

The New Proposed Contract Manufacturing Regulations Under Subpart F

By Sam K. Kaywood, Jr.

Sam Kaywood analyzes the new proposed contract manufacturing regulations under Subpart F and provides a much-needed background for the Subpart F policies and history that relates to contract manufacturing.

Introduction

On February 28, 2008, the IRS and the Treasury proposed the long-awaited contract manufacturing regulations.¹ The Proposed Regulations attempt to walk a very difficult line between upholding the policy behind the manufacturing exception and the branch rule crafted by the framers of Subpart F in 1962 versus promoting the competitiveness of U.S. multinationals doing global business in a much more sophisticated commercial environment than existed in 1962. This article provides background for the Subpart F policies and rules that relate to contract manufacturing as well as a history of the IRS' and the Treasury's positions with respect to it. That background leads up to discussion and analysis of the Proposed Regulations as well as suggestions for improvement.

Foreign Base Company Income

In General

Subpart F of the Code was added to prevent the deferral of income through offshore "tax haven companies." To review the basic rules, each "U.S. shareholder" must include in gross income its *pro rata* share of any "Subpart F income" of a "controlled

foreign corporation."² Subpart F income includes foreign personal holding company income (e.g., dividends, interest, rents and royalties, subject to certain exceptions),³ foreign base company sales income and foreign base company services income.⁴

Foreign base company sales income means income⁵ (whether in the form of profits, commissions, fees, etc.) that satisfies one of the following conditions:

- Derived in connection with the purchase of personal property from a related person and its sale to any person
- The sale of personal property to any person on behalf of a related person
- The purchase of personal property from any person and its sale to a related person
- The purchase of personal property from any person on behalf of a related person where:

... the property was manufactured, produced, grown or extracted outside the country of incorporation of the CFC and is sold for use, consumption or disposition outside such foreign country.⁶

These rules are intended to apply to circumstances where profits arising from the purchase and sale of personal property are separated from manufacturing profits and artificially located in a low-tax jurisdiction. For example, Chart 1 depicts the separation of selling profit from manufacturing profit. In Scenario

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1, a CFC organized in a high-tax jurisdiction (“HT”) purchases raw materials from related persons and manufactures the finished goods. HT sells the finished goods to its subsidiary, organized in a low-tax jurisdiction (“LT”), which sells them to unrelated persons. In Scenario 2, the facts are the same except that the CFCs are inverted, as LT owns the stock of HT.

Both scenarios produce FBCSI on the part of LT because, in both cases, (1) LT is purchasing finished goods from a related person; (2) the finished goods originate from outside of LT’s country of incorporation; and (3) the finished goods are being sold for use, consumption or disposition outside that country. There are other permutations that produce FBCSI,⁷ but these basic scenarios provide a good background for understanding the branch rule and the Proposed Regulations.

It is worth noting that President Kennedy’s original proposal envisioned a broader repeal of tax deferral, but Congress decided on a more limited anti-deferral regime.⁸

The Manufacturing Exception

“The manufacturing exception” is not explicitly mentioned in the Code as such, but is embedded in statutory language stating that FBCSI can occur only if the property purchased “manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized.”⁹ The statute does not state by whom the property is to be manufactured, *etc.*, but strongly implies that property manufactured by any-

one in the country of incorporation of the CFC cannot give rise to FBCSI.¹⁰ The Regulations contain another manufacturing exception for income of a CFC:

... derived in connection with the sale of personal property manufactured, produced, or constructed by such corporation in whole or in part from personal property which it has purchased.¹¹

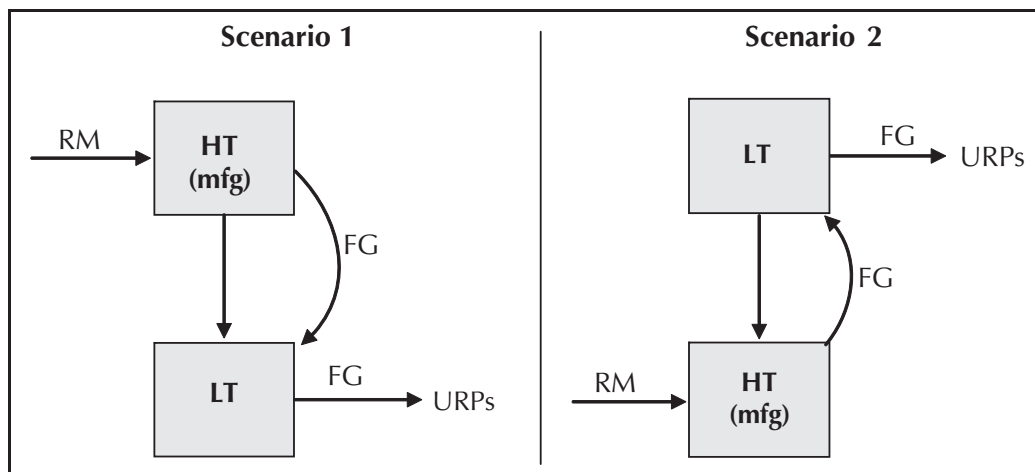
This Regulation does not focus on where the property is manufactured but does require that the property be manufactured “by such corporation,” *i.e.*, the CFC.¹²

A CFC is considered to have manufactured, produced, or constructed personal property that it sells “if the property sold is in effect not the property which it purchased.”¹³ The property is considered to be “in effect not the property which is purchased” if one of two tests (referred to herein as the “physical manufacturing” tests) is satisfied. Under one test, the property is treated as having been manufactured if it is “substantially transformed” prior to sale.¹⁴ The regulations provide various examples of substantial transformation, including converting wood pulp to paper, making screws and bolts out of steel rods and processing and canning fish.¹⁵

The assembly of component parts can also constitute manufacturing if the assembly operations are “substantial in nature” and are “generally considered to constitute the manufacture, production, or construction of property.”¹⁶ While this is determined under the facts and circumstances, the Regulations provide a safe harbor where the conversion costs (e.g., direct labor and factory overhead) account for 20 percent or more of the total cost of goods sold.¹⁷ However, in no event will packaging, repacking, labeling or minor assembly operations constitute the manufacture, production or construction of the property.¹⁸ In this respect, the legislative history states:

The “foreign base company sales income” referred to

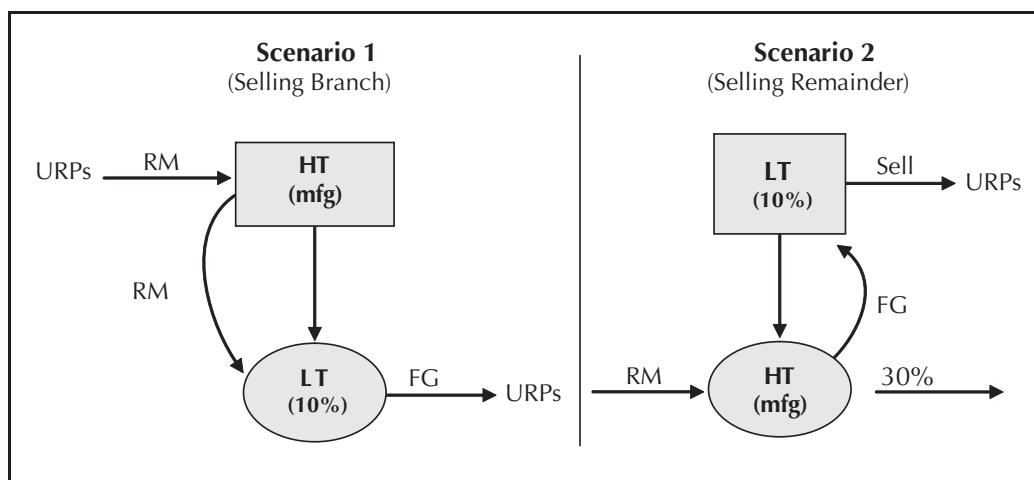
Chart 1. Selling CFCs*



* In all examples, “RM” refers to raw materials, “FG” refers to finished goods, “URPs” refers to unrelated persons, and “mfg” denotes that the company manufactures the product under the relevant tests under Subpart F.

here means income from the purchase and sale of property, without any *appreciable value* being added to the product by the selling corporation. This does not, for example, include cases where any significant amount of manufacturing, major assembling, or construction activity is carried on with respect to the product by the selling corporation. On the other hand, activities such as minor assembling, packaging, repackaging, or labeling will not be sufficient to include the profits from this definition.¹⁹ [Emphasis supplied.]

