Outbound and Inbound Sales Branches: The (Sometimes Dysfunctional) Interaction of the Branch Basket Regulations, the Proposed Code Sec. 863(b) Regulations and FDII

By Sam K. Kaywood

A. Introduction

This article reviews the tax consequences and problems of manufacturing with outbound and inbound sales branches in light of the Tax Cuts and Jobs Act of 2017 (the "TCJA") under the underlying regulations which have now been finalized.[1] The article first reviews the final foreign branch regulations as they relate to manufacturing in the United States and selling abroad. The article then reviews the other ship passing in the night: the changes to Code Sec. 863(b) and the final Code Sec. 863(b) regulations with the potential for double taxation that they bring. Lastly, the article reviews the final Code Sec. 863(b) regulations as they relate to selling foreign manufactured goods through a U.S. sales office, as the Treasury tries to reason through a patchwork statutory regime with several inconsistencies, like Odysseus making his way back to Ithaca.

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B. The Foreign Branch Regulations

1. In General

Under the TCJA, Code Sec. 904 now provides for a new branch basket for "foreign branch income." Consequently, income attributable to the branch basket will be subject to a separate calculation of the foreign tax credit limitation.

Foreign branch income means the business profits which are "attributable" to one or more qualified business units ("QBUs") in one or more foreign countries.[2] The statute provided a broad grant of authority for the IRS to promulgate regulations on what constitutes attributable income. As part of a large package of Final Regulations on foreign tax credit issues, the IRS and Treasury published regulations on December 28, 2019.[3]

The key focus of the Branch Regulations is to treat a foreign branch more or less as if it were a regarded corporation. That means that virtually all transactions between the branch owner and the foreign branch must be regarded for purposes of attributing income to the foreign branch basket versus the general basket. Generally, the effect of the Branch Regulations is to reattribute gross income between the branch and general baskets with certain adjustments made to gross income initially attributed to the branch owner versus one or more foreign branches. The notion is to avoid manipulation of the branch basket with artificial transactions that are disregarded for U.S. tax purposes.

One purpose of the Branch Regulations is to "promote conformity between the income attributed to a foreign branch … and the income subject to tax in the foreign jurisdiction"[4] and to reduce "mismatches between the amount of gross income attributable to a foreign branch and the foreign tax base."[5] Consequently, the overall goal of the Regulations is to "rightsize" the amount attributable to the branch basket so that it is commensurate with the amount of income subject to tax in the foreign jurisdiction.

However, the Branch Regulations have important ramifications outside the utilization of foreign tax credits. For example, income attributed to the branch basket cannot qualify for the deduction for "foreign derived intangible income" ("FDII").[6]

2. What Is a "Foreign Branch"?

The starting point for a foreign branch is what the Code refers to a QBU, as defined in Code Sec. 989(a). Under that provision, a QBU is any "separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records."[7] The trade or business must be conducted outside the United States.[8] Activities carried out outside the United States that constitute a permanent establishment under a tax treaty are treated as carried out pursuant to a trade or business even if they do not constitute a trade or business under U.S. tax law.[9] In addition, any disregarded payments are taken into account in determining whether the foreign presence is a trade or business. Lastly, where the taxpayer does not maintain a separate set of books and records for the foreign business but does have a foreign trade or business, the taxpayer may construct a set of books and records for the foreign branch.[10]

3. Mechanics of the Disregarded Payment Rules

The Branch Regulations start with the gross income reflected on the separate books and records that the branch is required to keep, which is treated as "attributable" to the foreign branch.[11] All other income is attributable to the branch owner (in any appropriate basket other than the branch basket). The income on the books and records foreign branch is adjusted for (1) any items recorded or not recorded due to a tax avoidance purpose; and (2) any interest recorded by the foreign branch, which is automatically attributable to the branch owner.[12]

As a baseline, the branch books and records should be prepared on the basis of U.S. tax principles so that items paid to and received from the owner would be disregarded for income tax purposes.[13] If a foreign branch makes a disregarded payment to its branch owner and the disregarded payment is "allocable" to gross income that would be attributable to the foreign branch, the gross income attributable to the foreign branch is adjusted downward to reflect the allocable amount of the disregarded payment and the gross income attributable to the branch owner is adjusted upward by the same amount.[14] Such disregarded payments are allocable to gross income attributable to the branch owner to the extent a deduction for that payment or any disregarded cost recovery deduction relating to the payment, if regarded, would be allocated and apportioned to gross income attributable to the foreign branch under Code Sec. 861 allocation and apportionment principles.[15] This adjustment would have the effect of moving income from the foreign branch basket to the general basket (in most cases). The effect of this rule is to reverse the basic rule that the branch's books and record not reflect disregarded payments and to determine the basket income as if those payments were regarded.

Likewise, if the branch owner makes a disregarded payment to the foreign branch and the disregarded payment is allocable to gross income allocable to the branch owner, the gross income attributable to the branch owner is adjusted downward and gross income of the foreign branch is adjusted upward to reflect the "allocable amount of the disregarded payment."[16] This adjustment has the effect of moving income from the general basket to the foreign branch basket (in most cases). Again, this has the effect of adjusting the branch's book income to reflect disregarded receipts from the owner and making the owner deduct those payments in determining its general basket income.

4. Impact on the Sale of Equipment Between the Branch Owner and the Branch

The disregarded cost recovery deduction is the amount the branch would have deducted as depreciation if the branch had bought property from the branch owner in a regarded transaction (as if it purchased it from a third party). Of course, the branch's books and records are required to reflect depreciation but it would be based on a carryover basis as to disregarded purchases.

For example, assume that branch owner has equipment with a basis of $200 and a recovery life of 10 years and sells that equipment to the foreign branch for $500. In the first year, the depreciation recorded by the branch on its books (under U.S. tax principles) would be $20. If the purchase were regarded, the foreign branch would reflect depreciation of $50 ($500/10 years) and would allocate and apportion that depreciation against gross income of the branch under Code Sec. 861 principles. Consequently, the difference of $30 is a "disregarded cost recovery deduction" and is "allocable" to gross income of the foreign branch.[17] Thus, the gross income of the foreign branch (in the foreign branch basket) is reduced by $30 and gross income attributable to the branch owner (likely in the general basket) is increased by the same amount.[18] Note that the branch owner will not reflect a sale gain on the disregarded sale of the equipment but will record income "attributed" to it in the amount of the deduction the branch would have had if the purchase were regarded—all purely for basketing purposes.

Note that these adjustments do not affect the total amount of gross income recognized by the taxpayer nor the source and character of the income.[19] In the above example, if the foreign branch had $30 of foreign source income that is attributed to the branch owner, it is still foreign source income in the hands of the branch owner—the only change is that income is moved out of the foreign branch basket and into the general basket. These adjustments also do not affect any other baskets. Thus, if the foreign branch has income in the passive basket, that income is unaffected by the disregarded payment rules. Also, as will become relevant later in this article, the disregarded payment rules do not affect whether an item of gross income can be resourced under an income tax treaty.[20]

The disregarded payment rules apply to disregarded payments between foreign branches if either branch has a disregarded payment with the branch owner.[21] Commentators had criticized this rule because of its administrative complexity, but Treasury noted that if either branch has a disregarded payment with the branch owner, disregarded transactions between the two branches can affect the attribution of income relative to the disregarded payment between one of the branches and its branch owner.[22] Because a branch almost always will have a disregarded transaction with its owner, this rule will almost always apply.

