Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFP:MIA:POSTF-157451-01
TSMoraviaIsrael

date:

to: Ted Takeuchi, Case Manager, Glendale, California

from: Industry Counsel to Shipping Technical Advisor Team, CC:LM:RFP:MIA

subject: [redacted]
Taxable periods [redacted] through [redacted]

This memorandum responds to your request for assistance. This memorandum should not be cited as precedent.

ISSUE

Whether Taxpayer's controlled foreign corporation can characterize all of its income as income from sales or must the controlled foreign corporation separately characterize the income attributable to the transportation of goods by ship as foreign base company shipping income pursuant to I.R.C. § 954(f).

FACTS

[redacted] (hereinafter "[redacted]"), a United States multinational corporation, is the common parent of the wholly owned foreign subsidiary [redacted], a [redacted] Corporation (hereinafter referred to as "[redacted]"), and the wholly owned domestic subsidiary [redacted] (hereinafter referred to as "[redacted]"). [redacted] filed a consolidated United States corporate income tax return (Form 1120) for its domestic entities and a Form 5471 for [redacted] for the taxable years ending [redacted] through [redacted]. In [redacted], [redacted] restructured its [redacted] business in [redacted]. Prior to this [redacted] date, [redacted] reported a large amount of foreign base company shipping income. After the reorganization, the amount reported was zero.

The transactions[1] that are the subject of the audit are the sales by [redacted] to [redacted]. The taxpayer at issue is [redacted]. Although [redacted] has many areas of business, those to be addressed in this advisory opinion are the purchase and sale and transporting of [redacted] and other [redacted].

[redacted] is responsible for the sales and marketing of [redacted] in North America. [redacted]'s routine sales activities include the wholesale distribution of [redacted] and [redacted] for [redacted]. [redacted]'s customers include retail [redacted] chains and other wholesalers in North America. Both [redacted]'s and [redacted]'s regular place of business during the above mentioned years is in [redacted], California.

[redacted] purchases [redacted] and other [redacted] from independent [redacted] and affiliated companies in [redacted]. [redacted]'s largest selling product to [redacted] is [redacted]. With respect to [redacted]'s purchases from both related and unrelated [redacted], orders for specific quantities are gathered by [redacted] through its United States sales and distribution network and transmitted periodically to [redacted]. Quantities matching those orders are purchased by [redacted] from the [redacted] and resold to [redacted].

When the products are ready for [redacted], [redacted] brings its containers into the [redacted] so that the products can be loaded directly into the containers.[2] After the product has been placed in the container, it is closed, sealed, and taken to the local seaport (docking area) to be placed on ships. [redacted] purchases (takes title to) [redacted] from the [redacted] as they are placed onboard the ship.

[redacted] owns or charters the ships that make the deliveries all over the world. [redacted] from Central America is exported to either Europe or to the United States. Although [redacted] is incorporated in [redacted], [redacted]'s regular place of business during the above mentioned years is in [redacted].

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[1] These "facts" are being taken from Exam's request for an advisory opinion and the "rough draft" of a document entitled "[redacted]", written by Rick Marchioni, the International Examiner assigned to this case.

[2] [redacted].

During the taxable years [redacted] through [redacted], [redacted] had no [redacted] facilities, offices, or employees in the United States. [redacted]'s activities relating to the sale of [redacted] to [redacted] took place within [redacted]. [redacted] did not file a separate income tax return in the United States with respect to its sales of [redacted].

When the ships arrive in the United States port, the containers are unloaded to an area rented by [redacted]. The containers are then placed on chassis owned by [redacted]. The ultimate customers in the United States, primarily the [redacted] chains, pick up the containers and the chassis and take them to their warehouses where the goods will be distributed to the individual stores.

Since [redacted]'s reorganization in [redacted], [redacted]'s[3] charging practice in its invoices to [redacted] has been to combine the charge for the [redacted] and the transportation without a separate itemization for each amount.

LAW AND ANALYSIS

Pursuant to I.R.C. § 954(f), foreign base company shipping income includes income derived from, or in connection with, the use, or leasing for use, of any aircraft or vessel in foreign commerce. An aircraft or vessel is generally used in foreign commerce to the extent that it transports people or property between the United States and a foreign country or vice versa. Treas. Reg. § 1.954-6(b)(3)(i).