Chart 2. Selling Remainder or Branch



as Chart 1 except that the subsidiary CFC is a branch instead of a separately organized CFC. This could be accomplished with a check-the-box election or an actual branch. In Scenario 1, the selling branch's purchases of finished goods from LT would be ignored absent the branch rule. In that scenario, HT is referred to as a manufacturing "remainder."²¹

In Scenario 2 of Chart 2, the roles are reversed and the manufacturing is done through a branch while the remainder sells the finished goods. In both cases, the purchasing function has been separated from the manufacturing function and moved to a low-tax jurisdiction. As a general matter, it is relatively easy to establish purchasing or selling activities in low-tax jurisdictions (e.g., Cayman Islands, Hong Kong, etc.), whereas manufacturing activities are more likely to occur in high-tax jurisdictions (e.g., China, Mexico, Germany, etc.). In enacting Subpart F of the Code in 1962, Congress sought to impose current tax on these arrangements, as the Senate Finance Committee stated:

The sale income with which your committee is primarily concerned is income of a selling subsidiary (whether acting as a principal or agent) which has been separation from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income. This accounts for the fact that this provision is restricted to sales of property, to a related person, or to purchases of property from a related person. Moreover, the fact that a lower rate of tax for such a company is likely to be obtained only through purchases

The Branch Rule

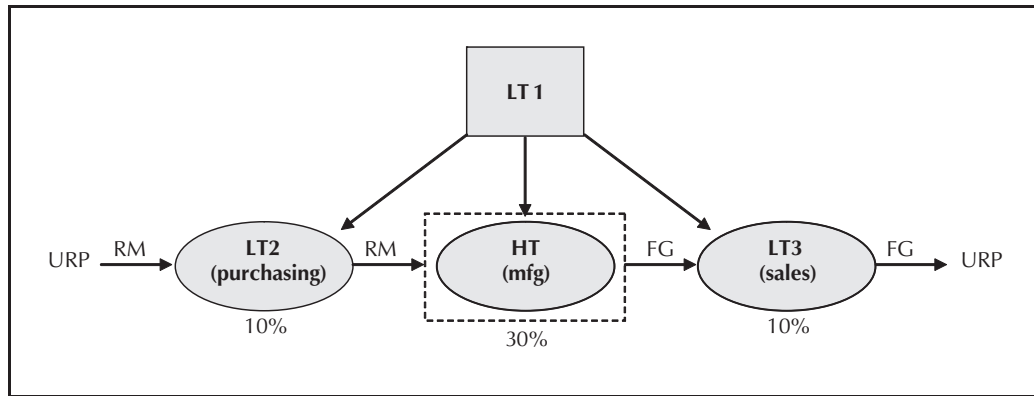
General Background

The branch rule is contained in Code Sec. 954(d) (2) and applies where the taxpayer uses a branch rather than a separately incorporated CFC in order to obviate the tests for having FBCSI. In particular, the branch rule provides:

For purposes of determining foreign base company sales income in situations in which the carrying on of activities by a controlled foreign corporation through a branch or similar establishment outside the country of incorporation of the controlled foreign corporation has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income, under regulations prescribed by the Secretary, the income attributable to the carrying on of such activities of such branch, or a similar establishment shall be treated as income derived by a wholly owned subsidiary of the controlled foreign corporation and shall constitute foreign base company sales income of the controlled foreign corporation.²⁰

Chart 2 depicts how this branch rule applies to selling CFCs. Both scenarios are precisely the same

Chart 3. Multiple Branches



a rate of 10 percent, while the manufacturing remainder or branch is taxed at a rate of 30 percent. The RDT is satisfied because the 10 percent rate of the sales branch or remainder is both less than 90 percent of the 30 percent (27 percent) and more than five percentage points (25

and sales of outside of the country in which it is incorporated, accounts for the fact that the provision is made inapplicable to the extent the property is manufactured, produced, grown or extracted in the country where the corporation is organized or where it is sold for use, consumption, or disposition in that country. Mere passage of title or the place of the sale are not relevant in this connection.

Also included in foreign base company sales income are operations handled through a branch (rather than a corporate subsidiary) operating outside of the country in which the controlled foreign corporation is incorporated, if the combined effects of the tax treatment accorded the branch, by the country of incorporation of the controlled foreign corporation and the country of the operation of the branch, is to treat the branch substantially the same as if it were a subsidiary corporation organized in the country in which it carries on its trade or business.²²

To determine whether a branch or similar establishment has substantially the same tax effect as a wholly owned subsidiary of the CFC, the Regulations provide a rate disparity test (RDT). Under the RDT, a branch is treated as a wholly owned subsidiary of a CFC if income allocated to the selling or purchasing branch or remainder is taxed at an effective rate less than 90 percent and at least five percentage points less than the effective rate that would apply to that income if it were subject to tax in the manufacturing country.²³ For example, in Chart 2, the selling branch (Scenario 1) and the selling remainder (Scenario 2) are both taxed at

percent) less than 30 percent.

Where a purchasing or selling branch satisfies the RDT in relation to a manufacturing branch or remainder, the branch is treated as a separate corporation for purposes of testing for FBCSI.²⁴ In the case where the branch is manufacturing, while the remainder does the purchasing/selling, the manufacturing branch is treated as a separate corporation. The purchasing or selling branch or remainder is treated as purchasing or selling *on behalf of* the manufacturing entity (whether a branch treated as a subsidiary or the remainder of the CFC).²⁵ Thus, the branch rule creates a fictional related person.

Multiple Branches

If the taxpayer conducts no activities in the country of incorporation, but has a manufacturing branch and one or more purchasing or sales branches, the RDT is applied by comparing the effective tax rate of each purchasing or sales branch separately to the effective tax rate of the manufacturing branch.²⁶ The income allocated to any purchasing or sales branch that satisfies that RDT is treated as a separate corporation for testing FBCSI.²⁷ This is illustrated in Chart 3. In that case, both the purchasing and selling branches satisfy the RDT. Accordingly, HT is treated as a separate corporation, and LT2 and LT3 are treated as purchasing and selling, respectively, on behalf of HT.²⁸

Inclusion of Amounts in Gross Income of U.S. Shareholders

A branch is treated as a wholly owned subsidiary only for purposes of testing for FBCSI but not for other purposes.²⁹ For example, the earnings and profits limitation under Code Sec. 952(c) is ap-

plied to the CFC inclusive of any branch deficits or positive earnings and profits.³⁰ Furthermore, the CFC has only one set of foreign tax credit pools, inclusive of foreign taxes paid by any branches.³¹ Finally, a transfer made by a branch to the remainder of the CFC is not treated as a dividend to the CFC for purposes of determining foreign personal holding company income under Code Sec. 954(c).³²

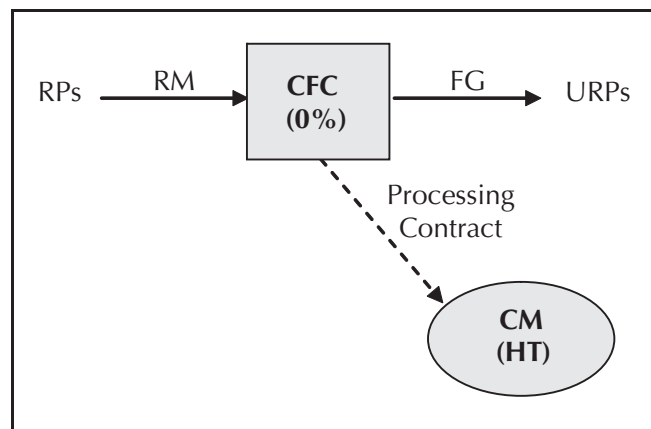
The Contract Manufacturing Issue and Various Authorities Leading up to the Proposed Regulations

In General

The circumstances that gave rise to the contract manufacturing controversy are varied, but one illustration of it is set forth in Chart 4 where the CFC, organized in a low-tax jurisdiction, purchases raw materials from related persons and provides them to an unrelated contract manufacturer, organized in a high-tax jurisdiction. Under a “consignment” arrangement, the CFC owns the raw materials, work-in-process and finished goods and directs the manufacturing process, while the contract manufacturer does all the actual manufacturing.³³ The CFC then sells the finished goods to unrelated persons and earns a profit that is subject to minimal tax in the CFC’s country of incorporation.³⁴

The goal of this planning is to generate profits in the CFC’s country of incorporation with minimal tax while deferring U.S. tax.

Chart 4. Typical Contract Manufacturing



Rev. Rul. 75-7

In Rev. Rul. 75-7,³⁵ the IRS provided its initial guidance on contract manufacturing. In that ruling, a CFC purchased raw materials from related persons and had them manufactured by an unrelated contract manufacturer. The CFC controlled the time and quantity of production and provided quality assurance through its engineers and technicians that would visit the contract manufacturer from time to time. The CFC handled the negotiation and sale of the products, while the contract manufacturer simply manufactured the product and earned a conversion fee.

The IRS ruled that CFC was deemed to be manufacturing for purposes of the manufacturing exception, but that the manufacturing took place through a branch in the contract manufacturer’s country, thereby invoking the branch rule. In the specific facts in Rev. Rul. 75-7, the CFC did not satisfy the RDT,³⁶ and accordingly, the IRS ruled that these facts did not give rise to FBCSI. However, in most cases, the taxpayer would satisfy the RDT and would have FBCSI.

