NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

THE PROPOSED CONTRACT MANUFACTURING REGULATIONS

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This report responds to a request for comments from the IRS and Treasury on recently proposed regulations under section 954 (the "Proposed Regulations").[1] This report is divided into four parts. Part I contains background concerning the regulations. Part II contains a summary of the Proposed Regulations. Part III contains a summary of our recommendations and Part IV contains a discussion of our comments on the Proposed Regulations.[2]

PART I. OVERVIEW

1. In General.

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"). FBCSI, in turn, 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

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[1] REG-124590-07, 73 Fed. Reg. 10716 (Feb. 28, 2008) as modified in 73 Fed. Reg. 12486 (Apr. 15, 2008) and as further modified by 73 F.R. 20201 (May 2, 2008).

[2] The principal draftsperson of this report is Peter Connors with substantial assistance from Peter Blessing and David Miller. Members of the working group included Alan Granwell, Paul Housey, Stephen Lessard and Thomas Zollo. Helpful comments were provided by Richard Andersen, Andrew Braiterman, Douglas Borisky, Patrick Brown, Kevin Colan, Mathew Clausen, Pamela Fuller, Deborah Jacobs, David Hardy, Susan Klein, Matthew O'Halloran, Stephen Land, Lawrence Schoenthal, Steven Sklar and Robert Stack.

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 of the CFC's country of organization.

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 branches in low-tax jurisdictions to reduce the CFC's effective rate of tax,[3] and treats the low-taxed income as subpart F income on the theory that this low-taxed income is "mobile." For instance, assume that a CFC incorporated in the Cayman Islands purchases goods that an affiliate manufactured in Germany, and the CFC sells the goods to customers in France. Because the goods were purchased from a related person and sold to an unrelated person and the property was both manufactured and sold for use outside the CFC's country of incorporation, FBCSI would result. In this case, Congress believed that the Cayman Islands corporation is being used merely to obtain a lower rate of tax for the sales income and, therefore, the income is not entitled to deferral.

Section 954(d)(1) and the current regulations provide three exceptions from FBCSI. First, under section 954(d)(1)(A) and current Treasury Regulation section 1.954-3(a)(2), if property is purchased from a person on behalf of a related person (or sold on behalf of a related person) but the property is manufactured, produced, grown or extracted by the CFC or a third party within the country of the CFC's organization, income and gain from that property is not FBCSI (because it is not described in (iv)(a) above). This exception from FBCSI for property manufactured in the country of the CFC's incorporation is referred to as the "same-country

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[3] *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.").

manufacturing exception." This exception applies regardless of who manufactures or purchases the goods or where they are used. For example, if a French company purchases goods that a third party has manufactured in France, the sale of those goods will not produce FBCSI, even if the sale is to a related person (wherever located).

Second, under section 954(d)(1)(B) and current Treasury Regulation section 1.954-3(a)(3), if property is sold for use, consumption or disposition in the CFC's country of organization or purchased by the CFC on behalf of a related party for use, consumption or disposition in the CFC's country of organization, income derived from the purchase or sale is not FBCSI (because it is not described in (iv)(b) above). For example, if a French company purchases from a related party goods that are manufactured in Taiwan, but sells the goods in France for use in France, the sale of the goods will not produce FBCSI.

Third, under current Treasury Regulation section 1.954-3(a)(4), if a CFC manufactures, produces or constructs property in whole or in part, 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. Thus, if a French CFC manufactures goods in Germany, a sale of those goods to customers (even related customers) in Italy will not generate FBCSI. (The regulations refer to this manufacturing exception simply as the "manufacturing exception," but it is different from the "same-country manufacturing exception": the same-country manufacturing exception requires that the CFC or a third party manufacture the goods in the CFC's country of incorporation; the manufacturing exception requires that the CFC itself (rather than a third party) manufacture the goods (but, subject to the branch rules described below, permits the CFC to manufacture the goods in any jurisdiction).

Current Treasury Regulation section 1.954-3(a)(4)(ii) and (iii) contain two tests to determine whether a CFC is considered to manufacture, produce or construct personal property

that it sells. First, if personal property is "substantially transformed" by a selling CFC prior to sale, the property sold is treated as having been manufactured, produced or constructed by the selling CFC. For example, a CFC that converts wood pulp to paper, steel rods to screws and bolts, or tuna fish to canned fish is treated as having manufactured, produced or constructed the paper, screws, and bolts or canned fish. This test is referred to as the "substantial transformation" test.

Second, current Treasury Regulation section 1.954-3(a)(4)(iii) provides that if the operations conducted by the CFC in connection with property are "substantive in nature" and are "generally considered to constitute the manufacture, production or construction of the property," then the sale of the property is treated as the sale of a property manufactured by the CFC (rather than a sale of component parts). For example, if a CFC assembles an automobile from component parts, the CFC is treated as having manufactured the automobile rather than having sold the component parts. This test is referred to as the "substantive test." Treasury Regulation section 1.954-3(a)(4)(iii) also provides a safe harbor. Under the safe harbor, a selling CFC is treated as satisfying the substantive test if conversion costs (direct labor and factory burden) related to the component property account for 20% or more of the total cost of goods sold. However, under Treasury Regulation section 1.954-3(a)(4)(iii), in no event do packaging, prepackaging, labeling or minor assembly operations constitute the manufacture, production or construction of property. The substantive transformation and the substantive test are together referred to as the "physical manufacturing" test.

These 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 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."

In the absence of the branch rule, a CFC could engage in purchasing or manufacturing activities within a high-tax jurisdiction, and selling activities in a low-tax jurisdiction without generating FBCSI because the same person would be both purchasing or manufacturing the personal property and selling the personal property.[4]

The current regulations implement the authority granted by section 954(d)(2) with rules for "manufacturing branches" (in Treasury Regulation section 1.954-3(b)(1)(ii)) and different rules for "sales or purchase branches" (in Treasury Regulation section 1.954-3(b)(1)(i)). Treasury Regulation section 1.954-3(b)(1)(ii)(a) (the "manufacturing branch rule") provides that if a CFC carries on manufacturing, production, construction or growing activities by or through a branch or similar establishment outside its country of organization, the CFC purchases or sells the property manufactured by that branch, and the tax imposed on the income derived by the remainder of the CFC satisfies the "manufacturing branch tax rate disparity test" (described below), the branch will be treated as a separate corporation for purposes of determining the FBCSI of the CFC. Thus, if a Cayman Islands corporation has a manufacturing branch in Germany, and the Cayman Islands corporation purchases or sells the products manufactured in the German branch, the manufacturing branch rules may treat the German branch as a separate corporation and deem the head office in the Cayman Islands to earn FBCSI.

The manufacturing branch tax rate disparity test is satisfied if the income that would be FBCSI after applying the branch rules is taxed in the year when earned at an effective rate of tax

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[4] *See* Preamble to the Proposed Regulations (describing policy underlying the branch rule).

that is less than 90% of, and at least 5 percentage points less than, the "hypothetical effective rate of tax" that would apply to such income under the laws of the country in which the manufacturing branch is located if, under the laws of that country, the entire income of the CFC was considered to be derived by the CFC from sources within that country doing business through a permanent establishment there, received in that country and allocable to the permanent establishment, and the CFC was created or organized under the laws of, and managed and controlled in, that country. Thus, in the prior example, if the Cayman Islands would tax what would be FBCSI of the German branch if the German branch were a corporation at a rate that is less than 90% of, and at least 5 percentage points less than, the hypothetical effective German rate of tax imposed on the German branch, the manufacturing branch tax rate disparity test would be satisfied and the income earned by the head office would be treated as FBCSI. Since the Cayman Islands has no corporate income tax, FBCSI would result.

Analogous rules apply to sales and purchase branches. Thus, for instance, if a French manufacturing corporation that is subject to a high-tax rate establishes a sales branch in the Cayman Islands, and sales by the Cayman branch are subject to a low-tax rate, such that, if the branch was treated as a separate corporation, a tax rate disparity would exist between the French corporation and its Cayman Islands branch, then the Cayman Islands branch will be treated as if it is a separate corporation for purposes of determining the CFC's FBCSI. The sales branch tax rate disparity test is met when income allocated to the sales branch or similar establishment is taxed in the year when earned at an effective rate of tax that is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income under the laws of the country in which the CFC is created or organized. Here, since the Cayman Islands has no income tax, FBCSI would also result.

As mentioned above, the purpose of the FBCSI rules is to identify income that is low-taxed and effectively mobile and to deny it deferral (*i.e.*, treat it as subpart F income).[5] These rules do, however, have the effect of discouraging taxpayers from reducing their foreign taxes, and some have questioned whether the characterization of income as FBCSI should turn on whether the taxpayer has reduced its foreign taxes.[6] We note that the check-the-box regime has dramatically increased the ability of taxpayers to reduce the effective tax rate on branch operations and, therefore, has dramatically expanded the potential applicability of the FBCSI rules, particularly the branch rules.