If an item is foreign base company shipping income under I.R.C. § 954(f), that item cannot be any other type of foreign base company income. I.R.C. § 954(b)(6)(A). Treas. Reg. § 1.954-1(e)(1) states that "[f]or purposes of section 954, income shall be characterized in accordance with the substance of the transaction, and not in accordance with the designation applied by the parties to the transaction. For example, an amount that is designated as rent by the taxpayer but

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[3] See attached as Exhibit "C", a functional analysis of [redacted], a ship operator. This analysis is an excerpt taken from a transfer pricing study performed on [redacted], written by William Pfeil, PFTA for Shipping, Simon Janew, I.R.S. Economist, and Walter Jones, I.R.S. Shipping Engineer.

actually constitutes income from the sale of property, royalties, or income from services shall not be characterized as rent but shall be characterized as income from the sale of property, royalties or income from services, as the case may be. Local law shall not be controlling in characterizing income."

Under Treas. Reg. § 1.954-1(e)(2), a single transaction can give rise to income in more than one category of foreign base company income. The example noted in Treas. Reg. § 1.954-1(e)(2) directly relates to the factual scenario in this case. The example reads as follows:

> [I]f a controlled foreign corporation, in its business of purchasing personal property and selling it to related persons outside its country of incorporation, also performs services outside its country of incorporation with respect to the property it sells, the sales income will be treated as foreign base company sales income and the services income will be treated as foreign base company services income.

Finally, income derived by a CFC from the performance of each integrated business transaction is considered a single item of income and will be classified in accordance with the predominant character of the transaction, even though an incidental part of the income could be characterized as a different class of income. Treas. Reg. § 1.954-1(e)(3). In situations in which a CFC is engaged in performing separate business transactions, even though pursuant to the same contract or arrangement, the income from each such transaction shall be separately considered for purposes of classification under the predominant character test, absent unusual circumstances where said income or gain is not separate determinable. Treas. Reg. § 1.954-1(e)(3).

Prior to [redacted]'s [redacted] reorganization, [redacted] provided [redacted] with two bills for every shipment. The first bill was for the product shipped and the second bill was for the transportation charge for shipping the product. After the [redacted] reorganization, [redacted]'s charging practice changed in that they began to combine the charge for the [redacted] and the transportation on one invoice without separately stating each item. This is certainly evidence of the fact that at one point prior to reorganization, [redacted] believed that it had income from transportation.

[redacted] is a CFC and is in the transportation business. Its balance sheet carries millions of dollars in shipping assets. [redacted] owns or charters the ships that make the deliveries all over the world. As the facts above suggest, [redacted]'s role in this vertically integrated business is to be the transportation arm. [redacted] is not the [redacted], nor the marketer/distributor. Its economic contribution to the vertically integrated business is due principally to its transportation function. Transportation is [redacted]'s primary business rather than the sale of [redacted], regardless of the manner in which the respective parties structured their transactions. [redacted] may have income from other activities[4] and the residual amounts remaining in [redacted] after our allocations to cost of goods and to shipping more than compensate [redacted] for any other possible activities. Finally, as per the facts determined by Exam, [redacted] clearly does not fall into the "unusual circumstance" situation described in Treas. Reg. § 1.954-1(e)(3).

CONCLUSION

[redacted]'s foreign base company shipping income needs to be separately stated and reported as foreign base company shipping income pursuant to I.R.C. § 954(f) and the Regulations thereunder for the taxable years ending [redacted] through [redacted].[5]

This advisory opinion was originally sent to the National Office for a ten (10) day Significant Advice Review. This current version takes into account all changes proposed by the

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[4] For the years under examination, [redacted] reported net income in the amount of $[redacted], $[redacted], $[redacted] and $[redacted], and contends that it is all or principally all income from sales. Our economic analyses under I.R.C. § 482 say that a certain percentage of that amount is allocable to [redacted] as a reduction in the price [redacted] pays to [redacted] for the [redacted] and another piece is attributable to the transportation of the goods. Therefore, [redacted] may have income from other activities, but clearly, a portion of their income is from shipping.

[5] The above analysis is equally applicable to the sale and transportation of [redacted] by [redacted] to related European companies. However, no facts have been presented regarding these transactions.

National Office as per a telephone conference call on November 8, 2001 between the Field and ACCI. If you have any questions regarding the foregoing, please contact Tamara S. Moravia-Israel at (305)982-5319.

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