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August 1, 2008

The Honorable Eric Solomon
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The Honorable Douglas H. Shulman
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Report on the Proposed "Contract Manufacturing Regulations"
Issued Under Section 954(d)

Dear Sirs:

We write to comment on the proposed "contract manufacturing regulations" issued under section 954(d).¹

By way of background, United States shareholders in a controlled foreign corporation ("CFC") report their pro rata shares of subpart F income. One category of subpart F income is foreign base company sales income ("FBCSI"). Very generally, the FBCSI rules are designed to identify those situations where a manufacturing CFC located or operating in a high-tax jurisdiction uses separate corporations or

¹ REG-124590-07, 73 Fed. Reg. 10716 (Feb. 28, 2008).

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branches in low-tax jurisdictions to reduce the CFC's effective rate of tax, and the FBCSI rules treat the low-taxed income as subpart F.²

More specifically, FBCSI is defined in section 954(d)(1) as income derived in connection with (i) the purchase of personal property from a related person and its sale to any person, (ii) the sale of personal property to any person on behalf of a related person, (iii) the purchase of personal property from any person and its sale to a related person, or (iv) the purchase of personal property from any person on behalf of a related person if, in each case described in (i)–(iv), the property is both (a) manufactured, produced, grown or extracted outside of the CFC's country of organization and (b) sold for use, consumption or disposition outside the CFC's country of organization.

Some taxpayers have argued that use of the word “its” in clauses (i) and (iii) implies that the property sold must be the same property that is purchased for the sales income to be FBCSI (this is referred to as the “its’ argument”). Accordingly, these taxpayers take the position that where the personal property purchased by the CFC is altered in such a manner that the property purchased is not the same as the property sold by the CFC, the sale of the property does not generate FBCSI, even if the CFC itself performs no part of the manufacture of that property.

The proposed regulations eliminate the “its” argument. They provide that, for purposes of determining FBCSI, personal property sold by a CFC is the same property purchased by the CFC regardless of whether it is sold in the same form in which it was purchased, in a different form than in which it was purchased or as a component part of a manufactured product, except as specifically provided in the regulations.

Section 954(d) and the existing regulations provide several exceptions from FBCSI. Current Treasury regulation section 1.954-3(a)(4) provides, for example, that if a CFC manufactures, produces or constructs property, income from the sale of the property by the CFC does not produce FBCSI, regardless of where the goods are manufactured and regardless of where the goods are used. This exception is referred to as the “manufacturing exception.”

The exceptions from FBCSI are, in turn, subject to an exception. If a CFC carries on activities through a branch or similar establishment outside its country of organization, and carrying on those activities has substantially the same effect as if the branch were a

² See S. Rep. No. 1881, 87th Cong., 2d Sess. at 84 (1962) (“The sales income with which your committee is primarily concerned is income of a selling subsidiary (whether acting as principal or agent) which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income.”).

wholly-owned subsidiary corporation, section 954(d)(2) authorizes regulations to treat the income attributable to those activities as derived by a wholly-owned subsidiary of the CFC and, therefore, as potentially constituting FBCSI of the CFC. This rule is referred to as the “branch rule.”

The proposed regulations generally liberalize the IRS’s position with respect to contract manufacturing by permitting a CFC whose employees make a substantial contribution with respect to the manufacture, production or construction of personal property to qualify for the manufacturing exception from FBCSI, even if the CFC does not itself physically manufacture the property. (This rule is referred to as the “substantial contribution test.”)

Our principal comments are as follows:

1. The “Its” Argument. We support the IRS’s and Treasury Department’s decision to eliminate the “its” argument by regulation.

2. The Substantial Contribution Test. The substantial contribution test is generally welcome by taxpayers because it allows CFCs conducting activities in low-tax jurisdictions to be treated as engaged in manufacturing activities in those jurisdictions (and therefore potentially to avoid FBCSI) at relatively low foreign tax cost. However, we note that the substantial contribution test in practice will tend to erode the FBCSI tax base if the contribution relates to manufacturing in a different and significantly higher tax jurisdiction and does not give rise to a “branch” for purposes of the branch rule in that jurisdiction.

Assuming that the substantial contribution test is retained, we recommend that the final regulations clarify a number of aspects of the test and provide more examples illustrating its application.

3. Employees. As mentioned above, under the proposed regulations, a CFC may satisfy the substantial contribution test only through its “employees.” We recommend that the regulations define the term “employee” for purposes of the substantial contribution test as a common-law employee under U.S. federal income tax principles and, under certain circumstances, include employees who are seconded to and under the control of the CFC (even if their salaries are paid by another entity).

