JCT Transfer Pricing Report Describes Low-Taxed Foreign Structures

The Joint Committee on Taxation recently published a report presenting case studies of six U.S. multinational corporations (the “Report”). The corporations had an effective tax rate on worldwide income of less than 25 percent during at least one multi-year period since 1999. The Report focused on foreign-based supply chain structures that resulted in a low tax rate on foreign earnings, including profits associated with intellectual property and valuable functions, and the income generally was not subject to U.S. taxation under subpart F.

The corporations engaged in the development, manufacture and sale of products. They organized their foreign supply chains using a “principal” model. A foreign entity was formed as a principal in a low-tax jurisdiction (e.g., Ireland, Switzerland or the Netherlands). The principal generally oversaw the development, production, and sale of goods, either globally or in a designated region.

The foreign principal either owned the make and sell rights to its product lines, or licensed the intangible rights from the U.S. group or from a low-taxed foreign affiliate that owned the intangibles (i.e., Switzerland or Bermuda). Much of the research and development for the products was conducted in the United States by the U.S. group, and foreign subsidiaries that owned intangibles shared in the costs through cost sharing arrangements.

In some cases the principal physically manufactured products in its country of organization or in a foreign branch, generally located in a low-tax country (e.g., Puerto Rico, Switzerland, Ireland or Singapore). In other cases, the principal hired a related or unrelated contract manufacturer to physically manufacture the products on its behalf. The principal generally performed important manufacturing related functions, such as manufacturing oversight, vendor selection and quality control. Some contract manufacturers were located in higher tax countries (e.g., Latin America). A smaller amount of system profit was allocated to related contract manufacturers because they operated as low-risk service providers and acted at the direction of the principal.

The products generally were sold through separate entities. Some distributors purchased the products from the principal and sold them to customers. Alternatively, the distributor operated as a commissionaire marketing the products without disclosing the principal, but title to the products passed from the principal to the customers. The distributors often were
organized in higher tax countries to be close to their markets, and generally were responsible for developing a local sales force and maintaining relationships with customers. The principal generally performed valuable sales functions, such as developing global marketing strategies, demand planning and setting guidelines for terms and pricing. The distributor earned a routine return for its sales functions, assuming minimal risks with respect to the products and operating at the direction of the principal.

As discussed above, much of the system profits in the foreign-based principal structures were derived in low-tax countries. This resulted from the concentration of the more profitable functions, risks and intellectual property in foreign jurisdictions where the average tax rate was lower. The low average income tax rates were provided by statute or through negotiations with the local government.

In addition, the income derived by the controlled foreign corporations (CFCs) from selling the products generally was not subject to U.S. tax under subpart F under the manufacturing exception. Accordingly, low-taxed sales income derived by a foreign principal that physically manufactured the property it sold generally is not subpart F income.

When products are manufactured in a branch of the principal (or in an entity classified as a branch for U.S. tax purposes), a branch rule provides that under certain circumstances a portion of the sales income can be subpart F income. However, the branch rules do not apply when the products are manufactured in a country with a very low tax rate (e.g., five percent or less) or where the sales income is derived in the manufacturing branch.

The manufacturing exception can also apply where the principal hires a contract manufacturer to physically manufacture the property on its behalf. The Report points out that in the past taxpayers relied on attribution to the principal of the physical manufacturing activities of the contract manufacturer for this purpose based on IRS rulings and general case law. Under final regulations issued in 2008, a principal can qualify for the manufacturing exception if it engages in activities that substantially contribute to the manufacture of the products physically manufactured by a contract manufacturer, such as oversight, vendor selection, quality control, manufacturing logistics and demand planning. The Report notes that the manufacturing branch rule may have a broader application to contract manufacturing arrangements under temporary regulations also issued in 2008.

Companies may structure their supply chain such that the principal neither purchases the products from related parties nor sells the products to related parties. For example, the principal may purchase raw materials from unrelated suppliers and consign them to a related “tol” manufacturer to produce the finished products. The products may then be sold through a disregarded limited-risk distributor to the ultimate customers or via a commissionaire where title passes directly to the customer. Subpart F does not apply where there is no related party purchase or sale (subject to the branch rule in the temporary regulations).

Income associated with intangible property was realized as a portion of the profits from the sale of the products and accordingly avoided subpart F as described above. Where the intangible property was owned by a separate entity that licensed it to the principal, the royalty payment was ignored for U.S. tax purposes because the two parties were part of a disregarded entity structure. The Report notes that even if the royalties had been earned by a separate CFC, for a period of time they should not be subpart F income under a temporary look-through exception provided in Code Sec. 954(c)(6). Quoting legislative history, the Report points out that the entity classification rules and the look-through exception have allowed taxpayers to operate from a tax perspective in a manner that reflects the business realities without triggering subpart F income.

The Report, which was prepared for a hearing before the House Committee on Ways and Means, may indicate that there is some concern with low tax principal structures. Nevertheless, it suggests that such structures may have substance and good business reasons, and that they very well might work under current law. Particularly noteworthy is the Report’s acknowledgement that foreign based multinationals use the same low-tax structures. If the United States enacted rules that increased taxes on low-taxed principal structures, this would result in U.S. multinationals being at a significant competitive disadvantage.

ENDNOTES

1 The Joint Committee on Taxation, Present Law and Background Related to Possible Income Shifting and Transfer Pricing (JCX-37-10), July 20, 2010.
2 Reg. §1.954-3(a)(4).
3 Reg. §§1.954-3T(b)(1)(i)(c)(1), (2)(ii)(a) & (e); -3T(b)(4), Ex. 9. See Yoder, Limits on the Application of the Subpart F Branch Rules, 38 TAX MGMT. INT’L J. 366 (June 12, 2009).
4 See Yoder, Indicia of Manufacturing, 38 TAX MGMT. INT’L J. 642 (Oct. 9, 2009).