

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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to:

from: Trina L. Dang
General Attorney (San Francisco)

subject: Books and Records Income Allocation Method under Section 863

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Country A =

Year 1 =

Product B =

Manufacturers =

Product X =

ISSUE

Where a foreign corporation conducts sales activity both within and without the United States related to sales occurring within the United States, whether an income allocation method that considers only the sales activity occurring within the United States is a proper "books and records" method for determining gross income attributable to sales activity under Treas. Reg. § 1.863-3(b)(3).

CONCLUSION

Where a foreign corporation conducts sales activity both within and without the United States related to sales occurring within the United States, an income allocation method that allocates income only to sales activity occurring within the United States is not an acceptable “books and records” method because it does not clearly reflect income attributable to all sales activity. A proper “books and records” income allocation method must clearly reflect income attributable to all production and all sales activities, regardless of whether those activities occur within or without the United States. Under the facts presented, all income attributable to sales activity is U.S. source income under Treas. Reg. § 1.863-3(c)(2) because the rights, title and interest to the property pass to the customer in the United States.

FACTS

In Year 1, five taxpayers each requested approval from the Director of Field Operations (“DFO”) to use the books and records income allocation method, set forth under Treas. Reg. § 1.863-3(b)(3), for purposes of sourcing the taxpayers’ income under section 863 of the Internal Revenue Code (“Code”).¹ These requests are currently pending before the DFO.

The five taxpayers, all corporations incorporated in Country A, a foreign country, manufacture Product B in Country A and sell Product B to Manufacturers throughout the world. The Manufacturers incorporate Product B into finished Product X and sell finished Product X to end users. A portion of the sales made by the Country A companies are to Manufacturers located in the United States (“U.S. Manufacturers”), which in turn incorporate Product B into finished Product X that ultimately is sold to U.S. end users. There is no tax treaty between the United States and Country A.

The Country A companies sell Product B to the U.S. Manufacturers pursuant to master purchase agreements, which typically give the Country A companies the right to sell Product B to the U.S. Manufacturers for a specified period and at specified volumes. The Country A companies represent that the solicitation and negotiation activities undertaken in connection with these master purchase agreements are performed solely by employees of the Country A companies in Country A without the involvement of any U.S. persons.

The Country A companies distribute their products to the U.S. Manufacturers under a “just-in-time” (“JIT”) distribution model. Under the JIT model, the Country A companies ship Product B to the United States based on the U.S. Manufacturer’s projected needs. The Country A companies continue to hold rights, title and interest to Product B and store it in the United States at third party warehouse facilities until the U.S. Manufacturer is ready to receive it. When instructed by the U.S. Manufacturer to do so, the warehouse ships Product B directly to the U.S. Manufacturer and the Country A

¹ All section references herein are to the Internal Revenue Code of 1986, as amended.

companies' rights, title, and interest to Product B pass to the U.S. Manufacturer upon receipt. The U.S. Manufacturer typically incorporates Product B immediately into finished Product X and sells finished Product X directly to end users. This JIT model is desirable for the U.S. Manufacturer because it allows the U.S. Manufacturer to hold rights, title and interest to Product B for a minimal period, thereby providing a positive effect on the U.S. Manufacturer's financial accounting position.

The Country A companies, on their own behalf and through the activities of U.S. affiliates acting on their behalf, conduct, in the United States, logistics and warehouse management activities to ensure the timely and smooth flow of Product B to the U.S. Manufacturers. Although the Country A companies have not provided detailed information regarding the nature and extent of the U.S. activities, we are aware of at least one instance where a U.S. affiliate, acting under a service contract for the Country A company, undertakes virtually all coordination activities with the U.S. warehouse facilities and occasionally makes on-site visits to the warehouses for quality control purposes.

The Country A companies believe that their U.S. activities may give rise to a U.S. trade or business, thus subjecting them to potential U.S. taxation. For purposes of determining the income subject to U.S. tax, these companies requested permission from the DFO to use the books and records method under Treas. Reg. § 1.863-3(b)(3) and such requests are currently pending before the DFO. The method for which the companies seek approval allocates income between production and sales activities using section 482 arm's length principles for allocating income to two hypothetical separate taxpayers based on the functions and risks borne by each taxpayer. That is, these companies propose to allocate their gross income from sales to U.S. activities and Country A activities based on the functions and risks borne at each location as if the U.S. branch and the Country A home office were separate entities dealing with each other at arm's length. The companies propose to use the income allocated to the U.S. branch under this approach to derive the gross income from sales activity for section 863 purposes.

LAW AND ANALYSIS

The section 863 sourcing rules source income from the sale of inventory property produced within the United States and sold without the United States, or produced without the United States and sold within the United States. In the case of a nonresident, section 865(e)(2) applies to source the income from the sale of personal property (including inventory property) attributable to an office or other fixed place of business ("FPB") that the nonresident maintains in the United States.

Although they believe they may be engaged in a U.S. trade or business, the Country A companies do not admit that they have a U.S. office or FPB and in any event, maintain that their sales are not attributable to a U.S. office or FPB even if one exists. Thus, they claim that the section 863 sourcing rules apply to their situation. For purposes of this

memorandum, we will accept as true the taxpayer's assertions and assume that the section 863 sourcing rules apply.²

Under the section 863 sourcing rules, gross income from these sales, termed "Section 863 Sales" under Treas. Reg. § 1.863-3, first must be allocated to either production activity or sales activity. Treas. Reg. § 1.863-3(a). As described below, the section 863 regulations set forth three income allocation methods for this purpose. After income is allocated between production and sales activity under one of these three methods, separate section 863 sourcing rules then apply to source income from production activity and income from sales activity. Treas. Reg. §§ 1.863-3(c)(1) and (2).

