position that neither the operation of the internet platform nor the purchasing activities conducted by the U.S. group member cause the sales income to be attributable to an office or fixed place of business within the U.S. This means that even with no foreign office that is a material factor in the realization of income and with no purchasing activities performed by the foreign group member, the gross income from sales will not be ECI.

With the suggested amendment of the first sentence of Reg §1.864-6(b)(2)(iii) (and the other suggested regulatory changes included in this submission), it will be clear that the sales income will be attributable to an office or fixed place of business within the U.S. Once this "attributable to" condition is met, the sales income will be U.S. source income under §865(e)(2) and ECI under §864(c)(3).

- **Production and Sale of Inventory Property (§863(b)(2))**

With the amendment by the TCJA of §863(b), there will undoubtedly be significant amendments to certain of the regulations under §863. We suggest below several items that could be included as a part of these amendments.

Reg §1.863-3(c)(1)(i)(A)

Amend the first three sentences of this subclause to read:

> For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory including activities that constitute a substantial contribution (within the meaning of section 1.954-3(a)(4)(iv)) to the manufacture, production, or construction of personal property. See section 1.864-1. Subject to the provisions in section 1.1502-13 or paragraph (g)(2)(ii) of this section, the production activities that are taken into account for purposes of sections 1.863-1, 1.863-2, and this section are those conducted directly by the taxpayer and those conducted by the taxpayer's agents and related persons within the meaning of section 1.954-1(f).

Reg §1.863-3(c)(1)(i)(B)

Amend the first sentence of this subclause to read:

> Subject to the provisions of section 1.1502-13 and paragraph (g)(2)(ii) of this section, production assets include tangible and intangible assets owned directly by the taxpayer, the taxpayer's agents, and related persons (within the meaning of section 1.954-1(f)) that are directly used to produce inventory described in paragraph (a) of this section.

Reg §1.863-3(c)(1)(i)(C)

The location of intangible production assets could be based on where the personnel are who perform relevant "substantial contribution" activities as described in Reg §1.954-3(a)(4)(iv)*(b)*.

Consideration of Alternative Manner of Apportionment

Given the need to modernize Reg §1.863-3 to reflect new business models such as those using contract manufacturers and activities constituting a "substantial contribution to the manufacture of personal property" as described in Reg §1.954-3(a)(4)(iv)*(b)*, consideration should be given to an alternative method of apportionment when basing apportionment on the location of production assets is inappropriate. For example, perhaps allocations based on the location of personnel (whether employed by the taxpayer, its agents, or its related parties) involved in the Reg §1.954-3(a)(4)(iv)*(b)* production activities could be more appropriate in such situations. Or, the personnel costs of such production-involved persons could be used.

Reg §1.863-3(g)(3)

To make clear the application of the §863 rules to a foreign partner in a partnership for purposes of determining effectively connected income, add the following **Example 3** to Reg §1.863-3(g)(3):

> **Example 3.** Distribution in kind to foreign partner.
>
> Assume the same facts as in Example 1 except that the partnership, instead of selling the widgets, distributes the widgets to A and B. B sells the widgets outside the United States through a sales office in its country of incorporation. In determining the effectively connected income earned by B on its gross profit from sales outside the United States, B is treated as conducting the activities of the partnership related to production of the distributed widgets. Accordingly, in applying this section, B is treated as owning its proportionate share of the partnership's production assets based upon its distributive share of partnership income. The source of gross income on the sale of the widgets is determined under section 863 and these regulations. B makes sales of inventory property produced in whole by the taxpayer within the United States and sold without the United States. Accordingly, income from B's sale of widgets shall be allocated and apportioned between sources within and without the United States solely on the basis of the production activities. As all production activities

> occur within, and all production assets are within the United States, all gross profits on B's sale of widgets are sourced within the United States. (If B simply purchased widgets from a third party located in the US for sale outside the US, wouldn't B avoid having US sourced income?)

To make clear the application of the §863 rules to a foreign partner in a partnership that uses a contract manufacturer for the physical production and makes a substantial contribution to production within the meaning of Reg §1.954-3(a)(4)(iv)*(b)*, add the following **Example 4** to Reg §1.863-3(g)(3):

> **Example 4.** Partnership makes substantial contribution to the production of inventory.
>
> Assume the same facts as in Example 3 except that the partnership, instead of manufacturing widgets in the partnership's plant located in the United States, engages an unrelated contract manufacturer in another county for the physical manufacture of the widgets. The partnership through its facilities and personnel within the United States conducts the activities specified in Reg §1.954-3(a)(4)(iv)*(b)*, thereby making a substantial contribution to the manufacture, production, or construction of the widgets. The partnership is accordingly considered to have produced the widgets sold. In determining the effectively connected income earned by B on its gross profit from sales outside the United States, B is treated as conducting the activities of the partnership related to production of the distributed widgets. The consequences described for Example 3 apply as well for this Example 4.

Anti-Abuse Rules in Connection with Certain Disregarded Entities

Our article attached to this submission as Appendix G, "Effects of New Sourcing Rule: ECI and Profit Shifting", in section III discusses foreign producer sales into the U.S. The article explains the double non-taxation result that some foreign producers will have from selling foreign manufactured products into the U.S. through a disregarded entity (DRE) subsidiary (e.g. a limited liability company) that is treated as a sales branch of the foreign producer by the U.S. but as a separate taxpayer by the country of the producer.

Through such a mechanism, while profit attributable to the manufacturing functions conducted in the producer's home country will be subject to tax in that country, the profits attributable to sales activities conducted within the DRE subsidiary will typically go untaxed by both the producer's home country and the U.S.

Under territorial tax systems used in most producers' home countries, there will typically be no home country taxation of the profits within the DRE subsidiary. Non-taxability by the U.S. of those same DRE subsidiary earnings is the result of the U.S. entity classification rules and the TCJA amendment to §863(b). Under that amendment, gross income from sales of property produced by a taxpayer in one country and sold in another is sourced solely in the location (or locations) where produced. As such, all gross income will be foreign source and will escape effectively connected income treatment despite the foreign producer being engaged in trade or business within the U.S.

Setting up a hybrid structure like this to create double non-taxation will likely be relatively easy for many foreign producers selling into the U.S. We strongly recommend that an anti-abuse rule that would override such structures be included in new regulations that reflect the TCJA amendment to §863(b).

- **Required Technical Correction of §864(c)(4)(D)(i)**

  Code §864(c)(4)(D)(i)) provides an exception to ECI treatment when a foreign corporation pays dividends, interest, or royalties that are foreign source income in the hands of the foreign taxpayer recipient and the foreign "…taxpayer owns (within the meaning of section 958(a)), or is considered as owning (by applying the ownership rules of section 958(b)), more than 50 percent of the total combined voting power of all classes of stock entitled to vote..."

