INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference: September 29, 2004

LEGEND

USCorp =
FCorp =
CountryA =
Products =
Distributors =

Year1 =
Year2 =
Year3 =
ContractX =
Rider =
RiderY =

=
DocumentA =

DocumentB =

Taxpayer's Submission =

ISSUE

Where property manufactured outside the United States is purchased by a domestic corporation outside the United States and resold to domestic distributors located within the United States for ultimate sale to end-users within the United States, and where the domestic corporation transfers to the distributors incidents of ownership outside the United States but bears certain commercially insurable risk of in-transit casualty loss or damage until delivery to the distributors' places of business in the United States on the resale, whether the income from such resales is sourced within or outside the United States pursuant to Treas. Reg. § 1.861-7(c).

CONCLUSION

Based solely on the facts described below, the income from such resales is sourced outside the United States pursuant to Treas. Reg. § 1.861-7(c) because the facts reflect terms of sale similar to C.I.F. sale terms that would generate foreign source income under the case law.

FACTS

USCorp is a domestic corporation that wholly owns FCorp, a foreign corporation organized under the laws of CountryA. FCorp manufactures Products in CountryA. FCorp sells Products to USCorp in CountryA. The time and place of the sale by FCorp are <u>not</u> disputed. USCorp then resells Products to domestic Distributors. The time and place of the resales by USCorp <u>are</u> disputed because USCorp bears certain risk of in-transit casualty loss or damage with respect to the resales. The Distributors then resell Products to end-users in the United States.

USCorp contracts with unrelated carriers to ship Products from CountryA to the Distributors in the United States. USCorp acts as the importer of record for customs purposes with respect to Products (see 19 U.S.C. § 1484(a)(2)(B) and Customs Directives 3530-002 (Nov. 6, 1984) (formerly numbered as 3530-02) and 3530-002A (June 27, 2001, reviewed June 2003)). Distributors are not directly involved in the importation of Products or the dealings with carriers.

USCorp opts not to purchase insurance against certain risk of in-transit losses or damages that it bears, such as certain losses due to <u>force</u> <u>majeure</u>. USCorp represents that insurance coverage against the type of in-transit risk of loss or damage that it bears with respect to Products was commercially available during the taxable years at issue (Year1 through Year2) and during other taxable years dating back as far as Year3. The risks borne by USCorp are discussed in more detail below.

USCorp treats its Product sales to Distributors as consummated outside the United States under Treas. Reg. § 1.861-7(c) and, therefore, as generating foreign source income.

Sales agreements between USCorp and each Distributor, such as ContractX, specify when and where legal title to Products passes to the Distributor. Paragraph of ContractX provides:

In practice, USCorp always makes delivery to the carrier at FCorp's plant in CountryA. Thus, pursuant to the sales agreements such as ContractX between USCorp and Distributors, legal title to Products passes from USCorp to Distributors (or other designated parties) in CountryA.

Under the sales agreements, a Distributor's legal obligation to pay USCorp is fixed on delivery of the Product to the carrier or the Distributor, whichever occurs first. See, e.g., ContractX, and RiderY, To meet their payment obligations, most Distributors establish a relationship with a financing company pursuant to which the financing company acquires a security interest in the Products (as reflected in ContractX, , and USCorp collects payment from the financing company.

Pursuant to the sales agreements, a Distributor obtains a right to receive a particular Product (specified by coincident with passage of legal title in CountryA and the creation of the Distributor's legal obligation to pay.

The sales agreements also address risk of loss. Paragraph of ContractX provides:

Thus, a Distributor bears no in-transit risk of casualty loss or damage, provided the Distributor

A Distributor bears risk of loss from when the Products are delivered at the Distributor's place of business in the United States.[1] Pursuant to law and contract, a carrier must compensate USCorp for in-transit damage or loss of Products other than damage or loss caused by USCorp, USCorp's agents, or force majeure events beyond the reasonable control of the carrier. See, e.g., DocumentA, DocumentB, p.1; and 49 U.S.C. § 11706. To summarize, USCorp bears certain risk of in-transit loss or damage, but is compensated by the carriers for certain losses and damage caused by the carriers.