Ashland and Vetco

The IRS’ position in Rev. Rul. 75-7 was litigated in *Ashland Oil Co.*,³⁷ where the taxpayer established a low-taxed CFC that entered into a contract manufacturing agreement with a high-taxed unrelated manufacturer organized in Belgium.³⁸ The IRS argued that the CFC’s relationship with the Belgian manufacturing company constituted a “branch or similar establishment” in Belgium, thereby applying the branch rule. The RDT would have been satisfied given that Belgium had much higher tax rates than Liberia, where the CFC was organized. Consequently, the IRS argued that the CFC derived FBCSI under this arrangement, even though the CFC did not purchase raw materials from or sell finished goods to related persons.³⁹

After an extensive review of the legislative history, the Tax Court held that the CFC did not maintain a branch or similar establishment in Belgium. The taxpayer cited BLACK’S LAW DICTIONARY, which defined a branch as a “division, office or other unit of business located at a different location from the main office or headquarters.”⁴⁰ The Tax Court neither adopted this definition nor set forth its own definition, but stated:

Regardless of the precise ordinary meaning of a “branch,” we are confident that such meaning

does not encompass [the contract manufacturer], an unrelated corporation operating under an arm's length contractual arrangement with [the CFC].⁴¹

The IRS contended that Congress enacted the branch rule to serve as a broad "loophole closing" provision and that any arrangement resulting in a significant tax rate disparity could invoke the branch rule. The Tax Court, after an extensive review of the legislative history, declined to construe the branch rule broadly and concluded that mere tax rate disparities alone could not invoke the branch rule.⁴² The Tax Court also rejected an IRS argument to the effect that the statute granted the IRS such special regulatory authority to determine the existence of a branch or similar establishment.⁴³

The IRS' Revised Position in Rev. Rul. 97-48

In Rev. Rul. 97-48,⁴⁴ the IRS announced that it would follow the *Ashland* and *Vetco* opinions and revoked Rev. Rul. 75-7. However, as part of that revocation, the IRS noted that the activities of the contract manufacturer cannot be attributed to the CFC for purposes of qualifying the CFC for the manufacturing exception.⁴⁵ In doing so, the IRS stated:

The Service has never been of the view that Rev. Rul. 75-7 allows the activities of a contract manufacturer performed outside the controlled foreign corporation's country of incorporation to be attributed to the controlled foreign corporation without treating those activities as performed through a branch or similar establishment of the controlled foreign corporation.⁴⁶

The Proposed Contract Manufacturing Regulations

General Background

The IRS has come to believe that the FBCSI regulations need to be modernized due to "business considerations in the global marketplace" and the fact that "cross-border manufacturing networks are created primarily to leverage expertise and cost efficiencies."⁴⁷ Consequently, the IRS drafted the Proposed Regulations to permit deferral under contract manufacturing arrangements where the CFC is performing activities meaningful to the manufacturing process through its own employees.

The Rejection of the "Its" Defense

Some taxpayers have been taking the view that the statute itself implicitly permits contract manufacturing arrangements, as FBCSI can only arise for income derived in connection with the purchase of personal property from a related person and "its" sale to any person.⁴⁸ Some taxpayers take comfort in Reg. §1.954-3(a)(4)(i) because it states that "[a] foreign corporation will be considered ... to have manufactured, produced, or constructed personal property which it sells if the property is *in effect not the property which it purchased.*" (Emphasis supplied.) Thus, as long as the property changes form, it has been manufactured, and it does not matter who did the work to convert the property.⁴⁹

The Treasury and the IRS disagreed with the "its" defense in the Preamble to the Proposed Regulations, stating:

The plain language of the regulation, as well as the examples, clarify that in order to satisfy [the physical manufacturing tests], the relevant manufacturing activities must be performed by the CFC itself.⁵⁰

The Proposed Regulations would clarify this point:

Personal property sold by a controlled foreign corporation will be considered to be the same property that was purchased by the controlled foreign corporation regardless of whether the personal property is sold in the same form in which it was purchased, in a different form than the form in which it was purchased, or as a component part of a manufactured product.⁵¹

The commentators generally support the IRS and Treasury's decision to eliminate the "its" argument by regulation.⁵²

The Substantial Contribution Test

Basic Framework

Under the Proposed Regulations, a CFC will be considered to be manufacturing if it makes a "substantial contribution" to the manufacturing process.⁵³ This "substantial contribution" test adds to the physical manufacturing tests (e.g., substantial transformation and component assembly) and is only applied if these tests are not satisfied.⁵⁴ The substantial contribution test considers only the activities of the CFC's own

employees and weighs them under the facts and circumstances. These activities may include:

- oversight and direction (including management of risk of loss) over the manufacturing process;
- manufacturing activities that are considered in the physical manufacturing tests but that are insufficient to satisfy those tests;
- control over raw materials, work-in-process and finished goods;
- management of manufacturing profits;
- material selection;
- vendor selection;
- control over logistics;
- quality control; and
- direction of the development, protection and use of trade secrets, technology, product design and other intellectual property used in manufacturing.

The Proposed Regulations contain a number of examples illustrating the substantial contribution test. For example, having the right to exercise direction and control over the manufacturing process without actually utilizing employees to do so is insufficient to satisfy the test.⁵⁵ However, a CFC that actually performs product design and quality control and oversees and directs the activities of the contract manufacturer satisfies the substantial contribution test.⁵⁶ It does not matter whether the contract manufacturer uses its own employees or those of someone else as long as *someone* performs enough manufacturing activities to satisfy the physical manufacturing test.⁵⁷ Arrangements whereby a domestic parent or other related persons do the bulk of the “substantial contribution” activities while the CFC is relegated to a passive role will not pass muster.⁵⁸

Comments and Issues with Substantial Contribution

Several commentators have weighed in favorably on the substantial contribution test, considering it a helpful liberalization of the IRS and the Treasury positions.⁵⁹ While, the NYSBA Report agrees with the overall approach of the substantial contribution, it sought detailed clarification of each of the nine factors comprising substantial contribution.⁶⁰ Both the NYSBA and the AICPA question what it means to have control over raw materials, work-in-process and finished goods.⁶¹ The AICPA Report seeks clarification that buy-sell contract manufacturing arrangements can satisfy the substantial contribution test.⁶² Commentators also seek to clarify whether the management of manufacturing profits factor relates

to the treasury function (e.g., financing operations, cash pooling arrangements, etc.) or to risks associated with the use of raw materials (including undertaking hedge contracts, raw material costs, energy, etc.).⁶³ The commentators also queried whether one or more factors could be treated as “superfactors”⁶⁴ in a particular industry or whether the oversight and direction factor could be treated as “first among equals.”⁶⁵ Also, commentators were split on whether formulary safe harbors should be used to determine substantial contribution.⁶⁶

The author prefers to leave the nine factors of substantial contribution in their current form or with modest changes as providing detailed clarification may do more harm than good. These factors will apply very differently in the various industries, e.g., pharmaceuticals, electronics, etc., and the IRS should take sufficient time to evaluate industry needs and provide additional guidance through revenue rulings and other pronouncements. Nevertheless, the IRS and the Treasury should consider whether vendor selection should be given less weight, given that it is closely linked with the purchasing function, i.e., a “bad” act when separated from manufacturing. It would also be desirable for the IRS to establish an advanced ruling procedure similar to those available for APAs, with a separate office trained in these regulations.⁶⁷

Use of Employees

The IRS requested comments whether it should permit a CFC to satisfy the substantial contribution test with employees of another person but controlled by employees of the CFC.⁶⁸ The commentators generally recommend that employees should include individuals who are seconded or leased to the CFC as long as the CFC exercises the same level of control and supervision as it would over permanent employees⁶⁹ but should exclude independent contractors or employees of affiliates.⁷⁰

Potential Anti-Abuse Rule

The IRS also requested comments on whether it would be appropriate to add an anti-abuse rule to compare the relative contribution of the CFC to that of one or more related U.S. persons.⁷¹ The inherent problem with an anti-abuse rule that weighs unfavorably the contribution of U.S. related persons is that it provides an incentive to move jobs offshore. In enacting Subpart F, the question posed by the Senate Finance Committee is whether the selling corporation

added “appreciable value” to the product.⁷² Consequently, a cost-based anti-abuse rule could be crafted to take into account only the costs incurred by the CFC as compared to the costs of the contract manufacturer (exclusive of raw material costs).⁷³ This type of test would measure whether the CFC adds value in relation to what the contract manufacturer is doing.

Use of More Than One Manufacturing Branch

Different Products

The Proposed Regulations introduce new rules where there is more than one manufacturing branch used to manufacture either the same product or different products. Where separate branches manufacture different products, those branches are tested separately under the RDT, treating each branch as if it were the only branch and treating manufacturing branches that manufacture other products as separate corporations.⁷⁴ This rule can be illustrated with the example in Chart 5, taken from the Proposed Regulations.⁷⁵ In that example, CFC, subject to an effective rate of 10 percent, manufactures product A through Branch A, which is taxed at an effective rate of 20 percent. At the same time, CFC manufactures a different product (product B) through Branch B at an effective tax rate of 12 percent. Branch A satisfies the RDT (10 percent versus 20 percent) and accordingly, is treated as a separate corporation, giving rise to FBCSI.⁷⁶ On the other hand, Branch B is taxed at an effective rate of 12 percent, which does not satisfy the RDT.⁷⁷ Consequently, Branch B is not treated as a separate corporation and does not give rise to FBCSI. The fact that CFC satisfies the manufacturing exemp-

tion for product B is irrelevant in testing product A for FBCSI.

