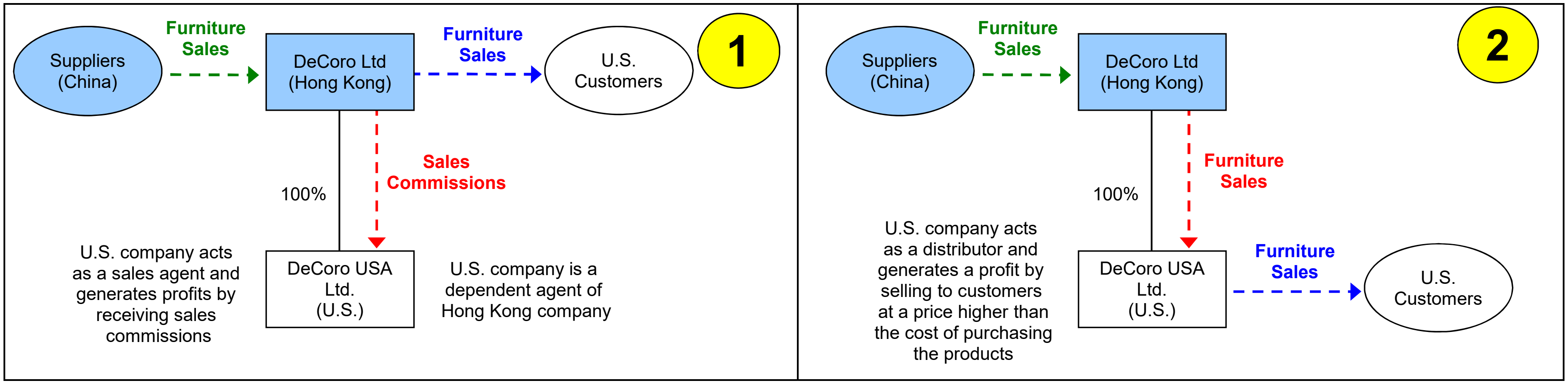
In Re DeCoro USA Ltd
U.S. Bankruptcy Court, M.D.N.C.,
Case No. 09-10846C-11G

Inbound Furniture Sales: Sales Comm. Model vs. Distributor Model

Sales Commission Model --- Primary IRS Position | **Distributor Model --- Alternative IRS Position**



During the years 2004-2007, substantial sales of furniture were made to customers located in the United States involving furniture manufactured in China and shipped to the United States by DeCoro Limited ("HKCo"), a Hong Kong limited liability company. Decoro USA Ltd. ("USCo") was a North Carolina corporation and was a wholly owned subsidiary of HKCo.

The furniture sales to customers in the U.S. were procured by USCo through either employees of USCo or independent sales representatives engaged by USCo. During 2008 or early 2009, the IRS began an examination regarding the U.S. tax liability of HKCo and USCo. The primary question during the examination was which company should pay the income tax due from the furniture sales to customers located in the U.S., which depended upon which company should be regarded as the seller of the furniture.

If USCo were a dependent agent of HKCo, then the sales would be treated as having been made by HKCo and HKCo would be taxed as a foreign corporation making sales in the United States. This was initially (prior to HKCo and USCo declaring bankruptcy) the primary position of the IRS. That is, the IRS initially argued that HKCo was making the sales to U.S. customers.

Conversely, if USCo were an independent distributor, then the sales would be treated as having been made by USCo and USCo would be liable for any income taxes due as a result of the domestic sales. The 2004-2007 tax returns filed by USCo claimed the furniture sales as having been made by USCo. This was the position of USCo during the audit. That is, HKCo and USCo initially argued that USCo was making the sales to U.S. customers.

In February of 2009, the IRS issued an audit letter saying that income taxes would be assessed against HKCo based upon the furniture sales to customers in the U.S. However, prior to any assessment being made by the IRS, HKCo filed an insolvency proceeding in Hong Kong and USCo filed for bankruptcy relief in the U.S.

The IRS filed a claim against USCo in the U.S. bankruptcy proceedings, arguing (implicitly or explicitly) that USCo had made the sales to U.S. customers and that the profit earned by USCo should have been higher under transfer pricing (Code §482) rules. USCo filed a motion for summary judgment, maintaining that the IRS's tax claim should be asserted against HKCo and not USCo. The Bankruptcy Court denied USCo's motion for summary judgment.

In a later opinion, the Bankruptcy Court disallowed the IRS's claim against USCo under the transfer pricing theory. The Bankruptcy Court stated that "the reality of the transactions between [USCo] and [HKCo] is that the sales by [HKCo] were not to [USCo]." The IRS had asserted a tax deficiency of over $11 million for USCo. USCo