  Given the potentially expansive effect on this provision by the deletion of §958(b)(4), it would appear that there should be a technical correction proposed to make this sub-clause read:

  > (i) consists of dividends, interest, or royalties paid by a foreign corporation in which the taxpayer owns (within the meaning of section 958(a)), or is considered as owning (by applying the ownership rules of section 958(b) as in effect before its amendment by the Tax Cuts and Jobs Act), more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or

  In order to reverse the effect of the deletion of §958(b)(4) by the Tax Cuts and Jobs Act within the regulations, Reg §1.864-5(d)(1) should be amended by adding the phrase "as in effect before its amendment by the Tax Cuts and Jobs Act (P.L. 115-97)", so that after amendment this subparagraph reads:

  > Dividends, interest, or royalties paid by a foreign corporation in which the nonresident alien individual or the foreign corporation described in paragraph (a) of this section owns, within the meaning of section 958(a), or is considered as owning, by applying the ownership rules of section 958(b) as in effect before its amendment by the Tax Cuts and Jobs Act (P.L. 115-97), at the time such items are paid more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

- **Update of Reg §§1.864-5(d)(2)(iv) and (v)**

  Reg §1.864-5(d)(2) provides an exclusion from ECI treatment for certain subpart F income of a CFC. One reference in this clause is to §954(c)(3) instead of §954(c)(2)(A). Another is to §954(c)(4) instead of §954(c)(3). These differences are due to subsequent reordering of the paragraphs within §954(c). Reg §§1.864-5(d)(2)(iv) and (v) should be amended to reflect these changes so that they would read:

  > (iv) Any income derived in the active conduct of a trade or business which is excluded under section 954(c)(2)(A), or

(v) Any income received from related persons which is excluded under section 954(c)(3).

- **Update of Reg §§1.864-5(b) and 1.864-6(b)**

  Reg §1.864-5(b), which deals with the treatment of certain foreign source income, refers in subparagraph (1)(ii) to gain or loss on the sale of intangible personal property. The Tax Reform Act of 1986 (P.L. 99-514) inserted §865, which deals with sales of intangibles and causes §§865(d)(1)(A) and (e)(2) to govern the treatment of such transactions. P.L. 100-647, §1012(d)(10)(A), also amended §864(c)(4)(B) to eliminate coverage of such sales of intangibles by paragraph (4). Since §865(e)(2) can make such sales U.S. source and therefore covered by §864(c)(3), clause (ii) of Reg §1.864-5(b)(1) no longer has any relevance and should be deleted. In addition, Reg §§1.864-5(b)(3)(iii) and 1.864-6(b)(2)(i) should be amended to remove any reference to gains or losses on the sale or exchange of intangible personal property.

If the Treasury and IRS do issue modernized regulations, they should consider issuing a notice as soon as possible to alert taxpayers to any planned regulatory changes. This could be done in a manner similar to the notices issued for inversions (i.e. Notice 2014-52 and 2015-79) and anticipated regulations to implement certain TCJA changes. Such a notice could not only announce the planned amendments to the sourcing and ECI rules, but it could also alert taxpayers that ECI is subject to higher effective tax rates due to the branch profits tax (see §884) and the loss of deductions and credits and the open statute of limitations where no tax return has been filed (see §§882(c)(2) and 6501(c)(3)). Such notice(s) would strongly encourage MNCs to refrain from implementing or continuing profit shifting structures.

APPENDIX B

<u>Amendment of Reg §301.7701-1(a)(2) and/or Issuance of Revenue Ruling on Partnership Status for Certain Profit-Shifting Structures</u>

Problem: Many MNC profit-shifting arrangements involve U.S. and foreign group members that conduct joint business activities using personnel, assets, and activities of two or more of the group members. Despite this reality of how many MNCs are operating, they take the position that such group members are totally independent of each other. Two examples will help demonstrate this.

First, consider an MNC that conducts a seamless worldwide business earning advertising revenues through a software platform, developed and expanded primarily by U.S. group members, that displays advertisements to the users of free services (e.g. email, search, etc.). While individual MNC group members record income from advertisers based on the advertiser's geographic location, U.S. group members conduct within the U.S. in one integrated operation for all applicable group members the day-to-day management and functions that allow the platform to operate and generate advertising revenues worldwide. These day-to-day management activities and functions are the guts of business operations and the actual activities that earn the profits.

Although zero- and low-taxed foreign group members, which license group IP or own it through cost sharing agreements, record their revenues and related expenses as if they were separate independent businesses, from a management and operational standpoint, they are not independently run businesses. Rather, they are part of one enterprise centrally run and conducted from within the U.S. Typically, such foreign group members do not have either the personnel or capabilities to conduct their own independent business or to even direct independent contractors acting on their behalf.

(Note that to keep the example simple, the above paragraph assumes a platform that is generating advertising revenues. The example could also cover platforms such as those that serve the gig economy and those that sell third-party produced products on either a buy-and-resell or commission basis.)

Second, using an unrelated Asian contract manufacturer, an MNC produces products for sale worldwide through a centrally managed supply chain. U.S. group members manage and conduct the bulk of the product development. Importantly, U.S. group members also manage and conduct the day-to-day production process itself, including functions such as:

- (i) Oversight and direction of production activities;
- (ii) Material selection, vendor selection, control of raw materials, work-in-process, or finished goods;
- (iii) Management of manufacturing costs or capacities;
- (iv) Control of manufacturing-related logistics; and
- (v) Quality control.

The MNC makes product sales through a number of sales channels. One channel is large volume sales made to major multinational customers and distributors around the world. Personnel within the U.S. not only set group-wide sales policy, but they may also be involved in maintaining relationships and negotiating sales terms with these major customers and distributors. Another channel involves sales made through a software platform used worldwide, for which U.S. group members conduct within the U.S. for all group members the day-to-day management and functions that allow the platform to operate and make sales. Despite this critical involvement of U.S. group members, sales to all foreign customers and distributors are recorded within zero- and low-taxed foreign group members. Such group members may provide local warehousing and other customer, logistical, and technical support, but they do not have the personnel or capability to independently conduct their own business. They are unable to direct the U.S. group members that are nominally acting as independent contractors, but that are in reality conducting crucial sales and production management, decision-making, and operational functions for the benefit of all group members making product sales.

(Note that this second example has been described as one that involves tangible inventory property. It could also involve the sale of intangible inventory property such as group-produced software.)

Although operationally the above two MNC group examples each conduct a globally seamless and centrally managed joint business, there is no overt partnership, joint venture, or similar contract governing the manner in which the group members conduct their joint business. Rather, each group member contracts separately with third parties (e.g. customers, raw material and component vendors, contract manufacturers, etc.) to give the legal appearance of separate and independently operating companies. Reflecting the reality that many functions benefiting zero- or low-tax foreign group members are being conducted by U.S. group members, intercompany service and similar agreements are executed that treat the U.S. group members as independent contractors and not as agents, partners, or joint venturers.

Solution: As covered in detail within the undersigned's article on unexpected partnership status, the above-described MNC profit shifting structures often create separate entities for federal tax purposes under Reg §301.7701-1(a)(2). Under the Reg §301.7701-3(b) default rules, these separate entities are characterized as partnerships.

It will be useful to contrast today's business models such as those described above with multinational businesses of decades ago that had a much different format than what has become so common today. Under this decades-old format, a U.S. parent company set group policies and provided oversight over its subsidiaries. However, these subsidiaries had a full complement of their own corporate officers (e.g. CEO, operations director, sales director, finance director, etc.) working from the subsidiary's facilities. The subsidiaries were truly standalone operations. Real on-the-ground management was an absolute necessity given the pre-internet communications and other technologies of the time (e.g. the telephone, telex, and fax machines). Enterprise software was in its infancy and even email did not emerge as a business communications device until the 1990s. *Given these independently run subsidiaries, there were not sufficient "joint business activities" that would ever cause any separate entity for tax purposes or a partnership. The issue simply didn't arise.*

Today, however, there is no longer any need for each subsidiary to have a full complement of its own corporate officers. The technology advances of the past several decades have allowed both a true centralized management and an isolation of specific and often narrow business functions that contribute to one worldwide business. The subsidiaries are each contributing to the group's worldwide business; they are no longer conducting their own independent businesses. The rise of supply chains where various functions occurring in different locations all contribute to one worldwide business is just one example. Another is the centralized management and operation of a worldwide internet-based business. Today's reality within many, if not most, MNCs is actual joint business activities and integrated management and operations.