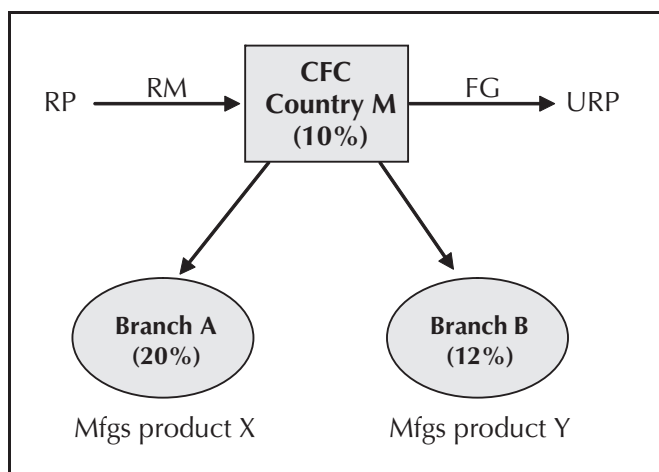
The Same Product

Overall Framework. The Proposed Regulations provide more complicated rules where more than one branch is used to manufacture the same product.⁷⁸ To step back, the overall goal of these Regulations is to detect inappropriate deferral by comparing the tax rate in the selling or purchasing jurisdiction to the tax rate in the manufacturing jurisdiction. However, this task is not easy where the CFC performs either physical manufacturing or substantial contribution (or a combination of both) in several different jurisdictions. Consequently, the Proposed Regulations craft a series of rules and presumptions to determine a single physical manufacturing or substantial contribution jurisdiction and to apply the RDT between the selling or purchasing jurisdiction and that jurisdiction. The analysis begins with physical manufacturing. If the CFC does not perform physical manufacturing, or if the physical manufacturing activities are excluded under the RDT, *i.e.*, the manufacturing branch or remainder is treated as a separate corporation, then the CFC and its branches are tested for substantial contribution. If there is substantial contribution, the Proposed Regulations narrow it down to one jurisdiction, excluding the activities of branches that satisfy the RDT. Once a single physical manufacturing or substantial contribution jurisdiction is identified, the RDT is applied between the selling or purchasing jurisdiction and that jurisdiction.

Mechanics for Determining Location of Manufacturing. With the above in mind, if one branch or the remainder of a CFC performs physical manufacturing either under the substantial transformation or component assembly tests, then that branch or remainder is treated as the location of manufacturing for purposes of the RDT even if other branches conduct activities that might constitute substantial contribution.⁷⁹ If more than one branch perform physical manufacturing with respect to a product, then the location of manufacturing is presumed to take place in the jurisdiction that imposes the lowest effective rate of tax assuming that all of the income of the CFC were to be taxed there (“lowest rate default”).⁸⁰

If a branch performs physical manufacturing and is treated as a separate corporation under the RDT, then the remainder and any other branches

Chart 5. More Than One Manufacturing



are presumed not to meet the substantial contribution test.⁸¹ This presumption can be rebutted by demonstrating to the satisfaction of the IRS that the substantial contribution test is satisfied.⁸² This presumption was added to the Proposed Regulations as a backstop to taxpayer attempts to obfuscate the division of manufacturing labor and income between the CFC and its branches.⁸³ If the CFC does provide substantial contribution, the CFC can avoid the presumption by incorporating the branch that performs the traditional manufacturing.⁸⁴

If none of the branches or the remainder of the CFC perform physical manufacturing, or if one or more physical manufacturing branches are treated as a separate corporation under the RDT, but the CFC as a whole satisfies the substantial contribution test, then the RDT is applied to the branch or remainder that makes the predominant contribution.⁸⁵ The predominant contribution is made by the branch or remainder that provides “a significantly greater contribution” to manufacturing than any other branch or remainder of the CFC.⁸⁶ If no branch or remainder makes a predominant contribution, then it is presumed that the branch or remainder of the CFC that has the highest effective tax rate on income allocated to that branch or remainder is where the manufacturing takes place for purposes of applying the RDT (“highest rate default”).⁸⁷

The location of any activity with respect to manufacturing is deemed to occur where there are actual employees performing that activity.⁸⁸ For example, the location of activities involving tangible property is not determined based upon where that intangible property is assigned or legally protected but where employees of the CFC develop, protect or direct the use of that property.⁸⁹

Multiple Branch Examples. These rules can be illustrated using the examples contained in the Proposed Regulations. In Chart 6, CFC in Country M has Branch A that performs design work, Branch B which provides quality control and oversight work and Branch C which performs physical manufacturing⁹⁰ (see Chart 6). CFC purchases raw

materials from related persons and sells the finished product to unrelated persons. CFC manages the raw materials, work-in-process, finished goods and the risk of loss and handles logistics.

In this example, the RDT is first applied to Branch C because it performs physical manufacturing. If Branch C were not treated as a separate corporation under the RDT, then its activities would be attributed to the remainder of the CFC (where the selling takes place) and the CFC would be entitled to the manufacturing exception, *i.e.*, the analysis would stop there. However, in this case, the RDT is satisfied (10 percent is less than 90 percent and five percentage points less than 20 percent). Consequently, Branch C is treated as a separate corporation and CFC must look to the substantial contribution test for relief. However, because CFC has a physical manufacturing branch treated as a separate corporation, it is presumed not to meet the substantial contribution test.⁹¹ To determine whether CFC can rebut that presumption, we look to the activities of CFC in Country M (purchasing, management of raw materials, works-in-process, finished goods, risk of loss and logistics). The design work of Branch A and the quality control and oversight work of Branch B can only be counted if they are not treated as separate corporations under the RDT. (The example does not provide sufficient information to make this determination.)

Example 2 is the same except that Branch A does physical manufacturing and is taxed at 12 percent.⁹² Because more than one branch performs physical manufacturing, under the lowest rate default, Branch A is deemed to be the manufacturer. Because Branch A does not satisfy the RDT (10 percent versus 12 per-

Chart 6. Reg. Example 1

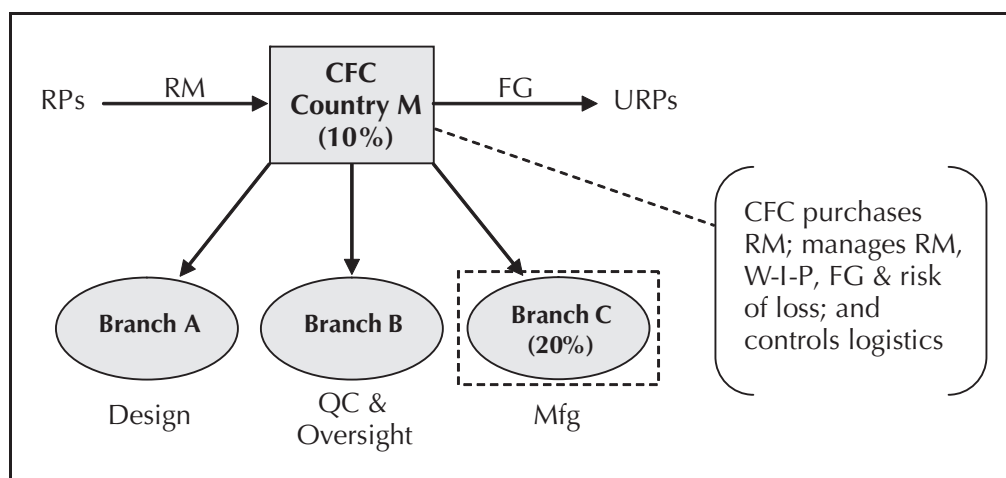
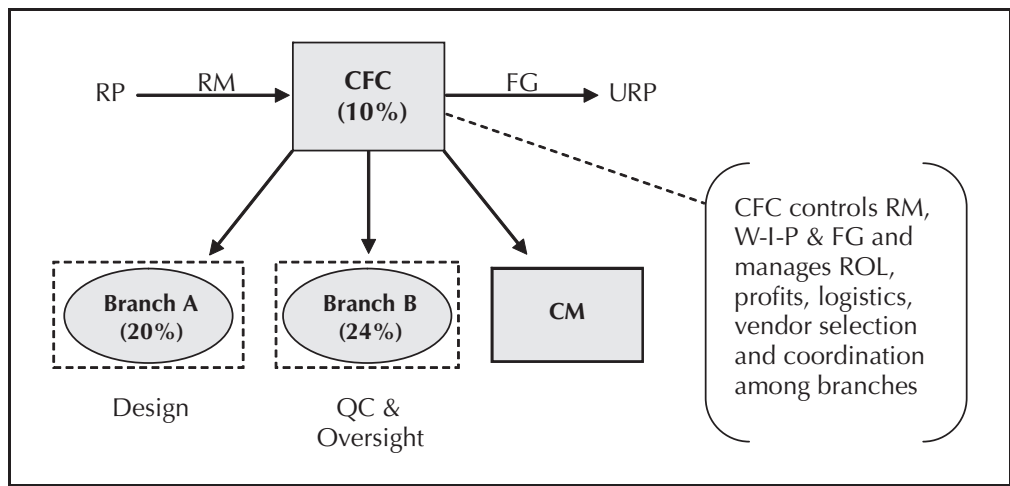


Chart 7. Example 4



rials, works-in-process and finished goods and manages outside vendor, logistics and the risk of loss. CFC uses CM, an unrelated contract manufacturer, to manufacture the product.

