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Applying Transfer Pricing Principles to a U.S. Sales Branch: An Illustration of Rev. Proc. 2008-31

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I recently co-authored an article about Rev. Proc. 2008-31[1] (the "Rev. Proc."), relating to Advance Pricing Agreements (APAs), that BNA Tax Management published in the *Tax Mgmt. Memo.*[2] That Article explains why the Rev. Proc. was issued and identifies the kinds of cases that have been deemed to fall within the purview of the Rev. Proc. To be specific, the Rev. Proc. expanded APA Program coverage to include:

> other issues arising under certain income tax treaties, the Code, or the Income Tax Regulations, *for which transfer pricing principles may be relevant*, such as attribution of profits to a permanent establishment under an income tax treaty, determining the amount of income effectively connected with the conduct by the taxpayer of a trade or business within the United States, and determining the amounts of income derived from sources partly within and partly without the United States, as well as related subsidiary issues. [Emphasis supplied.]

The Article identifies three main subject areas outside §482 where APA jurisdiction has been granted pursuant to the Rev. Proc.: (1) under the new Article 7 language in U.S. income tax treaties that adopt transfer pricing principles in determining the attribution of profits to permanent establishments (PEs); (2) global dealing cases; and (3) non-new-treaty, non-global-dealing situations where the Internal Revenue Code (the "Code") and the accompanying regulations require or permit the application of transfer pricing principles in determining the income that is attributable to a PE or connected with a branch. Notably, the Article does not generally describe *how* transfer pricing principles have been applied in any of these areas, but rather identifies only *when* transfer pricing principles have been deemed to apply.

Since the Article was published, a number of individuals have contacted me asking for guidance on how transfer pricing principles might be applied in one or more of the circumstances described in the Article, especially in non-treaty, non-global dealing situations (i.e., category (3) above). In response to these questions, this Commentary attempts to illustrate how transfer pricing principles might apply in one setting described in the Article — that is, when a foreign corporation manufactures goods outside the United States and sells such goods using an office or other fixed place of business within the United States.

Illustrative Facts

Suppose Foreign Corporation, a resident of Country X — a country with which the United States has

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[1] 2008-1 C.B. 1133.

[2] Armitage, Osborne, and Sharon, "The APA Program's Experience with Rev. Proc. 2008-31: Increased Opportunities for Certainty," 52 *Tax Mgmt. Memo.* 459 (11/7/11) (hereinafter the "Article.")

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not entered into a tax treaty — manufactures semiconductors and related electronic components on behalf of a few U.S. original equipment manufacturers (OEMs). Foreign Corporation negotiates sales agreements from its Country X office with the U.S. OEMs, manufactures the products abroad, and ships the products to the United States for resale.

Foreign Corporation has established a U.S. limited liability company that has elected to be disregarded for U.S. tax purposes (the ''Branch''). The Branch receives the products manufactured by Foreign Corporation, performs administrative and logistical support services, monitors the transfer of the inventory to the U.S. OEMs, receives payment from the U.S. OEMs, and remits the payments to Foreign Corporation's Country X office (less a small percentage of the sales price as compensation for its services).

Summary of Applicable U.S. Rules in the Code and Regulations

Pursuant to §882(a)(1), Foreign Corporation is subject to U.S. tax on the portion of its income that is effectively connected to its U.S. trade or business (ECI). Under §864(c)(3) and (4), a foreign corporation's income is *generally* ECI if it is U.S.-source income and is not ECI if it is foreign-source income. Section 863(a) and (b) provide that income from the sale of products manufactured abroad and sold in the United States must be allocated between U.S.-source income and foreign-source income under regulations that include Regs. §1.863-3(b)(3). That regulation allows a taxpayer that manufactures products abroad and sells them in the United States to use a ''books and records'' method to allocate the resulting income between ''sales'' income, to be sourced in the United States, and ''production'' income, to be sourced abroad.[3] The regulation requires the taxpayer electing this method to maintain regular ''books of account,'' which must include a detailed presentation of ''receipts and expenditures'' that ''clearly reflects'' the amount of the taxpayer's income from production and sales activities.