Over the past several decades, the now commonly used centralized management of worldwide business has become the norm. It is easier, more cost effective, and commercially viable to manage and control a world-wide business using a management structure that relies on integrated technology and that directs personnel, assets, and activities located around the world toward a common goal. *The reality of this centralized management of group members and each member's sometimes narrow contribution to the group's worldwide business falls squarely within the applicable rules to create a separate entity and a partnership for tax purposes.*

Once the relationship between the U.S. and foreign group members is determined to be a partnership, there are several consequences.

- The U.S. and foreign group members are partners with the activities conducted and the assets used in that business considered to be those of the partnership and no longer the activities and assets of the respective partners. With the partnership carrying on a business through one or more U.S. offices, the foreign group member partners are similarly conducting a trade or business in the U.S. (§875(1)), which is the threshold test for applying the effectively connected income rules (§864(c)). Application of the ECI rules will be clear and unambiguous.
- Both partnership filing and §1446 withholding will apply.

Given both the important deterrence effect that partnership status will have on aggressive profit shifting structures and the important tool it represents for the government in its efforts to attack such structures, the authors recommend one, or, preferably, two actions. First, the Treasury and the IRS should make appropriate regulation amendments. Second, they should issue one or more revenue rulings that find separate entity and partnership status for relevant group members in certain profit shifting structures.

Amendment of Reg §301.7701-1(a)(2)

We suggest that Reg §301.7701-1(a)(2) be amended to read as follows:

> A separate entity for federal tax purposes shall include a joint venture or other arrangement, whether or not evidenced by a contract or other written agreement, through or by means of which the participants carry on any business, financial operation, or venture. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. On the other

> hand, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. A joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes. Participants, however, may create a separate entity for federal tax purposes if they actively carry on a trade, business, financial operation, venture, or any portion thereof and divide in any manner the profits or the products or other results thereof. Such a trade, business, financial operation, or venture may include, for example, (i) the joint production of inventory property, whether tangible or intangible, where the participants take in-kind or dispose of their shares of any property produced, extracted, or used, or (ii) the joint conduct of an internet platform-based business (e.g. giving advertisers access to platform users or providing cloud or other services including, for example, providing software and applications to users and acting as a sales agent or intermediary between users and third-party providers).

The above recommended language does two things. First, it adds examples that take into account modern business models using digital technologies. Second, it moves and expands the phrase "divide the profits therefrom".

While the addition of modern business model examples is self-explanatory, the movement and expansion of the "profits" phrase deserves some explanation.

The first sentence of present Reg §301.7701-1(a)(2) reads:

> A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture *and divide the profits therefrom*. [Emphasis added.]

This sentence implies that for a separate entity to exist for federal tax purposes, the arrangement amongst the participants must have profits (or presumably losses) that are shared in some manner between them. Importantly, this implication is neither consistent with other Code and regulatory provisions nor with the historical regulations on which the current Reg §301.7701-1(a)(2) is based.

Regarding this inconsistency with other Code and regulatory provisions, first note §§761(a) and 7701(a)(2) that provide, with only minor language differences:

> For purposes of this subtitle, the term ''partnership'' includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate.

Focusing solely on this statutory language, joint production alone carried out by MNC group members reasonably falls within ''any business, financial operation, or venture.'' This is made 100% certain by §761(a)(2), which effectively states that an organization that is availed of "for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted" may elect to be excluded from the application of all or part of subchapter K. If such an organization were not a partnership covered by subchapter K in the first place, it would not be necessary to have a specific provision allowing it to elect out of subchapter K. The point here, of course, is that an arrangement in which two or more participants solely produce inventory property with each participant taking its share in-kind will have no revenues from joint sales or services. As such, it will have no profit to share amongst the participants. Hence, without question, a separate entity for federal tax purposes can exist without the sharing of profits.

Note that even if this §761(a)(2) were not already a 100% certainty for joint production, for any MNC group members that also conduct joint sales, licensing, and service activities, these joint activities absolutely fall within these statutory provisions.

We stated above that there is also an inconsistency between the current regulation (Reg §301.7701-1(a)(2)) and the historical regulation on which the current regulation is based. This inconsistency directly involves the phrase "*divide the profits therefrom*".

Specifically, to repeat, the first sentence of Reg §301.7701-1(a)(2) is:

> A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and *divide the profits therefrom*. [Emphasis added.]

This placement of the "divide the profits" phrase makes it appear that the existence of profits and their being divided amongst the participants is a condition for there to be a separate entity for federal tax purposes. By contrast, the pre-1997 regulation (Reg §301.7701- 3(a)) from which this language was taken reads, in part:

> (a) In general. The term ''partnership'' is broader in scope than the common law meaning of partnership and may include groups not commonly called partnerships. Thus, the term ''partnership'' includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate. . . . Mere co-ownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership. . . . Tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and *divide the profits thereof*. For example, a partnership exists if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. [Emphasis added.]

This "divide the profits" phrase was previously only a means of distinguishing within the regulation *one example* of a situation involving co-ownership of property and did not modify the basic definition of a partnership, which was: "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on." This use in one example was, of course, fully consistent with the statutory definitions in both §§761(a) and 7701(a)(2), neither of which included any "divide the profits" requirement and neither of which was changed when the current regulation was promulgated in 1997.

By moving this "divide the profit" phrase to the first sentence in Reg §301.7701-2(a), it became in appearance a principal part of the definition of a separate entity for federal tax purposes, and thus narrowed the meaning of that term.

Was there any intention when the new 1997 the check-the-box regulations were issued to actually change the meaning, or at least the emphasis, of the definition of separate entity for federal tax purposes and narrow it through the addition of this "divide the profit" phrase?

We believe there was no such intention for any change that would narrow the meaning. First, of course, the statutory definition of "partnership" of many decades had not changed in either of §§761(a) or 7701(a)(2). Thus, there was no authority for any narrowing of the definition of "partnership" or the term "separate entity for federal tax purposes", which is critical for defining the classification of entities under the new check-the-box regulations. Second, with the overall intention of the 1997 check-the-box regulations being simplification, the Treasury and IRS were likely just cleaning up the language of the reconfigured regulations without intending any change of meaning.

Interest in Partnership for Determining Distributive Share (§704(b))

As indicated earlier, the statutory definition of partnership, and by extension the definition of a separate entity for federal tax purposes, is very broad and includes organizations established under applicable local law and those established through contracts and the joint actions of the parties. The MNC group member relationships briefly described in the above examples are established through the operating joint activities of the parties and by other relevant factors, including verbal understandings, internal group policies, management lines of authority, and intercompany contracts — including any licensing and cost sharing agreements as well as any intercompany service agreements under which U.S. group members provide services to foreign group members. All of these will be factors in defining each participant's interest in the separate entity for federal tax purposes, and thus each participant's interest in the partnership for determining its distributive share under §704(b).

Consideration should be given to adding guidance and examples to Reg §1.704-1.

