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A Case Study: Effectively Connected Income

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In this report, Kadet and Koontz continue their series of articles on various aspects of applying effectively connected income taxation to multinationals by creating an ECI case study using the facts provided in a Hong Kong decision concerning an unidentified multinational that is clearly based in the United States.

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We have written a series of articles over the past five years that explores application of the effectively connected income rules to common profit-shifting structures.[1] For the most part, those articles provide hypothetical examples to demonstrate how the ECI rules should apply. However, a Hong Kong Inland Revenue Department (IRD) Board of Review decision released last December provides a real-life example of how a U.S. company shifting income into its wholly owned foreign subsidiary may be subject to ECI taxation.[2]

Conveniently, the decision provides considerable detail of the internal operations for an unidentified group that is assumed throughout this case study to be a U.S.-based multinational. Consistent with the decision, we refer to this group and its Hong Kong-incorporated group member (the taxpayer) as "Group A" and "the appellant," respectively. The decision covers a period from mid-1999 through 2010.[3]

Because the decision solely concerns taxation of the appellant in Hong Kong, it does not focus on whether the appellant was engaged in a U.S.

[1]Those articles are listed at the end of this report. *See infra* note 14.

[2]Case No. D25/17 (Feb. 14, 2018) According to the IRD website, the board of review is an independent statutory body constituted under the Inland Revenue Ordinance to hear and determine tax appeals.

[3]Hong Kong tax years from 1999-2000 to 2009-2010.

trade or business under U.S. tax law. However, as part of the facts presented, it provides many details allowing for a firm conclusion that the appellant was engaged in a trade or business in the United States. For example, the decision specifies that Group A U.S.-based personnel regularly solicited, negotiated, and concluded sales to North American customers on the appellant's behalf. Particularly telling is that the appellant had no sales personnel or sales management of its own.

The conduct of a U.S. trade or business would require the appellant to file and report its ECI on Form 1120-F, "U.S. Income Tax Return of a Foreign Corporation," for each year beginning from its 1999 incorporation. Although the decision is silent about any U.S. tax filings or payment of U.S. tax by the appellant, there is a strong inference that no filings or payments were made. In addition to ECI taxation, this case study briefly touches on subpart F and some transfer pricing and recharacterization issues.

I. Background and Summary

Over the period covered by the decision, the appellant earned income from the sourcing of products in Asia. Its income was partially from the sale of those products and partially from commissions it earned for related procurement services rendered outside Hong Kong. The appellant declared that all its income was sourced outside Hong Kong, and thus nontaxable under the jurisdiction's territorial tax system, because it conducted no actual business activities in Hong Kong. Rather, according to the appellant, it instead earned its income through a branch in China and through personnel of other group companies outside Hong Kong. The decision quotes the appellant as stating: "Activities in Hong Kong are administrative, paper-pushing, filing and bookkeeping, and are not profit generating."

IRD disagreed. To resolve the dispute, the decision included a detailed analysis of the business conducted by the appellant, its contractual relationships with related and unrelated persons, and the activities conducted by its own personnel and those conducted on its behalf by personnel of related parties.

In sum, the IRD Board of Review found that the appellant had earned no income in Hong Kong, meaning that its income was deemed to have been earned elsewhere, so none of its income was taxable in Hong Kong under the jurisdiction's territorial tax system.[4] Although not an issue in the case, the facts set out in the decision demonstrate that a portion of the appellant's income must have been ECI. This appears to be a classic situation in which a group engaged in planning to shift profits to a territorial jurisdiction to achieve the perfect tax answer — zero tax. But in doing so, the taxpayer inadvertently ran afoul of the U.S. ECI rules and, as shown in the following case study, may actually have increased its tax burden over what it would have paid had it simply recorded all its income within U.S. group members.

II. Case Study Assumptions

Because of IRD Board of Review protocols, the decision does not disclose the identity of Group A, the identity of Group A's parent (Company A3), the identity of Company A3's country of incorporation (Country U), or whether the appellant is a controlled foreign corporation. The language in the decision strongly implies that Company A3 is incorporated in the United States; therefore, this case study assumes that:

- Country U is the United States;
- Company A3 is incorporated in the United States;
- the appellant is a CFC whose U.S. shareholder is Company A1; and
- Company A1 is incorporated in the United States and is the principal operating company of Group A for the business conducted by the appellant.

III. Summary of Relevant Facts

Group A is engaged in the manufacture and distribution of electric fans, heaters, and humidifiers for residential and commercial purposes. Sales are primarily made to mass

[4] The facts supporting this were that specific procurement services that generated commission income were conducted in mainland China, while activities that generated trading profits (income from sales) were conducted by a related group member in Group A's home country, which in this case study is assumed to be the United States.

merchandisers. The decision specifies that Group A's main operating group member, Company A1 (incorporated in 1946), maintained the following in the United States:

- three manufacturing operations;
- a design and engineering department;
- purchasing departments for domestic and foreign products and components;
- a quality assurance department; and
- a sales and marketing department.