These adjustments are carried through until the eventual sale or disposal of the property, such as equipment. Consequently, if the property is sold, any actual gain derived by the foreign branch is attributed to the branch owner to the extent of any remaining "adjusted disregarded gain."[23] Adjusted disregarded gain is the gain built in to the property at the time of the disregarded sale, less any previous reattributions of income due to depreciation.[24]

5. Sale of Inventory Between the Branch Owner and the Foreign Branch

Similar rules apply to the sale of inventory through a foreign branch.[25] So, when a foreign branch purchases inventory from its branch owner, the adjusted disregarded gain (basically the owner's unrecognized gain) with respect to that inventory is attributed to the branch owner upon sale of the inventory by the foreign branch. For example, assume that a branch owner manufactures goods with a cost of $1,200 and sells the goods to the foreign branch for $1,500. Assume further that the foreign branch incurs another $100 of costs to finish the inventory and then sells the inventory for $1,750. The total gross profit earned by the taxpayer is $1,750 – $1,300 = $450 – the intercompany sale at $1,500 is disregarded. However, the adjusted disregarded gain with respect to that inventory is $1,500 – $1,200 = $300. Consequently, that $300 amount is attributed to the branch owner (and therefore in the general basket) and the $150 of the gross profit on the sale earned by the foreign branch is classified foreign branch basket.[26] This is analogous to a deferred intercompany transaction in consolidation.

The reattribution of the gross income will generally occur in the year in which the inventory is sold.[27] The principles of Code Sec. 482 apply to disregarded payments in a manner that results in the attribution of the proper amount of gross income to the foreign branch and the branch owner as if the foreign branch were a corporation.[28] In many cases, there needs to be a transfer pricing study in place for foreign tax purposes anyway, since in many cases, these foreign branches are entities disregarded for U.S. tax purposes but regarded for foreign tax purposes.

The basketing of income from a foreign manufacturing branch can also be affected by transfers of intellectual property (*e.g.*, patents, know-how, branch name ("IP")). In particular, the amount of gross income attributable to a foreign branch (and the branch owner) must be adjusted for disregarded transactions in which IP is transferred to or from a foreign branch (or between foreign branches), whether or not a disregarded payment is made in connection with the transfer.[29] The principles of Code Secs. 367(d) and 482 apply such that a transfer of IP to a foreign branch results in an imputed royalty from the foreign branch to the branch owner as if the IP were contributed to the foreign branch as a regarded corporation in a Code Sec. 351 transaction.[30] Consequently, each year, the foreign branch basket income of the foreign branch must be reduced and the general basket income of the branch owner must be increased by the amount of the royalty that would be imputed under Code Sec. 367(d).

6. Transfers of IP and the Branch Regulations

Similar rules apply if the foreign branch transfers IP back to the branch owner. In that case, the foreign branch is treated as having sold the IP to the branch owner in exchange for annual payments contingent on the productivity or use of the property under the principles of Code Sec. 367(d).[31] This has the reverse effect—it would reattribute gross income from the general basket to the foreign branch basket. These rules apply to disregarded transfers of IP that occurred on or after December 7, 2018[32] and do not apply to certain cases where the owner of the IP has transitory ownership.[33]

7. Impact of Foreign Branch Basket Rules on Maquiladoras

The foreign branch basket rules could cause confusion in the case of contract manufacturing arrangements where a U.S. principal engages the services of a foreign contract manufacturer and provides both equipment and IP to that manufacturer. Arrangements of this sort occur frequently under the Mexican maquiladora program. In that case, does the presence of the assets and IP in Mexico require that income be attributed to a foreign branch? This would be a nightmare because the Regulations would want to attribute sales of equipment, sale of inventory and license of IP that don't exist. The likely answer is "no" in that the presence of equipment, inventory and IP at the site of the contract manufacturer is not likely to be a "separate and clearly identified unit of a trade or business." While the assets might be part of the trade or business conducted by the U.S. principal, they wouldn't by themselves be sufficient to be considered a trade or business outside the United States.[34] It might nevertheless be advisable to not maintain separate books and records for those foreign assets.

Note that in the case of the Mexican maquiladora program, the U.S. principal is generally considered not to have a permanent establishment in Mexico if amounts paid to the Mexican manufacturer satisfy Mexican transfer pricing requirements. If the U.S. principal fails these requirements and is unexpectedly taxed in Mexico, then that would be treated as a branch even without a trade or business.[35]

C. The Post-TCJA Source Rules for Manufacturing in the United States and Selling Outbound

1. General Background

Critical to any foreign tax credit analysis is whether the underlying income is foreign source which will maximize the foreign tax credit limitation. The TCJA made a seemingly simple change to the source rules but with potentially devastating effects for U.S. companies that manufacture in the United States and sell abroad.

The starting point for sourcing income on the sale of personal property is Code Sec. 865(a) which generally provides that gross income on the sale of personal property is sourced where the seller resides. However, Code Sec. 865(b) defers to Code Secs. 861(a)(6), 862(a)(6) and 863 to source income from the sale of inventory. Under those provisions, there were two source rules relative to the sale of inventory for quite a long time. Gross income on the sale of inventory that was purchased and sold was sourced under the "title passage" test.[36] Under the title passage test, income on the sale of inventory is sourced based on where the risk of loss associated with the products is transferred.[37]

To source gross income on the sale of inventory produced by the taxpayer, Code Sec. 863(b) provides:

> the portion of such taxable income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Secretary. Gains, profits, and income—
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> * * *
>
> (b) from the sale or exchange of inventory property … produced (in whole or in part) by the taxpayer within and sold or exchanged without the United States, or produced (in whole or in part) by the taxpayer without and sold or exchanged within the United States. …
>
> Shall be treated as derived partly from sources within and partly from sources without the United States.

Code Sec. 864(a) provides that for purposes of the source rules, "the term 'produced' includes created, fabricated, manufactured, extracted, processed, cured, or aged."[38] If the taxpayer produced inventory in the United States, the title passage test (alone) did not apply to the resulting income; instead the Regulations under Code Sec. 863(b) applied, as described below.

2. The 50/50 Method

Under the prior Code Sec. 863(b) regulations, the taxpayer could choose from one of three approaches: (1) the independent factory price (IFP) method; (2) the 50/50 method; and (3) the books and records method. The most popular of the three methods was the 50/50 method under which 50% of the gross income on the sale of inventory produced by the taxpayer would be sourced according to the title passage test and the other 50% in accordance with the location of production assets.[39] The assumption here is that gross income from the production and sale of inventory should be bifurcated between profit from selling activities and profit from manufacturing activities (50% each).

The location of production assets test is administered with respect to the taxpayer's adjusted basis in production assets. Those assets include only tangible and intangible assets owned by the taxpayer that are directly used by the taxpayer to produce the inventory for which the source rule is being applied.[40] Manufacturing intangibles (such as manufacturing know-how, patents, *etc.*) are located in the same place as the underlying tangible production assets to which they relate.[41] As a general matter, manufacturing intangibles may not have significant tax basis, which may result in overweighting towards the sales function.

Where the taxpayer's production assets are located both inside and outside the United States, foreign source income is determined by multiplying the income attributable to the taxpayer's production activity by a fraction, the numerator of which is the average adjusted basis of production assets located outside the United States and the denominator is the average adjusted basis of all production assets wherever located.[42] The remainder of the income is U.S. source.[43] There is an anti-abuse rule under which the IRS may make appropriate adjustments to clearly reflect the source of income where the taxpayer has entered into or structured one or more transactions with a principal purpose of reducing its U.S. tax liability by manipulating the formula.[44]

Consequently, a U.S. manufacturing company could rely on the 50/50 method to assure itself of significant foreign source income by arranging for foreign title passage on sales. In many cases, the taxpayer wasn't being taxed on the foreign sales in the foreign country[45] such that the foreign source income on export sales could be used to relieve excess foreign tax credits on subpart F income or dividends attributable to the general basket.[46] Arranging for foreign title passage is not always easy as it requires changes to shipping terms and insurance arrangements such that the taxpayer retains the risk of loss until the inventory has been exported. Nevertheless, tax advisors frequently resorted Code Sec. 863 sales as a helpful tool to address excess foreign tax credits.