First, as a simplified approach that would be practical and easy to apply, the partnership profits (i.e., generally the combined profits of the joint business conducted by the group member partners) could be apportioned each year based on some appropriate factor(s) that each group member partner brings into the partnership. These factors could include, for example, the year's average net assets, average personnel, average compensation, gross income from sales, etc. An additional factor that could often be relevant would be cumulative R&D expenses to reflect the contribution of intangibles.[7] Where production occurs through use of a contract manufacturer and group personnel are performing the functions described in Reg §1.954-3(a)(4)(iv)*(b)*, the personnel performing these manufacturing functions may be quite important and indicative of what each group

[7] Note that where a partnership is found, any CSA that the partners may have executed would no longer be recognized since all relevant activities would be treated as occurring within the partnership, which is a single taxpayer. A CSA requires that there be two or more taxpayers.

member partner contributes to the partnership with net assets having little relevance. For many profit shifting structures, the zero- or low-taxed foreign group members will likely bring little or nothing into the partnership in the way of many of these factors.

A possible second approach would be to determine partner interest-in-the-partnership percentages as of the creation of the partnership. Those percentages would then be applied to the partnership profits for each subsequent year. Such percentages could be based on the original terms of the intercompany agreements executed among the group members when the partnership was created (i.e. likely at the same time that the group initiated its profit shifting structure). The terms of those various agreements (cost sharing agreement, any licensing agreements, intercompany service agreements, etc.) should reflect any IRS transfer pricing adjustments or advance pricing agreement that may have been obtained by the group.

A third approach would be to apportion the partnership profits by determining for each year each partner's interest-in-the-partnership, and thus its distributive share, based on the various written agreements between them (e.g. the cost sharing agreement, service agreements, etc.) and each partner's separate agreements with third parties (e.g. customers, contract manufacturers, suppliers, etc.).

Issuance of Revenue Rulings

We recommend that one or more revenue rulings be issued that prescribe when a joint business conducted by an MNC's group members shall create a partnership for tax purposes with those group members as the partners and their separate activities, which are limited to those activities that are part of the joint business, being treated as activities of the partnership. Such guidance for certain profit shifting structures should be a simple approach to demonstrating the government's resolve to fight artificial profit shifting structures.

One or more revenue rulings could also explore the issue of what group members' activities might be factually included within the joint business, and therefore included as activities of the partnership and not the separate activities of any partner. In addition to activities such as joint purchasing, production, and sales activities, research and development benefiting all group member partners would be included as well. As noted above in footnote 7, when so included, a ruling could provide that any cost sharing agreement signed by the group member partners would be no longer recognized for tax purposes.

Article 3 in footnote 3 provides detailed information from which a ruling may be drafted. The writers of this letter would be pleased to provide further guidance if it would be helpful.

APPENDIX C

Designate Certain MNC Profit-Shifting Structures as Listed Transactions

Many MNC profit-shifting structures exhibit three factors that suggest the existence of a U.S. trade or business, a partnership, and ECI. The three factors are:

(a) Critical value-drivers performed predominantly by U.S. group members;

(b) Extensive U.S.-located control and decision-making that far exceed what would be found in typical unrelated-party situations; and

(c) A lack of capable foreign member management personnel and no CEO or similar position within the foreign group member who in substance runs that entity's worldwide business from an office outside the U.S.

We suggest that profit-shifting structures with these characteristics be designated as a "listed transaction" under Reg §1.6011-4(b)(2). If so designated, all parties will be on notice concerning the various penalty and disclosure requirements that apply to taxpayers that fail to report relevant income and pay tax. This should encourage some MNCs and their advisors to change or unwind existing profit-shifting structures as well as discouraging the creation of new structures. It should also discourage professional firms from pushing risky structures on existing and potential clients due to the disclosure and penalties applicable to any material advisor.

If for any reason it is determined that it is not possible to designate these structures as "listed transactions", they could be designated as "transactions of interest" under Reg §1.6011-4(b)(6).

Whether or not it is decided to designate certain profit-shifting structures as listed transactions or transactions of interest, and to the extent that doing so would not require Congressional action, consideration should be given to providing administrative relief to unwind profit-shifting structures so as to encourage compliance and self-reporting of prior years' tax obligations on amended or late filings through abatement of penalties and/or other amounts that might otherwise be due.

APPENDIX D

Profit-Shifting Structures Implemented Following Inversions and Acquisitions by Foreign Acquirers

There have been and continue to be both inversion transactions and acquisitions of U.S.-based MNCs by foreign persons (including foreign acquisition vehicles owned by U.S. private equity funds). In all of these cases, following the inversion or acquisition, there are considerable tax-motivations to transfer U.S.-owned intangible assets to foreign group members and to establish profit-shifting structures that route profits to group members that are not CFCs.

Treasury and the IRS should consider issuing one or more notices to make clear that following any such inversion or acquisition the valuation of any transferred assets and the potential for ECI and earnings stripping will be priorities for examination. This could also be made a part of the LB&I Campaign program.

The following paragraphs include two examples. The first clearly illustrates post acquisition transfers of U.S. intangibles and related issues. The second, while not a tax case, illustrates how the acquisition of IP may be an important motivation for a foreign acquirer. In such cases, IRS examinations should be looking not only for undervaluation of IP transfers, but also for unrecorded transfers where acquirer group members merely start using the IP in their other products. This may have occurred in this Segway example.

Example 1 – Valeant Pharmaceuticals International

The first and perhaps best example is Valeant Pharmaceuticals International, a Canadian public company listed in the U.S. that is the result of a 2010 inversion. Interestingly, because Valeant was invited on July 30, 2015, to testify before the Senate Homeland Security and Affairs Permanent Subcommittee on Investigations ("PSI"), there is significant internal company information on tax avoidance involved in Valeant's acquisitions of U.S. groups (including, for example, Salix Pharmaceuticals (2015) and Bausch and Lomb (2013)).[8]

The PSI Majority Staff Report,[9] on pages 12 through 31 provides significant detail on how Valeant transferred intangibles owned by the acquired companies out of the U.S. shortly after each acquisition and set up profit-shifting arrangements. Not only is there the issue of valuation for transferred intangibles, which were transferred to an Irish subsidiary, but with the apparent lack of any change in the conduct of the acquired companies' businesses, it is likely that the Irish company has significant taxable ECI following the transfer of these intangible assets.

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[8] All PSI hearing documents are available at http://www.hsgac.senate.gov/subcommittees/investigations/hearings/impact-of-the-us-tax-code-on-the-market-for-corporate-control-and-jobs

[9] Available at http://www.hsgac.senate.gov/download/?id=2C48E3A3-AFBE-43CB-8F05-0996EAAFCDF7

Example 2 – Segway

Turning to another U.S. taxpayer, on September 9, 2014, Segway Inc. filed a trade complaint[10] against a number of companies, most of which are Chinese. The basis for the trade complaint was that the respondents were importing products that infringed various Segway patents. Later in April 2015, it was announced that one of the Chinese respondents, Ninebot Inc., would acquire Segway.[11] An interview with a co-founder of the acquirer stated:

> The primary benefit of buying Segway is the patents. … Ninebot is still young, as is Xiaomi [a major Chinese company partially funding Ninebot], so we can't successfully apply for many patents. Segway has the core patents for the self-balancing vehicle industry, so this acquisition will help us with our patents a lot.[12]

It seems likely that in many acquisitions like this, there may be not only undervalued transfers of intangibles to foreign acquirers, but there may be many undocumented transfers of designs, processes, and patent rights to foreign acquirers. IRS audit activity must identify such transferred intangibles and discourage such transfers through giving notice to applicable taxpayers of this priority.