Beginning in the mid-1980s, a Company A1 employee was assigned to spend time in Asia acting as a buyer, conducting sourcing activities for Company A1. The decision says that the employee "spent the majority of the year in Taiwan and travelled through Hong Kong on his way to Mainland China."

The appellant was incorporated in Hong Kong in 1999 and in mid-2003 registered a representative office in Shenzhen, which is in mainland China (that is, outside Hong Kong). The decision specifies that the appellant maintained offices and personnel in both Hong Kong and its Shenzhen representative office.

A. Types of Transactions

The decision describes five types of transactions that the appellant conducted. Among them are the procurement of components and the sale of finished goods.

1. Procurement of components.

Before August 2005, the appellant earned commission income from Company A1 for the services the appellant performed that supported Company A1's sourcing of components from Asian suppliers and contract manufacturers.

From August 2005, the appellant sourced components from suppliers and contract manufacturers and sold them to Company A1. Under the facts presented in the decision, it appears that no operational changes were made in the course of moving from the prior commission income model to the new income-from-sale method.

2. Sale of finished goods.

In all years (1999 through 2010), the appellant recorded the sales of finished goods shipped directly to third-party customers from Asian suppliers or contract manufacturers.

Before August 2005, the appellant recorded the sales for its finished goods held in Company A1's warehouse in the United States.

From August 2005, the appellant recorded as its sales all finished goods shipped to Company A1's warehouse in the United States. Company A1 then recorded as its sales shipments from its warehouse to third-party customers.

B. Group's Intercompany Contracts

The above types of transactions reflected intercompany agreements that Company A1 and the appellant executed, and included the following:

1. 1999 agreements.

a. Buyer's exclusive agency agreement.

This agreement governed the procurement services performed by the appellant for Company A1's Asian sourcing of finished products and components. For these procurement services, Company A1 paid the appellant a one-time signing fee of $1.2 million at the initiation of the agreement and a 4 percent commission on products sourced for Company A1.

The agreement included a clause limiting the appellant's authority in its representation of Company A1.

b. Marketing and distribution agreement.

The decision states that this marketing and distribution agreement made Company A1 the appellant's exclusive agent and representative for the sale of finished products to third-party customers in the United States.

The decision lists Company A1's duties under the agreement, which included:

- holding the appellant's inventory;
- conducting an active sales program for sales to third-party purchasers within the defined territory of "the Continents of North America, Central America and South America";
- providing transport and delivery of products within the territory;
- providing warranty and service support; and

- collecting sales proceeds from third-party purchasers.

For those services, the appellant paid Company A1 a 5 percent fee based on the net invoice price for sales made.

The agreement also included a limitation of authority clause providing a number of strict restrictions on Company A1. In addition to holding no authority to act for or to bind the appellant in any way, Company A1 could not alter any of the terms or conditions of the appellant's standard sales agreements and documentation.

That clause was presumably meant to prevent the appellant from having a U.S. trade or business.[5] However, as summarized in the decision (para. 6), the appellant's factual situation belied that purported limitation of authority:

> The Appellant's case was that the Commission Income and the Trading Profits are offshore income. The actual activities performed by the Appellant's personnel in respect of the five types of transactions that generated the Commission Income and the Trading Profits did not differ. The Appellant earned income by getting products (both finished goods and components) in Mainland China and elsewhere (but not Hong Kong) for sale in the North America. *The sales activities were conducted in [the United States] by Company A1's Sales Department or other personnel on behalf of the Appellant. The Appellant did not have its own sales personnel. All the customers were located in the North America.* The procurement and sourcing activities were done in Mainland China or other places in Asia (but not in Hong Kong). The Appellant earned the Commission Income by providing services outside Hong Kong under the Agency Agreement (as defined in paragraph 56). [Emphasis added.]

This clearly shows that the parties to the agreement did not respect or act in accordance with its terms. When that is the case, courts have disregarded the contract terms and applied tax law based on the actions of the parties.

The decision describes the sales process in more detail (paras. 122-126), including that Company A1 under the marketing and distribution agreement was engaged within the United States in soliciting, negotiating, and making sales on behalf of the appellant. As specified, the appellant had no sales management or other personnel in either Hong Kong or Shenzhen who had effective authority over the company's sales. Rather, the personnel who had that authority were located in the United States and routinely made business decisions on behalf of the appellant and negotiated sales contracts with third-party customers that contractually bound the appellant.

2. 2005 restructuring: Additional agreements.

The decision describes two later agreements — the development and technology agreement and the purchase and sale agreement — both of which were effective beginning August 1, 2005. From that date, although the marketing and distribution agreement remained in full effect, the buyer's exclusive agency agreement was no longer relevant and was presumably canceled.

a. Development and technology agreement.

The decision describes what must be a cost-sharing agreement meant to qualify as such under reg. section 1.482-7A (as in effect in 2005). It notes the sharing of various costs calculated in accordance with the standards set out in a transfer price study performed by a third-party adviser. Those various costs include "product design, development and engineering, testing, safety, quality control processes and procedures; and intellectual property rights etc."

The decision does not mention whether the development and technology agreement included any buy-in by the appellant of the intangibles existing as of the August 1, 2005, effective date.

