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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL
CONNECTICUT-RHODE ISLAND DISTRICT
ATTN: Robert E. Marum, CC:NER:CTR:HAR

FROM: Anne P. Shelburne
Assistant to the Branch Chief, CC:INTL:BR6

SUBJECT:

This Field Service Advice responds to your memorandum received June 8, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND:

Company X =
Company Y =
Company Z =

Country X	=
Country Y	=
Country Z	=
Date 1	=
Date 2	=
Date 3	=
Insurance Co	=
Product A	=
Product B	=
Product C	=
Taxable Year 1	=
Taxable Year 2	=
US City	=
US Company	=

ISSUE:

Where US Company's sales of inventory property to related and unrelated non-United States customers took place in Taxable Years 1 and 2.

CONCLUSION:

US Company's sales of inventory property to related and unrelated non-United States customers in Taxable Years 1 and 2 took place outside the United States in the foreign country of ultimate destination.

FACTS:

US Company is a United States corporation which manufactures inventory property (Product A, Product B, and Product C) in the United States. In Taxable Years 1 and 2, US Company sold its products to customers located within and without the United States.

In Taxable Years 1 and 2, US Company used the same price list for all its non-U.S. customers, both related and unrelated. The sales prices of the products sold to related and unrelated non-U.S. customers were the same.

The sales process began when a customer contacted US Company to place an order.[1] At that time, US Company prepared a "purchase order package" by entering

[1] Customers placed orders by phone, fax, or in writing.

information about the order on a pre-printed form (such as the customer's name and address, "ship to" address, "quantity ordered," "part number/description," and "unit price"). The purchase order package comprised three identical pages marked, respectively, "original invoice," "accounting copy," and "purchase order copy."

US Company responded to all customer orders by sending the customer an "order acknowledgment."[2] The front side of the order acknowledgment set forth specific information for the particular order. The reverse side of the order acknowledgment contained thirteen pre-printed, numbered "Terms & Conditions," which provided in relevant part as follows:

> 1. <u>Acceptance</u>
> Any order to purchase goods from US Company will be in accordance with and expressly limited to the terms of this quotation notwithstanding any prior writing, usage of trade, course of dealing, or conflicting terms in the buyer's order to the contrary.
>
> 2. <u>Title</u>
> Title is to remain with US Company until the full purchase price is paid.
>
> 3. <u>Shipments</u>
> All shipments are F.O.B. US City. All shipments must be completed within one (1) year from the date of order entry with a maximum of four (4) separate shipments. For shipments to destinations inside continental United States, the risk of loss or damage to the goods shall be assumed by Customer on and as of the date of shipment. For shipments to destinations outside continental United States, the risk of loss or damage to the goods shall be assumed by Customer upon arrival at the Port of Entry of country of ultimate destination.
>
> . . . . .
>
> 5. <u>Terms of Payment</u>
> A separate invoice will be issued for each shipment . . . . All payments are due within 30 days of the invoice date . . . .

After sending the order acknowledgment, US Company assembled and packaged the order and shipped the products to the customer (utilizing various shippers including FedEx and UPS). The original invoice, from the purchase order package, was attached to the packaged order.

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[2] US Company could not provide order acknowledgments for Taxable Year 1 and indicated that order acknowledgments are not maintained for more than one year from the date of issuance.

The pre-printed information on the original invoices included the notation "F.O.B. US City." On certain original invoices for Taxable Year 1 to three related non-U.S. customers (Companies X, Y, and Z), the pre-printed terms "F.O.B. US City" were stricken through and substituted by the words "F.O.B. Destination" (added above the stricken shipping terms). This change appears to have been made at the time the original invoice was prepared. Not all of the original invoices for Taxable Year 1 to Companies X, Y, and Z were changed (i.e., some of the Taxable Year 1 original invoices to these companies retain the "F.O.B. US City" notation). No changes to the notation "F.O.B. US City" were made on the original invoices of any unrelated customers (U.S. or non-U.S.).

All of US Company's non-U.S. customers paid their own shipping and freight costs as well as the customs duties and value added taxes on the products purchased from US Company.