If the U.S. manufacturer had a foreign sales office, the analysis was a bit more complicated. In that event, the taxpayer was likely attracting foreign tax since the sales office would likely be a permanent establishment. Here, treating the income as foreign source was critical to crediting those foreign taxes against U.S. tax on the profits. Consequently, it was critical that title to those goods passed in the foreign country to ensure sufficient foreign source income so that those foreign taxes could be credited against United States on that income.[47]

3. The IFP and Books and Records Methods

Under the IFP method, the taxpayer may allocate income between the sale and manufacturing activities based on the price at which he "regularly sells part of its output to wholly independent distributors or other selling concerns in such a way as to reasonably reflect the income earned from production activity."[48] Due to numerous restrictions, the IFP method was generally unavailable to taxpayers.[49]

Under the books and records method, the taxpayer may obtain advance permission to use allocations contained in her books and records to source income, but in so doing must satisfy the IRS that those allocations are made "in good faith and unaffected by considerations of tax liability" and "clearly reflects the amount of the taxpayer's income from production and sales activities."[50] Seeking advance clearance on the books and records method tended to dissuade taxpayers from availing of this method. Consequently, by default, the 50/50 method was the most popular.

4. The TCJA, the Demise of the 50/50 Method and the Foreign Sales Branch Problem

Enter the TCJA, which added the following sentence at the end of Code Sec. 863(b):

> Gains, profits, and income from the sale or exchange of inventory property [produced by the taxpayer] 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.[51]

This simple change eliminated all three methods for sourcing manufacturing profits, effectively converting the 50/50 method into the 100% method, *i.e.*, 100% of gross income on the sale of produced inventory is sourced based on the location of production assets.

On December 20, 2019, the Treasury proposed new regulations under Code Sec. 863(b), which eliminates the three methods and adds the 100% location of production assets method ("Proposed Regulations").[52] On September 29, 2020, these regulations were finalized with Treasury Decision 9921 ("Final Regulations"). The Final Regulations retain the basic rules described above for determining the location of assets, with one exception. They require that the taxpayer use the alternative depreciation system ("ADS") under Code Sec. 168(g)(2) for the entire period the property has been in service. In addition, the adjusted basis of assets must be determined without regard to any immediate expensing provisions or bonus depreciation.[53] This change was designed to prevent overweighting the adjusted basis of foreign assets because ADS does not permit bonus depreciation on foreign assets,[54] thus ensuring that "the basis of both U.S. and non-U.S. production assets is measured consistently on a straight line method over the same recovery period."[55]

The new 100% location of production assets rule gives rise to a difficult issue for those taxpayers with all their manufacturing assets in the United States but sell through a foreign sales branch (whether an actual branch or through a disregarded entity). The sales branch is likely a permanent establishment attracting foreign tax. The Branch Regulations discussed above go to great lengths to ensure that the resulting income is classified in the branch basket but say nothing about sourcing the income. Unless there is foreign source income available to credit foreign taxes in the branch basket, those rules are a "sound in the forest." In other words, both the branch basket income and the general basket income are likely to be U.S. source income if the branch owner manufactured the inventory. That is not the fault of the allocation between the branch and general baskets—those rules likely approximate the income on which the foreign country imposed the foreign tax. It is the fault of the overall limitation that will prevent crediting of foreign taxes actually paid due to an arbitrary choice to source manufacturing and sales income to the site of manufacturing.

For example, in the above example, the branch owner manufactures goods with a cost of $1,200 and sells the goods to the foreign branch for $1,500, who then incurred another $100 of costs and sold the inventory for $1,750. In that example, there was total gross profit of $450, and $150 of that gross profit was classified in the foreign branch basket and the remaining 400 of profit was treated as general basket income. If we assume that all the manufacturing assets were located in the United States, how much of that $150 of foreign branch basket income is foreign source? Zero. The same result applies to the $300 of general basket income—all of it U.S. source. As John McEnroe used to say to his tennis judges: "you can't be serious!" But this is the unfortunate result is required by the statute, which was perhaps over-corrected due to concerns that the 50/50 rule was too easily manipulated.

These regulations are effective for tax years ending on or after December 23, 2019, although taxpayers may apply them (on an all or nothing basis) to tax years beginning after December 31, 2017.[56]

5. Tax Planning Alternatives

a. Contributing the Branch to a CFC

The U.S. manufacturer—foreign sales branch problem gives rise to double taxation and requires a solution. The first possibility is to contribute the foreign sales branch into a CFC (either as a legal contribution or by unchecking the box on a DRE). This would isolate the sales and distribution profit in a CFC subjecting it to the GILTI rules, resulting in a 10.5% tax before applying foreign tax credits. This profit along with the related foreign taxes would then be classified in the GILTI basket rather than the foreign branch basket. Most importantly, the sales and distribution profit would be foreign source, allowing the foreign tax credit limitation to work properly. The one hang-up with converting the branch into a CFC is gain on the outbound transfer of goodwill and imputed royalties on the outbound transfer of trademarks and any other intangibles.[57] In some cases, this may be manageable due to relatively low value that may be associated with foreign goodwill and marketing intangibles.

b. Converting Manufacturing CFCs into DREs

Another possibility would be to convert CFCs with foreign manufacturing operations into DREs to bring their manufacturing assets into the location of assets test. In most cases, this could be done with a simple check-the-box election, treated as a Code Sec. 332 liquidation for U.S. tax purposes (having no effect for foreign tax purposes).[58] However, this converts GILTI income taxable at a maximum of 10.5% to branch income taxable at 21% (before credits). The conversion to a DRE would also result in inbounding any manufacturing intangibles, which is like checking into the "Hotel California."

Converting a manufacturing CFC into a DRE seems like a drastic change and may not work numerically unless the CFC has high-basis manufacturing assets with relatively low profit. Consider the following example: U.S. Parent manufactures widgets and sells them to its German sales branch (in the form of a DRE), which distributes them in Germany. U.S. Parent has manufacturing assets located in the United States with a tax basis of $1,000. U.S. Parent sells the widgets for a gross profit of $20 and the German sales branch distributes them for a profit of another $20 (total gross profit of $40). U.S. Parent also owns French CFC which manufactures and sells widgets in France. French CFC has the same metrics as U.S. Parent (tax basis in manufacturing assets of $1,000 and total gross profit of $40). With no tax planning, U.S. Parent has foreign source income of zero (zero tax basis in foreign manufacturing assets/$1,000 × $40). Thus, any taxes incurred by the German sales branch would not be creditable.

If U.S. Parent were to convert French CFC to a DRE with a check-the-box election, the results are not likely to be better, especially if the French and German tax rates are the same. While the French manufacturing assets would then be included in the calculation, so would the French gross income of $40. Thus, the calculation would be $1,000/$2,000 × $80 = $40, basically with the same amount of foreign source income (previously lodged in the French CFC) as before. In addition, the French income is converted from GILTI income (maximum tax of 10.5%) to income of a branch (maximum tax of 21%). On the other hand, if the CFC has high-basis assets that produce relatively low amounts of foreign source income, converting to a DRE may be beneficial. The conversion could be beneficial if there are disparities in tax rates, *i.e.*, the CFC's income is low-taxed in relation to the income of the sales branch. Nevertheless, projecting the income and tax rates of branches can often be difficult and tax managers are sometimes reluctant to make decisions (such as converting a CFC to a DRE) that are difficult to reverse on the strength of projections that may be reliable for only a year or two in the future.

c. Impact of Contract Manufacturing Arrangements

In the past, taxpayers have tried to take the position that foreign manufacturing assets of related entities used by a U.S. principal under a contract manufacturing arrangement can be favorably counted in the location of assets test. For example, under a typical maquiladora arrangement, the U.S. company ("U.S. Parent") would own the stock of a Mexican company with a manufacturing facility ("Maquila Sub"). U.S. Parent would own and control the tooling, machinery, plant, and equipment located at the manufacturing site of Maquila Sub, and U.S. Parent would hold title to raw materials, work-in-process, and ending inventory. In many cases, U.S. Parent would supply technology, dictate design specifications, production volumes, and scheduling and bear economic risk of loss for the resulting inventory.

