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Avoiding U.S. Tax On Foreign Sales To U.S. Customers

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Many U.S.-based multinational companies manufacture or purchase goods abroad through foreign subsidiaries for distribution in the United States. Typically, the goods are sold to customers through an affiliated U.S. distributor. The result, at best, is that a portion of the income earned on such sales can avoid current U.S. taxation. Even with careful tax planning such partial deferral is not assured. It may be possible, however, to modify this traditional distribution structure to shield *substantially all* of the income arising from such sales from current U.S. tax and to do so with greater certainty. To understand how this can be accomplished requires a basic understanding of how foreign subsidiaries are taxed in the United States.[1]

U.S. Taxation Of Foreign Subsidiaries

Generally, foreign corporations are not subject to U.S. tax on their business income unless they engage in a trade or business in the United States and their U.S. shareholders are not subject to U.S. tax until they receive dividends or dispose of their shares.

However, where a majority of the foreign corporation's stock is owned by U.S. shareholders the foreign corporation is defined as a "controlled foreign corporation" (CFC) under Subpart F of the Internal Revenue Code (IRC). This requires that its U.S. shareholders include in their income currently their share of the CFC's "Subpart F income."

Subpart F income includes, among other things, most passive income and "foreign base company sales income." In the context of this discussion, foreign base company sales income includes income from the purchase of personal property from any person and its sale to a related person, unless such personal property is manufactured or sold for use in the foreign country in which the CFC is created or organized (the CFC Country). As long as the CFC manufactures the goods, income from their sale will nevertheless be excluded from foreign base company sales income. Thus, even though the CFC sells to a related party in the United States, income from these sales will not be Subpart F income if the CFC is the manufacturer of the goods, with the result that the sales income generally qualifies for deferral from current taxation.

Treatment Of Contract Manufacturing

For many years, the Internal Revenue Service (IRS) held that, if a CFC engaged a contract manufacturer to manufacture its products, the activities of the contract manufacturer would be attributed to the CFC, and in effect, the CFC would be considered the manufacturer under Subpart F. In 1997, however, the IRS revoked its long-standing 1975 ruling, holding instead that such attribution is not permissible. The IRS has never clearly articulated the rationale for the reversal of its position. Although certain subsequent developments have been encouraging to taxpayers utilizing contract manufacturing arrangements, the issue is still unsettled. In addition, legislation has recently been proposed that would preclude attribution of the activities of a contract manufacturer to a CFC.

Traditional Inbound Distribution Arrangement

Many U.S.-based multinational companies are operating under what has become a traditional inbound distribution arrangement, whereby the U.S. parent corporation formed a CFC that manufactures or purchases products for distribution in the United States. Those products are then sold to a U.S. affiliate for resale to third parties in the United States.

Under Subpart F, the profit earned by the CFC on the sale to a related party of personal property that is neither manufactured nor sold for use in the CFC Country will not qualify for tax deferral unless it is actually manufactured by the CFC or "treated" as manufactured by the CFC under a contract manufacturing arrangement. With the status of contract manufacturing uncertain, the question arises as to whether there might be a better alternative structure for handling these sales. And even when the CFC's sales income qualifies for deferral, the U.S. distributor's income on the transaction is subject to U.S. tax. Moreover, the IRS might always challenge the transfer pricing between the CFC and the U.S. distributor if it considers the latter's taxable profit insufficient.

Direct Import Arrangement Alternative

The tax issues involved in the traditional arrangement are caused fundamentally by the need to employ an affiliated U.S. distributor to get the product to the customer. The CFC's sale to the U.S. distributor constitutes a related-party transaction, which is what creates the potential for Subpart F income. If the related-party aspect can be avoided, then whether the

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CFC is, or can take the position that it is "considered," the manufacturer will become academic. In that event all of the sales income (including that portion previously earned by the distributor) may qualify for deferral.

A practical business question to be addressed is whether it is possible to eliminate the affiliated U.S. distributor. Can the CFC sell directly to unrelated purchasers in the United States? Where once quality and timely delivery may have been issues, current perceptions actually favor imported goods due to lower labor costs outside the United States.

Avoiding A U.S. Trade Or Business

Any effort to eliminate the affiliated U.S. distributor raises a threshold tax issue; *viz.*, whether the CFC's activities can be conducted in such a way that it will not be considered engaged in a U.S. trade or business. For, if the CFC is so engaged, then any income that is "effectively connected" with its U.S. trade or business will be subject to U.S. tax currently.