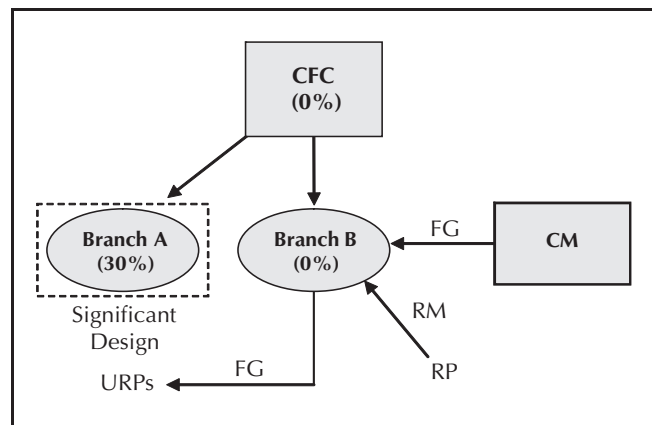
The example states as a fact that neither Branch A nor Branch B provides a predominant contribution. Consequently, the highest rate default applies and Branch A is deemed to be the manu-

facturer. Because Branch B is the selling jurisdiction, its tax rate (zero percent) is compared to that of Branch A (30 percent), and accordingly, the RDT is satisfied. Thus, Branch A is treated as a separate corporation. Unless Branch B can independently satisfy the substantial contribution test, Branch A would be treated as a separate corporation and Branch B would be treated as selling on behalf of Branch A, giving rise to FBCSI.

cent), it is not treated as a separate corporation, and CFC is entitled to the manufacturing exception.⁹³
 Example 4 (Chart 7) of the Proposed Regulations provides a good illustration of how the highest rate default works. In that example, CFC purchases raw materials from related persons and has them manufactured by an unrelated contract manufacturer. Branch A provides design, while Branch B provides quality control and oversight. CFC controls raw materials, work-in-process and finished goods, manages the risk of loss and manufacturing profits and handles logistics, vendor selection and coordination among branches. Overall, CFC, together with Branches A and B, satisfies the substantial contribution test, but none of them individually makes a predominant contribution. Consequently, the manufacturer is deemed to be Branch B because it has the highest effective tax rate (24 percent).⁹⁴ Because Branch B is the manufacturer and the remainder of CFC sells the product, the remainder must make a substantial contribution in order to avoid FBCSI. CFC could have counted the activities of Branch A, except that Branch A is treated as a separate corporation under the RDT (20 percent versus 10 percent). Consequently, CFC must attempt to satisfy the substantial contribution test by its own activities.⁹⁵

This example also provides guidance on what constitutes predominant contribution as neither design, quality control and control over the use of intellectual property on one hand nor the control of purchasing and raw materials, work-in-process and finished goods and management of vendors, logistics and risk of loss on the other hand, constituted predominant contribution. The Example implied that some design work may be weighted more heavily as Branch A performed "significant time and resources to design a sophisticated product"

Chart 8



Example 5 (Chart 8) is a good illustration of how the RDT is to be applied to the selling jurisdiction when it is different than the home jurisdiction of CFC.⁹⁶ In that example, CFC has no employees and does nothing consequential. Branch A, taxed at 30 percent, provides design and quality control and directs the use of IP. Branch B is taxed at zero percent and purchases raw materials, controls raw mate-

through a “large number of employees working at a state of the art facility.”

Example 6 is the same as Example 5, except that the tax rates are swapped—Branch A is taxed at zero percent while Branch B is taxed at 30 percent. Because Branch B is the manufacturing jurisdiction under the highest rate presumption and is also the selling jurisdiction, there cannot be FBCSI. (Branch B cannot be treated as a separate corporation from itself.)

Comments on the Multiple Branch Rule. Commentators felt that the RDT should be performed with respect to a weighted average of effective tax rates rather than using the highest rate default for substantial contribution.⁹⁷ The NYSBA suggested that the weighted average approach should also apply to physical manufacturing.⁹⁸ The commentators also believe that the presumption of “no substantial contribution” where a CFC does physical manufacturing is unnecessary and too harsh. The substantial contribution test requires (even under the best of circumstances) a number of factual determinations under fluid circumstances. The taxpayer will need to keep books and records to clearly indicate who is doing what and where. These determinations are going to be difficult for both tax advisors and the government alike, and the fact that a CFC manufactures through a branch does not materially add obfuscation. Accordingly, the author agrees that presumption is unnecessary.

Definition of a Branch. The Proposed Regulations are silent as to the definition of a “branch.” The *Ashland* case did not offer a definition and rejected the notion that the Treasury and the IRS had special authority to define a branch under Code Sec. 954(d)(2).⁹⁹ There are several definitions available elsewhere in the Code. For example, Code Sec. 367 Regulations define a “foreign branch” as an “integral business operation carried on by a U.S. person outside the United States,” determined under the facts and circumstances.¹⁰⁰

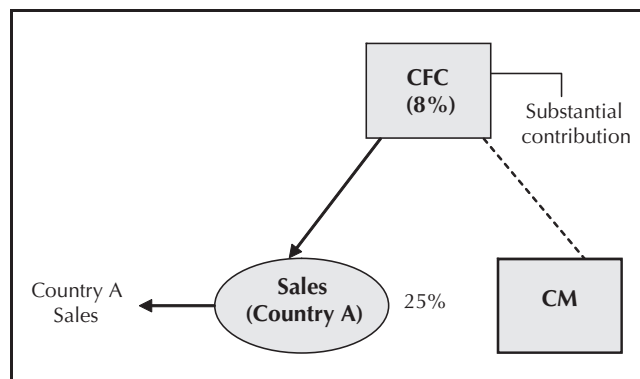
The examples in the Proposed Regulations evidence the IRS’ view that an office consisting of employees providing merely oversight and direction is a “branch” even though that branch may not charge CFC for its services. This view is problematic for most taxpayers because the oversight is often provided in a high-tax jurisdiction where the contract manufacturer is located, with the likely result that the oversight and direction activities are excluded from the substantial contribution test under the RDT.¹⁰¹

Commentators have suggested that the Final Regulations allow the taxpayer to take into account favorable rulings, tax holidays and special incentives.¹⁰² However, even if this suggestion were to be adopted, it would not help the oversight problem because the sales income in all likelihood would not qualify for reduced rates that an oversight office typically would enjoy. Consequently, unless the contract manufacturer is located in a low-tax jurisdiction, treating an oversight presence as a branch is likely to result in those activities being excluded in testing for substantial contribution.¹⁰³

There is likewise scant guidance on when a sales presence constitutes a branch. Consider the scenario in Chart 9 where CFC provides substantial contribution in its country of incorporation, which has an effective tax rate of eight percent. CFC has a sales presence in Country A, where the tax rate is 25 percent, but CFC’s presence is insufficient to give rise to a permanent establishment there.¹⁰⁴

The IRS should consider defining sales presence as a branch under principles similar to determining whether foreign source sales is effectively connected with a U.S. trade or business under Code Sec. 865(c)(4). Under that regime, the sales through an office or fixed place of business¹⁰⁵ is taken into account if the office is actively participating in negotiations or held out to customers as accepting orders.¹⁰⁶ A sales presence in a country would also not be a branch if the sales presence sells for eventual use outside that country if another office actively negotiated the orders or is held out as accepting orders.¹⁰⁷ The activities of dependent agents should be excluded whether they have the authority to conclude contracts.¹⁰⁸ The CFC should be entitled to a “trump card” in that if a sales presence is ac-

Chart 9. Sales Presence



tually subject to tax in the jurisdiction where it is located, the taxpayer can elect to treat it as a branch with respect to the sales actually taxed there.¹⁰⁹

The Use of Partnerships. The Proposed Regulations retain the rule under the current Regulations that in determining a CFC’s distributive share of partnership income, the manufacturing exception applies to the partnership’s income by taking into account only the activities, employees and property of the partnership itself.¹¹⁰ Strictly speaking, this “ring fencing” of the partnership only applies in determining whether the income produced by the partnership is FBCSI and does not apply to cases where one or more of the substantial contribution factors occur through a partnership. For example, it would be unfair to exclude the contribution of a partnership that is 100 percent owned by affiliated CFCs. The IRS should consider allowing a CFC to include the activities of partnerships where the CFC directly or indirectly¹¹¹ controls the partnership (*i.e.*, more than 50 percent of voting power). Thus, a CFC would include the activities of a partnership only where it has a direct influence over what the partnership does.¹¹²

The Proposed Regulations and Base Erosion Planning. The Final Regulations should respect taxpayer strategies to reduce tax in the manufacturing jurisdiction. For example, in Chart 10, CFC owns a disregarded manufacturing subsidiary to which it loans money and licenses intellectual property. The

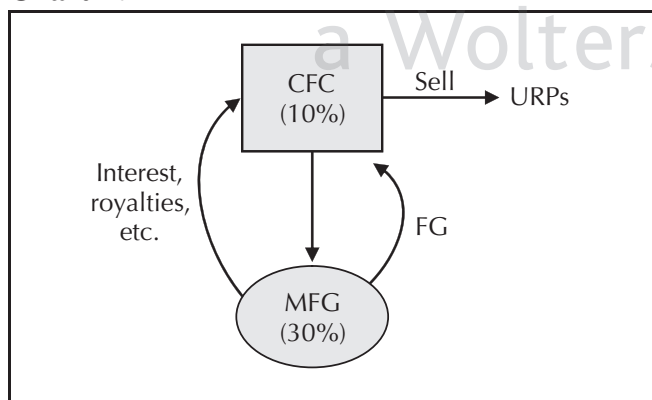
manufacturing branch pays interest and royalties to the remainder of CFC in order to reduce the tax burden in the manufacturing jurisdiction and pays little or no tax in the jurisdiction where CFC is organized. Assume that the remainder of CFC does not satisfy the substantial contribution test and that the RDT is satisfied. Consequently, the branch is treated as a separate corporation and CFC remainder is treated as selling on behalf of that corporation, giving rise to FBCSI.