Under the latter rules, the income attributable to production activity is sourced based on the location of the taxpayers' production assets and, thus, if all the taxpayers' production assets are located outside the United States, the income attributable to production activity would be foreign source. The income attributable to sales activity is sourced in accordance with Treas. Reg. § 1.861-7(c) and, thus, to the extent the sales are consummated by transfer of the rights, title, and interest to buyers in the United States, the income attributable to sales activity would be U.S. source. Since we assume that none of the taxpayers' sales are attributable to a U.S. office or FPB, to the extent the section 863 sourcing rules source income attributable to production or sales activity to foreign sources, such income will not be effectively connected with a U.S. trade or business ("ECI") under section 864(c)(4). To the extent the section 863 sourcing rules source income from these sales to U.S. sources, the income will be ECI under section 864(c)(3).

The section 863 regulations prescribe three methods for allocating income between production and sales activities: (1) the 50/50 method, (2) the independent factory price ("IFP") method, and (3) the books and records method, which requires approval from the District Director (now the DFO). Treas. Reg. § 1.863-3(b).

Under the 50/50 method, 50% of the gross income from Section 863 Sales is allocated to production activity and 50% is allocated to sales activity. Treas. Reg. § 1.863-3(b)(1). The IFP method permits a taxpayer to allocate its gross income based on the price at which the taxpayer regularly sells its products to wholly independent distributors or other selling concerns, provided that the taxpayer's sales activities with respect to such sales are not significant. Treas. Reg. § 1.863-3(b)(2)(i). Under this method, the gross sales price equal to the IFP charged to the distributor or other selling concern is treated as attributable to production activity and the excess of the gross sales price over the IFP is treated as attributable to sales activity. Treas. Reg. § 1.863-3(b)(2)(ii).

² We have not been asked to opine on how the sourcing rule under section 865(e)(2) would apply if the taxpayers do in fact have a U.S. office or FPB to which their sales are attributable. Accordingly, this memorandum expresses no opinion on the application of the sourcing rule under section 865(e)(2) and no inferences regarding section 865(e)(2)'s operation should be drawn from this memorandum's discussion.

Under the books and records method set forth by Treas. Reg. § 1.863-3(b)(3), a taxpayer may elect to allocate its gross income from Section 863 Sales between production and sales activities based upon the taxpayer's books of account. Treas. Reg. § 1.863-3(b)(3) provides:

A taxpayer may elect to determine the amount of its gross income from Section 863 Sales that is attributable to production and sales activities for the taxable year based upon its books of account if it has received in advance the permission of the District Director [now the DFO] having audit responsibility over its tax return. The taxpayer must establish to the satisfaction of the [DFO] that the taxpayer, in good faith and unaffected by considerations of tax liability, will regularly employ in its books of account a detailed allocation of receipts and expenditures which clearly reflects the amount of the taxpayer's income from production and sales activities. If a taxpayer receives permission to apply the books and records method, but does not comply with a material condition set forth by the [DFO], the [DFO] may, in its discretion, revoke permission to use the books and records method. The source of gross income treated as attributable to production activity under this method may be determined under the rules of paragraph (c)(1) of this section, and the source of gross income attributable to sales activity will be determined under the rules of paragraph (c)(2) of this section.

The Country A companies have requested permission to allocate income under the books and records method between production and sales activities using section 482 arm's length principles for allocating income to two separate taxpayers based on the functions and risks borne by each taxpayer. Under this approach, the Country A home office and the U.S. branch would be treated as two separate taxpayers. The Country A home office, the manufacturer, would sell products to the U.S. branch, which would in turn act as a reseller of these products to U.S. customers. If only the U.S. reseller, and not the Country A manufacturer, engages in sales activity, the Country A manufacturer's gross income attributable to its production activity would equal the gross sales price (less COGS) charged to the reseller of goods. The reseller's gross income attributable to its sales activity would equal the gross sales price (less COGS) charged to its customers.

The Country A companies wish to allocate gross income between production and sales activities based on the arm's length price that the Country A home office, as a hypothetical separate taxpayer, would charge the U.S. branch, as a hypothetical separate taxpayer, under the manufacturer/reseller model described above. They have requested approval to use such hypothetical treatment of the Country A home office and the U.S. branch as separate taxpayers, to allocate income to the U.S. branch on this basis and so derive the gross income from sales activity for section 863 purposes.

In each case of the five Country A companies, however, both the foreign home office and the U.S. branch engage in sales activity. The U.S. branches perform logistical support services relating to the warehousing of inventory in the United States. Customer relationship and other sales activities take place in Country A through their home offices. Because the Country A companies conduct sales activity outside the United States, the companies' methodology does not clearly reflect income attributable to sales activity, as required by the section 863 regulations. The taxpayers' method fails to recognize that gross income attributable to sales activity must include all income attributable to all sales activities connected with U.S. sales, wherever those activities take place.

The section 863 regulations require a taxpayer, as a condition to receiving approval to use a books and records method, to establish to the DFO's satisfaction that its proposed allocation method clearly reflects income attributable to production and sales activities. The taxpayers' approach does not meet this requirement because it fails to allocate income to sales activity taking place in Country A, and sources to the United States only gross income attributable to sales activity performed in the United States. A proper books and records method must allocate income between all production and all sales activities, and gross income attributable to sales activity, regardless of where the sales activity takes place, must then be sourced to the place of sale. Thus, the Country A companies' proposed method is not a proper books and records method under Treas. Reg. § 1.863-3(b)(3).

Please call _____ if you have any further questions.

By: _____
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