These arrangements pose two questions under Code Sec. 863(b): (1) is U.S. Parent "producing" inventory outside the United States; and (2) can the assets of Maquila Sub be counted favorably in the location of the assets test. In FSA 200141010, the IRS ruled unfavorably on the second question, noting that nothing in the statute or the regulations hints that assets *owned by foreign affiliates* or third parties can be favorably counted. In the view of the IRS, counting the assets of Maquila

Sub would distort the calculation since the purpose of the calculation is to source income of U.S. Parent and the income of Maquila Sub (which result from the use of Maquila Sub's assets) is not included in U.S. Parent's income.[59]

On whether the taxpayer was a producer of inventory, the IRS noted that further development was required regarding "the roles and location of [US Parent] personnel vis-a-vis the activities undertaken, risks assumed, or assets employed in any production process."[60] Note that under Code Sec. 863(b) (as it then existed) there must have been either foreign sales or foreign production "in whole or in part" in order to apply the 50/50 test.

The ruling left open the possibility that the taxpayer could be a "producer" if it has people on the ground in a foreign country involved in quality control, managing raw materials, *etc*. In addition, equipment owned by the taxpayer but used by the maquiladora in Mexico should be counted as productions assets located in a foreign country if it is owned directly by the taxpayer. Here is a scenario where a check-the-box election may be helpful, as disregarding a maquiladora subsidiary would bring all of the foreign manufacturing assets into the numerator of the sourcing rule. In addition, they generally generate low routine returns such that there isn't a significant onshoring of income.

6. Impact of FDII Rules

The TCJA added section 250 to the Code, which allows a 37.5% deduction for FDII. These rules may act as a consolation prize for the loss of foreign source income under the amended Code Sec. 863(b). The FDII rules were designed to encourage export sales although the bar was set rather high to qualify for the benefit. In the context of export sales, FDII is an allocated portion of "deemed intangible income" based on the proportion that "foreign derived deduction eligible income" ("FDDEI") bears to all "deduction eligible income" ("DEI").[61] Deemed intangible income is DEI minus a 10% return on "qualified business asset investments" (also known as "QBAI").[62] The details of the FDII regime are beyond the scope of this article, but the notion is that any profit on foreign sales or services in excess of a routine return (10%) on manufacturing assets should qualify for the 37.5% deduction.

FDEI includes income from the sale of inventory to foreign persons provided the sale of the property is for "foreign use" and certain substantiation requirements are satisfied.[63] A sale is for foreign use if the property is delivered to an end user outside the United States or is used in manufacturing, assembly or processing outside the United States.[64] If the sale is to a foreign related party, then the foreign related party must resell the inventory (or incorporate it in property sold) to a foreign unrelated person for foreign use.[65]

DEI, the beginning point for FDII, is all the taxpayer's gross income excluding foreign branch income and certain other items basically designed to arrive at domestic operating income.[66] Here, the rules described above that attribute income either to or from the foreign branch are important.[67] Recall that in the above example, $300 of total gross profit of $450 was removed from the foreign branch basket and attributed to the U.S. branch owner (likely general basket). That $300 of profit should qualify for FDII since it is not classified in the foreign branch basket.[68] The remaining $150 of profit in the foreign branch basket does not qualify for FDII.[69] Note that the FDII deduction is determined without regard to whether the income is foreign source—Code Sec. 863(b) is irrelevant. If the FDII calculations yield favorable results, that's helpful for the $300 of profit attributable to the U.S. owner, but the remaining $150 is still left in the cold—foreign branch basket with no foreign source income.

7. Impact of Treaty Re-Sourcing Rules

Treaty re-sourcing rules may come to the rescue in some cases. Many treaties provide that if income may be taxed by the foreign country as attributable to a permanent establishment (or otherwise), then the United States must treat that income as foreign source income.[70] The question is whether Congress intended for the new Code Sec. 863(b) source rule to override re-sourcing rules under our tax treaty obligations. Code Sec. 7852(d) provides that "neither the treaty nor the law shall have preferential status by reason of its being a treaty or a law." This has been read to mean that whichever occurs later in time takes priority.[71] Since the changes to Code Sec. 863(b) are so recent, arguably U.S. manufacturers selling in countries with which we have a tax treaty are out of luck.

The Preamble to the Proposed Regulations was silent on whether Treasury believes Code Sec. 863(b) should override our tax treaties.[72] However, the Preamble to the Final Regulations provides some comfort:

> [t]hese regulations do not affect the ability of a taxpayer to rely on treaty provisions to mitigate or relieve double taxation, including treaty provisions that permit a taxpayer to make a reqruest to the competent authority for assistance pursuant to a

> mutual agreement procedure article of an applicable income tax treaty.[73]

This is the right result. It has long been our treaty policy that the source country has the primary right to tax income earned within its borders and the country of residence should provide relief from double taxation—that is the *sine qua non* of having treaties in the first place. It is also true that the title passage test is easily manipulated to optimize foreign tax credits while at the same time avoiding local country tax on export sales. However, in cases where there is an actual foreign sales branch (through a DRE or otherwise), then title passage isn't being manipulated for tax advantage and a credit should be allowed.

8. Selling Through or to Affiliates

The question is whether it is possible for the taxpayer to create its own bifurcation of the manufacturing and sales activities so that the sales profit does not get clawed into adverse sourcing under the location of assets test. This could be done by arranging for the manufacturer to sell produced inventory to or through affiliates who don't manufacture with the idea that the sales related profit could be divorced from the manufacturing profit and then sourced under the title passage test.

As an initial matter, selling to the foreign branch through another member of a U.S. affiliated group that is not a manufacturer does not change the results as the matching rule under the consolidated regulations would apply.[74] Arranging to sell the inventory to a CFC which resells it to the sales branch in the country of destination might be disregarded as a sham unless there is substance to what the CFC does. As noted above, incorporating the sales branch would be safe, assuming the Code Sec. 367(a) traps have been run.

Additionally, selling through a foreign sales branch in a partnership may run afoul of the anti-abuse rule which provides that the IRS can make "appropriate adjustments where taxpayers enter into or structure certain transactions with a principal purpose of reducing U.S. tax liability under 1.863-3, including by using production assets owned by a related party."[75] The anti-abuse rule in the Final Regulations was clarified to specifically reference partnerships:

> For example, a taxpayer may be subject to the [anti-abuse] rule if domestic production assets are acquired by a related partnership (or a subsidiary of a related partnership) with a principal purpose of reducing its U.S. tax liability by claiming that the taxpayer's income from sales of inventory is subject to section 862(a)(6) [the title passage rule] rather than section 863(b).[76]

However, this anti-abuse rule does not expressly address the reverse situation, *i.e.*, where a foreign sale branch is owned by a foreign partnership. Transactions with foreign partnerships are generally regarded.[77] Treating income of the foreign partnership as foreign source under the title passage test seems like less of an abuse where the foreign sales branch is taxed by a foreign government and the taxpayer is merely trying to avoid double taxation, especially in cases where a treaty re-sourcing rule is unavailable. The purpose of the Branch Regulations is to align the income in the branch basket with the income that is subject to foreign tax at the level of that branch. Those regulations seem pointless if there is no foreign source income to support the credit. Nevertheless, this path must be trod cautiously in light of the broad language of the anti-abuse rule.