Under the Associate Chief Counsel (International's) (ACCI's) interpretation of the books and records method, only income from the sales function, and not income from the manufacturing function, should be treated as U.S.-source — i.e., the word ''attributable'' modifies the word ''income'' and not the word ''sale.''[4] Section 864(c)(5)(C) limits the income attributable to a U.S. sales office or other fixed place of business to ''the income . . . properly allocable thereto,'' which is interpreted as distinguishing manufacturing income, which will be foreign-source, from sales income, which will be U.S.-source. This allocation is understood to invoke transfer pricing principles for items of *gross income*. In other words, a taxpayer choosing the books and records method may apply transfer pricing principles to determine U.S.-source gross sales income. Expenses associated with the activities are then apportioned and allocated based on the Code provisions and regulations that govern this situation.[5]

Illustration of Transfer Pricing Principles Under the Books and Records Method

Assume that Foreign Corporation as a single enterprise (i.e., including the Branch):

(1) incurs $210 million of manufacturing costs abroad;

(2) incurs $15 million of sales costs in Country X (i.e., the costs of negotiating sales agreements with the U.S. OEMs), which, under Regs. §1.861-8, are properly allocable to sales in the United States;

(3) incurs $45 million of sales costs in the United States, which, under Regs. §1.861-8, are properly allocable to sales in the United States; and

(4) receives $300 million in sales revenue from its U.S. OEM customers.

Thus, Foreign Corporation's total gross income or profit (GP) is $90 million ($300 million minus $210 million), and its system operating profit (OP) is $30 million ($90 million GP minus $60 million in operating expenses (OE)). Under Regs. §1.863-3(b)(3), the $90 million GP must be allocated between ''production'' income, which will be treated as foreign-source income, and ''sales'' income, which will be treated as U.S.-source income.

Under the books and records method, Foreign Corporation would treat the Branch as if it were a separate, but related, U.S. corporation that purchases the products from Foreign Corporation's Country X office and sells them to third-party customers for $300 million. The key in arriving at a division of Foreign Corporation's GP between foreign-source GP and U.S.-source GP is to select a purchase price for the imported finished products, to be ''paid'' by the Branch

[3] The regulations contain two other methods for sourcing such gross income: (1) the 50/50 method, which splits gross income evenly between manufacturing and sales; and (2) the independent factory price (IFP) method, which treats the gross income calculated using an IFP as manufacturing gross income and the remainder as sales gross income. Regs. §1.863-3(b)(1), (2). Neither of these tests applies transfer pricing principles.

[4] *See* the Article at p. 469.

[5] Regs. §1.863-3(d).

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to Foreign Corporation's Country X office, that meets the arm's-length standard.

To determine whether a selected inventory price is arm's length, the Foreign Corporation would conduct a search of comparable low-risk distributors in the United States. Assume the comparables reflect a Berry ratio (GP divided by OE) interquartile range (IQR) of 1.05 to 1.12.[6] If the Branch's Berry ratio falls within that range, the Branch will be treated as having purchased the inventory for an arm's-length price, and the GP reported as U.S.-source on the Foreign Corporation's Form 1120F should be accepted.

In determining the Branch's Berry ratio, *both* the $45 million of sales costs incurred in the United States *and* the $15 million of sales costs incurred in Country X are included in the OE denominator because Regs. §1.861-8 requires that all sales expenses be allocated to U.S.-source GP. The GP numerator of the Berry ratio is simply sales revenue less the price booked by the Branch as payment to the Foreign Corporation for the goods (i.e., the Branch's cost of goods sold (COGS)).

In the example above, assume the pricing reflected in Foreign Corporation's books results in aggregate COGS for the Branch of $234 million. The *Branch*'s books would reflect the following:

(1) $300 million of sales revenues (the amount actually received from third-party customers in the United States);

(2) $234 million COGS for the Branch;

(3) $66 million GP (i.e., $300 million sales minus $234 million COGS);

(4) $60 million of OE; and

(5) $6 million of OP (i.e., $66 million GP minus $60 million OE).