2. Contract Manufacturing.

In a typical contract manufacturing relationship, the entrepreneur (or principal) hires a related or unrelated entity to produce property, subject to the oversight, direction and control of the principal. The principal provides the product specifications, rights to use intangibles to manufacture the product and, in some instances, necessary tools or dies, while the manufacturer owns the plant, property and equipment used to manufacture the product, uses its own employees to perform the actual manufacturing activities and, sometimes, uses its own intangibles in the manufacturing process. The principal may exercise varying degrees of control over the manufacturing activities, such as controlling the quantity, quality and timing of production. Either the principal or the contractor may have title to the raw materials, work-in-process and finished products.[7]

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5 S. Rep. No. 1881, 87th Cong., 2d Sess. at 84.

6 Lawrence Lokken, *Foreign Base Company Sales and Services Income: An Overreaching Anachronism or an Essential Element of the Controlled Foreign Corporation Regime?*, 3 J. TAX'N GLOBAL TRANSACTIONS 47 (Spring 2003); Charles I. Kingson, *Reform Intercompany Sales and Services Income Under Subpart F*, 118 TAX NOTES 951, 953 (Feb. 25, 2008).

7 The term "contract manufacturing" was used in the repealed possessions tax credit under section 936. Section 936(h)(5)(B)(flush language). Under Treasury Regulation section 1.936-5(c) A-1, the term includes any arrangement between a possessions corporation (or another member of the affiliated

Contract manufacturing arrangements are subdivided into two categories, depending on which party has legal title to the work product. In a "consignment" or "tolling" arrangement, the principal acquires the raw materials and components and consigns them to the contract manufacturer, who performs the manufacturing service. In this type of arrangement, the principal has title to the property (*i.e.*, raw materials, components and work-in-process) while it is being manufactured and to the finished goods. In contrast, in a turnkey or a "buy-sell" arrangement, the contractor holds title to the raw materials, components and work-in-process and, upon completion of the manufacturing process, transfers title to the finished product to the principal.

Under either a buy-sell arrangement or a consignment arrangement, the manufacturer typically incurs the risk of loss while the property is undergoing manufacturing.

In both buy-sell and consignment arrangements, the principal has the entrepreneurial risk of selling the finished product to customers and the manufacturer has the risk of manufacturing the goods to the satisfaction of the principal, for which it is paid a fee. Other benefits and burdens of ownership of the property regarding the cost of manufacturing, raw materials, work-in-process and finished goods may be allocated under either type of arrangement between the principal and the contractor based on variations in the contractual terms.

CFCs often engage in contract manufacturing. Taxpayers have argued that the manufacturing activities of a contract manufacturer should be attributed to the selling CFC, but there are no specific rules for contract manufacturing in the existing FBCSI regulations. If the

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group) and an unrelated person if the unrelated person: (1) performs work on inventory owned by a member of the affiliated group for a fee without the passage of title; (2) performs production activities (including manufacturing, assembling, finishing or packaging) under the direct supervision and control of a member of the affiliated group; or (3) does not undertake any significant risk in manufacturing its product (*e.g.*, it is paid by the hour).

activities of the contract manufacturer are attributed to the CFC, the CFC would be able to avoid FBCSI provided such activities do not result in a branch of the CFC.

A Treasury subpart F study that was released in 2000 described contract manufacturing by CFCs as follows:

> Assume CFC2, a contract manufacturer, is related to CFC1, the selling CFC. CFC1 holds title to raw materials that are being processed by CFC2 and CFC1 pays CFC2 for processing them. CFC2 is incorporated and has its operations in a high-tax jurisdiction, while CFC1 is incorporated and has its operations in a low-tax jurisdiction. The processing takes place outside of CFC1's country of incorporation. CFC1 purchases the raw materials from an unrelated party and sells the finished goods to an unrelated party outside CFC1's country of incorporation. If CFC1 had instead sold raw materials to CFC2 and then repurchased the manufactured goods from CFC2, or if CFC1 had purchased finished goods from CFC2, CFC1's resulting sales income would have been FBCSI. [8]
>
> However, in this case, the taxpayer takes the position that subpart F does not apply to CFC1 because there has been no sale to, from or on behalf of a related person. This is despite the fact that the group of related corporations has managed to reduce income in a high-tax jurisdiction by splitting off the sales profit into CFC1 and reducing the manufacturer's profit in CFC2 (for example, to a small mark-up over costs). Thus, the sales profits have been diverted within the group to an entity (CFC1) in a low-tax jurisdiction, in the manner that the FBCSI rules were intended to prevent. The taxpayer might also take the position that the amounts paid to CFC2 are not foreign base company services income because the goods are manufactured (and hence the manufacturing services are performed) in the country where CFC2 is incorporated.

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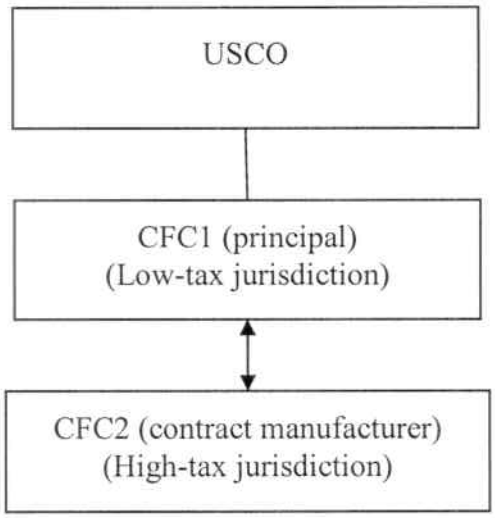
[8] Office of Tax Policy, Dep't of the Treasury, The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study 65 (Dec. 2000) (footnotes omitted).



The legal precedents concerning contract manufacturing in the context of subpart F are inconsistent. In Revenue Ruling 75-7,[9] the IRS held that the manufacturing activities of a contract manufacturer were "considered" that of the principal.[10] The ruling also concluded that the unrelated contract manufacturer was a branch or similar establishment within the meaning of Treasury Regulation section 1.954-3(b)(1)(ii) but, because the branch did not fail the tax rate

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[9] 1975-1 C.B. 244, revoked by Rev. Rul. 97-48, 1997-2 C.B. 89. Under the terms of the contract, a CFC paid a contract manufacturer a conversion fee to process ore concentrate. The ore concentrate, before and during processing, and the finished product remained the sole property of the CFC at all times. The CFC alone purchased all raw material and other ingredients necessary in the processing operation and bore the risk of loss at all times in connection with the operation. Complete control of the time and quantity of production was vested in the CFC. Complete control of the quality of the product was also vested in the CFC, and the contract manufacturer was at all times required to use such processes as were directed by the CFC. The CFC could, when the occasion warranted it, send engineers or technicians to the contract manufacturer's plant to inspect, correct or advise with regard to the processing of the ore concentrate into the finished product.

[10] Two recent cases also have attributed the activities of the contract manufacturer to the principal under section 263A. *See Suzy's Zoo v. Commissioner*, 114 T.C. 1 (2000), *aff'd* 273 F.3d 875 (9th Cir. 2001) (the principal was treated as the manufacturer for purposes of section 263A where it hired printers to produce products incorporating principal's designs); *Electronic Arts, Inc. v. Commissioner*, 118 T.C. 226 (2002) (for purposes of the active trade or business requirement under section 936(a)(2)(B), principal may be considered manufacturer of products that were produced by a third party); *see also MedChem (P.R.) Inc. v. Commissioner*, 116 T.C. 308 (2001) *aff'd* 295 F.3d 120 (1st Cir. 2002) (for purposes of the active trade or business requirement under section 936(a)(2)(B), contract manufacturing activities may be imputed to principal but only if contract manufacturing services are supervised by principal's employees); *cf.* Treas. Reg. § 1.199-3(f)(1) (for purposes of determining who is the manufacturer when a taxpayer enters into a contract with another party, only the person with the benefits and burdens of ownership of the qualifying production property is treated as engaging in the qualifying activity).

disparity test, the CFC did not have FBCSI. In effect, the ruling was an attempt by the IRS to create a manufacturing branch out of the activities of an independent contract manufacturer. However, in *Ashland Oil, Inc. v. Commissioner* and *Vetco, Inc. v. Commissioner*, the Tax Court held that the activities of a contract manufacturer corporation, whether unrelated or related, could not be attributed to the principal for purposes of the branch rules.[11] These cases gave legal support to taxpayers that used the approach of Revenue Ruling 75-7 to attribute the manufacturing activities of the contract manufacturer to the CFC without implicating the branch rules. *Ashland* and *Vetco* undercut a fundamental element of the analysis contained in Revenue Ruling 75-7 and thereby allowed taxpayers to use the ruling to open what has been described as a significant loophole in the FBCSI regime.[12]

Subsequently, the IRS issued Revenue Ruling 97-48,[13] which revoked Revenue Ruling 75-7 and affirmed the holdings of *Ashland* and *Vetco*. As a result, under Revenue Ruling 97-48, the IRS does not treat a contract manufacturer, whether related or unrelated, as a "branch or similar establishment" for purposes of section 954(d)(2). Also, in revoking Revenue Ruling 75-7, the IRS ruled that the activities of a contract manufacturer cannot be attributed to a CFC for purposes of either sections 954(d)(1) or 954(d)(2) to determine whether the income of the CFC is FBCSI.