D. Manufacturing Outside the United States and Selling in the United States

1. General Aspects of Doing Business in the United States

Here is an example of what's good for the goose is not permitted for the gander, as one might have hoped that the new location of the assets rule could be used favorably for foreign manufacturers that sell into the United States through a U.S. office, but not so. By way of background, a foreign corporation is taxed in the United States if it has a U.S. trade or business ("ETB") and if it has income that is "effectively connected" ("ECI") with that trade or business. Generally, a foreign corporation that has an office in the United States that sells products, *etc.*, is considered to be ETB.[78] The question of whether income is ECI involves a somewhat complicated but reasonably well settled regime (or at least we thought so). If gross income on the sale of inventory is U.S. source income, it is automatically ECI.[79]

If the income is foreign source, then the income is ECI if the foreign person has an "office or fixed place of business" within the United States to which such income is "attributable."[80] However, the income is not ECI if the property is sold for use, consumption, or disposition outside the United States and a foreign office of the taxpayer participated materially in the sale.[81] A foreign person has a U.S. office or fixed place of business if it has an actual office or if the office of a dependent agent is attributed to it.[82] The sale is attributable to the U.S office if the office is a "material factor" in the realization of the income.[83] In connection with the sale of inventory, the U.S. office is 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.[84] Generally, if the U.S. office solicits and receives purchase orders, the income is attributable to that office. However, if the goods are sold for use, consumption or disposition outside the United States and a foreign office materially participated in the sale (using the same test, *e.g.*, soliciting and negotiating sales contracts), then the sale is not attributable to the U.S. office.[85] So, in the base case where a U.S. office actively sells inventory for delivery in the United States, at least some of that foreign source income will be ECI.

2. Enter the Source Rules Prior to the TCJA

All of this begs the question as to whether the sales generate U.S. or foreign source income. If they generate U.S. source income, the automatic ECI rule applies and the above analysis is moot. Prior to the enactment of the TCJA, the same source rules as described above applied. Consequently, gross income from the purchase and sale of property was sourced according to the title passage test and gross income from the manufacturing and sale of property was sourced according to the Code Sec. 863(b) methodologies described above (applied in reverse for non-residents).

There is another significant wrinkle to the analysis. Code Sec. 865(e)(2) provides as follows:

> *Notwithstanding any other provisions of this part*, if a nonresident maintains an office or other fixed place of business in the United States, income from any sale of personal property (including inventory property) attributable to such office or other fixed place of business shall be sourced in the United States. (emphasis added)

In addition, the "principles of section 864(c)(5) shall apply" in determining whether the taxpayer has an office or fixed place of business and whether a sale is attributable to it.[86] Furthermore, the same exception (described above for the foreign source income ECI test) applies, *i.e.*, the exception for sale of inventory for use, disposition or consumption outside the United States where a foreign office materially participates in the sale.[87]

All of this seems circular. If a foreign person has foreign source income that is attributable to a U.S. office, the income is ECI even though it is foreign source. But wait! If a foreign person has foreign source income attributable to a U.S. office, the income is *U.S. source* under Code Sec. 865(e)(2) and is caught by the automatic ECI rule.

3. And Then the TCJA

This regime became even more confusing after the TCJA which eliminated the 50/50 source rule under Code Sec. 863(b) and sourced income 100% on the basis of the location of manufacturing assets test. So, can a foreign company that manufactures its products in a foreign country and sells them through a U.S. office apply the new 100% location of the assets test to treat *all* of the resulting gross income foreign source, out of the reach of U.S. taxation? Apparently, some taxpayers were taking precisely that position. The idea here lay in the interaction of Code Secs. 865(e)(3), 865(c)(5)(C) and 863(b).

Code Sec. 865(e)(3) states that "the principles of section 864(c)(5) shall apply in determining whether a taxpayer has an office or other fixed place of business and whether a sale is attributable to such office or other fixed place of business." Code Sec. 865(c)(5)(C) provides that the income attributable to the office shall be the income "properly allocable thereto." The last clause of Code Sec. 864(c)(5)(C) provides:

> In the case of a sale or exchange described in clause (iii) of [section 864(c)(4)(B)], the income which shall be treated as attributable to an office or other fixed place of business within the United States shall not exceed the income which would be derived from sources within the United States if the sale or exchange were made in the United States. (the "Last Clause")

Historically, the regulations under the Last Clause allow foreign taxpayers to use the methodologies under Code Sec. 863(b) in determining how much of production income would be sourced in the United States versus abroad.[88] In the past, as a practical matter, this meant that 50/50 test would be applied such that 50% of the income would be U.S. source and the remaining income would be foreign source (since the production assets were foreign). However, now that Code Sec. 863(b) requires that production income be sourced 100% according to the location of assets, so the thinking runs, all income (whether production or sales related) should be foreign source and escape the ECI regime.

The IRS has a different view. In their view, it has never been clear that the methodologies in Code Sec. 863(b) *must be* applied in the context of Code Sec. 865(c)(2) sales. Prior to the TCJA, the IRS had said that it would be *reasonable* to apply Code Sec. 863(b) methodologies, but that until regulations specifically addressed that point under Code Sec. 865(e)(2), it wasn't mandatory.[89] Nevertheless, the IRS had interpreted these provisions to say that income from the production of inventory abroad and its sale through an office in the United States should be bifurcated between production income and sales income and that using one of the three methodologies under Code Sec. 863(b) (including the 50/50 test) would be a reasonable way to make that bifurcation.[90] In other words, in determining the amount "attributable" to the U.S. office (*i.e.*, attributable to the U.S. sales function as opposed to the foreign manufacturing function), the IRS allowed taxpayers to use the 50/50 rule under the prior Code Sec. 863(b).

4. And Now the Final Code Sec. 863(b) Regulations

The Final Regulations endorse the prior view of the Service that Code Sec. 865(e)(2) could act independently of Code Sec. 863(b) as they untether Code Sec. 865(e)(2) allocations from the *new* Code Sec. 863(b) and re-attaches it to a revised version of the *old* Code Sec. 863(b) rules. As a starting point, the Treasury states that the re-sourcing rule under Code Sec. 865(e)(2) would enjoy priority over the revisions to Code Sec. 863(b) because Code Sec. 865(e)(2) applies "notwithstanding any other provisions of this part." Consequently, the new 100% location of assets rule can be ignored for Code Sec. 865(e)(2) purposes.

The Final Regulations add new Reg. §1.865-3, which basically reinstates the 50/50 test for foreign taxpayers.[91] Under that test, 50% of the gross income would be allocable to the U.S. office (and therefore ECI) and the remaining 50% would be sourced in accordance with the location of assets test.[92] Thus, if the foreign taxpayer produces the inventory with assets located outside the United States, 50% of the gross income would be U.S. source income and the remaining 50% would be foreign source income.

Alternatively, *in lieu* of the 50/50 method, the taxpayer may elect to allocate the income under the books and records method although the taxpayer need not obtain advance approval for its methodology.[93] That method must, nevertheless, "clearly reflect" the division between sales income and production income and transfer pricing principles will apply as if the U.S. sales office were a separate taxpayer.[94] The Final Regulations add protections over the Proposed Regulations to ensure that taxpayer's don't flip the switch from the books and records method to the 50/50 method just when it produces a better tax result.[95]

> *The branch basket regulations are well-crafted to align the taxpayer's foreign branch basket income with income that is taxed for local tax purposes.*

Under the Final Regulations, existing law would be used to determine whether a nonresident has a U.S. office (including through the activities of U.S. agents[96] and whether a sale is attributable to that office).[97] As under existing law, if the foreign person does not produce inventory, but merely buys and sells it, then all of the gross income is U.S. source income (and therefore ECI).[98]

5. Living Under the New Regime

Since the new regime is not substantially different than the old regime, the Final Regulations should not require significant structural changes. If the 50/50 test does not provide a fair result, a foreign manufacturer can rely on transfer pricing principles and use the books and records test, getting to mostly the same place as selling through a wholly owned subsidiary. Alternatively, it should be easy to incorporate the U.S. sales office as a distributor to avoid ECI altogether. Another possibility would be to run the U.S. sales through a separate foreign corporation that does no manufacturing. In that case, all of the profits of that foreign sales corporation would be ECI, but with a clear demarcation of its profits under transfer pricing principles.