LAW AND ANALYSIS

The rules in sections 861 through 865 source income from certain sales to the place of the sale. For this purpose, the first two sentences of Treas. Reg. § 1.861-7(c), to be referred to together as the title passage rule, provide, in pertinent part:

> [A] sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss.

The issue is the interpretation of the title passage rule and its application to the facts set out above.[2]

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[1] Taxpayer has suggested that the language in of ContractX supports a conclusion that the relevant in-transit risk of casualty loss or damage passed from USCorp to Distributors at the FCorp plant and then was immediately re-assumed by USCorp pursuant to an indemnification agreement embodied within that same provision. We do not give weight to such hypothetical immediate passage and assumption back of such risk. Rather, the agreement provisions and other facts and circumstances support that USCorp bore such in-transit risk until delivery to the Distributor's place of business.

[2] The third and fourth sentences of Treas. Reg. § 1.861-7(c), to be referred to as the tax avoidance rule, provide:

> However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied.

G.C.M. 25131, 1947-2 C.B. 85, preceded Treas. Reg. § 1.861-7(c). G.C.M. 25131 reflects the Service's adoption of the title passage rule from East Coast Oil Co., S.A. v. Commissioner, 31 B.T.A. 558 (1934)[3] and Ronrico Corp. v. Commissioner, 44 B.T.A. 1130 (1941).[4] The positions in G.C.M. 25131 were carried forward into Treas. Reg. § 1.861-7(c) promulgated in 1957.

In East Coast, the Service applied a place of contract rule to sales of oil. The controlling contracts for sale had been written and signed in the United States prior to ascertaining or appropriating the oil that would be subject to the contracts. As the United States Board of Tax Appeals framed the issue:

> Of course, the place of contract, the place of delivery and of payment, the terms of the agreement, and extraneous circumstances may each have a bearing [on the determination of the place of sale]. But the ultimate goal of the examination of all such considerations is to ascertain when and where the title to the goods passes from the seller to the buyer. It is then and there a sale is consummated -- when and where property in the goods passes, when and where the incidents of ownership vest in the vendee. Such is the rule, long and firmly established.

East Coast, 31 B.T.A. at 560 (footnote omitted). The court held with respect to oil sales under C.I.F.[5] shipping terms (using a common carrier) and under F.O.B.[6] shipping terms (using the purchaser's own ships) that the sales occurred upon delivery to the ship

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> In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred.

It is assumed, solely for purposes of this memorandum, that the tax avoidance rule does not apply on the facts of this case.

[3] The full citation for East Coast is: 31 B.T.A. 558 (1934), nonacq. 1935-1 C.B. 27, aff'd, 85 F.2d 322 (5th Cir. Tex. 1935), cert. denied, 299 U.S. 608 (1936), nonacq. withdrawn and acq. 1947-2 C.B. 2.

[4] The full citation for Ronrico is: 44 B.T.A. 1130 (1941), nonacq. 1941-2 C.B. 22, nonacq. withdrawn and acq. 1944 C.B. 24. G.C.M. 25131 also reflects the Service's adoption of the tax avoidance rule from Kaspare Cohn, Inc. v. Commissioner, 35 B.T.A. 646 (1937).

[5] "C.I.F." (cost, insurance, and freight) means that the seller pays the costs and freight necessary to bring the goods to the port of destination and buys insurance against the buyer's in-transit risk of loss.

[6] "F.O.B." (free on board) means that the seller fulfills its delivery obligation when the goods have passed the ship's rail at the port of shipment. Thus, the buyer bears all in-transit costs and risk of loss.

outside the United States because that was where and when "title passes to the purchaser; thereafter the goods, and the risks, are his." Id. at 561-62. East Coast stands for the proposition that a sale is consummated when and where "title to the goods" passes to the buyer. In the context of the East Coast decision, "title to the goods" is synonymous with "property in the goods" and "incidents of ownership." The context further indicates that these concepts include "risks." See also Ronrico, 44 B.T.A. at 1134-1135 (relying on East Coast and using materially similar passage of title and risks terminology).