[5] Judicial decisions set the quantum of activity to have a U.S. trade or business (section 864(b)) at a low level. Just having an agent regularly acting in the United States for a foreign principal is generally sufficient for that foreign principal to have a U.S. trade or business. The marketing and distribution agreement establishes that the appellant was conducting a U.S. trade or business. Even if the parties respected the limitation of authority clause, the clause would only potentially prevent the appellant from having a dependent agent within the meaning of reg. section 1.864-7(d), as discussed in Section IV.C.3.

b. Purchase and sale agreement.

The decision simply explains that the agreement provides that the appellant would produce and sell as *manufacturer* to Company A1 components and finished products on a sole and exclusive source basis.

Under this new purchase and sale agreement, the gross profit on sales to Company A1 earned by the appellant would be determined by a benchmarking formula to achieve an arm's-length pricing structure. Presumably, this pricing structure resulted in the appellant's profit level reflecting its ownership of relevant intangibles, its manufacturing functions (conducted mostly or solely by unrelated suppliers and contract manufacturers), and the commercial and financial risks the appellant contractually assumed. Likely, the profit level within Company A1 from its U.S. distribution function was not more than that of a limited-risk distributor. As such, the bulk of Group A's profits on the manufacture and sale of products to third parties was reported by the appellant.

These new contractual arrangements put into place the now commonly seen profit-shifting structure under which intangibles are transferred to a zero- or low-taxed CFC, with the CFC then acting contractually within the group as a manufacturer earning a level of profits that is commensurate with manufacturing functions and risks and with the CFC's ownership of applicable intangible rights. It seems likely that no operational changes accompanied the 2005 contractual changes.

The decision describes (para. 69) the background to the contractual changes and the two new agreements that Group A executed between the appellant and Company A1:

> There was a change in the legal structure for the sourcing activities undertaken by the Appellant with effect from 1 August 2005 for tax and accounting reasons. The change was based on a study conducted by Company BJ on inter-company transfer pricing policy for the compliance of [U.S.] tax regulations in 2006. Based on Company BJ's recommendations in this study, Company A1 and the Appellant entered into the Purchase and Sale Agreement . . . and the Development and Technology Agreement.

Before the changes, the appellant solely performed procurement services for Company A1 under the buyer's exclusive agency agreement. Beginning August 2005, after the execution of the new contractual arrangements, the appellant acted as a manufacturer and principal, sourcing all components and finished products from various Asian sources. It then sold all components and finished goods, recording its own sales revenue.

From August 2005, the appellant sold all components directly to Company A1.

From August 2005, the appellant sold finished goods directly to Company A1 only when delivery was to be made to Company A1's warehouse. Company A1 would later sell these items to its customers and record the sales in its books. If a customer wanted delivery directly from Asia, the appellant would make the sale to that customer and record the full sales revenue. Although the decision indicates that these sales were made to North America, presumably, most of them were made for use, consumption, or disposition within the United States.

As noted earlier, the decision describes Company A1 as the main operating unit of Group A in the United States and mentions that it had, among other departments, a design and engineering department, an imports purchasing department, and a quality assurance department. Company A1 management and personnel must also have been involved on a day-to-day basis in deciding many product and production issues, negotiating specifications and terms (including pricing, quantities, and timing) with third-party component makers and contract manufacturers, and giving guidance and direction to those third-party component makers and contract manufacturers either directly or indirectly through the appellant's Shenzhen personnel. Although the decision is not explicit about all of the appellant's personnel who worked in the Shenzhen representative office, it does seem likely that much, if not the bulk, of the production support functions — such as those described earlier and in reg. section 1.954-3(a)(4)(iv)(b) — continued to be performed by Company A1 personnel and not by the appellant's personnel in Shenzhen. See *infra* Section III.C.

It is typical in structures like this that a foreign group member like the appellant is contractually manufacturing as a principal (often labeled an "entrepreneur") but can only do so with the support of one or more of its U.S. group members that perform critical and core manufacturing functions, such as those described in reg. section 1.954-3(a)(4)(iv)(b). In these cases, there will normally be an intercompany service or other agreement under which applicable U.S. group members charge the foreign group member service fees for the activities and functions conducted. The decision does not mention any such intercompany agreement.

C. Management of Appellant's Business

Setting the tone, the decision makes clear (para. 99) an important part of the appellant's rationale for the non-Hong Kong source of its income: "We accept the Appellant's evidence that its senior management personnel were all based" in the United States.

An example from the decision shows how much more than mere policy direction was being provided from the United States. The decision provides details for "Mr. E," who at various times held management positions in both Company A1 and the appellant, while also serving as a director of the appellant. From the United States, Mr. E was responsible for overseeing procurement and purchasing from both domestic and foreign suppliers. The decision states (paras. 106 and 108, respectively):

> Mr. E was formally Position BD of the Appellant in 2002, and he focused entirely on the procurement in Asia. Both Mr. B and Mr. E testified that before and after 2002, Mr. E was in charge of the Appellant. He had general responsibility for the suppliers. These are the works within the operation of the Appellant. . . .
>
> We find that Mr. E was in charge of the Appellant, both before and after 2002 and what he had done, insofar as they relate to the Appellant, were done for the account of the Appellant.