The interest and royalties should not be attributable to the selling function and accordingly, should not be included in FBCSI. This approach goes to the core of the policy behind the branch rule, which is to disallow deferral where selling or purchasing income is separated from manufacturing income. But, that policy should be construed in light of *Ashland* and *Vetco*, which held that the branch rule is not a broad loop-hole closing provision¹¹³ and in light of more recent efforts by Congress to permit foreign base erosion.¹¹⁴

Conclusion

The IRS and the Treasury have made a very admirable attempt to craft regulations that are helpful to U.S. multinationals doing business in a more complicated international environment, while at the same time giving appropriate deference to the original intent of Subpart F, which was to disallow deferral where the selling or purchasing function was artificially separated from the manufacturing functions without adding “appreciable value.” While improvements can be made, if these Regulations are finalized roughly as proposed, it would put a great deal of pressure on the government and tax advisors alike to administer and enforce these Regulations properly in an area that is fraught with factual fluidity. As indicated, a streamlined pre-filing procedure would require focus on the factual and legal issues early to arrive at fair results, avoiding what would otherwise give rise to endless disputes and litigation. Nevertheless, the Treasury and the IRS are to be commended for their thoughtfulness in drafting these Regulations.

Chart 10



ENDNOTES

¹ See Proposed Reg. §1.954-3 and the Preamble thereto, 73 FR 40, 10716 (referred to herein as the “Proposed Regulations” and the “Preamble”).

² A controlled foreign corporation (CFC) is a

foreign corporation in which “U.S. shareholders” own more than 50 percent of the voting power or value. Code Sec. 957(a). A “U.S. shareholder” is a U.S. person who owns 10 percent or more of the voting

power of the foreign corporation. Code Sec. 951(b). Certain attribution rules apply for determining direct, indirect and constructive ownership. Code Sec. 958(a) and (b).

³ Code Sec. 954(c).

- ⁴ Code Sec. 952(a); Code Sec. 954(a). There are various special rules affecting Subpart F income, including a *de minimis* rule for foreign base company income that is the lesser of five percent of gross income or \$1 million, and a “high tax exception” for income that is taxed at 90 percent of the maximum U.S. tax rate. Code Sec. 954(b)(3)(A). Code Sec. 954(b)(4).
- ⁵ Foreign base company sales income is referred to herein as “FBCSI.”
- ⁶ Code Sec. 954 (d)(1). Generally, personal property is presumed to be sold for use, consumption or disposition in the country of the destination of that property. Reg. §1.954-3(a)(3)(ii). However, if the CFC sells property to an unrelated person under circumstances whereby the CFC knew or should have known that the property would be used, consumed or disposed of elsewhere, the CFC must determine the country of ultimate use, consumption or disposition. *Id.*
- ⁷ The same results would arise if LT did not take title to the finished goods but received a sales commission for selling on behalf of HT. Additionally, similar results (*i.e.*, FBCSI) would arise if LT were purchasing raw materials and selling them to HT. In that case, the profits earned by LT would be FBCSI because (1) LT is purchasing personal property and selling it to a related person; (2) the personal property comes from outside of LT’s company of incorporation; and (3) the personal property is being sold for use, consumption, or disposition outside of LT’s country of incorporation.
- ⁸ President Kennedy had recommended the elimination of deferral in all forms (including trading, licensing, insurance and others) except for operations in less developed countries. Congress retained deferral of operations located in economically developed countries because investments in these countries is an important factor in stimulating American exports to the same areas. Moreover, American-owned businesses operating abroad would place such firms at a disadvantage with other firms located in the same areas not subject to U.S. tax. H.R. REP. NO. 1447, 87th Cong., 2d Sess., 1962-3 CB 405, 461. See *Message to Congress*, Apr. 20, 1961, H.R. Doc. No. 140, 87th Cong., 1st Sess., 107 Cong. Rec. 6377 (1961).
- ⁹ Code Sec. 954(d)(1)(A).
- ¹⁰ Reg. §1.954-3(a)(2). This is sometimes referred to as the “same-country manufacturing exception.”
- ¹¹ Reg. §1.954-3(a)(4).
- ¹² Referred to herein as the “manufacturing exception” as distinct from the “same-country manufacturing exception.”
- ¹³ Reg. §1.954-3(a)(4)(i).
- ¹⁴ Reg. §1.954-3(a)(4)(ii).
- ¹⁵ Reg. §1.954-3(a)(4)(ii), Examples 1, 2 and 3.
- ¹⁶ Reg. §1.954-3(a)(4)(iii). *Dave Fischbein Manufacturing Co.*, 59 TC 338, Dec. 31, 615 (1972) (although the assembly operation of a CFC did not meet the 20-percent cost safe harbor, the Tax Court found that the assembly operations were substantial in nature.) See *Action on Decision* 1973 WL 34669 (IRS acquiescence); *Webb Export Corp.*, 91 TC 131, Dec. 44,914 (1988) (Tax Court relied on *Dave Fischbein* to hold that cutting trees into veneer logs was an operation that was “substantial in nature” and constituted “production” for purposes of Code Sec. 993(c)(1)); *Bausch & Lomb Inc.*, 71 TCM 2031, Dec. 51,160(M), TC Memo. 1996-57 (thorough analysis of when assembly operations are substantial in nature and generally considered to be manufacturing. See also *Dolph Spalding*, 66 TC 1017, Dec. 34,015 (1976) (noting how the assembly test under Reg. §1.954-3(a)(4)(iii) differs from other definitions of “manufacturing” contained in the Code, such as that contained in Code Sec. 48 for determining the investment tax credit).
- ¹⁷ *Id.*
- ¹⁸ *Id.*
- ¹⁹ S. REP. NO. 1881, 87th Cong., 2d Sess., 1962-3 CB 703, 790.
- ²⁰ Code Sec. 954(d)(2). Treasury Secretary Douglas Dillon had submitted a draft of the Subpart F statute that included a provision similar to the branch rule ultimately passed by Congress. Secretary Dillon described the controlled foreign corporation portion of the draft as consistent with the “more limited tax-haven approach” of the House bill. See Hearings on H.R. 10650 Before the S. Comm. on Finance, 87th Cong. (1962). The House bill did not contain a branch rule, but the Senate Finance Committee included the branch rule in its bill in the form later enacted as Code Sec. 954(d)(2). The Conference Committee Report discussed the branch rule without elaboration. H.R. REP. NO. 2508 (Conf. Rep.), 87th Cong., 2d Sess., 1962-3 CB 1129, 1159. See also Staff of H. Comm. on Ways & Means, 87th Cong., *Comparative Analysis of Differences in House and Senate Versions of H.R. 10650* (1962) (describing FBCSI provisions as generally the same, except that the Senate version would apply to branches).
- ²¹ *I.e.*, the remainder of the CFC, as distinct from one or more branches.
- ²² S. REP. NO. 1881, 87th Cong., 2d Sess., 1962-3 CB 703, 790.
- ²³ The effective tax rate is determined by calculating a hypothetical tax on the sales or purchasing income under the assumption that such income were taxed in the manufacturing jurisdiction through a permanent establishment there, and the corporation were organized under the laws of that jurisdiction and managed and controlled there. Thus, the Regulations require the CFC to construct a hypothetical tax on the sales or purchasing income in the manufacturing jurisdiction. The actual tax rate of the sales or purchasing branch or remainder is then compared to the hypothetical tax rate under the RDT. These rules are contained in Reg. §1.954-3(b)(1)(i)(b) for sales branches and in Reg. §1.954-3(b)(1)(ii)(b) for manufacturing branches. Note that if for some reason the effective tax rate of the sales jurisdiction is *higher* than that of the manufacturing jurisdiction, the RDT cannot be satisfied.
- ²⁴ Reg. §1.954-3(b)(2)(ii)(a).
- ²⁵ Reg. §1.954-3(b)(2)(ii)(b) and (c).
- ²⁶ Reg. §1.954-3(b)(1)(ii)(c); Reg. §1.954-3(b)(1)(i)(c).
- ²⁷ *Id.*
- ²⁸ The dotted box depicts the fact that HT is treated as a corporation under the branch rule.
- ²⁹ Reg. §1.954-3(b)(3).
- ³⁰ *Id.*
- ³¹ *Id.*
- ³² *Id.*
- ³³ Contract manufacturing generally takes place in one of two ways. In a “consignment” or “tolling” arrangement, the principal purchases raw materials and components and consigns them to the contract manufacturer who converts them into a finished product. In that arrangement, the principal retains title to raw materials, work-in-process and finished goods. In “buy-sell” arrangements, the contract manufacturer acquires the raw materials and may retain title to raw materials, work-in-process and finished goods until the finished goods are transferred to the principal. Generally, under both arrangements, the principal has the risk of selling the finished goods and the contract manufacturer are paid on a cost-plus basis. Whether the principal enters into a consignment or buy/sell arrangement often depends on local VAT and customs duty considerations.
- ³⁴ The CFC would also endeavor to avoid having a permanent establishment in CM’s country of incorporation.
- ³⁵ Rev. Rul. 75-7, 1975-1 CB 244. See GCM 35961 (1974) (discussing earlier drafts of Rev. Rul. 75-7, which attributed the manufacturing activities of the contract manufacturer to the CFC, but did not invoke the branch rule).
- ³⁶ The effective tax rate in CFC’s country exceeded that in CM’s country of incorporation.
- ³⁷ *Ashland Oil Co.*, 95 TC 348, Dec. 46,899 (1990).
- ³⁸ This was a buy/sell arrangement, as the Belgium company purchased raw materials from vendors unrelated to either party and processed them on a cost-plus basis, guaranteeing the Belgian manufacturer a

profit. The CFC sold the products to unrelated customers. The CFC did not maintain an office in Belgium, but periodically sent employees there to visit the manufacturing facilities.