As noted, the Service adopted the title passage rule in G.C.M. 25131:

> [T]his office adopts the general rule that, for the purpose of determining the source of income attributable to the sale of personal property, a sale is consummated at the place where the seller surrenders all his right, title, and interest to the buyer.

1947-2 C.B. at 86. The language "all his right, title, and interest" corresponds to the terms "title to the goods," "property in the goods," and "incidents of ownership" used by the East Coast court. See also United States v. Balanovski, 236 F.2d 298, 306 (1956), cert. denied, 352 U.S. 968 (1957) (associating title passage with passage of "property in the goods") and American Food Products Corp. v. Commissioner, 28 T.C. 14, 18 (1957) (describing the title passage test in terms of "beneficial ownership and title to the goods").

The Ronrico case involved facts similar to those in East Coast with one significant difference. In Ronrico, although the C.I.F. sale terms provided for the passage of "title to the goods and the risks involved" at the point of shipment outside the United States, the bills of lading and insurance policies were made in the name of the seller or to the order of the seller. 44 B.T.A. at 1134. The seller retained bare legal title until delivery of the bills of lading within the United States. Addressing the apparent inconsistency between the C.I.F. sale terms (i.e., passing "title to the goods and the risks" outside the United States) on the one hand and the retention of bare legal title (i.e., passing bare legal title within the United States) on the other hand, the Board of Tax Appeals stated:

> It is well recognized that where [bare legal title is retained] only for the purpose of giving some security to the seller, it does not prevent the passage of beneficial ownership and risk in the goods to the buyer at the point of shipment.

Ronrico, 44 B.T.A. at 1135.

Thus, the Ronrico court considered that beneficial ownership and risk of loss are relevant concepts under the title passage rule. Further, as evident from the above quote, the Ronrico court considered that retention of bare legal title alone is not controlling under the title passage rule.

To summarize, the title passage rule of Treas. Reg. § 1.861-7(c) is based on decisions such as East Coast and Ronrico. Both cases indicate that the determination of title passage includes a consideration of legal and economic rights and risks.

In Balanovski, the Second Circuit Court of Appeals determined the source of income from a sale of personal property, relying on the precedent set by cases such as East Coast and Ronrico as well as the language of G.C.M. 25131. 236 F.2d 298. Applying the title passage rule, the Second Circuit determined:

> Here, by deliberate act of the parties, title, or at least beneficial ownership, passed to [Purchaser] in the United States. . . . When documents of title, such as a bill of lading, are given up, the presumption is that the seller has given up title, together with the documents. . . . In F.O.B. and F.A.S. contracts there is a presumption that title passes from the seller just as soon as the goods are delivered to the carrier 'free on board' or 'free alongside' the ship, as the case may be. . . .
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> * * *
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> All the available evidence confirms, rather than rebuts, these presumptions of passage of title in the United States. All risk of loss passed before the ocean voyage. [Purchaser] took out the marine insurance. [Seller] performed all acts to complete the transaction, retained no control of the goods, and there was no possibility of withdrawal.

Id. at 305-306. In Balanovski, the passage of incidents of ownership such as beneficial ownership and risk of loss supported the presumption raised by documentation and shipping terms that title passed within the United States. The Balanovski court, like the Ronrico court, recognized that beneficial ownership and risk of loss are relevant factors under the title passage rule.

Taxpayer argues that the first and second sentences of Treas. Reg. § 1.861-7(c) taken on their face, as well as in light of the legal background, articulate two discrete rules. Namely, Taxpayer asserts that the first sentence indicates that title passage turns on when and where legal ownership is conveyed. In Taxpayer's view, the second sentence states an exception in the case where bare legal title is retained, so that only in such circumstances is reference made to beneficial ownership and risk of loss. Thus, in Taxpayer's view, the second sentence does not provide any gloss on the first sentence.