PART II. DISCUSSION OF THE PROPOSED REGULATIONS

The Preamble to the Proposed Regulations indicates that Treasury and the IRS now believe that contract manufacturing is not being used to separate sales and purchasing income

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[11] *Ashland Oil, Inc. v. Commissioner*, 95 T.C. 348 (1990) (unrelated contract manufacturer corporation is not a branch of CFC and *Vetco, Inc. v. Commissioner*, 95 T.C. 579 (1990) (related contract manufacturer corporation is not a branch of CFC).

[12] LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION ¶ 69-5.6, 69-50.

[13] 1997-2 C.B. 89.

from the manufacturing activities of a related corporation merely to obtain a lower rate of tax on the sales and purchasing income but, instead, that contract manufacturing is used "primarily to leverage expertise and cost efficiencies," and offers "flexibility and efficiencies." Moreover, Treasury and the IRS believe that updated rules "are important to the continued competitiveness of U.S. business operating abroad."[14] On the basis of this consideration of purpose and policy of competitiveness, the Proposed Regulations generally liberalize the FBCSI rules as applied to contract manufacturing by permitting a CFC that makes a substantial contribution with respect to the manufacture, production or construction of personal property to qualify for the manufacturing test, even if the CFC does not itself physically manufacture the property. Moreover, if the final regulations follow the Proposed Regulations in allowing a CFC to be treated as substantially contributing to the manufacture of property without automatically giving rise to a branch in the jurisdiction of manufacture, then the regulations will, as a practical matter, permit the elimination of FBCSI for most taxpayers.

In adopting this approach, the Proposed Regulations invalidate, at least prospectively, an argument referred to as the "its" argument, as described below, under which taxpayers argue that CFCs that do not engage in any physical manufacturing or substantially contribute to manufacturing may avoid FBCSI.

1. Substantial Contribution to Manufacturing.

a. The "Its" Argument. Under section 954(d)(1), FBCSI includes income from the purchase of personal property from any person and "its" sale to a related person. Some taxpayers have argued that use of the word "its" 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'

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[14] Preamble to the Proposed Regulations.

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. Certain other taxpayers believe that, in order for an "its" argument to succeed, the CFC must perform more than a negligible part in the manufacturing process.

The IRS, however, has publicly rejected these arguments and believes that FBCSI is generated under current law whenever a CFC purchases personal property and sells that personal property, even if the property is modified before its sale, unless the CFC manufactures or substantially contributes to the manufacture of the property. According to the IRS, section 954(d)(1) is concerned with the segregation of purchase or sales and manufacturing into different jurisdictions and not merely whether the property was altered. Thus, under this view, FBCSI includes income derived in connection with the purchase (or sale) of personal property that is manufactured, produced, grown or extracted outside of the CFC's country of organization and sold for use outside the CFC's place of incorporation, unless the CFC manufactures or substantially contributes to the manufacture of the property being sold.

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 by the same-country manufacturing exception contained in Treasury Regulation section 1.954-3(a)(2) and the manufacturing exception contained in Treasury

Regulation section 1.954-3(a)(4).[15] Therefore, only if the manufacture of a product is performed either by the CFC or in the CFC's country of organization will its income be exempt from FBCSI. The Preamble to the Proposed Regulations indicates that this aspect of the Proposed Regulations is a clarification of prior law.

b. The Manufacturing Exception. The Proposed Regulations provide that a CFC qualifies for the manufacturing exception from FBCSI only if the CFC, acting through its employees, manufactures, produces or constructs the relevant product. Proposed Treasury Regulation section 1.954-3(a)(4)(i) provides that a CFC is treated as having manufactured, produced or constructed personal property if it satisfies one of three tests, set forth in Treasury Regulation section 1.954-3(a)(4)(ii) and (iii) and Proposed Treasury Regulation section 1.954-3(a)(4)(iv).

First, Treasury Regulation section 1.954-3(a)(4)(ii) sets forth the "substantial transformation" test that exists under current law, pursuant to which personal property that is substantially transformed prior to sale will be treated as having been manufactured, produced or constructed by the selling corporation. Examples of substantial transformation provided in the regulations include the conversion of wood pulp to paper, steel rods to screws and bolts, and tuna fish to canned tuna. The Proposed Regulations do not change the substantial transformation test.

Treasury Regulation section 1.954-3(a)(4)(iii) sets forth the general "substantive test." The Proposed Regulations do not change this test. As mentioned above, satisfaction of the requirements of either the substantial transformation test or the substantive test is referred to as satisfaction of the "physical manufacturing test." The Proposed Regulations clarify that the

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[15] As mentioned above, under the manufacturing exemption, the CFC must be involved in the transformation of the product. The activities need not necessarily have occurred in the location of the place of incorporation of the CFC.

physical manufacturing test applies only where the selling CFC itself performs the physical transformation, physical assembly or conversion of component parts but otherwise leaves the existing physical manufacturing test intact. [16]

The Proposed Regulations would significantly change the existing regulations by adding clause -3(a)(4)(iv), which provides that a CFC that provides a "substantial contribution" with respect to the manufacture, production or construction of personal property but does not satisfy the physical manufacturing test, may nonetheless be treated as manufacturing the property for purposes of the manufacturing exception. (The "substantial contribution" test is not contained in the current regulations.) In this respect (*i.e.*, that non-physical manufacturing may constitute manufacturing), the Proposed Regulations are consistent with Revenue Ruling 75-7 and are generally favorable to taxpayers. Under the Proposed Regulations, a CFC will satisfy the substantial contribution test with respect to personal property only if the facts and circumstances evidence that the CFC makes a "substantial contribution" through the activities of its "employees" to the manufacture of that property, even if the CFC does not itself physically manufacture the property.

Under the Proposed Regulations, the factors to be considered in determining whether a CFC makes a substantial contribution to the manufacture of personal property include: (1) oversight and direction of the manufacturing activities or process (including management of the risk of loss); (2) performance of manufacturing activities that are considered in, but insufficient to satisfy, the physical manufacturing test; (3) control of the raw materials, work-in-process and finished goods; (4) management of the manufacturing profits; (5) material selection; (6) vendor selection; (7) control of logistics; (8) quality control; and (9) direction of

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[16] Prop. Treas. Reg. § 1.954-3(b)(1)(ii)(a).

the development, protection and use of trade secrets, technology, product design and design specifications and other intellectual property used in manufacturing the product.

The Proposed Regulations clarify that the substantial contribution test is not relevant to the same-country manufacturing exception.[17] Thus, only physical manufacturing by the third-party manufacturer is relevant for that exception. Accordingly, even if a person satisfies the substantial contribution criteria in the country of incorporation, it will not qualify for the same-country manufacturing exception unless physical manufacturing occurs in the CFC's country of incorporation.[18] On the other hand, the Proposed Regulations indicate that a CFC that fails to qualify under the new substantial contribution test may nevertheless qualify for the same-country manufacturing exception.[19]

2. The Branch Rule.

As mentioned above, the purpose of the branch rule is to prevent a CFC from engaging in purchasing and selling activities through an office in a low-tax jurisdiction and manufacturing activity in a branch or similar establishment in a high-tax jurisdiction (or a CFC from manufacturing in a high-tax jurisdiction and selling through an office in a low-tax jurisdiction) and to avoid FBCSI under the theory that the same "person" is both purchasing or manufacturing and selling the property. The definition of a "branch" for this purpose is fundamental to the operation of the Proposed Regulations.[20]

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17 Prop. Treas. Reg. § 1.954-3(a)(2).

18 Given that non-physical manufacturing permitted otherwise under the Proposed Regulations, the term "manufacturing" appears to be construed inconsistently under the Proposed Regulations.

19 Prop. Treas. Reg. § 1.954-3(b)(1)(ii)(e).

20 The Tax Court in *Ashland Oil*, after describing the existing legislative history of section 954(d)(2), stated in *dicta* that "[s]ection 954(d)(2) does grant specific regulatory authority, but, as is apparent from the sentence structure of that section, the authority becomes operative only if a branch or similar establishment is a given. In other words, the Secretary has a specific grant of authority to address certain consequences flowing from the existence of a branch or similar establishment, but does not have such authority to determine what a branch or similar establishment is." *Ashland Oil, Inc. v.*

On the one hand, the definition of a branch or similar establishment could be interpreted broadly such that, if a CFC that is located in a low-tax jurisdiction substantially contributes to manufacturing activities in a high-tax jurisdiction (so that the CFC is treated as engaging in those manufacturing activities), then the CFC would automatically be treated as having a branch in the high-tax jurisdiction that is potentially subject to the branch rule, which would be consistent with the position of uniform interpretation of the concepts that the IRS has taken publicly prior to the Proposed Regulations.

On the other hand, the term branch or similar establishment could be interpreted narrowly so as to require substantial physical presence in the low-tax jurisdiction. Under this interpretation, it would be possible under the Proposed Regulations for a low-tax CFC to contribute substantially to manufacturing activities in a high-tax jurisdiction without causing the CFC to operate "through a branch or similar establishment" in that high-tax jurisdiction (for example, by having employees that oversee and direct the manufacturing activities and otherwise engage in the "substantial contribution" do so remotely without physically traveling to the high-tax jurisdiction). A CFC that operates in this manner will generate low-tax income from its sales activity that is not FBCSI, which would be consistent with the position taxpayers have taken since at least the 1970s. The Proposed Regulations are silent on whether the broad or narrow definition applies.