US Company maintained an insurance policy for all products shipped to its non-U.S. customers from the United States, covering damage to goods in transit.[3] The insurance attached from the time the products left US Company's warehouse and continued until the products were delivered to the customer's warehouse or place of storage in the country of destination. Under the policy, US Company products were insured against all risks of physical loss or damage from any external cause, with certain expressly provided exceptions (e.g., nuclear incidents). Related customers did not carry any insurance policies for goods in transit. It is not clear whether unrelated customers or others (such as carriers or bailees) carried insurance policies for goods in transit.[4]

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[3] We have been provided a copy of US Company's "Open Ocean Cargo Policy," under which Insurance Co agreed to insure US Company's international shipments made on or after Date 2, a date falling within Taxable Year 1. We have not been informed whether US Company maintained insurance for international shipments made during Taxable Year 1 but prior to Date 2 and, for the purposes of this discussion, we have assumed that an insurance policy with similar terms covered US Company shipments made prior to Date 2. US Company's insurance policy provides that it was to remain in force until canceled by either party on 30 days' written notice. We have assumed that the policy remained in force from Date 2 through all of Taxable Year 2.

[4] The insurance policy provided that it would be deemed void to the extent of any insurance procured by a carrier or bailee which was available to US Company. If US Company or others (excluding a carrier or bailee) procured ocean marine insurance attaching on a date earlier than the policy's date of attachment, the policy would be liable only to the extent of any deficiency in the prior insurance. If US Company or others (excluding a carrier or bailee) procured ocean marine insurance attaching on a date later than the policy's date of attachment, the policy would be liable up to the sum insured without any claim to contribution. If US Company or others (excluding a carrier or bailee) procured ocean marine insurance attaching on the same date as the policy, the policy would be liable only for a pro rata share of any claim.

LAW AND ANALYSIS:

The Place of US Company's Sales to Non-United States Customers

The issue in this case is where sales occur in US Company's export sales to related and unrelated foreign customers. Under the Code, the place of sale determines whether the taxpayer's income from the sale is from sources within or without the United States. See I.R.C. §§ 861-865. In this case, if the sales occurred outside the United States, US Company's income from these sales would, pursuant to section 863, be treated as partly from sources within the United States and partly from sources without the United States. If, instead, the sales occurred in the United States, US Company would derive U.S. source income from the sales.

Since 1957, the regulations in Treas. Reg. § 1.861-7(c) have defined place of sale as follows:

> For the purposes of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, 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. 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. 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.

Thus, the issue here is where US Company passed the rights, title, and interest in the inventory property to its customers or, if US Company retained bare legal title, where beneficial ownership and risk of loss in the inventory property passed to its customers. In applying Treas. Reg. § 1.861-7(c), the terms "rights" and "interest" should be interpreted to include economic as well as legal rights and interests (e.g., risk of loss with respect to the property). This approach is consistent with the regulation language providing that even if a seller retains bare legal title, a sale is deemed to occur where beneficial ownership and risk of loss pass to the buyer.

According to a Contact Memorandum dated Date 1, US Company's Secretary and Treasurer (hereinafter "US Company's Secretary") stated that unrelated non-U.S. customers "most likely" carried insurance on the products in transit. In an undated response to the Form 5701 Notice of Proposed Adjustment (dated Date 3), US Company stated that its Secretary could not know whether unrelated non-U.S. customers carried such insurance.

Case law holds that the parties' agreement will generally control in determining the place of sale. See, e.g., A.P. Green Export Co. v. United States, 284 F.2d 383, at 387-388 (Ct. Cl. 1960); United States v. Balanovski, 236 F.2d 298, at 305 (2d Cir.), cert. denied, 352 U.S. 968 (1957); Liggett Group, Inc. v. Commissioner, T.C. Memo. 1990-18 (1990).

In the present case, the writings between the parties — the "purchase order package" (containing the "original invoice") and the "order acknowledgment" — are the primary evidence of the place of sale. These writings could be viewed to contain some conflicting statements as to the place of sale, most notably the inconsistencies between the delivery terms in the order acknowledgments and some original invoices. Moreover, pursuant to these writings, different components of the bundle of rights considered in determining place of sale were transferred at different times. While title to the products did not pass until payment, risk of loss or damage was assumed by the customer upon the products' arrival at the port of destination. US Company's insurance policy, however, covered the products until their arrival at the customer's warehouse. We have analyzed the effect of these writings under the United Nations Convention on Contracts for the International Sale of Goods[5] ("the Convention") and the Uniform Commercial Code, given that the Convention will not necessarily apply to all of US Company's agreements with its non-United States customers.[6] Our analysis also considered the International Chamber of Commerce Incoterms[7] as well as case law.

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[5] United Nations Convention on Contracts for the International Sale of Goods, done April 11, 1980, 19 I.L.M. 671 (entered into force for the United States on January 1, 1988) [hereinafter Convention].