E. Conclusion

The branch basket regulations are well-crafted to align the taxpayer's foreign branch basket income with income that is taxed for local tax purposes. They will be complicated to administer but using the foreign books and records (where disregarded payments are likely regarded) is a good starting point. However, the 100% location of production assets rule (mandated by Code Sec. 863(b)) produces an unfortunate misalignment of source and basketing of income for foreign sales branches, easily resulting in double taxation. The Preamble to the Final Regulations is helpful clarifying that Code Sec. 863(b) does not override tax treaties. In addition, allowing entity treatment for sourcing income in foreign partnerships (as required for FDII purposes) would be helpful. This would be consistent with Treasury's reasoned approach on inbound sales to bifurcate U.S. sales versus foreign manufacturing income, such that only U.S. sales related profit would be ECI.

ENDNOTES

1 This article is a revision to a prior article published in this journal and now includes the Final Regulations under Code Sec. 863(b), which were finalized shortly after publication.

2 Code Sec. 904(d)(2)(J).

3 Referred to herein as the "Branch Regulations." *See* T.D. 9882, Dec. 18, 2019.

4 Preamble to Branch Regulations at Part III.B.1.

5 Preamble to the Branch Regulations at section Part II.B.2.i.

6 Code Sec. 250(b)(3)(A)(i)(VI).

7 Reg. §1.989(a)-1(b)(2).

8 Reg. §1.904-4(f)(3)(vii).

9 *Id*. This was a change between the proposed and final Branch Regulations in response to comments that a strict application of the trade or business test would result in a mismatch where a taxpayer's activities in a foreign country are taxed as a permanent establishment by that country but do not rise to the level of a trade or business. Preamble to Branch Regulations at Part III.B.3.i.

10 Reg. §1.904-4(f)(3)(vii)(C)(2). The taxpayer may use principles under the dual consolidated loss rules. *See* Reg. §1.1503(d)-(5)(c).

11 Reg. §1.904-4(f)(2)(i).

12 Reg. §1.904-4(f)(2)(v). If there is a tax avoidance purpose to recording or failing to record an item of gross income on the books of the foreign branch or of making or not making a disregarded payment, the item must be attributed to one or more foreign branches of the branch owner in a manner that reflects the substance of the transaction.

13 Reg. §1.904(f)(2)(i). This involves a "round robin" of journal entries as often the foreign books and records will respect transactions between the branch owner and the branch. Then, they need to be adjusted to U.S. tax principles to disregard those payments. And then, those accounts must be adjusted *again* to attribute income between the branch owner and the branch in accordance with the rules explained herein.

14 Reg. §1.904-4(f)(2)(vi)(A). Translate any payments in foreign currency to USD using the spot rate on the date of the payment. *Id*.; *see* Reg. §1.988-1(d).

15 Reg. §1.904-4(f)(2)(6)(B)(1)(ii).

16 Reg. §1.904-4(f)(2)(vi)(A).

17 As noted above, the amount of the adjustment is the "disregarded cost recovery deduction." This is the amount that would be hypothetical depreciation that would be allowed if the purchase of the property by the branch were regarded minus the actual depreciation on the transferred property. Reg. §1.904-4(f)(3).

18 Taken from Reg. §1.904-4(f)(4), Example 5.

19 Reg. §1.904-4(f)(2)(vi)(A). The Treasury had received comments encouraging them to permit adjustments to the source and character of income based on the disregarded payment rules. The Treasury declined to adopt this approach noting that doing so would be inconsistent with the foreign tax credit limitation which does not permit foreign taxes to be credited against U.S. source income.

20 Reg. §1.904-4(f)(2)(vi)(A).

21 Reg. §1.904-4(f)(2)(vi)(A).

22 Preamble to the Branch Regulations, Part III.B.1.iii.

23 Reg. §1.904-4(f)(2); *see* definitions, Reg. §1.904-4(f)(3)(ii) (adjusted disregarded gain).

24 In particular, the adjusted disregarded gain is the lesser (i) of any "adjusted disregarded basis" of the property reduced by the actual basis in the property at the time of the sale; and (ii) any gain recognized on the actual sale of the property. The adjusted disregarded basis in the property is its "tentative disregarded basis" *minus* any "disregarded cost recovery deductions" *plus* any disregarded capital expenditures with respect to the property. The tentative disregarded basis is the basis that would have resulted under Code Sec. 1012 if the disregarded transaction were regarded for Federal income tax purposes. *See* definitions, Reg. §1.904-4(f)(3).

25 Reg. §1.904-4(f)(2)(vi)(B)(2)(iii).

26 Taken from Reg. §1.904-4(f)(4), Example 9.

27 Specifically, the gross income attributable to the foreign branch is adjusted in the tax year in which a disregarded payment, if regarded, would be allowed as a deduction or otherwise would be taken into account as an increase to cost of goods sold. Reg. §1.904-4(f)(2)(vi)(B)(3)(i).

28 Reg. §1.904-4(f)(2)(vi)(E).

29 Reg. §1.904-4(f)(2)(D)(1). The IP affected by this rule is broadly defined in Code Sec. 367(d)(4) which includes patents, inventions, designs, patterns know-how, trademarks, trade names, brand names, franchises, licenses contracts, customer lists, technical data, goodwill, going concern value or workforce in place or other items the value or potential value of which is not attributable to tangible property or the services of any individual.

30 Reg. §1.904-4(f)(2)(D)(1).

31 *Id*.

32 Reg. §1.904-4(f)(2)(D)(2).

33 Reg. §1.904-4(f)(2)(D)(3). For the transitory exception is designed to apply where a taxpayer checks the box to liquidate a foreign CFC (thereby making it a branch) and desires to transfer IP from the branch to the branch owner. In that case, the branch's ownership of the IP is transitory and absent an exception, the transfer of the IP would be treated as a sale resulting in reattribution of income. For the transitory ownership exception to apply the transferor must have transitory ownership of the IP (*i.e.*, for a short period of time after a deemed liquidation) and must not have developed, exploited, or otherwise employed the IP in its other than in the course of its business during the period of transitory ownership. *Id.*

34 *See* Reg. §1.989(a)-1(b)(2); Reg. §1.904-4(f)(3)(vii).

35 *See* Reg. §1.904-4(f)(3)(vii), discussed above.

36 Under Code Sec. 865(i), the term "inventory property" means personal property described in Code Sec. 1221(a).

37 The statute says nothing about title passage. It simply treats as foreign source income any profits derived "from the purchase of inventory property … within the United States and its sale or exchange without the United States." Code Sec. 862(a)(6). However, Reg. §1.861-7(a) provides that the income on the sale of personal property is sourced where the property is "sold." Reg. §1.861-7(c) provides that a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale occurs at the time and place of passage to the buyer of beneficial ownership and the risk of loss. This often requires analysis of various shipping terms (*e.g.*, FOB, CIR, EXW), each of which sets forth a time and place for passage of the risk

of loss. A helpful explanation of these terms is set forth in *InCoterms*, published by the International Chamber of Commerce.

38 *See also* Reg. §1.864-1.

39 Prior Reg. §1.863-3(b)(1). Note that "gross income" is sales income less cost of goods sold. Code Sec. 61; Prior Reg. §1.863-3(b)(1)(ii) (example).