The TechCrunch piece cited in footnote 8 commented regarding Xiaomi:

> This marks the latest in a series of hardware and Internet of Things investments by Xiaomi, which has also given funding to companies like Misfit, Pebbles Interfaces, and iHealth Labs. Alliances with these startups can potentially help Xiaomi build its e-commerce unit, which, along with Internet services and hardware like its smartphones, form the core parts of its business.

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10 Available at http://www.itcblog.com/images/segwaycomplaintLR.pdf

11 Shu, "Beijing-based Ninebot Acquires Segway, Raises $80M From Xiaomi And Sequoia", TechCrunch (April 15, 2015), available at http://techcrunch.com/2015/04/15/ninebot-segways-into-the-future/.

12 Horwitz, "The founder of China's Ninebot says he bought Segway for the patents", TechinAsia (April 17, 2015), available at https://www.techinasia.com/founder-chinas-ninebot-bought-segway-patents.

APPENDIX E

Addition of Examples to the Manufacturing Branch Rule

Article 6 listed in footnote 3 notes how the manufacturing branch rule may apply to cause some gross income not caught by the ECI rules to be subpart F income. This treatment is not sufficiently clear in existing regulations and we suggest the following examples be added to the regulations as set out below.

In brief, assume that the facts underlying an MNC's profit shifting structure cause there to be an unanticipated partnership for U.S. tax purposes with U.S. group members and zero- or low-taxed foreign group members as partners. An explanation of why this may be likely is covered in Appendix B of this submission.

Although the MNC group uses one or more unrelated Asian contract manufacturers for the physical production of inventory property, the joint production activities of the group members conducted through the partnership meet the requirements of Reg §1.954-3(a)(4)(iv)(*a*) so that the inventory property sold by the partnership is considered manufactured, produced, or constructed by the partnership, and in turn by the CFC partners (Reg §1.954-3(a)(6)). As a result of this, the manufacturing branch rule of Reg §1.954-3(b)(1)(ii) applies. Note the last sentence of subparagraph (a) of Reg §1.954-3(b)(1)(ii), which reads:

> … The provisions of this paragraph (b)(1)(ii) will apply only if the controlled foreign corporation (including any branches or similar establishments of such controlled foreign corporation) manufactures, produces, or constructs such personal property within the meaning of paragraph (a)(4)(i) of this section, or carries on growing or extracting activities with respect to such personal property.

Example 1 – All Manufacturing Performed in U.S.

Assume first that all of the partnership's production activities within the meaning of Reg §1.954-3(a)(4)(iv)*(b)* occur at offices and other facilities within the U.S. so that each CFC partner "carries on [through the partnership] manufacturing, producing, constructing, growing, or extracting activities by or through a branch or similar establishment located outside the country under the laws of which such corporation is created or organized". Also assume that some portion of the partnership's sales are made for use, consumption, or disposition outside the U.S.

Before the TCJA and its amendment of §863(b), gross income from the production of inventory property within the U.S. and its sale outside the U.S. was sourced through one of several regulatory approaches that sourced a portion of the gross profit based on the taxpayer's production activities and the remainder based on the taxpayer's sales activities. After this TCJA amendment of §863(b), all (100%) of the gross profit is sourced at the location(s) of production.

Prior to the TCJA §863(b) amendment, the manufacturing branch rule is relevant for this Example 1, which involves production activities *solely* within the U.S. This is because the pre-TCJA partnership will have some foreign source income due to sales made outside the U.S. Because this foreign source gross income is not ECI and therefore could not be directly taxable to a CFC partner, this foreign source income must be subjected to subpart F analysis. After the TCJA, with 100% of the gross profit based at the location of production, all gross profit under the facts of this Example 1 will be ECI, thereby causing subpart F and the manufacturing branch rule to no longer be relevant. (However, see Example 2 below with different facts where the manufacturing branch rule is relevant post-TCJA.)

With the partnership's manufacturing branch being located in the U.S., the manufacturing branch rule (Reg §1.954-3(b)(1)(ii)(b)) is applied to pre-TCJA years by comparing the effective tax rate on the relevant foreign source sales income with 30%. This 30% is the lower of 90% of, or 5 percentage points less than, the 35% U.S. tax rate that existed prior to the TCJA. If the actual taxes imposed are less than 30%, the manufacturing branch rule applies to relevant foreign sales income that would otherwise be caught by the Code §954(d)(1) definition of foreign base company sales income (FBCSI).

Note that not all foreign source income will be FBCSI. For example, say that the partnership (or a low-taxed foreign member partner) has a sales office in Singapore. In that case, inventory property sold for use, consumption, or disposition within Singapore would not be caught by the Code §954(d)(1) FBCSI definition. However, sales into nearby Malaysia where there is no sales office would be caught.

Example 2 – Manufacturing Performed Both Within and Without the U.S.

Assume now that 50% of the partnership's production activities for certain personal property occurs at offices and other facilities within the U.S. and 50% for that personal property occurs at offices in China adjacent to the facilities of an unrelated contract manufacturer. All activities performed by the partnership within the U.S. and in China are those described in Reg §1.954-3(a)(4)(iv)*(b)* and the partnership (and each CFC partner) is considered to have manufactured these items of personal property under Reg §1.954-3(a)(4)(iv)*(a)*. The countries of incorporation of the CFC partners are zero- or low-taxed countries other than the U.S. or China. Through these U.S. and Chinese facilities, the partnership (and each CFC partner) "carries on manufacturing, producing, constructing, growing, or extracting activities by or through a branch or similar establishment located outside the country under the laws of which such corporation is created or organized". The partnership makes sales both within and outside the U.S.

With production activities being conducted both within and outside the U.S., under §863(b), whether prior to or following the above-mentioned TCJA §863(b) amendment, some portion of the gross income earned will be foreign source and, therefore, not ECI. With this foreign source income not being directly taxable ECI to any CFC partner, this foreign source income must be subjected to subpart F analysis.

The facts of this Example 2 make Reg §1.954-3(b)(1)(ii)(*c*)(*3*) applicable, which provides in part:

> This paragraph (b)(1)(ii)*(c)(3)* applies to determine the location of manufacture, production, or construction of personal property for purposes of applying paragraph (b)(1)(i)*(b)* or (b)(1)(ii)*(b)* of this section where more than one branch or similar establishment of a controlled foreign corporation, or one or more branches or similar establishments of a controlled foreign corporation and the

> remainder of the controlled foreign corporation, each engage in manufacturing, producing, or constructing activities with respect to the same item of personal property which is then sold by the controlled foreign corporation. …

Without going into unnecessary detail, Reg §1.954-3(b)(1)(ii)(*c*)(*3*) includes a number of examples that cover various possible factual situations involving a CFC's production activities in multiple locations and the use of unrelated contract manufacturers. Understandably, the examples consider situations involving one CFC with multiple operating locations and with its own personnel in each such location. None of the examples specifically consider a situation where multiple CFCs are conducting joint business operations in a manner that has created a partnership for tax purposes.