After describing the personnel of the appellant who performed procurement and quality control work in mainland China, the decision says (paras. 120-121):

> These procurement and sourcing works were performed outside of Hong Kong by the Appellant's employees or Company BH engaged by the Appellant.
>
> For completeness, although the negotiations with the suppliers were done by the Appellant's employees in Mainland China, the final choice of suppliers and the terms were decided by Mr. E and/or Ms. D in [the United States].

The decision describes the important role that U.S.-based personnel played in procurement activities. Before August 2005, some of those activities were performed as services for Company A1 under the buyer's exclusive agency agreement. As such, to some extent, those services were performed within the United States. This affects the sourcing of the appellant's commission income for U.S. tax purposes.

The appellant also sold finished products to North American customers during this period before August 2005, both through direct shipment from Asian sources and from inventory held for the appellant by Company A1 in the United States. Although this was before the 2005 development and technology agreement, the appellant could reasonably be seen as contractually producing inventory property. This is in contrast to purchasing inventory property for sale. (As discussed later, this purchasing or producing issue also affects the sourcing of income for U.S. tax purposes.)

Beginning in August 2005, these procurement activities were solely for the appellant's own benefit, because all the components and finished products sourced by it were sold to some North American customers and to Company A1 under the purchase and sale agreement. In light of the appellant's rights to relevant intangibles under the development and technology agreement, it was contractually a manufacturer of the finished products (and perhaps of some components as well) and was not merely purchasing and reselling.

For these product sales both before and after August 2005, some of the production activities were conducted within the United States. (How this affects the sourcing of income for U.S. tax purposes is discussed later.)

D. Conduct of Appellant's Sales

The decision summarizes (paras. 122-125) the situation applicable to the third-party sales made by the appellant:

> *All the sales activities of the Appellant were conducted in North America as all the customers of Group A were there. The Appellant does not have its own sales department nor sales personnel. It relied entirely on Company A1's Sales Department for the sale of its finished goods to third-party customers.*
>
> Company A1's Sales Department was headed by Mr. AE. The sales teams and sales representatives contacted the customers, negotiated with them on the products to be sold and the terms of sale, and concluded the sales contracts or orders with the customers.
>
> The Sales Department was also responsible for warehousing products, pending delivery, arranging delivery of products within the North America, invoicing and collecting payment and providing warranty and service support.
>
> *Mr. AE approved and conducted the sales contracts on behalf of the Appellant.* [Emphasis added.]

Concluding its fact finding, the decision states (para. 133):

> Having considered the evidence before us, we are satisfied that the relevant sales activities performed by the Company A1 personnel in [the United States] were done on behalf of and for the account of the Appellant pursuant to the instructions of the Appellant under the relevant inter-company agreements and arrangements between them [that is, the marketing and distribution agreement], and such activities had been ratified by the Appellant. As such, these acts are attributable to the Appellant.

The quoted material concerns the appellant's sales to third-party customers, which occurred in all years covered by the decision. What about the appellant's sales to Company A1, which occurred from August 1, 2005, after the execution of the purchase and sale agreement? What evidence is there regarding where and by whom these related-party sales activities took place?

Section III.E of this report explains how Company A1 decided what was to be ordered and communicated that information to the suppliers through the appellant's personnel. Formal purchase orders were prepared only later. The appellant's personnel in China were intermediaries at best in this process. The decision also notes (para. 140) that any intercompany orders and sales were made in the United States through the internal computer system.

Especially given that the appellant had no sales personnel of its own, it seems fair to say that any decisions on the appellant's sales to Company A1 were made by Company A1 personnel in the United States on behalf of the appellant.

As a final point in the section on the appellant's sales, the decision explains (paras. 146-154) that a Hong Kong employee of the appellant, or the appellant's accountant, prepared invoices for commissions earned or sales made to Company A1 only upon instructions from a Company A1 employee.[6]

E. Issuance of Purchase Orders

The decision describes (paras. 134-140) the process under which purchase orders were issued to suppliers.[7]

Company A1 personnel made purchase decisions based on Company A1 information and communicated those decisions to the appellant's sourcing personnel, who passed them on to suppliers. These were accepted as binding orders

[6]The decision says nothing about the preparation of invoices for sales to third-party customers. It seems likely, however, that they were either prepared by Company A1 in the name of the appellant or by the Hong Kong employee or the appellant's accountant upon instructions from Company A1.

[7]The description mentions only components, but the process presumably also applied to purchase orders for finished goods.

that suppliers acted on. In some earlier years, the appellant's personnel also typed up formal purchase orders on the appellant's letterhead after the fact. In later years, the after-the-fact purchase orders on the appellant's letterhead were prepared by Company A1 and emailed to the appellant's sourcing personnel, who would presumably pass them on to suppliers.