40 Reg. §1.863-3(c)(1)(ii). Many of the rules regarding the location of production assets and quantifying them remain intact from the prior Regulations, but they have been moved in the Final Regulations. (This rule was previously located at Reg. §1.863-3(c)(1)(i)(B).) Thus, production assets do not include such assets as accounts receivables, intangibles not related to production of inventory (*e.g.*, marketing intangibles, including trademarks and customer lists), transportation assets, warehouses, the inventory itself, raw materials, or work-in-process. In addition, production assets do not include cash or other liquid assets (including working capital), investment assets, prepaid expenses, or stock of a subsidiary. *Id*. Assets are considered located where they are physically located. Reg. §1.863-3(c)(iii) (previously located at Reg. §1.863-3(c)(1)(i)(C)).

41 Reg. §1.863-3(c)(iii) (previously located at Reg. §1.863-3(c)(1)(i)(C)).

42 Reg. §1.863-3(c)(2)(i) (previously located at Reg. §1.863-3(c)(1)(ii)(A)). The adjusted basis of assets is computed by averaging the adjusted basis of the asset at the beginning and end of the taxable year, unless by reason of material changes during the taxable year such average does not fairly represent the average for such year. In this event, the average adjusted basis will be determined upon a more appropriate basis. Reg. §1.863-3(c)(2)(ii)(A). (The average adjusted basis rule was previously located at Reg. §1.863-3(c)(1)(ii)(B).) The material changes rule was added by the Final Regulations.

43 Reg. §1.863-3(c)(2)(i) (previously located at Reg. §1.863-3(c)(1)(ii)(A)). If production assets are used to produce inventory sold in Code Sec. 863 sales and non-Code Sec. 863 sales, the portion of its adjusted basis that is included in the fraction should be determined under any method that reasonably reflects the portion of the assets that produces inventory sold in Code Sec. 863 sales. For example, the portion of such an asset that is included in the formula may be determined in proportion to gross receipts from Code Sec. 863 sales produced by the asset in relation to all gross receipts from all property produced by that asset. Reg. §1.863-3(c)(2)(ii)(B) (previously located at Reg. §1.863-3(c)(1)(ii)(B)).

44 Reg. §1.863-3(c)(3) (previously located at Reg. §1.863-3(c)(1)(iii).

45 For example, a U.S. manufacturer wouldn't attract foreign tax where it doesn't have a foreign office but sells to a related or unrelated wholesaler in the foreign country.

46 Gross income on export sales would generally fall under the general basket. *See* Code Sec. 904(d)(2)(A)(ii).

47 Note that Code Sec. 865(e)(1) provides that income from the sale of personal property income would be foreign source if it is attributable to an office or other fixed place of business in a foreign country and subject to foreign tax at a rate of 10%. However, that provision does not apply to inventory, *i.e.*, income sourced under Code Sec. 865(b), which re-directs the taxpayer to the source rules under Code Secs. 861(a)(6), 862(a)(6), and 863.

48 Prior Reg. §1.863-3(b)(2).

49 For example, if a taxpayer elected to use the IFP method, the IFP was required to be applied to all Code Sec. 863 sales of inventory that were substantially similar and sold at a similar level of distribution as the inventory sold in the sale fairly establishing an IFP. In addition, the IFP was applicable only to sales that were reasonably contemporaneous with the sale fairly establishing the IFP. Lastly, an IFP could not be applied to sales in other geographic markets if the markets were substantially different. Prior Reg. §1.863-3(b)(2).

50 Prior Reg. §1.863-3(b)(3).

51 Added to the end of Code Sec. 863(b) by the TCJA, P.L. 115-97, §14303(a), effective for tax years beginning after December 31, 2017.

52 Proposed Reg. §1.863-3, REG-100956-19 (the "Proposed Section 863(b) Regulations").

53 Reg. §1.863-3(c)(2)(ii)(A); for immediate expensing provisions, *see, e.g.*, Code Secs. 179, 168(k), 168(l) and 168(m).

54 The TCJA amended Code Sec. 168(k) to allow "bonus depreciation," *i.e.*, an additional first-year deprecation deduction of 100% of the basis of certain property place in service after September 27, 2017 and before January 1, 2023. Therefore, certain new and used production assets placed in service and used predominantly within the United States during this period may have an adjusted basis of zero. Code Sec. 168(k)(1) and (6). Assets used predominantly outside the United States do not qualify for bonus depreciation, thus giving rise to a potential inconsistency in asset bases within and outside of the United States.

55 Preamble to the Proposed Code Sec. 863(b) Regulations at I(C).

56 Reg. §1.863-3(g), as added by the Final Regulations.

57 The exception for the transfer of an active trade or business to a foreign corporation was completely repealed by the TCJA. *See* TCJA (P.L. 115-97), §14102(e)(1), repealing former Code Sec. 367(a)(3).

58 This inbound liquidation would require a pick-up of any untaxed foreign earnings & profits ("E&P") under Code Sec. 367(b), although the new dividends received deduction under Code Sec. 245A may apply. In many cases, the prior E&P was subject to the transition tax under Code Sec. 965(a) and would be excluded as previously taxed income under Code Sec. 959.

59 The taxpayer cited various authorities that from time-to-time leaned in favor of attributing activities of contract manufacturers to a principal. *See, e.g.*, Rev. Rul. 75-7, 1975-1 CB 244, which took that position for purposes of claiming that a contract manufacturing arrangement gave rise to a "branch" for purposes of subpart F. However, this ruling was controversial and was eventually revoked by Rev. Rul. 97-48, 1997-2 CB 89. The ruling further noted that other authorities taking that view could be distinguished based on their unique relationship with an underlying statute. For example, in *Suzy's Zoo*, 114 TC 1, Dec. 53,701 (2000), the Tax Court held that, for purposes of Code Sec. 263A, a taxpayer was the producer of property under a contract manufacturing based on a unique requirement of the Code Sec. 263A regulations—that the producer be the owner of the property. *See* Reg. §1-263A-2(a)(1)(ii). In addition, in two excise tax cases cited by the *Suzy's Zoo* court, the term "manufacturing" included the activities of contract manufacturers, but again based on unique aspects of the excise tax regime. *See Charles Peckat Mfg. Co. v. Jarecki*, CA-7, 52-1 USTC ¶9344, 196 F2d 849; *Polaroid Corp.*, CA-1, 56-2 USTC ¶9650, 235 F2d 276. Thus, in FSA 200141010, the service held that these authorities are irrelevant in interpreting the term "produced by the taxpayer" for purposes of applying Code Sec. 863(b)(2).

60 In this regard, the ruling states:

> although not stated on the face of the statute, the early history of the source rules shows an intent to source income based on the location of the assets and activities that generate the income. *See, e.g., Piedras Negras Broadcasting Co. v. Commissioner*, 127 F.2d 260, at 261 (5th Cir. 1942) (noting that the statutory language of the source rules "denotes a concept of some physical presence, some tangible and visible activity"). *See also Piedras Negras Broadcasting Co. v. Comm*issioner, 43 B.T.A. 297, at 309 (1941) (citing 4 Paul & Mertens Law of Federal Income Taxation 350 for the proposition that "… It [the "source"] is not a place, it is an activity or property. As such it has a situs or location …."

61 Code Sec. 250(b)(1); Reg. §1.250(b)-1(b). The FDII Regulations were finalized on July 9, 2020 as part of T.D. 9901.

62 QBAI is the average quarterly adjusted bases of "specified tangible property" that is used in a trade or business and is depreciable. Reg. §1.250(b)(2)(b). Specified tangible property is property used in the production of DEI for the taxable year, generally meaning that any depreciation is allocated or apportioned against gross DEI. Reg. §1.250(b)-2(b).

[63] Reg. §1.250(b)-4(b). The sale of property is presumed to have been made to a foreign person if it is a "foreign retail sale" or a sale of "general property" (*i.e.*, inventory not part of a retail sale) delivered to a recipient or end user with a shipping address outside the United States. Reg. §1.250(b)-4(c)(2). This presumption does not apply if the seller knows or has reason to know the recipient is not a foreign person. For example, if the shipping documents reflect a U.S. phone number or shipping address, the seller will need to obtain additional evidence of foreign status. Reg. §1.250(b)-4(c)(1).