The Proposed Regulations provide new rules to address the tax disparity test for multiple manufacturing branches. First, Proposed Treasury Regulation section 1.954-3(b)(1)(ii)(c)(2) addresses situations in which multiple branches each perform manufacturing activities with

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Commissioner, 95 T.C. 348, 357 (1990). This statement of the court seems very questionable. However, section 7805(a) grants general rulemaking authority. *See* section 7805(a) ("the Secretary shall prescribe all needful rules and relations for the enforcement of this title," including "all rules and regulations as may necessary by reason of any alteration of law in relation to internal revenue").

respect to separate items of personal property that the CFC then sells. Consistent with the rule for multiple sales branches, the Proposed Regulations require the separate application of the manufacturing branch tax rate disparity test to each branch that is manufacturing a separate item of personal property. For instance, suppose a manufacturing branch produces tires and another branch produces widgets. The Proposed Regulations apply the tax rate disparity test separately for each branch, depending on where the item is sold. Presumably, separate testing also would be required if the same branch produced both tires and widgets.

Second, Proposed Treasury Regulation section 1.954-3(b)(1)(ii)(c)(3) addresses situations in which multiple branches, or one or more branches and the CFC's "head office," perform manufacturing activities with respect to the same item of personal property that the CFC then sells. In such a situation, the physical manufacturing test is applied first, and if only one branch (or only the remainder of the CFC) satisfies the physical manufacturing test, then the location of that branch (or of the remainder of the CFC) is treated as the location of manufacturing for purposes of applying the manufacturing branch tax rate disparity test. If more than one branch, or one or more branches and the remainder of the CFC, each satisfies the physical manufacturing test, then the branch or the remainder of the CFC located or organized in the jurisdiction that would impose the lowest effective tax rate is treated as the location of manufacturing for purposes of applying the manufacturing branch tax rate disparity test. This rule benefits taxpayers. For example, assume a CFC incorporated in the Singapore (16.5% rate) has manufacturing branches in Germany and Ireland. Sales are conducted through Singapore. Assume the rates of tax in Germany and Ireland are 45% and 12.5%. In calculating the tax rate disparity test, 12.5% would be compared to the rate in Singapore (16.5%). Since the

manufacturing rate is lower than the sales rate, there would be no FBCSI from the sales though the Singaporean office.[21]

If none of the branches or the CFC's head office satisfies the physical manufacturing test, but the CFC as a whole satisfies the substantial contribution test, and if one branch or the head office provides a "predominant amount" of the CFC's contribution to manufacturing, then the location of manufacturing is treated as the location of the branch or the head office that provides the predominant amount of the CFC's substantial contribution. Whether any branch or the remainder of the CFC provides a predominant amount of the CFC's contribution to manufacturing is determined by applying the facts and circumstances test provided in Proposed Treasury Regulation section 1.954-3(a)(4)(iv) to weigh the contribution to manufacturing of each branch or the remainder of the CFC. No safe harbor has been provided to indicate the minimal level of activity that will satisfy the predominant requirement, but informal discussions with the IRS have indicated that it is the highest qualitative level of contribution, even if that contribution is less than the majority of the contribution level. (In other words, if one branch provides 40% of the substantial contribution and no other branch (or the head office) provides 40% of the substantial contribution, then (assuming that 40% is sufficient to constitute a predominant amount) the branch providing 40% of the substantial contribution would be treated as the manufacturing branch.)

If a predominant amount of the CFC's contribution to manufacturing is not provided by any particular branch, the location of manufacturing for purposes of applying the manufacturing branch tax rate disparity test will be that place where either the remainder of the CFC or one of

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[21] As this example suggests, one effect of the Proposed Regulations for taxpayers that must physically manufacture in a high-tax jurisdiction for commercial or historical reasons would be to establish a manufacturing branch for at least a small part of the overall manufacturing process in a low-tax jurisdiction (if logistics permit).

its branches performs activity representing such contribution and which would impose the highest effective rate of tax when applying either the sales branch or manufacturing tax rate disparity tests. The use of the highest rate increases the likelihood that meaningful tax rate disparity will exist under the test.

For example, assume a CFC organized in Canada conducts manufacturing through disregarded entities located in the Cayman Islands, Singapore and Germany, with tax rates of 0%, 16.5% and 40%, respectively. Each of those branches provides a substantial contribution to the manufacture of the product, but none provide a predominant amount. Under the highest tax rate presumption, Germany will be presumed to be the location of the manufacturing branch.[22] As a result, if a sales branch has an effective rate that is 35% (which is less than 90% of 40% and at least 5% percentage points less than 40%), the sales branch will generate FBCSI. However, if Singapore were treated as the manufacturing branch, a sales branch with a 35% effective rate would not generate FBCSI.

Checking the box on a disregarded entity to treat it as a corporation would eliminate the disregarded entity from the determination of whether the substantial contribution test has been met, but would also serve to remove the entity from the potential branches that could be identified as the manufacturing branch. Thus, in the prior example, if the taxpayer checked the box on the German entity, then only the rate in the Cayman Islands or Singapore would be relevant for the tax rate disparity test, but only the activities performed by the Cayman Islands or Singapore entities would be relevant in determining whether the CFC substantially contributed to the manufacturing process.

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[22] Prop. Treas. Reg. § 1.954-3(b)(2)(ii)(a).

The Proposed Regulations contain a special rule for CFCs with multiple manufacturing branches that conduct physical manufacturing. Proposed Treasury Regulation section 1.954-3(b)(2)(ii)(c)(2) provides that, if a branch of a CFC satisfies the physical manufacturing test with respect to personal property sold by the CFC, the remainder of the CFC will be presumed not to make a substantial contribution to the manufacture of that personal property. The presumption may be rebutted only by demonstrating "to the satisfaction of the Commissioner" that the remainder of the CFC made a substantial contribution. However, if a CFC demonstrates, to the satisfaction of the Commissioner, that the remainder of the CFC (or any branch treated as the remainder of the CFC) makes a substantial contribution to the manufacture of that item of personal property, then the remainder of the CFC (or any branch treated as the remainder of the CFC), if treated as a separate corporation apart from its manufacturing branch, will be considered to manufacture, produce or construct that item of personal property under the substantial contribution test. If the taxpayer cannot rebut this presumption to the satisfaction of the Commissioner and the tax rate disparity test is met, then a sales branch will be deemed to earn FBCSI because it will not have conducted any manufacturing activities that would have made it eligible for the manufacturing exception.

The Preamble to the Proposed Regulations indicates that this presumption is necessary as a backstop to the branch rules to administer the rule effectively. The IRS and the Treasury Department are concerned that, in the absence of the presumption, it would be too easy for taxpayers to have low-tax jurisdictions substantially contribute to the physical manufacture of products, thereby "obfuscating the division of manufacturing labor and income between the CFC and its branches."

The effect of this presumption, if it is incorporated into the final regulations, will be, in certain cases, to encourage taxpayers whose CFCs have physical manufacturing branches and

substantial contribution sales branches to check the box on the physical manufacturing branches to treat them as separate CFCs, and then have the sales CFCs substantially contribute to the manufacturing activities of the manufacturing CFCs. In this case, the presumption would not operate against the taxpayer with respect to the substantial contribution sales CFCs. However, it would appear that the division of manufacturing labor and income is equally capable of obfuscation in this case (CFC substantially contributing to physical manufacturing by a related CFC) as it is when a CFC substantially contributes to physical manufacturing by its own branch.

If a branch or the remainder of the CFC fails the tax rate disparity test, it is treated as a separate CFC under the "treatment as a separate corporation rule."[23] The tax disparity test is applied again with respect to this deemed separate corporation to determine whether the separate corporation excludes other branches or the remainder of the CFC.[24]

Finally, the Proposed Regulations contain a taxpayer-favorable rule under which income derived by a branch or similar establishment, or by the CFC's head office, will not be FBCSI by reason of the branch rule if the income would not be FBCSI by reason of the branch rule if it were derived by a separate CFC under like circumstances. This is referred to as the "comparison with ordinary treatment" rule or, more simply, the "ordinary treatment" rule.[25] Under this rule, if a sales branch fails the tax rate disparity test but the sales branch also physically manufactures

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[23] Prop. Treas. Reg. § 1.954-3(b)(2)(ii)(a).

[24] Id.; Prop. Treas. Reg. § 1.954-3(b)(1)(ii)(c)(3)(f) Example 4 (tax disparity test met, and activities of Branch A excluded) and Example 5 (tax rate disparity test met for Branch B, but not remainder; Branch B excluded but the remainder of FS is included).