In short, the appellant's personnel in Hong Kong and its Shenzhen representative office were not involved in any meaningful manner beyond acting as intermediaries passing binding orders on to suppliers or typing up after-the-fact formal purchase orders to reflect the binding orders already communicated.

IV. U.S. Tax Consequences for the Appellant

The IRS has typically attacked aggressive structures such as that described in this case study through transfer pricing adjustments or through recharacterization of the parties' status and their contractual relations to reflect the substance of the transactions (for example, under substance-over-form or assignment of income principles).[8] It seems clear that either type of adjustment could be appropriate for these Group A arrangements. A few examples of possible adjustments for Group A are provided at the end of this case study. The decision includes no information on whether the IRS has reviewed or proposed any adjustments concerning Group A's Asian sourcing activities.

As a practical matter, because the decision covers the periods from 1999 to 2010, all corresponding tax years of U.S. group members are probably closed under section 6501. This practical reality means that it is likely impossible to apply transfer pricing and recharacterization adjustments to these years, and probably to some of the post-2010 years as well. This is because both transfer pricing and recharacterization adjustments cause changes in the taxable income of U.S. group members, all of which will have timely filed tax returns that started the running of the section 6501(a) assessment period.[9] Only recent years (for example, 2016 through 2019) would still be open.

In contrast to transfer pricing and recharacterization adjustments, ECI taxation is applied directly to the CFC that has recorded the income. Those foreign corporations cannot be included in any consolidated return filings made by their U.S. group members. As a result, if the appellant has filed no Form 1120-F for any of the years covered by the decision or subsequent tax periods (which is likely), all the appellant's tax periods are still open for application of ECI taxation, including the section 882(c)(2) loss of deductions and credits and the section 884 branch profits tax.[10]

ECI is the focus of this case study. Further, all the appellant's tax periods going back to its 1999 incorporation are probably still open for adjustment. Accordingly, the following discussion assumes that the IRS has not tried to make any transfer pricing adjustments or any recharacterization adjustments to Group A's corporate and contractual structuring. Even if the IRS made any transfer pricing adjustments that lower the appellant's profits in any year or years, that reduced level of profit would still be subject to ECI taxation as described later. Transfer pricing adjustments and ECI taxation can work together; they are not mutually exclusive.

A. ECI Taxation Regime

The analysis of the rules covering ECI taxation in this report shows that the appellant had some income that was U.S.-source income under section 865(e)(2) and therefore ECI under section 864(c)(3). That income is directly taxable to the appellant under section 882 (tax on income of foreign corporations connected with a U.S. business), taking into account section 882(c)(2) (denial of deductions and credits if no tax return

[8] Many of the matters covered in this brief summary of tax consequences are addressed in more detail in David L. Koontz and Jeffery M. Kadet, "Effects of the New Sourcing Rule: ECI and Profit Shifting," *Tax Notes*, May 21, 2018, p. 1119; and Kadet, "Attacking Profit Shifting: The Approach Everyone Forgets," *Tax Notes*, July 13, 2015, p. 193.

[9] Note that section 6501(c)(1) and (2) provide that assessments may be made any time in the event of a false or fraudulent return or a willful attempt to evade tax. Given Group A's apparent intent and its poor fact pattern showing how it ignored the limitation of authority clause in the marketing and distribution agreement, it is conceivable that the IRS would maintain that the otherwise closed years of relevant U.S. group members are still open.

[10] *See* section 6501(c)(3), which provides that the statute of limitations remains open if no tax return has been filed.

is filed). Further, the section 884 branch profits tax will apply at the statutory 30 percent rate because there is no tax treaty between the United States and Hong Kong that would exempt or lower this statutory rate. Again, under section 6501(c)(3), each prior year back to the 1999 formation of the appellant for which it filed no tax return (Form 1120-F) will still be open. The loss of deductions and credits and the application of the branch profits tax mean that U.S. tax imposed on ECI will normally be higher than the U.S. tax that would have been paid had the income simply been reported by a U.S. group member.

B. Appellants of U.S. Business

It is crystal clear that the appellant was engaged in a trade or business in the United States (section 864(b)), which is a prerequisite for ECI taxation. The following supports this:

- In all years, Mr. E worked in the United States; he did not work from the appellant's offices in either Hong Kong or Shenzhen. For some years, Mr. E held a position with the appellant while also being a director of the company. This means that the appellant had a management-level employee working in the United States from the offices of Company A1.
- Mr. E regularly conducted procurement activities on behalf of the appellant, allowing the appellant to earn commission income from Company A1 in the periods before August 2005. This means that the appellant was regularly conducting services in the United States.
- Company A1, as the appellant's exclusive agent and representative for the sale of finished products in the United States, conducted the appellant's business daily. Company A1 made business decisions for the appellant and contracted in the appellant's name with third-party customers. The decision makes clear that Company A1 and the appellant ignored the limitation of authority clause in the marketing and distribution agreement, which was effective for all years covered by the decision. Further, this provision was meaningless and truly disingenuous because the appellant had no management personnel in either Hong Kong or Shenzhen who had the authority or were capable of providing the commercial and risk assessments necessary to make pricing, credit, and other decisions regarding the sale of finished goods.