[64] Reg. §1.250(b)-4(d)(1)(ii) and (iii). The inventory is subject to manufacture, assembly or other processing only if the property is "physically and materially changed" or is incorporated as a component into another product such that it is "substantially transformed and distinguishable from and cannot be readily returned to its original state." Reg. §1.250(b)-4(d)(1)(iii)(B). Property is incorporated into another component if the fair market value of the property will constitute no more than 20% of the fair market value of the finished goods into which the property is incorporated. Reg. §1.250(b)-4(d)(1)(iii)(B). All these determinations must be made on the basis of the facts and circumstances.

[65] Reg. §1.250(b)-6(c). The seller in a related party sale may establish that the related party, in turn, is selling the product to unrelated parties with all available evidence, including contract terms to the effect that the related party may only sell to unrelated parties, past practices of the parties, a showing that the product is specifically designed for foreign markets, *etc*. Reg. §1.250(b)-6(c)(1)(i).

[66] DEI excludes other items such as subpart F income, GILTI income, financial services income, dividends received from CFCs and certain oil and gas extraction income. Reg. §1.250(b)-1(c)(15).

[67] *See* Reg. §1.250(b) §-1(c)(11), which incorporates the branch basket definitions in Code Sec. 904(d)(2)(j) and Reg. §1.904-4(f)(2).

[68] This assumes a host of other FDII requirements are satisfied.

[69] Reg. §1.250(b)-6(c)(15)(vi).

[70] For example, *see* Art. 23(2) to the U.S.–Germany Income Tax Treaty, as amended by the 2006 Protocol; Art. 23(2) of the U.S.–Japan Income Tax Treaty. The U.S.–Mexico Income Tax Treaty originally provided that each country would apply the source rules under their respective domestic laws. *See* Art. 24(3) of the U.S.–Mexico Income Tax Treaty. However, that provision was amended by the 2002 protocol to provide that income taxed in Mexico would be treated as foreign source income.

[71] *See Albert Tag v. Rogers*, 267 F2d 664 (CA Dist Col 1959) *cert. denied* 362 US 904 (Sup Ct 1960), *rehearing denied* 362 US 957 (Sup Ct 1960); *Hing*, CA-9, 230 F2d 664 (1956).

[72] The legislative history to the TCJA changes to Code Sec. 863(b) is also silent on whether a treaty override was intended.

[73] Preamble to the Final Regulations (T.D. 9921) at V.

[74] *See* Reg. §1.1502-13(c)(1) (matching rule for attributes); Reg. §1.1502-13(b)(6) (source is an attribute for purposes of the matching rule); Reg. §1.1502-13(c)(7)(ii)(N), Example 14. The Final Regulations modify this example to conform to the 100% production of assets test, but the import of the example would not change.

[75] Reg. §1.863-3(c)(3).

[76] *Id*.

[77] *See, e.g.*, Reg. §1.250(b)-3(e)(1), which provides that for purposes of determining whether a sale of property to or by a partnership is a sale qualifying for FDII, a "partnership is treated as a person. Accordingly, a partnership may be a seller, renderer, recipient, or related party, including a foreign related party …." Also note Reg. §1.250(b)-3(e)(2), Example 1 (U.S. seller can treat a sale to a foreign partnership as a FDII sale. The foreign partnership itself was a foreign branch and the profit of that branch did not qualify for FDII because foreign branch income is excluded from DEI).

[78] The Code does not define a "U.S. trade or business" and the Regulations merely say that it must be determined "on the basis of the facts and circumstances in each case." Reg. §1.864-2(e). However, the caselaw generally holds that a foreign person is engaged in a U.S. trade or business if his activities in the United States are "considerable, continuous and regular." *See, e.g.*, *InverWorld Inc.*, 71 TCM 3231, Dec. 51,428(M), TC Memo. 1996-301 (1996); *Pinchot, Amos R. E., Exr.*, CA-2, 40-2 USTC ¶9592, 113 F2d 718; *Spermacet Whaling & Shipping Co. S/A*, 30 TC 618, Dec. 23,035 (1959), *aff'd*, CA-6, 60-2 USTC ¶9645, 281 F2d 646; *Linen Thread Co., Ltd.*, 14 TC 725, Dec. 17,620 (1950); *J.C. Lewenhaupt*, 20 TC 151, Dec. 19,606, *aff'd*, CA-9, 55-1 USTC ¶9339, 221 F2d 227; *Consolidated Premium Iron Ores, Ltd.*, 28 TC 127, Dec. 22,343, *aff'd*, 59-1 USTC ¶9387, 265 F2d 320.

[79] Code Sec. 864(c)(3).

[80] Code Sec. 864(c)(4)(B).

[81] *Id*.

[82] Under Code Sec. 864(c)(4)(5)(A), the activities of agents are disregarded unless the agent (i) has the authority to negotiate and conclude contracts in the name of the foreign person and regularly exercises that authority or has a stock of merchandise from which he regularly fills orders on behalf of that person, and (ii) is not an independent agent acting in the ordinary course of its business.

[83] Reg. §1.864-6(b).

[84] Reg. §1.864-6(b)(2)(iii).

[85] Reg. §1.864-6(b)(3).

[86] Code Sec. 865(e)(3).

[87] Code Sec. 865(e)(2)(B).

[88] *See* Prior Reg. §1.864-6(c)(2), which provides a cross reference to Code Sec. 863(b) and the three methods available thereunder. Code Sec. 864(c)(5)(C) was enacted pursuant to the Foreign Investors Tax Act of 1966 and the relevant House Report echoed the view that production income should not be allocated in its entirety to the U.S. sales office. *See Ways and Means Committee Report*, reprinted at 1966-2 CB 965, at 1014.

[89] In FSA 3857 (1996), the Service reviewed Code Secs. 865(e)(2), 864(c)(5) and 863(b) and the underlying legislative history to say that, while not free from doubt, the income should be bifurcated along the principles of Code Sec. 863(b), stating:

> It seems, therefore, that some type of bifurcation of income attributable to production and income attributable to sales activity, such as that provided for under section 863, is obviously intended. In certain cases, deviation from the regulations under section 863 may be necessary for the purposes of section 865(e)(2), but, until regulations under section 865 are published, general adherence to the section 863 regulations would be reasonable.

[90] *Id.*

[91] Reg. §1.865-3(d)(2), added by T.D. 9921.

[92] Reg. §1.865-3(d)(2)(i).

[93] Reg. §1.865-3(d)(2)(ii)(A). The taxpayer must attach an election on a timely filed return and must maintain books and records that exist when the return is filed. The taxpayer must also prepare an explanation of how the allocation clearly reflects the taxpayer's income from production and sales activities under the principles of Code Sec. 482. That explanation must be sufficient to allow the service to understand the taxpayer's methodology but need not include transfer pricing documentation. *See* Preamble to Proposed Code Sec. 263(b) Regulations, at II(A)(4) (the Preamble to the Final Regulations is silent on this point.) Nevertheless, the taxpayer must make available the explanation and its records within 30 days of a request by the IRS (unless extended by the IRS). Reg. §1.865-3(d)(2)(ii)(B)(3).

[94] Reg. §1.865-3(d)(2)(ii)(B)(2).

[95] Reg. §1.865-3(d)(2)(ii)(B)(5). Once made, the books and records election cannot be revoked within 48 months of the end of the tax year for which it is first made without IRS consent.

[96] Reg. §1.865-3(c), which references the principles of Code Sec. 864(c)(5)(A) and Reg. §1.864-7, discussed above.

[97] Reg. §1.865-3(c), which references Code Sec. 864(c)(5)(B) and Reg. §1.864-6(b)(1)&(2), discussed above.

[98] Reg. §1.865-3(d)(3).