Simple Addition to Reg §1.954-3

Many MNC profit shifting structures implemented over the past two decades involve multiple group members (including both U.S. group members and CFCs) that conduct portions of a centrally managed and conducted worldwide business that is seamless to vendors, customers, and other third parties. As discussed in Appendix B, despite the lack of any partnership or joint venture agreement, the joint business activities conducted by these group members will often create a separate entity for federal tax purposes and a partnership under the Reg §301.7701-1 to -3 entity classification rules. Given such unanticipated partnerships, it is important to add clarity to Reg §1.954-3 such that taxpayers have increased guidance and the IRS has more specificity in taxing aggressive profit shifting structures that involve such jointly conducted businesses.

We believe that such clarity may be added to Reg §1.954-3 by adding the following example to Reg §1.954-3(a)(6):

> *Example.* USP, a U.S. corporation, wholly owns CFC, a controlled foreign corporation organized under the laws of Country A. It has been determined that USP and CFC conduct their centrally managed worldwide business in a manner that creates a separate entity for federal tax purposes under section 301.7701-1(a)(2) and a partnership under the section 301.7701-3(b) default rules (Partnership Y). As a result of this partnership classification, all assets, personnel, and activities involved in the joint production and sales are considered the assets, personnel, and activities of Partnership Y and not the assets, personnel, or activities of either partner.
>
> Through offices, facilities, and employees within the United States and Country B, Partnership Y performs activities within both countries that constitute the manufacture of Product P, within the meaning of paragraph (a)(4) of this section (including paragraph (a)(4)(iv)), if performed directly by CFC. Partnership Y, through its sales office in Country D, sells Product P to unrelated customers in Country E, a country in which Partnership Y maintains no sales branch.
>
> CFC's distributive share of Partnership Y's sales income must be analyzed to determine whether it is foreign base company sales income taking into account all of section 1.954-3 including both the manufacturing exception of paragraph (a)(4) and the branch rules of paragraph (b).

APPENDIX F

Regulatory and Ruling Guidance Concerning Tax Treaties

There has been significant profit shifting out of the U.S. and erosion of the U.S. tax base by both MNCs based in the U.S. and MNCs based abroad. Those based abroad include inverted MNCs, private equity acquisitions through foreign acquisition vehicles, and legitimate foreign-based groups. In some cases, such profit shifting has taken advantage of U.S. tax treaty provisions to reduce or eliminate withholding taxes or to apply treaty rules such as permanent establishment definitions in place of the lower-threshold standard of "engaged in trade or business within the United States".

Brief Background on Common Situations Involving Taxpayer Abuse of Treaties

- <u>Structures that Shift Business and Intangible Profits</u>

  With U.S.-based MNCs and some MNCs based abroad, especially inverted MNCs and private-equity structures, the foreign group member that is the "taxpayer" for U.S. tax purposes is a controlled foreign corporation (CFC) that is operating through one or more disregarded entity (DRE) subsidiaries. Some of those DRE subsidiaries are established in countries with which the U.S. maintains tax treaties. While such a DRE subsidiary is a bona-fide legal entity, fully respected as a separate taxable entity by its country of formation, it is treated solely for U.S. tax purposes as not existing and as a branch or division of its CFC owner, i.e., not an "entity". Accordingly, the U.S. views all DRE subsidiary personnel, assets, and activities as being employed, owned, and conducted by the CFC.

  As an example, assume that a U.S.-based MNC has established a CFC in a tax haven such as Bermuda. As that CFC has few or no employees of its own, it conducts business through subsidiaries in other countries for which check-the-box elections have been made to treat them as DRE subsidiaries. As a result of this structure, from a U.S. tax perspective, the only "taxpayer" is the Bermuda CFC. And that CFC operates through branches/divisions within the various countries where the DRE subsidiaries employ personnel, own assets, and conduct their respective operations. Those branches and divisions are not considered to be "entities" for U.S. tax purposes.

  The authors of this submission have written a number of articles (see footnote 3) describing some structures through which MNCs have shifted business and profits from intangible assets out of the U.S. and into zero- and low-taxed group members, one of which may be a CFC while others are DRE subsidiaries of that CFC. An important focus of these articles has been the possible application of effectively connected income taxation to some portion of these shifted profits (§864(c)). Typically, these profit shifting structures not only shift profits out of the U.S. They also shift profits out of the foreign countries in which they operate through DRE subsidiaries. As a result, these structures normally bear very low levels of foreign taxation.

ECI taxation requires that the foreign taxpayer (i.e., the CFC in this case) be engaged in a trade or business within the U.S. (§864(b)). Where a tax treaty properly applies, this "trade or business within the U.S." threshold is replaced by the permanent establishment definition included in the treaty. Further, where there is a permanent establishment and some amount of ECI is present, it is taxable at the normal corporate rate (pre-TCJA 35%, post-TCJA 21%). In addition, the branch profits tax (§884) applies at rate of 30% to the calculated dividend equivalent amount. If a tax treaty were to apply, then that 30% branch profits tax may be reduced or eliminated if the treaty specifies a lower rate or exemption.

- Structures Involving Interest, Royalties, and Dividends

  DRE Subsidiaries. In addition to business income, DRE subsidiaries may license IP for use in the U.S. or loan money to U.S. persons, thereby earning U.S. source royalties and/or interest. A DRE subsidiary might also invest in the shares of non-related U.S. companies, thereby earning U.S. source dividends. Where a DRE subsidiary is established in a country with which the U.S. maintains a tax treaty, it might maintain that it should receive a reduction or elimination of the 30% withholding tax that applies under domestic law to these types of payments.

  Other Foreign Entities. Foreign-based MNCs have aggressively eroded the U.S. tax base through interest and royalties charged to their U.S. operating subsidiaries. Concern about this has resulted in the TCJA adding new §59A, the base erosion minimum tax. This sort of base erosion by foreign-based MNCs normally does not involve either CFCs or DRE subsidiaries. It does, though, often involve routing interest and royalties though structures that arguably provide tax treaty benefits that reduce or eliminate the 30% U.S. withholding tax while avoiding any significant tax in the country of the treaty partner.

The U.S. enters into treaties to prevent double taxation; not to provide the opportunity for double non-taxation. Despite this, we see situations where taxpayers go through complicated structuring that arguably allows them to claim inappropriate treaty benefits. Most commonly, this means that they claim a treaty benefit from the U.S. while the relevant income is not taxed in the other treaty country on a normal resident basis. Thus, the sorts of profit-shifting structures and channeling of income from U.S. sources described above are normally only set up in treaty countries that offer special arrangements under which only a mere fraction (if any) of the normal resident tax is imposed. Well-known examples include Ireland and Luxembourg. Both have been documented as agreeing to special rulings and artificial practices that allow zero or little taxation far below the domestic effective corporate rates that apply to resident taxpayers. These special arrangements and low effective tax rates were not what U.S. treaty negotiators agreed to nor what the Senate thought it was ratifying.

The example within the first bullet point above assumes that the CFC is established in Bermuda, which maintains no tax treaty with the U.S. The CFC could also have been established in a country with which the U.S. maintains a tax treaty such as the U.K., Ireland, Switzerland, etc. In such cases, all (or virtually all) of the operating income is earned not within the CFC itself, but rather within the CFC's DRE subsidiaries. As such, that operating income would not be reported in the tax returns that the CFC submits to its own tax authorities in, say, the U.K. Further, due to the territorial tax systems and other exemptions and special rules employed by many countries, DRE subsidiary earnings actually distributed to the CFC typically go untaxed in the CFC's country of establishment.