More bullet points could be added from the detail in the decision. However, given the black-and-white situation, doing so is unnecessary. It may simply be said that case law is clear that the regular activities of an agent (even without authority to conclude contracts on behalf of the foreign principal) is more than enough to create a trade or business in the United States. Company A1 was a contractual agent of the appellant. The appellant even had its own management-level employee working from Company A1's offices. The appellant was engaged in a trade or business in the United States for all years.

C. Appellant's U.S. Office

The existence of an office or other fixed place of business of the appellant in the United States is one of several criteria described in section 865(e)(2) as necessary for finding U.S.-source income, and thus ECI, for income from sales activities. Under section 865(e)(3), the principles of section 864(c)(5) apply in determining whether a taxpayer has an office or other fixed place of business. Those principles are set out in reg. section 1.864-7.

It is clear that the appellant had an office for all years under the following four provisions of reg. section 1.864-7.

1. Reg. section 1.864-7(b)(2): Fixed facilities.

Mr. E, as an employee and director of the appellant, worked from the offices of Company A1. His work on behalf of the appellant was in no way "relatively sporadic or infrequent," as required by the regulation to avoid meeting the fixed facilities criteria.

2. Reg. section 1.864-7(c): Management activity.

The appellant's day-to-day business was run from the offices of Company A1. Further, the appellant had no "chief executive officer, whether or not he is also an officer of the domestic parent corporation, who conducts the day-to-day trade or business of the foreign corporation from a foreign office." Under these conditions, reg. section 1.864-7(c) makes clear that there was an office or other fixed place of business in the United States.

3. Reg. section 1.864-7(d): Dependent agents.

The overall facts include that Company A1 regularly exercised an authority to negotiate and conclude contracts in the name of the appellant. This is a stark reflection of Group A's disregard of the limitation of authority clause in the marketing and distribution agreement. Moreover, before August 1, 2005, Company A1 held the appellant's inventory, from which it regularly made sales on the appellant's behalf.

Under the express terms of reg. section 1.864-7(d)(1), these two facts cause Company A1 to be a dependent agent of the appellant, and thus cause the appellant to have an office or other fixed place of business in the United States.

4. Reg. section 1.864-7(f): Office or other fixed place of business of a related person.

The facts and circumstances show that the appellant was engaged in a trade or business in the United States through the offices of Company A1.

The various examples in reg. section 1.864-7(g) are all consistent with the above discussion and conclusion.

D. Income Attributable to U.S. Business

A foreign taxpayer's income from any sale of personal property (including inventory property) must be attributable to its office or other fixed place of business in the United States to be sourced in the United States under section 865(e)(2). Under section 865(e)(3), the principles of section 864(c)(5) apply in determining whether a sale is attributable to such an office or other fixed place of business. Those principles are set out in reg. section 1.864-6.

In brief, reg. section 1.864-6(b)(1) provides that income will be attributable to an office or other fixed place of business of a foreign taxpayer "only if such office or other fixed place of business is a material factor in the realization of the income, gain, or loss, and if the income, gain, or loss is realized in the ordinary course of the trade or business carried on through that office or other fixed place of business."

Reg. section 1.864-6(b)(2)(iii) provides rules for determining whether this material factor condition is met for the sale of goods or merchandise through a U.S. office. The general rule is that the office or other fixed place of business will be considered a material factor if it "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 decision determines as fact that Company A1 in the United States under the marketing and distribution agreement was engaged in soliciting, negotiating, and making sales on behalf of the appellant for sales to third-party customers. The appellant had no sales management or other personnel in either Hong Kong or Shenzhen who had any participation in or authority over the company's sales. These sales activities conducted in the United States meet the material factor condition, so the relevant sales are attributable to the appellant's office or other fixed place of business in the United States.

After the August 2005 restructuring, the appellant made some intercompany sales to Company A1. Concerning these intragroup sales, the decision stated that a Hong Kong employee of the appellant, or the appellant's accountant, would prepare invoices for sales made to Company A1 only upon instructions from a Company A1 employee. Considering that the more important commercial decisions regarding the sourcing of products in Asia through the appellant were made by Company A1 personnel in the United States, and that the appellant had no personnel with sales authority, these intercompany sales should be treated as attributable to the office or other fixed place of business in the United States.

E. Inapplicability of Section 865(e)(2)(B) Exception

The decision states that all sales were made to customers in North America. As such, some of those sales could have been made for use, disposition, or consumption in Canada or Mexico. The exception to U.S.-source treatment in section

865(e)(2)(B) potentially applies to those Canadian and Mexican sales; however, it requires that there be material participation in the sale by the taxpayer's (the appellant's) office or other fixed place of business in a foreign country. The decision states that the appellant had no sales management or other sales personnel in either Hong Kong or Shenzhen, and it does not mention sales offices of the appellant in Canada or Mexico. Therefore, there was no material participation, and the section 865(e)(2)(B) exception does not apply.