³⁹ The branch rule would have created a fictional related person, and the CFC is considered to sell on behalf of that related manufacturer.

⁴⁰ *Ashland*, *supra* note 37, 95 TC at 357.

⁴¹ *Id.*

⁴² *Id.*, at 360; *see also Vetco, Inc.*, 95 TC 579, Dec. 47,001 (1990), issued a few months after *Ashland*. In that case, the CFC entered into a contract manufacturing arrangement with a wholly owned subsidiary. In *Vetco*, the parties made more or less the same arguments as in *Ashland*. The Tax Court likewise held in favor of the taxpayer and stated, "Moreover, respondent's argument ignores the legislative history of Subpart F and the branch rule, which would suggest a narrower view. ... Thus, although Congress was concerned with tax savings, the resulting legislation did not contain the broad language necessary to support respondent's position." *Id.*, at 593.

⁴³ *Id.*, at 357. In FSA 1102 (Jan. 25, 1993), the IRS indicated that it would continue to follow its position stated in Rev. Rul. 75-7 and set forth a test for when a contract manufacturing operation would be treated as a branch or similar establishment of the CFC. Under that test, the CFC would be considered to have a branch or similar establishment if it bears the economic risk of loss with respect to the manufacturing operations. Factors to consider would include whether the contract manufacturer receives only a conversion fee for raw materials that it purchased rather than sharing in profits; whether the CFC negotiates the sales to third parties without participation of the contract manufacturer; whether the contract manufacturer owns the raw materials used to make the finished product; whether the CFC retains control over the quality and quantity of production; whether the CFC retains control over the manufacturing processes performed by the contract manufacturer by sending its personnel to supervise, inspect or advise; and whether the CFC developed the processes used in the manufacturing. If it is determined under these tests that the CFC bears the economic risk of loss with respect to manufacturing operations, then the CFC will be considered to be the manufacturer for purposes of the manufacturing exception. However, the FSA notes that the manufacturing exception would only apply to the deemed branch and that the RDT must be applied between that branch and the remainder of the CFC that performs the sales function and/or other sales branches of the CFC. The FSA noted

that the IRS was considering whether to issue a nonacquiescence in the *Ashland* case, but that under the facts of *Ashland*, the CFC would probably not contain a sufficient number of the factors for the contract manufacturing arrangement to be treated as a branch. (In *Ashland*, the contract manufacturer, rather than the CFC, purchased the raw materials.)

⁴⁴ Rev. Rul. 97-48, 1997-2 CB 89.

⁴⁵ The IRS further held that any taxpayer relying on Rev. Rul. 75-7 (through the date of its revocation) may attribute the activities of the contract manufacturer to the CFC for purposes of the manufacturing exception but must also treat those activities as a branch or similar establishment of the CFC in the country where the manufacturing takes place.

⁴⁶ Rev. Rul. 97-48 further noted that this position is harmonized with its treatment of contract manufacturing for purposes of Code Sec. 863(b) (involving the 50/50 source rule for manufacturing). *See* Reg. §1.863-3(c)(1)(i)(B) (production assets include "only tangible and intangible assets owned by the taxpayer that are directly used by the taxpayer to produce inventory"). *See also* FSA 200141010 (May 4, 2001) (the activities of two Mexican *maquiladoras* could not be attributed to the U.S. principal under a contract manufacturing arrangement for purposes of Code Sec. 863(b)). This FSA related to tax years prior to the adoption of Reg. §1.863-3(c)(1)(i)(B).

⁴⁷ Preamble.

⁴⁸ Code Sec. 954(d)(1). Alternatively, FBCSI arises in connection with the purchase of personal property from any person and "its" sale to a related person.

⁴⁹ The IRS may argue that this language is taken out of context, as the preceding sentence notes the applicability of the manufacturing exception for property manufactured "by such corporation" (*i.e.*, the CFC).

⁵⁰ Preamble.

⁵¹ Proposed Reg. §1.954-3(a)(1)(i). *See also* Proposed Reg. §1.954-3(a)(4)(i), (ii) and (iii) providing similar language.

⁵² New York State Bar Association, *Report on the Proposed "Contract Manufacturing Regulations" Issued Under Section 954(d)*. ("NYSBA Report").

⁵³ Proposed Reg. §1.954-3(a)(iv)(a).

⁵⁴ *Id.*

⁵⁵ Proposed Reg. §1.954-3(a)(4)(iv)(c), Example 1.

⁵⁶ *Id.*, Example 2. Consistent with the Tax Court's holding in *Vetco*, Example 2 notes that the result would be the same even if the contract manufacturer is related to the CFC.

⁵⁷ *Id.*, Example 3.

⁵⁸ *Id.*, Example 4. There, the domestic parent provided computer software to the CFC through a cost-sharing arrangement and

controlled various aspects of the manufacturing such as product design, vendor and material selection and management of profits. The CFC merely provided a few computer technicians to manage automated software that handle orders, the purchase of raw materials and quality control, which activities were insufficient to constitute substantial contribution.

⁵⁹ NYSBA Report, Part IV; *American Institute of Certified Public Accountants Comments on Proposed Foreign Base Company Sales Income regulations Regarding Contract Manufacturing Arrangements* ("AICPA Report") dated July 23, 2008.

⁶⁰ NYSBA Report, Part IV.

⁶¹ AICPA Report, Part I(A); NYSBA Report, Part IV. The NYSBA questions whether this factor includes quality control over raw materials or whether that is covered separately under the quality control factor and whether this category includes the capacity management and production scheduling.

⁶² AICPA Report, Part I(A). While the examples included in the Proposed Regulations all involve consignment arrangements, this clarification, while helpful, may not be necessary in light of the overwhelming body of law that ownership of bare legal title is irrelevant where another party has the benefits and burdens of ownership. *Ashland* and *Vetco* bear this out as *Ashland* involved a buy-sell arrangement and *Vetco* involved a consignment arrangement, and neither court placed any weight on that distinction.

⁶³ *See* NYSBA Report Part IV and AICPA Report Part I(A).

⁶⁴ *See* NYSBA Report, Part IV.

⁶⁵ AICPA Report, Part I(A). This approach was suggested by the comments of an IRS official on April 22, 2008 (*TNT.doc* 2008-8952).

⁶⁶ The AICPA opposes a formulary safe harbor with respect to substantial contribution at least until there is sufficient input from manufacturers and industry groups outside the regulation project. However, the NYSBA favored one. NYSBA Report, Part IV(4); AICPA Report, Part I(C).

⁶⁷ The pre-filing agreement procedure currently available is not likely to be feasible.

⁶⁸ Preamble.

⁶⁹ NYSBA Report, Part IV. The IRS could adopt rules similar to those that define a "substantial presence" under Code Sec. 7874. *See* Reg. §1.7874-2T(d)(3)(i) ("employees" includes common law employees working 35 hours per week). The NYSBA Report would not include the 35-hour requirement imposed in that Section. NYSBA Report, Part IV(3).

⁷⁰ The AICPA Report generally took the same view as the NYSBA, allowing the use of non-employees through "controlled labor." AICPA Report, Part I(D). The AICPA also suggests that the IRS make allowance (through

public and private rulings) for the utilization of independent contractors in certain industries where it is customary to do so.

⁷¹ Preamble. See Notice 2007-13, IRB 2007-5, 410, which prohibits U.S. related persons from providing services comprising 80 percent or more of the cost of services provided by a CFC under a new “substantial assistance” test. The Preamble sets forth an example where the U.S. parent, the CFC and the unrelated contract manufacturer provide 45 percent, five percent and 50 percent of the manufacturing contribution, respectively. Under an anti-abuse rule, the CFC would not satisfy the substantial contribution test because a related U.S. person provides 80 percent or more of the contribution provided by the U.S. person and the CFC combined (45/50 = 90 percent).

⁷² See note 20 and accompanying text.

⁷³ Commentators generally believe that an anti-abuse rule is inappropriate. NYSBA Report Part IV(4); AICPA Report Part I(E). Both reports recommend that the focus be on the substantiality of the activities of the CFC and not its comparative contribution relative to the activities of others.

⁷⁴ Proposed Reg. §1.954-3(b)(1)(ii)(c)(2).

⁷⁵ *Id.*, Example.