[6] The Convention automatically applies to sales contracts entered into by parties whose places of business are in different countries that have adopted the Convention, absent an express choice to exclude its application (which does not appear in the present case). Convention, arts. 1(1)(a), 6. See also Calzaturificio Claudia s.n.c. v. Olivieri Footwear Ltd., 1998 U.S. Dist. LEXIS 4586, at *12 (S.D.N.Y. Apr. 7, 1998). The U.S. Senate ratified the Convention in 1986, and it became a part of U.S. domestic law in 1988. Given the facts we have been provided, we assume that Countries Y and Z are the places of business of Companies Y and Z, respectively. Both Country Y and Country Z have adopted the Convention. Country X (which we assume to be Company X's place of business) has not adopted the Convention. For a list of countries where the Convention has entered into force, see International Trade Law Branch, United Nations Office of Legal Affairs, Status of Conventions and Model Laws (last updated June 8, 2000) <http://www.uncitral.org/english/status/status.pdf>. We have not been provided information on the places of business of US Company's other non-U.S. customers.

[7] International Chamber of Commerce, Incoterms (International Rules for the Interpretation of Trade Terms), 2 Basic Documents of Int'l Econ. L. (CCH) 711 (1980 edition) [hereinafter Incoterms]. The Incoterms are intended to provide rules for the

Although commercial law doctrine does not provide guidance for determining the place of sale for tax purposes, it does set out the rights and obligations of the parties with respect to the goods. To the extent Treas. Reg. § 1.861-7(c) and case law find the rights and obligations used in commercial transactions to be relevant in determining the place of sale for tax purposes, it is appropriate to consider the terms as used by the parties in a particular case to determine the place of sale.

Given the facts we have been provided, the original invoice, prepared by US Company at the time a customer's order was received, appears to be a written memorial of the customer's offer to purchase US Company products. Though the original invoice would appear to embody the terms of a customer's offer, it is not clear that US Company's customers indicated their desired shipping terms at the time they placed an order. US Company, not the customer-offeror, prepared the original invoice. The facts also suggest that US Company, not the customer, determined the shipping terms noted on the invoice.[8]

We believe that US Company's order acknowledgment, when sent to a customer, operated to confirm and accept the customer's offer. Given the facts we have been provided, however, it is not clear the extent to which the content of the customers' offers/orders corresponded to the order acknowledgment's "Terms & Conditions." We note that we have not examined the facts and circumstances surrounding each individual order in the taxable years at issue. We interpret the Convention and U.C.C. to provide that the terms and conditions noted in the order acknowledgment were part of the sales contract between US Company and its customers. Where, however, there is clear evidence of customer intent to include materially different terms in an order/offer, the order acknowledgment terms and conditions would not

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uniform interpretation of the trade terms used by parties to international sales contracts.

[8] According to the Date 1 Contact Memorandum, US Company's Secretary stated that US Company acquired computer software during Taxable Year 1 which was used to mark all sales invoices to related foreign customers "F.O.B. Destination." The Contact Memorandum also notes statements by US Company's Secretary to the effect that the shipping terms were changed <u>by US Company</u> to create foreign source income and get foreign tax credit benefits (e.g., "Our accountants told us to change the sales terms on the foreign related sales invoices to 'F.O.B. Destination.'").

necessarily form part of the parties' contract under the Convention[9] or U.C.C.,[10] and this issue would require further examination.

As noted above, Treas. Reg. § 1.861-7(c) defines place of sale with reference to the transfer of a bundle of rights. Under this approach, place of sale does not turn on any single factor, and its determination requires an examination of all relevant elements of the parties' agreement and conduct. Accordingly, in the present case, our analysis looks to delivery terms, contractual provisions regarding risk, US Company's insurance policy, and the passage of title to US Company products.

The writings between US Company and its customers contain delivery terms which in some cases conflict. The order acknowledgment states at Section 3 that all shipments are "F.O.B. US City." The invoices, however, do not all contain the same delivery terms. While some invoices state "F.O.B. US City," others state "F.O.B. Destination." Given this conflict, it is particularly important to clarify the meaning of the F.O.B. delivery term.