[25] This rule does not apply where the CFC has engaged in physical manufacturing but has failed to rebut the presumption that a branch has not substantially contributed. Prior to a technical correction in the Proposed Regulations, there was uncertainty as to whether CFCs that fail to satisfy the predominant contribution test could assert this provision, but the Proposed Regulations are now clear that even CFCs that fail to satisfy the predominant contribution test may satisfy the ordinary treatment rule. Prop. Treas. Reg. § 1.954-3(b)(ii)(f), Examples 4 and 5, as modified in 73 Fed. Reg. 12486 (Apr. 15, 2008).

the property, then the sales branch will be treated as satisfying the manufacturing exception and no FBCSI will result. As another example, if a branch of a CFC purchases personal property from one unrelated person and sells the same property to another unrelated person without any involvement by the remainder of the CFC (*i.e.*, a transaction that if conducted by a CFC would not generate FBCSI), the branch rule will not apply to create a related-party transaction between the branch and the remainder of the CFC and generate FBCSI.[26] Finally, if the manufacturing branch sells its product, without involvement of the head office, under the ordinary treatment rule, FBCSI will not result.[27]

However, the Preamble to the Proposed Regulations makes clear that the ordinary treatment rule merely provides an exception to the branch rule and cannot be asserted by a taxpayer to cause income that would be FBCSI under section 954(d)(1) in the absence of the branch rule to fail to be treated as such. The Preamble gives as an example a CFC that is incorporated in Country Y, purchases personal property from a related party and then has that property manufactured by a contract manufacturer in Country Z. If the CFC does not perform any activity with respect to the manufacture of the property (*i.e.*, the physical manufacture test and the substantial contribution test are both failed), and the CFC sells the manufactured property through a branch located in Country Z for use, consumption or disposition outside of

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[26] However, as discussed below in Part IV.8, if another branch or the remainder of the CFC substantially contributes to manufacturing the property, it is unclear whether the branch rule would apply.

[27] *See* TAM 8509004 (Nov. 23, 1984). In that TAM, a CFC incorporated in Country X (F1) was engaged in contract manufacturing of product Z through CFC (F2) in Country Y. The branch in Country Y sold all of product Z, and the remainder of the CFC performed no selling activities with respect to product Z. The IRS held that the branch rules did not apply because none of product Z manufactured by the branch was purchased or sold by the remainder of the CFC. The IRS further ruled that even if the branch rules applied, the branch's income would not be FBCSI because the CFC manufactured and sold the product. Finally, the IRS ruled that even if the branch did not manufacture the products, its sales income would not be FBCSI because the product was manufactured in the country in which the branch was located.

Country Y, then the income from the sale of the property will be FBCSI under section 954(d)(1) (because the property is purchased from a related person and is sold for use outside the CFC's country of incorporation). (If the branch located in Country Z were a separate CFC, the income from the sale of the property would not be FBCSI because the hypothetical CFC would be selling personal property manufactured in its county of organization, Country Z. However, because the income from the sale of the property would be FBCSI to the CFC under section 954(c)(1), the ordinary income rule does prevent subpart F income.)

PART III. SUMMARY OF RECOMMENDATIONS

Our recommendations 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 generally is welcomed by taxpayers because it allows CFCs organized and conducting the requisite activities in low-tax jurisdictions to be treated as engaged in manufacturing activities (and therefore potentially avoiding FBCSI) at a 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.[28]

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, including some in which a buy-sell arrangement, rather than consignment

[28] This base erosion will occur even after taking into account the practice of many taxpayers of attributing the activities of contract manufacturers to their CFCs under current law, notwithstanding Revenue Ruling 97-48 (which held that the activities of a contract manufacturer are not attributed to a CFC for FBCSI purposes).

manufacturing, is used. Second, we recommend that the final regulations clarify that the substantial contribution test is qualitative and not quantitative in nature (*i.e.*, a taxpayer may satisfy it without meeting a majority in number of the factors). Third, we recommend that, in order to establish a substantial contribution, a taxpayer have books and records that adequately document the expenses associated with the contribution. Finally, we have a number of questions regarding the substantial contribution test.

3. Employees. We recommend that the regulations define the term "employee" for purposes of the substantial contribution test and that employee be defined as a common-law employee under U.S. federal tax principles, and under certain circumstances include employees who are seconded to and under the control and active supervision of the CFC (even if their salaries are paid by another entity). We also recommend that similar principles apply to CFCs that are partners in partnerships: employees of the partnership should be treated as employees of the CFC if the CFC, through its own employees, has direct legal control over the partnership's employees (*e.g.*, by reason of the CFC being a general partner of the partnership or managing member of a limited liability company). However, in this case, the CFC's relative economic interest in the partnership should be relevant in determining whether the CFC substantially contributed to the manufacturing activity. We suggest that a CFC must have at least a 25% economic interest in a partnership before the activities of the partnership's employees alone can cause the CFC to contribute substantially to manufacturing. We do not believe that the term employee should include independent contractors or employees of affiliates. Finally, we also do not believe that the legal classification of the employee for local purposes should be relevant.

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 a safe harbor under which 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 by value 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. We note that *Ashland* and *Vetco* found no branches, but they did so in the absence of regulations and without the substantial contribution test. 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 are generally intended to be pro-taxpayer because they allow CFCs to establish that their substantial contributions give rise to manufacturing that may exempt a CFC from FBCSI. Given this, there is uncertainty as to whether a substantial contribution to manufacturing by a CFC was intended to also cause the CFC to earn FBCSI that it otherwise would not. We urge the Treasury Department and the IRS to address this issue directly in the final regulations. If, indeed, a substantial contribution may cause a CFC to earn FBCSI where it does not under current law, the Treasury and the IRS should consider delaying the effective date of the final regulations to allow-taxpayers to restructure their foreign operations in light of the regulations.

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, the location of the manufacturing branch is the one with the highest tax rate. 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, the location of the manufacturing branch is the one with the lowest rate. 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).

11. Hypothetical Tax Rate Calculation. We recommend that the hypothetical tax rate prong of the tax rate disparity test be clarified to give effect to tax holidays and similar foreign tax relief.

12. Allocation of Income Within the CFC. We recommend that, for purposes of applying the tax disparity tests, the final regulations expressly state that income is allocated to a branch or the remainder of the CFC based on the books and records for local tax purposes.

13. Treatment of Disregarded Payments by a Branch to the Head Office. Where a disregarded entity makes payments, such as royalties, that are respected for foreign tax purposes, but disregarded for U.S. tax purposes, we recommend that those payments not be treated as FBCSI, even if the sales activities of a sales branch would be attributed to the head office of the CFC for purposes of the FBSCI rules.

PART IV. COMMENTS ON THE PROPOSED REGULATIONS

1. The "Its" Argument.

As mentioned above, section 954(d)(1) includes as FBCSI income from the purchase of personal property from any person and "its" sale to a related person and some taxpayers take the position that a CFC may purchase property, cause the property to be transformed or altered by a third party and then sell the property to a related person without generating FBCSI because the word "its" implies the property purchased and the alteration by a third party alters the nature of

the property. We believe that the purpose of section 954(d)(1) and its legislative history make clear that the CFC itself must transform product to avoid FBCSI upon the sale to a related person.[29] Therefore, we believe that repudiation of "its" argument under the Proposed Regulations is an appropriate exercise of regulatory authority, and correct as a matter of tax policy.[30]

2. The Substantial Contribution Test.

a. In General. The substantial contribution test is expressed in terms of nine factors rather than a single test. We agree with this approach, given that no single test could encapsulate the concept of manufacturing across the various industry and product lines. In this regard, we specifically recommend that the final regulations clarify that the substantial contribution determination is based on a qualitative, rather than quantitative analysis, and that, in applying this analysis, the extent to which the various factors are satisfied is to be taken into account. In other words, a CFC that satisfies relatively few factors (or, on the facts, possibly even only one factor) could make a substantial contribution; conversely, a CFC, particularly in the absence of an existing body of caselaw, that satisfies five of the factors might not.

A multifactor test, however, necessarily gives rise to a great deal of uncertainty. The Proposed Regulations should attempt to reduce the scope of this uncertainty. For example, we believe that a number of the elements of the test should be clarified and that other factors should be specifically addressed. In addition, examples should specifically address the case of a buy-

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[29] *See* S. Rep. No. 1881, 87th Cong., 2d Sess (1962), 1962-3 C.B. 841, 949 ("[i]n a case in which a controlled foreign corporation purchases parts or materials which it then transforms or incorporates into a final product, income from the sale of the final product would not be foreign base company sales income if the corporation substantially transforms the parts or materials, so that, in effect, the final product is not the property purchased.") (emphasis added).