⁷⁶ The 10-percent rate is less than 90 percent of the 20-percent rate and is five percentage points less than the 20-percent rate.

⁷⁷ 10 percent is not five percentage points less than 12 percent.

⁷⁸ See Proposed Reg. §1.954-3(b)(1)(ii)(c)(3).

⁷⁹ Proposed Reg. §1.954-3(b)(1)(ii)(c)(3)(b).

⁸⁰ *Id.*

⁸¹ Proposed Reg. §1.954-3(b)(2)(ii)(c)(2).

⁸² *Id.*

⁸³ Preamble.

⁸⁴ See Proposed Reg. §1.954-3(b)(2)(ii)(e) and Preamble.

⁸⁵ Proposed Reg. §1.954-3(b)(1)(ii)(c)(3)(c).

⁸⁶ *Id.* Whether a branch or remainder makes a predominant contribution is determined by weighing the relative contribution of each branch. *Id.* If multiple branches are located in a single jurisdiction then the activities of those branches will be aggregated for purposes of determining predominant contribution. *Id.*

⁸⁷ Proposed Reg. §1.954-3(b)(1)(ii)(c)(3)(e).

⁸⁸ Proposed Reg. §1.954-3(b)(1)(ii)(c)(3)(d).

⁸⁹ *Id.*

⁹⁰ Proposed Reg. §1.954-3(b)(1)(ii)(c)(3)(f), Example 1. Unless otherwise stated, all examples in this section will assume that CFC performs its activities through its own employees in Country M and the branches are located in separate countries (e.g., Branch A located in Country A, Branch B located in Country B, etc.)

⁹¹ Proposed Reg. §1.954-3(b)(2)(ii)(c)(2).

⁹² Proposed Reg. §1.954-3(b)(2)(ii)(c)(3)(f), Example 2.

⁹³ *Id.*

⁹⁴ Proposed Reg. §1.954-3(b)(1)(ii)(c)(3)(f), Example 4.

⁹⁵ The Example does not state whether CFC makes a substantial contribution of its own. This example is a good illustration of how a CFC becomes ring-fenced from the activities of other branches that satisfy the RDT and must attempt to satisfy the substantial contribution test by itself. It is not clear whether the IRS intended to imply that the activities conducted by CFC in this example cannot constitute predominant contribution because the absence of predominant contribution is stated as a fact in the example. If the IRS intended that this configuration of facts should be normative to what does not constitute predominant contribution, the final regulation should so clarify. This example can be contrasted with Example 3 in the Proposed Regulations, which held that when the CFC provided the same activities as in Example 4 above in its home jurisdiction but also provided design, testing and quality control, it was deemed to be predominant contribution where only one other branch provided supplemental design. Proposed Reg. §1.954-3(b)(1)(ii)(c)(3)(f), Example 3. Part of the purpose of Example 3 was to illustrate the fact that CFC made a predominant contribution in its home jurisdiction even though its employees regularly travel to the contract manufacturing jurisdiction.

⁹⁶ Under the existing Regulations, when there is a selling branch that is different than the manufacturing branch, the RDT is applied with respect to the sales made through that selling branch as if it alone were the remainder of the CFC. Reg. §1.954-3(b)(1)(ii)(c). Thus, the RDT is performed by comparing the effective tax rate in the selling jurisdiction to that in the manufacturing jurisdiction, while the tax rate in the CFC's home jurisdiction is ignored.

⁹⁷ NYSBA Report, Part IV(9); AICPA Report, Part II(C).

⁹⁸ *Id.*

⁹⁹ The Tax Court believed that the IRS and Treasury have special regulatory authority only after the CFC is found to have a branch or similar establishment. See note 44 and accompanying text. The NYSBA Report remarks that the Tax Court's view “seems very questionable.” NYSBA Report, note 20. However, the IRS and Treasury have general rule-making authority under Code Sec. 7805(a), and they should exercise that authority to define a branch (perhaps under a separate tranch of regulations) because it is a critical predicate for the application of the branch rule.

¹⁰⁰ Reg. §1.367(a)-6T(g)(1). Evidence of a foreign branch includes, but is not limited to, the existence of “a separate set of books and records and the existence of an office

or other fixed place of business used by employees and officers for the U.S. person in carrying out business activities.” For these purposes, a presence that constitutes a permanent establishment under the terms of a treaty is deemed to be a foreign branch.

¹⁰¹ In many cases, the oversight branch may qualify as a “representative office” that is taxed at a very low rate. For example, a representative office in China is subject to corporate income tax on a small portion of its costs. Even though the oversight branch might be low-taxed, the RDT current Regulations compare the effective tax rate on the sales income in the selling branch or remainder to the effective tax rate on that income in the manufacturing jurisdiction under the assumption that the sales income is fully taxed in that jurisdiction. Consequently, the actual tax rate on the oversight branch is irrelevant to the RDT.

¹⁰² Lowell D. Yoder, *Letter to IRS*, dated July 24, 2008. Thus, if a manufacturing branch enjoys a rate lower than the statutory rate under a ruling or special regime, that lower rate should be taken into account in determining the hypothetical tax rate on the sales income. See also, NYSBA Report, Part IV (11) (to the same effect).

¹⁰³ This problem could be avoided by locating the oversight employees in a low-tax jurisdiction and having them travel to the manufacturing jurisdiction. The Proposed Regulations imply that traveling does not give rise to a branch in the manufacturing jurisdiction. Proposed Reg. §1.954-3(b)(1)(ii)(C)(3)(f), Example 3. The AICPA Report sought a more explicit statement that traveling employees does not give rise to a branch. This statement should be unnecessary in light of *Ashland* and *Vetco*.

¹⁰⁴ For example, the presence may consist of dependent agents without the authority to conclude contracts.

¹⁰⁵ An office or fixed place of business is defined as a “fixed facility, that is, a place, site, structure or other similar facility, through which [the taxpayer] engages in a trade or business. ... A fixed facility may be considered an office or other fixed place of business whether or not the facility is continuously used.” Reg. §1.864-7(b)(1).

¹⁰⁶ This test is the “material factor” test under Reg. §1.864-6(b)(2)(iii).

¹⁰⁷ This test is the “material participation” test under Reg. §1.864-6(b)(3)(i).

¹⁰⁸ This rule is at variance with Code Sec. 864(c)(5)(A) which takes into account the office or fixed place of business of dependent agents that have the authority to conclude contracts and regularly exercise that authority and likely goes beyond the parameters set for a branch or similar establishment in *Ashland* and *Vetco*. Similarly, in drafting Rev. Rul. 75-7, the IRS apparently considered, but

rejected, treating the activities of the contract manufacturer as a branch under an "agency or instrumentality" argument. See GCM 35961(1974).

¹⁰⁹This election would give the taxpayer the opportunity for a favorable result under the RDT where the sales of the CFC are actually taxed. In most cases, however, the taxpayer has established the sales presence in a low-tax jurisdiction or may have a rogue permanent establishment in a high-tax jurisdiction where the CFC is not filing a tax return. The approach suggested herein would attribute a sales branch in the case of a rogue permanent establishment if substantive sales activity (*i.e.*, negotiations, acceptance of orders) occurs there. This rule is likely to produce an unfavorable result under the RDT but follows the policy of penalizing the taxpayer for artificially separating sales income from manufacturing income.

¹¹⁰Proposed Reg. §1.954-3(a)(6)(i). The Proposed Regulations remove prohibiting the attribution of activities by a CFC partner to

a partnership. The Preamble notes that this language is unnecessary in light of similar "no attribution" rules contained in the Proposed Regulations.

¹¹¹Determined under Code Sec. 958(a).

¹¹²For symmetry sake, the IRS could consider including the activities of a partnership that are treated as related persons under Code Sec. 954(d)(3), *i.e.*, where the CFC or related persons own more than 50 percent of voting power or value. However, this approach is likely to be too permissive.

¹¹³See note 43.

¹¹⁴See Code Sec. 954(c)(6) (permitting deferral for 2006, 2007 and 2008 under similar circumstances). The House Ways and Means Committee indicated that the provision was intended to promote competitiveness for U.S. companies and U.S. workers by "allowing U.S. companies to re-invest their active foreign earnings where they are most needed without incurring the immediate additional tax that companies based in many other countries never incur." H.R. REP. NO. 304, 109th Cong., 1st Sess. (2005).

This legislation has its underpinnings in the episode where the Treasury attempted to prohibit foreign base erosion planning through hybrid branches. See Notice 98-11, 1998-1 CB 433; T.D. 8767 (Mar. 23, 1998). In that case, Congress reacted negatively to a perceived usurpation by the Treasury and the IRS of its legislative authority, and asked the Treasury and the IRS to withdraw Notice 98-11 and allow Congress to determine these international tax policy issues. S. REP. NO. 174, 105th Con., 2d Sess., at 114 (1998); *see also Statement of Senator Breaux*, 145 Cong. Rec. S2503-05 (Mar. 10, 1999) (stating, "We do not understand the rationale for penalizing U.S. multinational companies for employing normal tax planning strategies that reduce foreign (as opposed to U.S.) income taxes," and expressing concern that U.S. multinationals would "be placed at a competitive disadvantage *vis-à-vis* foreign companies who remain free to employ strategies to reduce the foreign taxes they pay").

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