F. Is Appellant Conducting Production Activities?

As explained in the preamble to proposed source rule regulations released late last year (REG-100956-19), Treasury and the IRS believe that the application of ECI taxation through the operation of section 865(e)(2) differs between inventory purchased and sold by the foreign taxpayer and inventory produced and sold. For inventory purchased and sold, all income from the sale is attributed to the office or other fixed place of business in the United States. For inventory produced and sold, the preamble says:

> With respect to inventory produced and sold by a nonresident in a sale attributable to an office or other fixed place of business in the United States and subject to section 865(e)(2), the Treasury Department and the IRS have determined that the disposition continues to give rise to gross income that is partly allocable to the nonresident's office or other fixed place of business in the United States (representative of the sales activity with respect to the transaction) and sourced under section 865(e)(2), with the remainder allocable to production activity and sourced under section 863(b).

This treatment applies both before and after the Tax Cuts and Jobs Act change to section 863(b). As such, it applies to all years covered by the decision.

As noted earlier, the appellant from August 1, 2005, was contractually a manufacturer. This is primarily based on the appellant's ownership of relevant intangibles under the development and technology agreement. As a result of this contractual status, the appellant recorded in its books an amount of profit to reflect its ownership of intangibles, its conduct (if any) of production activities, and its assumption of commercial and financial risks.

Considering the limited production activities conducted by the appellant's direct employees from its Shenzhen representative office (that is, liaison with suppliers and contract manufacturers, quality control, and inspection, etc.), the available evidence suggests that the appellant should be treated as having factually purchased and sold its inventory and not as having produced and sold that inventory. With this purchased and sold treatment, 100 percent of the appellant's income attributable to its office or other fixed place of business in the United States will be U.S.-source and subject to ECI taxation.

If the IRS decided to treat the appellant as having produced and sold the relevant property, the rules of reg. section 1.863-3(c) would be applied to determine the source of income attributable to production activities. Considering that many of these functions were performed by departments within Company A1 in the United States, some significant portion should be U.S.-source under the reg. section 1.863-3(c) rules.

It should be recognized that reg. section 1.863-3(c)(1)(i)(A)[11] provides that only production activities conducted directly by the taxpayer are taken into account. This, of course, suggests that the production activities conducted by Company A1 would be ignored. Reg. section 1.863-3(c)(1)(iii)[12] provides an antiabuse rule that should be applied in this case so that the U.S. production activities of Company A1 are included in the sourcing determination.

G. Income From Services

It was noted earlier that some portion of the appellant's pre-2005 commission income resulted from procurement activities conducted in the United States. To this extent, reg. section 1.861-4 provides for U.S.-source treatment. Any such U.S.-source income would be ECI under section 864(c)(3).

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[11] Prop. reg. section 1.863-3(c)(1)(i) under REG-100956-19.

[12] Prop reg. section 1.863-3(c)(3) under REG-100956-19.

H. Subpart F Issues

Because the application of subpart F results in income inclusions by U.S. shareholders, subpart F will be relevant only for years that are still open for Group A's U.S. group members. It seems likely that all years covered by the decision (1999 through 2010) are now closed. However, more recent years should still be open. In any case, the following could be considered for years that are still open during which Group A continued the contractual arrangements involving the appellant as described in the decision.

Notice 97-40, 1997-2 C.B. 287, provides that the IRS "will continue to treat Hong Kong and China as separate countries on and after July 1, 1997, for purposes of the Code and regulations, including subpart F."

In general, ECI taxation takes precedence over subpart F. Because of the U.S.-source treatment of income from sales described in section 865(e)(2) and its inclusion in ECI by section 864(c)(3), that income is excluded from subpart F income by section 952(b). The same is true for any services income, such as was earned in periods before August 2005.

As a result of ECI priority, subpart F will be relevant only if income is identified that is factually not attributable to the appellant's office or other fixed place of business in the United States. For the sake of discussion, assume that the IRS decides that intercompany sales made by the appellant to Company A1 were not attributable to the appellant's office or other fixed place of business in the United States. In this case, the relevant income would meet the conditions of section 954(d)(1) to be treated as foreign base company sales income.

In short, as applicable to the appellant, the two conditions are:

1. that the property is both manufactured and sold for use, consumption, or disposition outside the country of incorporation (Hong Kong); and
2. that a related party is involved (Company A1 as the purchaser of the property from the appellant).

Under the facts described in the decision, none of the property was manufactured in Hong Kong; most or all of it was manufactured in China. As such, under the position expressed in Notice 97-40, the first condition is met. The second condition is, of course, also met because it is assumed that only sales to Company A1 have been excluded from ECI taxation.

The only exception to foreign base company sales income treatment would be if the manufacturing exception of reg. section 1.954-3(a)(4) applied. The appellant itself conducts no physical manufacturing. It does, however, conduct some narrow functions described in reg. section 1.954-3(a)(4)(iv)(b). Given the very limited nature of functions performed by its employees, the appellant should not be seen as rising to the level of making a substantial contribution to the "manufacturing of personal property" as that term is defined in reg. section 1.954-3(a)(4)(iv). As such, the manufacturing exception should not apply.