Foreign Corporation's Country X office would reflect the following:

(1) $234 million of sales revenues (i.e., Foreign Corporation's sales to the Branch);

(2) $210 million of manufacturing costs incurred by Foreign Corporation abroad; and

(3) $24 million of GP (i.e., $234 million sales minus $210 million in manufacturing costs).[7]

Under Regs. §1.863-3, Foreign Corporation's gross income attributed to U.S. ''sales activity'' would be $66 million, the GP reported on the *Branch*'s books. Foreign Corporation's Form 1120F would reflect that amount as U.S.-source GP. Foreign Corporation's gross income attributed to ''production'' activity, within the meaning of Regs. §1.863-3, would be $24 million, and that amount would be treated as foreign-source GP (and thus not reflected on the Form 1120F).

Under the books and records method, the results above should be accepted for purposes of determining Foreign Corporation's U.S.-source gross income because the Branch's Berry ratio of 1.10 (i.e., GP of $66 million divided by OE of $60 million) falls within the IQR (1.05 to 1.12). Accordingly, the IRS would be obligated to respect the $66 million U.S.-source gross income figure reported on Foreign Corporation's Form 1120F.

Query whether the books and records method described above, which is a method permitted by Regs. §1.863-3(b)(3) to determine a *gross* item (i.e., U.S.-source GP), can be properly implemented through the application of a *net* profit level indicator, i.e., a Berry ratio indicator that relates GP to OE. The answer would seem to be ''yes'' — a Berry ratio test may be applied to validate a *gross* income figure, i.e., the Branch's $66 million GP, resulting from the $234 million internal inventory purchase price paid in the constructive covered transaction between Foreign Corporation and the Branch. Indeed, most transfer pricing methods (TPMs) under a comparable profits method (CPM) analysis apply a test at the *operating* profit level (operating margin (OM) or Berry ratio) to validate a *COGS* figure generated by the covered transaction. More specifically, the arm's-length GP split assumes that the Branch and Foreign Corporation's Country X office bear OE related to their respective functions, so that the GP represents a reimbursement of those expenses, plus a net profit (GP less OE) appropriate for those functions. Thus, as long as the Berry ratio benchmark reflects arm's-length standards, *and* the Taxpayer's own Berry ratio reflects OE computed under Regs. §1.861-8 standards, there should be no conflict between the use of the Berry ratio and its application to validate the U.S.-source gross income reported on a Form 1120F.

Although the Branch's GP is validated by a Berry ratio benchmark that takes into account the OE of

[6] The example assumes that the comparable profits method (CPM) using the Berry ratio is the most reliable transfer pricing method (TPM) to test the Branch's results, but the same analysis could apply to the CPM using an operating margin profit level indicator (PLI) or the resale price method. The resale price method would be the easiest method to apply — because it produces an arm's-length gross margin directly — but the method is not routinely available because of the lack of suitable comparables and/or reliable financial data. The illustration assumes there are no comparable uncontrolled transactions.

[7] Foreign Corporation may have operating expenses associated with its manufacturing function. Those expenses would presumably be treated as foreign-source under the books and records method.

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comparable companies, the OE of Foreign Corporation is still being determined under the principles set forth in Regs. §1.861-8. It is only the COGS that is determined under the arm's-length standard. Thus, if Foreign Corporation was to fail the Berry ratio test, the adjustment would not be to the Branch's OE (which remains fixed), but would be to the constructive internal inventory price paid by the Branch.

As a final note, the net U.S.-source income of a branch will not always correspond to the transfer pricing concept of net (or operating) profit. However, where the branch incurs no research and experimentation (R&E) expenses, as in the above example, the respective U.S.-source and foreign-source income, net of deductions for OE, should correspond to the net profit of the Branch and the Foreign Parent, respectively, under a transfer pricing analysis. That is because, as noted in the Article,[8] the APA Program's working assumption is that the Code and regulations allocate and apportion most expenses based on transfer pricing principles. The most common exceptions are R&E expenses, interest expense, and taxes. Because, of these three items, only R&E expenses are typically operating expenses in non-global dealing cases, the APA Program likely can, in many cases (including in the above example), provide or recommend a TPM that derives operating profit both for transfer pricing and Code and regulations purposes. If there are R&E expenses at issue, the APA could either be limited to a gross margin test, or provide for an operating profit test subject to an adjustment consistent with the U.S. allocation rules for R&E expenses.[9]

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[8] Article at p. 469.

[9] *See* Regs. §1.861-17.

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