[30] We leave for the courts to decide to what extent the "its" argument has merit prior to the finalization of the regulations.

sell contract manufacturer and the situation where the contract manufacturer is related to the CFC. Finally, in Example 4, a significant portion of the service-type activities performed by the manufacturer were historically completed by people are instead performed by machines. The manufacturer in Example 4 fails to meet the substantial contribution test. We recommend that an example be added in which a "virtual manufacturer" (such as the manufacturer in the example) actually meets the test.

b. Definitional Issues. The nine factors listed use new terminology that is unclear. We recommend some clarification.

i. *Oversight and direction of the activities or process (including management of the risk of loss) pursuant to which the property is manufactured.* The first factor is "oversight and direction of the activities or process (including management of the risk of loss) pursuant to which the property is manufactured." This factor potentially involves a number of contributions. First, in the ordinary case, a principal may provide the contract manufacturer with specifications for the overall process, including the layout of the production lines.[31] The principal may also retain the right to approve or disapprove of any material changes in the production line or require the contract manufacturer to adhere to safety and environmental standards, and retain the right to inspect the plant for violations. Finally, the principal may review accounting statements that show any material deviations from standard costs on a periodic (*e.g.*, monthly) basis. In other cases, the principal may contract for a price that assumes normal productivity and leave the contract manufacturer responsible for manufacturing efficiency (this provision is common in third-party contracts). Is this factor intended to cover all of these aspects? To what extent will this factor be treated as satisfied if the principal contributes

[31] This could include the procedures to be used in manufacturing the product.

in only certain of the suggested aspects? If a principal provides specifications for the manufacturing process, must it inspect the plant periodically to satisfy this factor? Or is oversight satisfied by reviewing periodic production efficiency reports if a plant is operating with normal efficiency? In this regard, some practitioners have questioned whether oversight is weighted more heavily than other factors in light of the apparent importance it takes in all four of the multiple branch rule examples, even though it typically requires relatively few people to undertake. We request that the regulations address and answer these questions.

ii. *Performance of manufacturing activities that are considered in, but insufficient to satisfy, the physical manufacturing test.* The second factor is performance of manufacturing activities that are considered in, but insufficient to satisfy, the physical manufacturing test. This factor seems appropriate.

iii. *Control of the raw materials, work-in-process and finished goods.* The third factor is "control of the raw materials, work-in-process and finished goods." This factor is unclear. Obviously, the contract manufacturer will have physical control over the inventory during the conversion process. This factor may refer to the principal having the contractual right to take possession of the inventory at any time and to have either title to the inventory or the contractual risk of loss. Control of inventory does not require ownership of legal title to the inventory. Additionally, in the case of contract manufacturers, a principal CFC may be viewed as controlling raw materials, work-in-process and finished goods by gathering marketing data on demand from marketing affiliates, entering procurement and production scheduling data into the taxpayer's electronic inventory control system and controlling the procurement qualifications and purchases from a central location. Does this factor include quality control over the raw materials, or is that covered under the separate "quality control" factor? Does this category

include capacity management and production scheduling? We request that the regulations address and answer these questions.

iv. *Management of the manufacturing profits.* The fourth factor is "management of the manufacturing profits." This factor is unclear and is subject to a variety of interpretations. Is this a managerial responsibility for the profits-and-loss statement of the manufacturing and sale of the manufactured products or a treasury function related to movement of the cash derived from the manufacturing operations? Presumably, this factor does not refer simply to ensuring that the manufacturing process is economically efficient, as that appears to be covered by the "oversight and direction of the manufacturing activities or process" factor. The more likely interpretation would seem to be that the principal bears the entrepreneurial risk with respect to what is produced, how much is produced and what price it is sold for, while the contract manufacturer's interest is limited to receiving a relatively fixed conversion process for its manufacturing function. We request that the regulations address and answer these questions.

v. *Material selection.* The fifth factor is "material selection." To what extent is this factor satisfied if the principal dictates the specifications for the materials used to the contract manufacturer, even if the determination of the materials used arises from product specifications that the principal did not create?[32] Is this factor fully or partially satisfied if the contract manufacturer has the right to substitute materials but only with the principal's prior approval? Is the factor satisfied if employees of other members of the controlled group make an initial selection subject to approval by an employee of the principal? We request that the regulations address and answer these questions.

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[32] For example, what if the principal specifies requirement steel of a certain grade, but does not create any requirements as to the steel mill from which it is purchased?

vi. *Vendor selection*. The sixth factor is "vendor selection." To what extent is this factor satisfied if the principal provides to the contract manufacturer a list of approved vendors but leaves the contract manufacturer to determine which vendors to use? Is it satisfied if the contract manufacturer has the right to identify alternative sources of supply but only with the principal's prior approval? Is it satisfied if employees of other members of the controlled group make an initial identification of vendors subject to approval by an employee of the principal? How much weight is given to whether the principal negotiates or executes supply agreements? In some cases, contracts may be negotiated centrally (*e.g.*, in the United States), with the principal executing an agreement for its region if its management considers the contract to be desirable. How much weight is given in this instance? We request that the regulations address and answer these questions.

vii. *Control of logistics*. The seventh factor is "control of logistics." Is this factor satisfied if the principal dictates to the contract manufacturer the common carriers used to transport goods? How much weight is given to whether the principal negotiates/executes contracts with the common carrier? Again, in some cases, contracts may be negotiated centrally (*e.g.*, in the United States), with the principal executing an agreement for its region if its management considers the contract to be desirable. We request that the regulations clarify these questions.

viii. *Quality control*. The eighth factor is "quality control." Can this factor be satisfied entirely by remote review of quality reports? If periodic inspections are required, how often do they have to be made? Presumably, physical inspections should bear some relationship to actual quality issues. What if quality control is supervised remotely as in Example 4, discussed above? Example 4 describes a CFC that owns sophisticated software and network systems that remotely and automatically (without human involvement) perform quality control of

the property manufactured by the contract manufacturer, with the CFC employing a small number of computer technicians who monitor the software and network systems, developed by the domestic parent, to ensure that they are running smoothly and apply any necessary patches or fixes.

ix. *Direction of the development, protection, and use of trade secrets, technology, product design and design specifications, and other intellectual property used in manufacturing the product.* The ninth factor is "direction of the development, protection and use of intellectual property." As an initial matter, we note that this test is stated as conjunctive, but presumably is meant to be interpreted as disjunctive. Possible factors to be considered in evaluating control of the direction of development, protection, and use of intellectual property include: (1) control of a cost-sharing budget; (2) input from the manufacturing side regarding intellectual property needs and uses; or (3) protection of intellectual property from improper use through incurring costs attributable to intellectual property protection costs. Are trademarks a form of intellectual property for this purpose? If a CFC licenses intellectual property from its U.S. parent, for example, should it be given credit for directing the use of the intellectual property and protecting it from infringement, even if it is not the owner? We request that the regulations address and answer these questions.

c. Facts-and-Circumstances Analysis. Although the regulations provide that the substantial contribution test is a facts-and-circumstances test, and that the weight given to any activity will vary with the facts-and-circumstances of the particular business, neither the text of the regulations nor the examples provide much insight into how taxpayers or field agents should apply the facts-and-circumstances test. We note that in Example 2, the substantial contribution test was met where only three factors (product design, quality control and production oversight) were conducted by the branch.

Consider the following issues:

i. Should the weight given to any activity be based on the economic contribution of that activity to the CFC's profit?

ii. Are supervisory positions given more weight than subordinate positions? For example, if 50 supply-sourcing employees around the globe identify and qualify vendors in various countries, but the CFC employs a senior Director of Sourcing who is responsible for final approval of vendors and execution of supply contracts, how much credit does it receive? While a multinational group may centralize authority in a single entity, actual performance of many functions (*e.g.*, vendor identification) may be by geographically dispersed persons.

iii. Are activities that require constant activity given more weight than those that require only periodic activity?

iv. Are there any factors that should be superfactors in a particular industry?

v. To what extent are purely contractual assumptions/insurance of risk given weight, if at all?[33]

3. Employees.

The substantial contribution test currently requires that the activities be performed by "employees" of the CFC. There is no definition of that term.[34] Since section 954(d)(1) was intended to permit a CFC to avoid FBCSI only where the CFC itself manufactures the personal property, we believe that the definition of employee should include only those persons who in fact work for the CFC. Therefore, we suggest that the definition of employee be the same as a

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[33] For instance, is any weight given to the risks associated with ownership of the property?

[34] The use of the word employees is consistent with the attribution principle in other aspects of section 954. Treas. Reg. § 1.954-2(d)(1) (relating to active royalties, makes reference to the work of a staff of employees).

"common law employee," determined under U.S. federal tax principles.[35] This is the approach that the regulations under section 7874 adopt in defining substantial presence, although we would not include the 35-hour requirement imposed in that section. We would include individuals who are seconded to a CFC under circumstances that involve the same level of control and supervision by "permanent" employees of the CFC as would be expected if the seconded employees were themselves permanent employees.[36] We would also include leased employees if they are in fact controlled by the CFC in this sense. We would not, however, look to local law to define employee because we believe that it would be difficult to administer the regulations if the U.S. tax consequences were dependent on local concepts of employee.

We also recommend that similar principles apply to CFCs that are partners in partnerships for purposes of characterizing income of a CFC that sells in respect of its own sales of products manufactured by the partnership; employees of the partnership should be treated as employees of the CFC if the CFC, through its own employees, has direct legal control over the employees (*e.g.*, by reason of the CFC being a general partner of a partnership or managing member of a limited liability company). However, in this case, the CFC's relative economic interest in the partnership should be relevant in determining whether the CFC substantially contributed to the relevant manufacturing activity. We suggest that a CFC must have at least a 25% economic interest in a partnership before the activities of the partnership's employees alone can cause the CFC to substantially contribute to manufacturing. In such a case, activities of the partnership should be deemed a branch of the CFC if they would have been if conducted directly

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[35] Treas. Reg. § 1.7874-2T(d)(3) (group employee means common law employee who normally works 35 hours a week or more). Rev. Rul. 87-41, 1987-1 C.B. 296, identifies 20 factors the IRS uses in identifying who is a common law employee.

[36] We note that seconded employees will cause the CFC to have a branch. Also, we note that merely seconding employees without the CFC having its own employees might permit a non-substantive arrangement that could be used to avoid subpart F income.

by the CFC. Assume that a sales CFC owns an interest in an entity that is a partnership for U.S. tax purposes, and the employees of the partnership oversee the manufacturing of that product under circumstances that constitute a substantial contribution. The question is whether the sales income of the CFC is FBCSI.