Under some case law, "[t]he use of the term 'F.O.B.' raises the presumption that title passes to the buyer on the seller's delivery of goods to the indicated place. . . . [U]pon such delivery, both title and the risk of loss during the course of any further shipment pass to the buyer. [Citation omitted.]" Liggett Group, T.C. Memo. 1990-18. The Court of Claims has noted, however, that presumptions connected with delivery terms "are useful in ascertaining intention only if no express intention of the parties appears. [Citations omitted.]" A.P. Green Export Co., 284 F.2d at 388 (emphasis added). The Convention does not expressly incorporate delivery terms. The Incoterms[11] define delivery terms by describing the respective risks and

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[9] Article 19 of the Convention provides that a reply to an offer containing additions or modifications which materially alter the terms of the offer is not an acceptance but instead a rejection and a counter-offer.

[10] U.C.C. § 2-207 provides that an acceptance or written confirmation sent within a reasonable time operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to the additional or different terms. Between merchants, the additional terms become part of the contract unless the offer expressly limits acceptance to its terms, the additional terms materially alter the terms of the offer, or the original offeror objects. In the present case, Section 1 of the "Terms & Conditions" states: "Any order to purchase goods from US Company will be in accordance with and expressly limited to the terms of this quotation . . . ."

[11] Article 9 of the Convention provides that the parties are bound by any usage to which they have agreed, any practices which they have established between themselves, and any usage they knew or ought to have known was a customary practice in the trade. The Incoterms are familiar to most parties to international sales and have been argued to represent a codification of international custom and usage.

obligations of buyer and seller and do not make use of the concept of title. The U.C.C. similarly defines delivery terms by reference to the risks and obligations of the parties.[12] Neither the Incoterms nor the U.C.C. definition of a delivery term will apply to the extent an agreement contains express provisions on the passage of risk and the relevant obligations of the parties.[13]

In the present case, the parties explicitly provided for the transfer of risk. Pursuant to Section 3 of the order acknowledgment, risk of loss or damage was assumed by US Company's non-U.S. customers outside the United States ("upon arrival at the Port of Entry of country of ultimate destination"). It is important to note that US Company's insurance policy with Insurance Co is consistent with the passage of risk of loss outside the United States. Under this policy, US Company insured the products against loss or damage until the products' arrival at the customer's warehouse or place of storage. Given the express language of the order acknowledgment as to risk of loss and US Company's insurance policy, we believe that risk of loss passed to the customer outside the United States regardless of the delivery terms used in the order acknowledgment and invoice.

The parties' agreement also provided for the passage of title. Section 2 of the order acknowledgment expressly provides: "Title is to remain with US Company until the full purchase price is paid." Under the terms of payment contained in Section 5, all payments were due "within 30 days of the invoice date." As the original invoice was attached to the packaged US Company products, non-U.S. customers would receive US Company invoices after the products' arrival at destination. If customers paid for US Company products after they had received an invoice, the functional result of Section 2 would be that the formal passage of title would occur after the products had entered the destination country.

In the present context, we believe title should be viewed as essentially equivalent to a security interest (i.e., the "bare legal title" of Treas. Reg. § 1.861-7(c)). We note that, in modern commercial law, the concept of title has largely been supplanted by a focus on the passage of rights, obligations, and risk of loss between buyer and

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See Peter Winship, Introduction to Incoterms, 2 Basic Documents of Int'l Econ. L. (CCH) 707 (Nov. 1989). Because the Incoterms are not law or treaty, however, they will not apply unless a contract expressly or implicitly incorporates them (by stating, e.g., "F.O.B. US City (Incoterms 1980 Revision)"). It is unclear whether the F.O.B. delivery term found in US Company's documents is used as an Incoterm or as a term that must be defined under the U.C.C.

[12] See, e.g., U.C.C. § 2-319 ("F.O.B. and F.A.S. Terms").

[13] The Incoterms state: "Special provisions in the individual contract between the parties will override anything provided in the rules." The definition of "F.O.B." in U.C.C. § 2-319(1) begins with the qualifying phrase, "Unless otherwise agreed . . . ."

seller.[14] The Convention does not contain any provisions on passage of title. Moreover, "[u]nder the U.C.C., the passage of rights, obligations, and risk of loss are determined independent of the passage of title."[15] U.C.C. § 2-401 provides:

> Each provision of this Article, with regard to the rights, obligations and remedies of the seller, the buyer, purchasers or other third parties applies irrespective of title to the goods except where the provision refers to such title. Insofar as situations are not covered by the other provisions of this Article and matters concerning title become material the following rules apply:
>
> (1) . . . Any retention or reservation by the seller of the title (property) in goods shipped or delivered to the buyer is limited in effect to a reservation of a security interest. . . .
>
> (2) Unless otherwise explicitly agreed title passes to the buyer at the time and place at which the seller completes his performance with reference to the physical delivery of the goods, despite any reservation of a security interest and even though a document of title is to be delivered at a different time or place . . . .