V. Potential Adjustments

- Company A1 personnel conduct the business of the appellant, and the appellant's personnel act at the direction of Company A1. Thus, it would be appropriate to recharacterize the appellant as an agent of Company A1.
- The one-time signing fee of $1.2 million under the buyer's exclusive agency agreement in 1999 upon the incorporation of the appellant should be reviewed from a transfer pricing perspective. Or, the payment should be recharacterized as equity capitalization of the appellant.
- The decision doesn't mention any buy-in payment at the time of the 2005 development and technology agreement. If the intangibles transferred had any value, there should have been a buy-in payment under reg. section 1.482-7A(g).
- If the appellant's sales to third-party customers in all years, as well as sales to Company A1 after the 2005 restructuring, place the bulk of profits in the appellant with only limited sales commissions being recognized by Company A1 under the marketing and distribution agreement, several transfer pricing issues may exist. First, the decision did not mention any intercompany agreement under which the appellant would pay Company A1 for its contribution to the sourcing/production of

the components and finished products. Recall that Company A1 maintained for many years internal departments that conducted procurement functions. Second, in years before the 2005 restructuring when the appellant acquired intangibles under the development and technology agreement, there should have been royalties or other compensation paid by the appellant to Company A1 for the rights to source/manufacture products and sell to third-party customers in North America. Considerable transfer pricing adjustments may be appropriate.

VI. Conclusion

Group A and its Hong Kong structure are really a poster child for the application of ECI taxation. This is partly because of the slipshod way U.S.-based personnel and Company A1 operating divisions blatantly conducted the Hong Kong company's business, thereby causing the appellant to be conducting a trade or business in the United States. Although Group A may have operated in this apparently ill-conceived manner, there are undoubtedly many other multinational groups that have used the same basic structures, but with perhaps greater attention to their intercompany agreements and the personnel and group members that conduct business activities that benefit the businesses of their foreign group members. This greater attention adds a degree of substance that undoubtedly helps support their tax filing positions.

Such "better behaved" groups will typically operate in a way that arguably characterizes U.S. group members as independent contractors providing various business and support services to their foreign group members that act as entrepreneurs that contract directly with customers, suppliers, contract manufacturers, and other third parties. These groups and their foreign group member entrepreneurs can be in any industry or sector, but perhaps most often conduct a manufacturing business (typically involving contract manufacturers) or a cloud service or other cloud-based business. Because the activities of an independent contractor are normally not attributed to the person (that is, the foreign group member entrepreneur) seeking the services of that independent contractor, these better-behaved groups maintain that their foreign group members do not conduct a trade or business in the United States.

Despite this position supported by independent contractor status, U.S. and foreign group members in these better-behaved groups may in reality be conducting joint businesses. For example, in a typical manufacturing business, the same personnel conduct a wide range of joint production activities that result in inventory property that is sold by both U.S. and foreign group members. Another example is where the same personnel conduct for a group's internet-based business some or all of the five DEMPE functions (development, enhancement, maintenance, protection, and exploitation) for the benefit of multiple group members, each of which contracts directly with customers within its defined geographic market. In particular, the significance of the latter three functions is that the same personnel manage and run on a day-to-day basis the internet-based platforms through which U.S. and foreign group members each conduct its portion of the group's worldwide cloud business. This represents the joint conduct of a worldwide business.

This joint conduct of production functions or the management and running of an internet-based platform should often create an unintended partnership for U.S. tax purposes under the entity classification rules.[13] Once a partnership is found to exist, section 875(1), by statute, causes the foreign group members to be engaged in a trade or business in the United States. That means that ECI must be determined, with some amount of direct U.S. taxation of the foreign group members.

[13] *See* Kadet and Koontz, "Profit-Shifting Structures and Unexpected Partnership Status," *Tax Notes*, Apr. 18, 2016, p. 335.

Although Group A may be a poster child for ECI taxation, many better-behaved groups might also be subject to such ECI taxation.[14] ■

[14] Kadet, "Attacking Profit Shifting," *supra* note 8; Kadet and Koontz, "Profit-Shifting Structures," *supra* note 13; Thomas J. Kelley, Koontz, and Kadet, "Profit Shifting: Effectively Connected Income and Financial Statement Risks," 221 *J. Acct*. 48 (Feb. 2016); Kadet and Koontz, "Profit-Shifting Structures: Making Ethical Judgments Objectively," *Tax Notes*, June 27, 2016, p. 1831; Kadet and Koontz, "Profit-Shifting Structures: Making Ethical Judgments Objectively, Part 2," *Tax Notes*, July 4, 2016, p. 85; Koontz and Kadet, "Internet Platform Companies and Base Erosion — Issue and Solution," *Tax Notes*, Dec. 4, 2017, p. 1435; Kadet and Koontz, "Effects of the New Sourcing Rule," *supra* note 8; Kadet, "Sourcing Rule Change: Manufacturing and Competitiveness," *Tax Notes*, Nov. 5, 2018, p. 717; and Kadet and Koontz, "Transitioning From GILTI to FDII? Foreign Branch Income Issues," *Tax Notes Federal*, July 1, 2019, p. 57.