First, assume that the CFC is a 99% limited partner and the general partner is unrelated. Here, we believe that the sales CFC should have FBCSI because the CFC does not control the partnership. Second, assume that the CFC is the 1% general partner and an unrelated party holds the remaining 99%. Again, we believe that the sales CFC should have FBCSI because, even though the CFC controls the partnership, the CFC does not have a sufficient interest to treat the employees as employees of the CFC (which is required for a substantial contribution). If, instead, the CFC was the general partner and owned a 25% or greater interest in the partnership, we believe that the CFC should not have FBCSI (absent the branch rule).

Finally, we do not believe that the term employee should include independent contractors or employees of affiliates.

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 a safe harbor under which a CFC that contributes at least a specific percentage of the costs of manufacturing personal property is deemed to have substantially contributed to its manufacture. Based on the concept of "substantial" generally and by analogy to the "substantive test" for manufacturing under the existing regulations, a possible safe harbor percent could be 20%. For purposes of determining the costs of manufacturing, personal property, research and development and other expensed items that contribute to the costs of manufacturing would be

included.[37] As suggested by the Preamble, we would not recommend taking into account the costs of raw materials and marketing intangibles.

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 economic contribution that constitutes a substantial contribution, but we do not believe that it should be relevant whether the related United States person or some other party contributes the balance.[38]

6. Branch-Related Issues.

a. Definition of "Branch or Similar Establishment."

Section 954(d)(1)(A)(2) and Treasury Regulation section 1.954-3(b)(1)(i) and (ii) provide that a branch or similar establishment located outside the country of incorporation of a CFC and through which a CFC carries on activities may be treated as a wholly-owned subsidiary of the CFC for purposes of determining FBCSI if the "branch or similar establishment" has substantially the same effect as if it were a wholly-owned corporation of the CFC. However, the Proposed Regulations do not define the term "branch or similar establishment" for this purpose. The definition of "branch or similar establishment" is fundamental to the operation of the FBCSI rules and therefore we request guidance on the definition of a "branch or similar establishment."

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[37] *Cf.* Section 1298(e)(1) (adjusted basis for purposes of the passive foreign investment company includes section 174 expenditures incurred during the taxable year and two preceding taxable years).

[38] We are aware that a different position was recently taken by the Treasury and the IRS in respect of section 954(e).

On the one hand, the statute requires a branch or similar establishment and most authorities interpreting the term branch require a meaningful presence in a jurisdiction. For example, Treasury Regulations under section 367 defines a branch as an integral business operation carried on by a U.S. person outside the United States which can be evidenced by a separate set of books and records and the existence of an office or other fixed place of business used by employees or officers in carrying out the business activities.[39] We note that if a narrow definition of branch is used, many taxpayers will be able to avoid FBCSI entirely by having the employees of a low-tax sales CFC substantially contribute to manufacturing activities in a high-tax jurisdiction either remotely or through occasional trips that do not establish a branch. However, other taxpayers may be unable to avoid a branch in a high-tax jurisdiction due to local law considerations or the nature of their business and may be subject to FBCSI. We are unaware of a tax policy reason for this distinction.

Alternatively, branch could be defined expansively to include activities in any jurisdiction in which a CFC is deemed to contribute substantially to manufacturing.[40] Thus, if a CFC that is incorporated in a low-tax jurisdiction substantially contributes to manufacturing conducted by an affiliate in a high-tax jurisdiction, the CFC would be deemed to have a branch in the high-tax jurisdiction and, therefore, would not be able to avoid FBCSI on the CFC's sales income in the low-tax jurisdiction. This definition is arguably more consistent with the FBCSI rules, which were designed to tax sales income "which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income," and the branch rule, which was designed to apply if "the combined effect of the tax treatment accorded the branch by the country of incorporation of the CFC and the country of operation of

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[39] Treas. Reg. §1.367(a)-6T(g).

[40] See footnote 20.

the branch, is to treat the branch as substantially the same as if it were a subsidiary corporation organized in the country in which it carries on its business."[41] However, this definition will tend to increase the FBCSI of taxpayers, which the Preamble to the Proposed Regulations suggests would be anti-competitive.

We recommend that the IRS and Treasury affirmatively articulate their position on this fundamental policy issue and that the final regulations clearly define branch and indicate whether and under what circumstances taxpayers may substantially contribute to manufacturing without establishing a branch that would subject them to the branch rules. In any event, we do not believe that local law treatment should be relevant to the definition of branch nor do we believe that the definition need be consistent with the definition of branch contained under the section 367 regulations.

7. Presumption Regarding Lack of Substantial Contribution.

Proposed Treasury Regulation section 1.954-3(b)(2)(ii)(c)(2) provides that if a branch or the remainder of a CFC meets the physical manufacturing test, then the remainder of the CFC (or any branch treated as the remainder of the CFC) is presumed to fail to meet the substantial contribution test with respect to the same item of personal property. To rebut the presumption, the CFC must demonstrate "to the satisfaction of the Commissioner" that the remainder of the CFC (or any branch treated as the remainder of the CFC) makes a substantial contribution. If the burden is met, the remainder of the CFC (or any branch treated as part of the remainder) if treated as a separate corporation apart from the manufacturing branch under the "treatment as a separate corporate rule", is deemed to manufacture the personal property. Although the Proposed Regulations provide an example in which the CFC successfully rebuts the

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[41] S. Rep. No. 1881, 87th Congress, 2d Session; H.R. 10650 at ¶ IX.

presumption, there is no indication of the standards that must be satisfied to rebut the presumption.[42]

The Preamble states that Treasury and the IRS believe that the presumption is necessary as a backstop to the branch rule and that in the absence of a rebuttable presumption, a rule permitting a CFC to qualify for the manufacturing exception based upon its contribution would prove difficult to administer. Such a rule would encourage CFCs to elect classifications of subsidiaries that engage in manufacturing activities as disregarded entities, obscuring the division of manufacturing, labor and income between the CFC and its branches.

The case-law involving the phrase "in the discretion of the Commissioner" has generally involved section 166.[43] Section 166 allows a taxpayer to take a deduction for losses incurred because of bad debts. Section 166(a) provides that a taxpayer may take a deduction for a debt

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[42] *See* Prop. Treas. Reg. § 1.954-3(b)(2)(ii)(c)(2), Example 1.

[43] *See, e.g., Roth Steel Tube Co. v. Comm'r*, 620 F.2d 1176 (6th Cir. 1980) (in allowing a section 166(c) deduction for an addition to a bad debt reserve, the grant of "in the discretion" of the Commissioner limits the scope of judicial review over the Commissioner's determinations); *Atlantic Discount Co. v. United States*, 473 F.2d 412, 414 (5th Cir. 1973) (in assessing taxpayer's evidence in computing its section 166(c) additions to bad debt reserves, the court noted that the statute permits only such additions as are allowed "in the discretion of the Secretary or his delegate," and emphasized the "heavy burden" that taxpayer must carry to overcome that discretion); *Maverick-Clarke Litho Co. v. Comm'r*, 180 F.2d 587 (5th Cir. 1950) (the Commissioner under section 23(k)(1), the applicable statute at the time, was vested with discretion in determining what constituted a reasonable addition to a reserve for bad debts and his determination is entitled to more than a mere presumption of correctness, but instead required the heavy burden of showing that the Commissioner abused his discretion). There have also been a number of cases dealing with section 482 that have involved a similar abuse of discretion standard. *See e.g., Kaps Warehouse, Inc. v. Comm'r*, 74 T.C.M. (CCH) 18 (1997) (where the Commissioner determines that an allocation under section 482 is necessary to prevent either tax evasion or the distortion of a taxpayer's income, the determination must stand unless the taxpayer proves that the determination is unreasonable, arbitrary or capricious); *Westreco, Inc. v. Comm'r*, 64 T.C.M. (CCH) 849 (1992) (the Commissioner's authority to make allocations under section 482 is broad and her determination of a deficiency is presumptively correct and must be sustained absent a showing that she has abused her discretion); *Eli Lilly v. Comm'r*, 84 TC 996 (1985) (the Commissioner has broad discretion in his application of section 482 so that his determination will be upheld unless the taxpayer proves it to be arbitrary, capricious or unreasonable); *Foster v. Comm'r*, 80 TC 34 (1983) (the Commissioner enjoys broad discretion under section 482 and in applying that section his determinations must be sustained absent an abuse of discretion that is unreasonable, arbitrary or capricious).

that becomes worthless within the taxable year. Sections 166(c) and (f) allow a taxpayer, "in the discretion of the Secretary," to take a deduction for a reasonable addition to a reserve established to cover future bad debts. In *Thor Power Tool Co. v. Commissioner,*[44] the Supreme Court discussed section 166(c) and held that the Commissioner's determination of a reasonable addition "must be sustained unless the taxpayer proves that the Commissioner abused his discretion." The taxpayer is said to bear a "heavy burden" in this respect. The taxpayer must show not only that its own computation is reasonable but also that the Commissioner's computation is unreasonable and arbitrary (*i.e.*, it represents an abuse of discretion).