The IRC does not prescribe the level of activity required to constitute a U.S. trade or business and the case law provides only limited guidance. For planning purposes, it should be assumed that virtually any activity conducted in the United States with regularity may cause a foreign corporation to be engaged in a U.S. trade or business. If possible, a CFC that imports directly to customers in the United States should avoid conducting any activity in the United States, except perhaps on a sporadic basis.

Avoiding Effectively Connected Income

Even if a foreign corporation is engaged in a U.S. trade or business, all or a portion of its income may not necessarily be effectively connected with that trade or business. Generally, a foreign corporation's income will be treated as effectively connected with a U.S. trade or business only if (among other requirements) it has a U.S. source. Income from sales of inventory effected outside the United States (*i.e.,* sales where title passes outside the United States) generally is treated as foreign-source, unless the taxpayer manufactures the property in the United States. However, the IRC contains a "U.S. Office Rule" under which any income from sales of personal property attributable to a U.S. office generally is considered to have a U.S. source.

Thus, assuming that under a Direct Import Arrangement our "direct import CFC" purchases or manufactures inventory outside the United States, and that in connection with sales into the United States it passes title outside the United States, the income from these sales will be foreign-source, and thus not "effectively connected income," provided that the U.S. Office Rule does not apply.

The U.S. Office Rule will apply to a foreign corporation engaged in a trade or business in the United States if it meets two conditions: (1) it maintains an office in the United States (U.S. office requirement) and (2) its income from sales of personal property is "attributable" to such office (attributable requirement).

The U.S. Office Requirement

A foreign corporation will not be considered to have a U.S. office merely because of the presence in the United States of officers of its domestic parent who are generally responsible only for the policy decisions affecting the foreign corporation, *provided that* the foreign corporation has a chief executive officer (who may also be an officer of the U.S. parent) who conducts its day-to-day trade or business from a foreign office. This will hold true even if the executive officer (1) regularly confers with the officers of the domestic parent, (2) occasionally visits the U.S. office of the domestic parent, and (3) during such visits temporarily conducts the business of the foreign corporation from the domestic parent's U.S. office.

Critical to achieving this result is that the foreign corporation has a real foreign office and a chief executive officer "who conducts the day-to-day trade or business of the foreign corporation" from that foreign office. Thus, under a Direct Import Arrangement some of the CFC's top-level management decisions may be made in the United States but day-to-day activities must remain offshore to prevent the CFC from having a U.S. office. In addition, the CFC should not regularly conduct *any* activities in the United States, whether through its own officers or employees or through those of an affiliate.

The Attributable Requirement

Although U.S.-based officers of the domestic parent may nod agreeably when advised not to participate in the day-to-day operations of the CFC, this may ultimately prove impossible. For example, they may need to review documents, send e-mails, take telephone calls, authorize fund transfers and do a host of other things on behalf of the CFC that may cause it to be engaged in a U.S. trade or business and to have a U.S office.

Fortunately, all is not lost if this happens. For even in this situation, the U.S. Office Rule will apply to characterize the income from "direct import" sales as U.S.-source *only* if such income is considered "attributable" to the U.S. office. Income shall not be considered attributable to a U.S. office unless such office is a "material factor" in the production of the income and the office regularly carries on activities of the type from which such income is derived.

To be a "material factor" in the production of income from the sales of inventory, the U.S. office would need to actively participate in soliciting orders, negotiating contracts of sale, or performing other significant services necessary for the consummation of the sale which are not the subject of a separate agreement between the seller and the buyer. So, in the case of our "direct import CFC," even if significant activities take place in the United States, it should be possible to achieve tax deferral on income from inventory sales if all of the critical sales activities are conducted offshore. This holds true even if the sales are subject to the final approval of the U.S. office.

Weighing The Pros And Cons

If properly implemented, the "direct import CFC" structure provides greater certainty and greater deferral than contract manufacturing. U.S.-based distributors should carefully consider whether this structure is realistic in light of their particular situation. In many cases, the requirement of a real office offshore with all solicitation and negotiations taking place outside the United States will be a nonstarter. But for companies with enough flexibility to locate these activities offshore, the tax benefits can be substantial.

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[1] *These tax rules are complex and the discussion herein is not intended to be comprehensive. For a more detailed technical discussion of these issues, see Howard J. Levine and Michael J. Miller,* Avoiding Subpart F Through Direct Import Structures, *J. Tax'n Global Trans., Summer 2004, at 5.*