4. Safe Harbor. The Preamble to the proposed regulations requests comments as to whether a safe harbor for the substantial contribution test would be appropriate. We do believe that it would be helpful to provide that a CFC that contributes at least a specific

percentage of the costs of manufacturing personal property (*e.g.*, 20%) is deemed to have substantially contributed to its manufacture.

5. Anti-Abuse Rule. The Preamble to the proposed regulations requests comments as to whether the final regulations should add an anti-abuse rule that would deny substantial contribution treatment if a related United States person provides a substantial portion of the manufacturing contribution relative to the CFC. We do believe that it would be helpful to indicate the minimum level of contribution that constitutes a substantial contribution, but we do not believe that it should be relevant whether a related United States person or some other party contributes the balance.

6. Branch-Related Issues. The final regulations should define the term “branch” for purposes of the branch rule. The definition of a branch is fundamental to the operation of the FBCSI rules, and there are substantial arguments that would support a narrow or, alternatively, an expansive definition of a branch. On the one hand, section 954(d)(2) refers to a “branch or similar establishment,” which implies that a CFC must have a permanent physical presence in a jurisdiction in order to implicate the branch rule. On the other hand, if this narrow definition of a branch is adopted, a low-tax sales CFC could satisfy the substantial contribution test without implicating the branch rule and entirely avoid FBCSI, which is arguably inconsistent with the purpose of the branch rule. Under this view, it may be appropriate to treat any CFC that substantially contributes to the manufacture of property as having a branch in the jurisdiction in which the property is manufactured for purposes of the branch rule. In any event, we do not believe that local law treatment should be relevant to the definition of a branch.

7. Presumption Regarding Lack of Substantial Contribution. The proposed regulations currently presume that if a CFC physically manufactures personal property, then the remainder of the CFC fails to meet the substantial contribution test. Under the proposed regulations, this presumption may be rebutted only if the taxpayer demonstrates that the CFC did substantially contribute “to the satisfaction of the Commissioner” (*i.e.*, an abuse of discretion test). We recommend that taxpayers be subject to a clear and convincing standard to demonstrate that the substantial contribution test is satisfied, and not an abuse of discretion test.

8. Substantial Contributions to Manufacturing That Produce FBCSI. The proposed regulations appear to be generally pro-taxpayer by allowing CFCs to establish that their substantial contributions give rise to manufacturing that may exempt a CFC from FBCSI. However, the proposed regulations may be read to cause a CFC that substantially

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contributes to manufacturing to earn FBCSI that it otherwise would not. In light of the apparent pro-taxpayer intent of the proposed regulations, we urge the Treasury Department and the IRS to clarify whether the regulations in fact may produce FBCSI for taxpayers that would not otherwise have been deemed to earn it.

9. Appropriate Testing Rate Where There Are Multiple Branches That Make Substantial Contributions. The proposed regulations provide that if there is no physical manufacturing branch and several branches make substantial contributions, for purposes of applying the branch rule, the location of the manufacturing branch is the one with the highest tax rate. This rule tends to increase the likelihood that the branch rule applies.

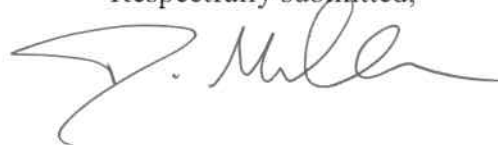
We recommend that this rule be changed. We suggest, instead, that for purposes of applying the tax disparity test where there are multiple manufacturing branches, a weighted average rate be applied. Alternatively, if the highest tax rate rule is retained, we suggest that any manufacturing branch that contributes a small amount (for example, 10% or less of the total substantial contributions) be excluded.

10. Appropriate Testing Rate Where There Are Multiple Branches That Engage in Physical Manufacturing. The proposed regulations provide that if multiple branches each engage in physical manufacturing, for purposes of applying the branch rule, the location of the manufacturing branch is the one with the lowest rate. This rule tends to decrease the likelihood that the branch rule applies.

We suggest that a weighted average rate may be more appropriate for physical manufacturing as well or, alternatively, that a proportionately small branch be excluded for purposes of determining the lowest rate.

We appreciate your consideration of our suggestions. Please let us know if you would like to discuss these matters further or if we can assist you in any other way.

Respectfully submitted,



Enclosure

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The Honorable Douglas H. Shulman
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