Say that this CFC established in the U.K. claims that the activities of its DRE subsidiaries do not cause a permanent establishment in the U.S. under the U.S.-U.K. tax treaty. Or, say that the CFC has ECI and files a U.S. tax return to report profits earned within its DRE subsidiaries, but claims that the U.S.-U.K. tax treaty reduces the 30% branch profits tax to 5%. With the relevant income for which the CFC is claiming benefits under the U.S.-U.K. tax treaty not being reported within any U.K. tax filings, it is inappropriate for treaty benefits to be granted.

It could also occur that a DRE subsidiary claims tax treaty benefits based on the *U.S. treaty with the country of establishment of the DRE subsidiary*. This could occur, for example, where the DRE subsidiary claims that it has no permanent establishment within the U.S. or that the 30% branch profits tax should be reduced or exempted. It could also occur where the DRE subsidiary claims treaty reductions in the 30% U.S. withholding tax on dividends, interest, and royalties. Often, such claims involve taxpayer abuse that seeks benefits not anticipated by either U.S. treaty negotiators or the Senate.

The second bullet point also notes the inappropriate use of tax treaties by foreign-based MNCs to erode the U.S. tax base. CFCs and DRE subsidiaries are often not involved in such claims for treaty benefits.

Discussion

Fiscally Transparent Entities. Our belief is that such above-described abusive situations involving a CFC taxpayer that conducts business operations or records transactions (including investments, loans, licenses, etc.) through DRE subsidiaries should never receive any treaty benefits, either at the CFC level or at the level of any DRE subsidiary. (The only exception might be where the DRE subsidiary is incorporated within the same country as the CFC for solely non-tax reasons and tax on a normal resident basis is being paid to that country by both the CFC and the DRE subsidiary.) Almost without exception, schemes involving CFCs and DRE subsidiaries have been carefully crafted to avoid or significantly reduce both foreign and U.S. taxation by carefully working to fall within mismatches between the tax laws of the U.S. and one or more other countries to arbitrage their tax systems.

Both Fiscally Transparent and Non-Fiscally Transparent Entities. Sometimes, carefully crafted structures involve a special arrangement between a foreign entity (whether a DRE subsidiary or any non-fiscally transparent foreign entity) and the foreign tax authorities that allows these companies to pay tax at zero or discounted rates not allowable absent such agreement. In these cases, since the home county is not taxing the foreign entity on a true resident basis, no reduction in or elimination of U.S withholding taxes or other tax treaty benefits (e.g. the application of business profits provisions and reduction in or elimination of the §884 branch profits tax) should be permitted.

The remainder of this Appendix F provides specific recommendations on regulation amendments or guidance that could be provided in a revenue ruling that would disallow these inappropriate treaty benefits.

Fiscally Transparent Entities—Treaty Benefits Other than Reduction or Elimination of Withholding Taxes

With respect to **non-withholding tax treaty benefits** claimed where CFC and DRE subsidiary structures are involved, the terms of tax treaties and current law allow the IRS to disallow these benefits. The IRS may directly enforce these rules against such abusive arrangements.

For the CFC, the fact that its tax filings made to its home country will exclude all income, deductions, credits, etc. recorded within its DRE subsidiaries means that it cannot be a resident for purposes of the tax treaty under the last sentence of Article 4, paragraph 1. This sentence in the February 17, 2017, version of the U.S. Model Income Tax Convention reads:

> … This term does not include any person whose tax is determined in that Contracting State on a fixed-fee, "forfait" or similar basis, or *who is liable to tax in respect only of income from sources in that Contracting State or of profits attributable to a permanent establishment in that Contracting State*. [Emphasis added.]

For the DRE subsidiaries, as indicated earlier, a DRE subsidiary is not recognized as an "entity" for U.S. tax purposes. As such, the IRS may simply refuse to grant any relevant tax treaty benefits under the treaty between the U.S. and the country of establishment of the DRE subsidiary on the basis that the DRE subsidiary cannot be a "person" for purposes of that treaty under Article 3, and therefore not a treaty "resident" under Article 4.

> **Needed: Regulatory and/or ruling guidance concerning the non-applicability of tax treaty benefits in the above circumstances.**

Fiscally Transparent Entities—Treaty Benefits for Withholding Taxes

With respect to **reduction in or elimination of withholding taxes**, Reg §1.894-1(d) provides relevant rules.[13]

A critical first rule relevant to these abusive arrangements is that the regulation provides for DRE subsidiaries at paragraph (d)(3)(i) an expansive definition of "entity". As such, this definition overrides the lack of any "entity" (as explained in the section immediately above) that otherwise occurs under the domestic U.S. rules.

> **Needed: A tax abuse rule that will override this paragraph (d)(3)(i) definition.**

A critical second rule is the regulation's concept of "derived by a resident" found in paragraph (d)(1). T.D. 8889 (65 F.R. 40993-41000, 2000) consciously included this

[13] Note that Reg §1.894-1(d) by its terms only applies to certain withholding taxes. These rules have no applicability to the non-withholding tax treaty benefits discussed immediately above.

concept as the mechanism to determine qualification for withholding tax treaty benefits. In brief, T.D. 8889 included the following explanation:

> Commentators suggested that the term subject to tax in the proposed and temporary regulations was ambiguous and could be misinterpreted. Commentators suggested that the term subject to tax could be interpreted as requiring that an actual tax be paid rather than requiring an exercise of taxing jurisdiction by the applicable treaty jurisdiction, whether or not there is an actual tax paid. Commentators suggested that such an interpretation would lead to anomalous results, for example, in cases when the applicable treaty jurisdiction provides an exemption from income for U.S. source dividends under its tax laws.
>
> The IRS and Treasury agree that the term subject to tax could cause unintentional confusion and that a more direct and simpler way of ensuring that an item of income is subject to the taxing jurisdiction of the residence country is to determine if the item of income is derived by a resident of a treaty jurisdiction. The concept of derived by a resident is a more useful surrogate for the concept of subject to the taxing jurisdiction of the residence state, the necessary prerequisite for the grant of treaty benefits on an item of income.

Because of this expansive "derived by a resident" rule that is totally divorced from any actual or potential tax liability or inclusion in taxable income, special rulings, administrative practices, and other artificial means have expanded to meet the needs of MNCs intent on creating complex structures that shift profits and/or erode the U.S. tax base, making full use of the U.S. treaty network in the process. The light shed on this from the LuxLeaks disclosures[14] and other sources has been extensive.

> **<u>Needed</u>: A tax abuse rule that will override this "derived by a resident" test and replace it with a "subject to tax" test.**

In considering the above, the Treasury and IRS should keep in mind that the MNCs that create these CFC and DRE subsidiary structures have voluntarily-made check-the-box elections. The applicable taxpayer (i.e., the CFC) was not coerced into making these elections for its subsidiaries. Rather, these elections are made only after careful group-wide study of how to maximize profit-shifting and base erosion benefits. This being the case, it is more than reasonable that such taxpayers must live with the consequences of their actions. The above recommendations are appropriate and in no way excessive.

Abuse Not Involving Fiscally Transparent Entities

Many foreign MNCs abuse the U.S. treaty network on interest and royalty flows. One of the clearest examples is described in the Majority Staff Report titled "Impact of the U.S. Tax Code on the Market for Corporate Control and Jobs" issued on July 30, 2015, by the Permanent Subcommittee on Investigations (Committee of Homeland Security and Governmental Affairs) under the Chairmanship of Rob Portman. The example involves Valeant Pharmaceuticals International, Inc., a Canadian-based pharmaceutical MNC that resulted from a 2010 inversion.