Applying U.C.C. § 2-401 to the present facts, title would pass outside the United States, upon delivery, despite US Company's reservation of title in Section 2.

Treas. Reg. § 1.861-7(c) and case law provide that a delay in the passage of title to protect the seller will not prevent the passage of beneficial ownership and risk (i.e., the consummation of a sale). In Ronrico Corp. v. Commissioner, 44 B.T.A. 1130 (1941), the Board of Tax Appeals stated:

> It is well established that where this method of dealing is followed 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 [(i.e., pursuant to the shipping terms agreed upon by the parties)]. [Citations omitted.]

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[14] See Kates Holding Co. v. Commissioner, 79 T.C. 700, 707-708 (1982) ("The concept of title, as used in article 2 [of the U.C.C.], is no more than 'bare legal title' such as is referred to in [Treas. Reg.] section 1.861-7(c) . . . ."). See also Linda Galler, An Historical and Policy Analysis of the Title Passage Rule in International Sales of Personal Property, 52 U. Pitt. L. Rev. 521 ("[T]he concept of title, . . . in the modern law of sales, exists largely as an historical footnote.").

[15] Kates Holding Co., 79 T.C. at 707.

44 B.T.A. at 1135. See also Yelencsis v. Commissioner, 74 T.C. 1513, at 1527 (1980) ("The retention by a seller of formal attributes of ownership does not preclude finding a sale.").

Regardless of the fact that US Company retained legal title to the products pursuant to Section 2 of the order acknowledgment, a sale can still take place where title has not been transferred. Even if title had not yet passed, we believe beneficial ownership and the risk of loss passed outside the United States and the sales at issue occurred outside the United States. Although US Company's documents in some cases contained inconsistent delivery terms, the totality of the circumstances indicates that the sales occurred outside the United States.

Examination also raises the issue of tax avoidance. Treas. Reg. § 1.861-7(c) provides that where a transaction is arranged in a particular manner for the primary purpose of tax avoidance, the general rule will not be applied and the sale will be treated as having been consummated at the place where the "substance of the sale" occurred. In the present case, it does not appear that this rule would apply to US Company's sales to its non-United States customers. The Court of Claims, citing Gregory v. Helvering,[16] has stated that taxpayers are free to arrange their affairs so that their taxes are as low as possible, and the reason for structuring sales in a particular manner is irrelevant "so long as the consummated agreements were no different than they purported to be, and provided the retention of title was not a sham but had a commercial purpose apart from the expected tax consequences. [Citations omitted.]" A.P. Green Export Co., 284 F.2d at 390. See also Barber-Greene Americas, Inc. v. Commissioner, 35 T.C. 365, at 387 (1960) ("The real issue is whether the petitioners' retention of title was a sham.").

US Company's retention of title in the present case does not appear to be a sham. US Company undertook real responsibilities and risks it would not have undertaken had title to the products passed in the United States. US Company maintained an insurance policy for all products shipped to its non-U.S. customers, covering damage to goods in transit. Retaining title until the customers' payment also appears to have served legitimate business purposes apart from the expected tax consequences. US Company has represented that retaining title permitted savings on insurance costs, as it was cheaper to insure the products from the United States than from overseas. According to US Company, assuming the risk of loss or damage during shipment would also protect its customer relationships by mitigating the potential for future disputes in the event products were damaged or lost during shipment. Finally, retention of title served to protect US Company should a non-U.S. customer become bankrupt or otherwise be unable to pay by making it more likely that the products would be recovered by US Company.

Accordingly, we conclude that US Company's sales to non-United States customers in Taxable Years 1 and 2 took place without the United States.

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[16] 293 U.S. 465 (1935).

The Source Rules

Pursuant to section 863, where US Company's sales of inventory property, manufactured by US Company in the United States, took place outside the United States, its income from these sales was partly from sources within the United States and partly from sources without the United States.

Please note that this advice considers solely the issue of where US Company's sales of inventory property to related and unrelated non-U.S. customers in Taxable Years 1 and 2 occurred. We express no view on US Company's allocation and apportionment of the income from these sales to sources within and without the United States.

Please call (202) 874-1490 if you have any further questions.

By: ______________________________
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