In our view, the language and context of the two sentences, as well as the legal background that is discussed above, indicate that the two sentences should be read together informing one another. Thus, in construing "the rights, title, and interest of the seller in the property," consideration should be given to factors including "beneficial ownership and the risk of loss."

This case involves a division of "rights, title, and interest" with respect to Products. Some factors favor a determination that the rights, title, and interest passed to Distributors in CountryA. These foreign source factors include: (1) the passage of legal title; (2) the creation of the Distributor's unrestricted right to a particular Product; and (3) the creation of USCorp's legal right to payment, when the are delivered to the carrier at FCorp's plant in CountryA. The primary factor favoring a determination that the rights, title, and interest did not pass to Distributors until delivery at their places of business in the United States is that USCorp bore certain in-transit risk of casualty loss or damage.

The title passage rule case law does not address situations such as this one where various incidents of ownership pass from the seller to the buyer at different times and places. In the cases, the courts' analyses typically identify several incidents of ownership all of which pass at the same time and place. In some cases, the courts summarily determine that title passed, in accordance with the title passage rule, at a certain place and time without analyzing individual incidents of ownership.

In reaching a conclusion regarding the significance in this case of USCorp's bearing certain risk of in-transit casualty loss, we observe that the terms of sale are substantially similar to the terms of sale in a C.I.F. sale. Several title passage rule cases that involve C.I.F. sales resulted in holdings that the sale is consummated, within the meaning of the title passage rule, at the place of shipment. See, e.g., East Coast, 31 B.T.A. at 561; 85 F.2d at 323; Ronrico, 44. B.T.A. at 1134-1135; Miami Purchasing

Service Corp. v. Commissioner, 76 T.C. 818, 828 (1981); and A.P. Green Export Co. v. U.S., 284 F.2d 383, 388 (Ct. Cl. 1960) (all cases showing that a C.I.F. sale is completed at the point of shipment for purposes of the title passage rule unless the express intention of the parties is otherwise).

We consider the case law to be clear that under C.I.F. terms of sale – i.e., where all incidents of ownership pass to the buyer before shipment, but the seller agrees to pay certain costs including insurance against the buyer's in-transit risk of loss – the sale is consummated at the point of shipment. The difference between the risks insured in a C.I.F. sale and the risk borne by USCorp in this case is that insurance in a C.I.F. sale does not cover the risk of certain in-transit losses such as certain losses due to force majeure, whereas USCorp in this case did bear the risk of in-transit losses due to force majeure.[7] Taxpayer has represented that insurance coverage was commercially available against the type of in-transit risk of loss or damage that it bore with respect to Products during the taxable years at issue.

We note that, whereas in a C.I.F. sale risk of loss passes to the buyer at the point of shipment, in this case, certain risk of loss was borne by USCorp during shipment. However, we also observe that, from the point of view of the buyer in both scenarios, risk of casualty loss does not pass to the buyer until delivery at the buyer's place of business. Thus, the two scenarios may be viewed as economically similar with respect to risk of loss.

We conclude that, taking into account the factual similarities between the present case and a C.I.F. case – particularly the economic similarity from the perspective of the buyer – the title passage determination in the present case is governed by the C.I.F. title passage rule case law. Therefore, on the facts described in this memorandum, the sales of Products by USCorp to Distributors are consummated outside the United States.

To summarize, because under Treas. Reg. § 1.861-7(c) a C.I.F. import sale results in foreign source income, the regulation also applies to result in foreign source income in Taxpayer's case where USCorp, rather than at its own cost purchase commercially available insurance against in-transit risks from a third-party insurer, instead itself effectively covers such risks.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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[7] See the detailed discussion of this point in Taxpayer's Submission, p.14.