[14] Available at: https://www.icij.org/project/luxembourg-leaks/explore-documents-luxembourg-leaks-database

The following is from pages 25-30 of this 2015 Majority Staff Report:

> In connection with the Bausch & Lomb acquisition, *Valeant pushed down $2.4 billion of the acquisition debt from its foreign affiliates to a Delaware subsidiary (VPI-Delaware), thereby creating a stream of deductible interest payments that have significantly reduced Bausch & Lomb's U.S. tax base*. Specifically, Valeant-Canada issued an aggregate $7.3 billion in debt financing from third-party banks. *Valeant-Canada then made an interest-free loan of $3.1 billion to a Luxembourg subsidiary, Biovail International S.a.r.l., which in turn made an interest-bearing loan (at 6%) of $2.4 billion to VPI-Delaware.*
>
> The result of this intercompany lending is evident in the rise in Valeant- U.S.'s tax-deductible, outbound related-party interest payments. In the two years preceding the Bausch & Lomb acquisition, Valeant's U.S. group made an average of $219,000 per quarter in related-party interest payments. In the first full year following the acquisition, those payments swelled to $59.9 million per quarter—a 273-fold increase. To date, Valeant's U.S. group has made $320.2 million in interest payments on the Bausch & Lomb acquisition debt to Biovail International S.a.r.l. and projects another $375 million in interest payments through the first quarter of 2017; those payments will continue through the life of the loan. *The interest payments are fully deductible in the U.S. and subject to no U.S. federal withholding taxes. Only a portion of the interest income received by Valeant in Luxembourg is taxable—at single-digit tax rates.*
>
> [Emphasis added and footnotes omitted.]

As if this insult to the U.S. taxation system were not enough, the following is from page 30 of the 2015 Majority Staff Report:

> Valeant structured the Salix acquisition debt in a manner that will significantly reduce Valeant's U.S. tax base. *Valeant-Canada raised $15.2 billion in debt* financing from third parties to support the Salix acquisition. *Valeant then made an interest-free loan of $16.5 billion to VFL (Luxembourg). VFL, in turn, made six intercompany loans totaling $16.5 billion to VPI Delaware* at an average interest rate of approximately 6.2%. Valeant projects that, from the first quarter of 2015 through the first quarter of 2017, it will make $1.67 billion in interest payments on the Salix debt to VFL; those payments are scheduled to continue until the maturity date of each loan (ranging from 2021 to 2025). To date, *Valeant's interest payments on the Salix acquisition debt have been fully deductible in the U.S. and subject to no U.S. federal withholding taxes. Only a portion of the interest income received by Valeant in Luxembourg is taxable—at single-digit tax rates.* [Emphasis added and footnotes omitted.]

This sort of artificial arrangement (very low effective tax rate in Luxembourg due to deemed interest deductions on an interest-free loan), and most likely a special ruling from the Luxembourg tax authorities, is abusive. The group's international planning likely results in a double deduction of interest and little or no effective taxation ever of the interest income in either Luxembourg or in Valeant's home country of Canada.

> <u>Needed</u>: **Regulatory and/or ruling guidance to help taxpayers and the IRS identify abusive situations where tax treaty coverage should no longer be appropriate given that the relevant income is not being taxed in the treaty country of residence in the same manner as a normal resident would be taxed.**[15]

As an indication of the basis for such broad guidance, the following is from T.D. 8999 (67 F.R. 40157-40162, 2002). The initial sentence refers to abuses involving domestic reverse hybrids.

> … The overall effect of these transactions, if respected, would be (1) a deduction under U.S. law for the "outbound" payment of an item of income, (2) the reduction or elimination of U.S. withholding tax on that item of income under an applicable treaty, and (3) the imposition of little or no tax by the treaty partner on the item of income. This result is inconsistent with the expectation of the United States and its treaty partners that treaties should be used to reduce or eliminate double taxation of income. The legislative history of section 894(c) supports this analysis. Congress specifically expressed its concern about the use of income tax treaties to manipulate the inconsistencies between U.S. and foreign tax laws to obtain similar benefits. See H.R. Conf. Rep. No 220, 105th Cong., 1st Sess. 573 (1997); Joint Committee on Taxation, 105th Cong., 1st Sess., General Explanation of Tax Legislation Enacted in 1997 (JCS-23-97), at 249 (December 17, 1997). The approach adopted by these regulations also is consistent with the U.S. view that contracting states to an income tax treaty may adopt provisions in their domestic laws to prevent inappropriate use of the treaty. …

As further encouragement of the critical need for additional regulatory and/or ruling guidance in this general area, it may be noted that Reg §1.894-1(d) was promulgated soon after the issuance of the new check-the-box entity classification rules and without anticipating how MNCs would aggressively utilize them to shift profits outside the U.S. and erode the U.S. tax base.

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[15] Interestingly, while guidance is needed to cover the entire U.S. treaty network, it should be noted that the U.S.-Luxembourg treaty states in Article 24 (Limitation on Benefits):

> 10. Notwithstanding the other provisions of this Article, Luxembourg holding companies, within the meaning of the Act (loi) of July 31, 1929 and the Decree (arrete grand-ducal) of December 17, 1938, or any subsequent revision thereof, *or such other companies that enjoy a similar special fiscal treatment by virtue of the laws of Luxembourg*, are not residents. [Emphasis added.]

Considering the low level of taxation within Luxembourg due to the interest free loan with a deemed interest deduction, this provides a strong treaty-based position to deny coverage of this tax treaty for abusive transactions. Consideration should be given to expanding rulings and other Treasury and IRS materials to provide guidance that takes actual tax treaty provisions such as this into account.

T.D. 8889 and T.D. 8999 expanded Reg §1.894-1 in 2000 and 2002, focusing principally on structures that would involve income flows to "real" foreign persons. Further, they were expressly limited to treaty benefits applicable to withholding taxes and domestic reverse hybrids. T.D. 8889 commented:

> These regulations apply with respect to all U.S. income tax treaties regardless of whether such treaties contain partnership provisions, unless the competent authorities agree otherwise. As with the proposed and temporary regulations, the final regulations address only the treatment of U.S. source income that is not effectively connected with the conduct of a U.S. trade or business. *The IRS and Treasury may issue additional regulations addressing the availability of other tax treaty benefits, such as the application of business profits provisions*, with respect to the income of fiscally transparent entities, particularly where a conflict in entity classification exists. [Emphasis added.]

After these regulations were issued, abusive profit shifting and base erosion by U.S. MNCs involving foreign hybrid entities grew quickly, if not exponentially, especially after the 2004 Jobs Act repatriation incentive. Despite this quick growth, detailed study and knowledge only started to become public in 2010 when the Staff of the Joint Committee on Taxation issued its report titled "Present Law and Background Related to Possible Income Shifting and Transfer Pricing" (JCX-37-10), dated July 20, 2010, for a Ways and Means Committee public hearing. This public hearing and the JCT's report, along with other hearings and investigative reporting in subsequent years (Google, Microsoft, Apple, Caterpillar, etc.), laid clear the aggressive and artificial nature of many of the structures that our MNCs eagerly adopted.

In short, it's time for regulatory and ruling guidance that eliminates inappropriate treaty benefits both within the framework of Code §894(c) and broader.

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APPENDIX G

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Effects of the New Sourcing Rule: ECI and Profit Shifting

by David L. Koontz and Jeffery M. Kadet

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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] ■

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[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.