We acknowledge the concern identified in the Preamble and note that the stated rationale that contract manufacturing is used to leverage expertise and cost efficiencies may have little application in this context. Nevertheless, we believe that the abuse of discretion standard is unjustifiably high. We recommend that taxpayers be required to rebut the presumption by clear and convincing evidence of a substantial contribution (to be determined by a court and not the Commissioner).

8. Substantial Contributions to Manufacturing That Produce FBCSI.

The Proposed Regulations are generally viewed as pro-taxpayer because they allow CFCs to establish that their substantial contributions give rise to manufacturing that may exempt a CFC from FBCSI. However, the Proposed Regulations are unclear as to whether a substantial contribution to manufacturing by a CFC may also cause the CFC to earn FBCSI that it otherwise would not. (This issue will be important only if the substantial contribution results in or its deemed to result in a branch.)

> Example. A CFC has two branches. The first branch is a sales branch located in a low-tax jurisdiction. It purchases a product from an unrelated third-party

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[44] 439 U.S. 522 (1979).

manufacturer and sells it to unrelated customers. The second branch performs functions that constitute a substantial contribution to manufacturing with respect to the product that is sold by the sales branch; this branch is in a high-tax jurisdiction.

Under current law, the taxpayer arguably does not earn FBCSI because it merely buys from an unrelated manufacturer and sells to unrelated customers. However, if the activities conducted by the second branch constitute a substantial contribution to the manufacturing then, under the Proposed Regulations, the CFC would be treated as engaged in manufacturing activity. If the sales branch is further deemed to sell the manufactured product on behalf of the second branch, it would potentially be subject to the branch rules. [45]

Although the result appears to be counterintuitive, there is a strong policy reason for the substantial contribution rule and the branch rule to apply under these facts. If the second branch in the example is substantially contributing to the manufacturing, then the income earned by the low-tax sales branch reflects the value added by an employee of the second branch located in a high-tax jurisdiction and, absent application of the substantial manufacturing and branch rules, the effect of the structure would be to permit the taxpayer to separate the manufacturing income and sales income to obtain a lower rate of tax on the income.[46]

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[45] The "ordinary treatment" rule arguably does not apply under these facts to eliminate FBCSI. As mentioned above, the ordinary treatment rule very generally provides that income derived by a branch or similar establishment, or by the remainder of a CFC, is not treated as FBCSI if the income would not be so considered if it were derived by a separate CFC under like circumstances. Treas. Reg. § 1.954-3(b)(1)(ii)(e). In the example, if the "second" branch were treated as a separate CFC engaged in manufacturing, and the remainder of the CFC were treated as purchasing the manufactured product from this separate CFC, the sales income would have been considered FBCSI if derived by a separate CFC under like circumstances as it would not have met any of the manufacturing tests.

[46] *See* S. Rep. No. 1881, 87th Cong., 2d Sess. at 84 (1962) ("The sales income with which your committee is particularly concerned is sales income of a selling subsidiary (whether acting as principal or agent) which has been separated from manufacturing activities of a related corporation thereby to obtain a lower rate of tax for the sales income."). Of course this same policy, standing alone, would also argue for automatic treatment of a substantial contribution as a branch.

However, this result is not clear under the Proposed Regulations. Moreover, because the Preamble suggests that the Proposed Regulations are intended to be taxpayer-favorable, and treating the income of the sales branch in the example as FBCSI would be adverse to taxpayers, it is not clear what the drafters of the Proposed Regulations intended. Therefore, if the intent is that example that income should be FBCSI, then the final regulations should clearly provide that if a branch substantially contributes to manufacturing conducted by a third party and another branch or the remainder of the CFC purchases the manufactured property from the third-party manufacturer, the substantial contributor is deemed to have engaged in manufacturing. In addition, in this situation, the IRS would be asserting that a CFC is a substantial contributor and the taxpayer would be arguing that the CFC does not substantially contribute. In light of the factor-based emphasis of the substantial contribution test, this may be a difficult argument for the IRS to make in the face of a taxpayer who argues that its CFC's employees contribute little to manufacturing. We also note that, to the extent that the taxpayer is able to cause the activities to be conducted by an entity that is treated as a corporation for U.S. tax purposes, the activities would not be considered for purposes of the substantial contribution test. Thus, planning can resolve this issue, but implementation may be a significant undertaking.

We urge the Treasury Department and the IRS to confront and directly address this issue in the final regulations. If, indeed, a substantial contribution may cause a CFC to earn FBCSI where it does not under current law, the Treasury and the IRS should consider delaying the effective date of the final regulations in this regard to allow taxpayers to restructure their foreign operations in light of the regulations. This effect is not clear from the Preamble or the Proposed Regulations, and it would affect a number of taxpayers. Delay would be especially appropriate because the Preamble suggests that the Proposed Regulations are intended to be taxpayer

friendly, and taxpayers are not currently on notice as to this adverse consequence of the regulations.

9. Appropriate Testing Rate Where There Are Multiple Branches.

Where there are multiple branches and no branch qualifies for the physical manufacturing standard or the predominant contribution standard, Proposed Treasury Regulation section 1.954-3(b)(1)(ii)(3) provides that the location of manufacturing will be the branch or head office where manufacturing activity is performed and which imposes the highest effective rate of tax. The effect of this rule is to increase the possibility that the tax rate disparity test will be met, thereby increasing possible FBCSI, and it can lead to harsh and arguably inappropriate results in extreme situations. (These inappropriate results increase if substantial contributions automatically give rise to a branch for purposes of the branch rules and if substantial contributions can give rise to FBCSI, as discussed in Parts IV.6 and IV.8, above. On the other hand, we note that a sales branch would be able to show that it substantially contributed to the manufacturing, thereby qualifying for the manufacturing exception.)

> Example. Assume that a CFC has four branches. The CFC purchases a product manufactured by a related party and sells the product to unrelated customers. Branch A is a sales branch with a 17.5% statutory rate. Branch B is a sales branch with a 28% rate. Branch C is an oversight branch with a 33.3% statutory rate. Assume that Branch C contributes 20% of the value of the product. Branch D is also an oversight branch with a statutory rate of 20%. Branch D contributes 20% of the value of the product (the third-party manufacturer contributed 60% of the value of the product). Assume that Branches C and D substantially contribute to manufacturing but neither of them physically manufactures the product.

Under the Proposed Regulations, because no branch physically manufactures the product or provides the predominant amount of the contribution, Branch C would be treated as the manufacturing branch (because it has the highest rate) and its 33.3% statutory rate would be the relevant rate for purposes of applying the tax disparity test, even though Branch C contributes

only 20% of the value of the product and only 50% of the substantial contribution. As a result, all of the Branch B sales income would be FBCSI. This result appears inappropriate.[47]

We suggest, instead, that the comparison rate be the weighted average rate based on relative amounts of taxable income.

	Relative Income[48]	Statutory Rate	Weighted Average Rate
Branch C	50%	33.3%	16.65%
Branch D	50%	28%	14.0%
Weighted Average Rate			30.65%

Applying the weighted average rate, Branch A (with a 17.5% rate) would produce FBCSI. However, Branch B (with a 28% rate) is within 5% of the average weighted rate (of 30.65%), so Branch B would not generate FBCSI.

While we believe that a weighted average rate calculation is more accurate, we recognize that it requires a determination of relative contributions. We propose using the tax base as a proxy for the contribution. Even assuming the tax base in each relevant country can be used as a proxy for contribution, there would be complexities resulting from tax base differences and audit disputes. Accordingly, simplifying assumptions and safe harbors might be considered. We recognize that the Treasury Department and the IRS rejected a rule that would allow taxpayers to use the mean effective rule of tax so long as it was within a certain number of percentage points of the highest effective rule because of concerns with the complexity of such a rule. An alternative would be to retain the highest rate test but exclude any branch that contributes less

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[47] We note that FBCSI will also result if the manufacturer is unrelated and (as discussed in Part IV.8.), substantial contributions can give rise to FBCSI.

[48] Taxable income against which the rate is applied as a percent of the total taxable income.

than 10% of the relative contribution (so long as the branch is not the most substantial contribution).

Finally, the Proposed Regulations do not provide guidance on the extent of activity that is required to meet the predominant contribution test. We recommend that this standard be clarified.[49]

10. Effective Rate for Physical Manufacturing.

For purposes of applying the tax disparity test to physical manufacturing conducted in multiple branches, the Proposed Regulations look to the branch or the remainder of the CFC located or organized in the jurisdiction that would impose the lowest effective rate (even if that branch is not the predominant branch).

We question whether the lowest effective rate is appropriate for physical manufacturing. Presumably, the rationale for the rule is that it is harder for taxpayers to shift physical manufacturing into low-tax jurisdictions. However, we question this premise and note that the rule strongly favors taxpayers that engage in physical manufacturing over those that do not.

> Example. A CFC has two branches. One is located in a high-tax jurisdiction and employs 5,000 employees who engage in physical manufacturing. The branch contributes 90% of the value of the product. The other branch is located in a low-tax jurisdiction and employs 100 employees who engage in physical manufacturing. The branch contributes 10% of the value of the product.

Under the Proposed Regulations, the rate of the low-tax jurisdiction would be applied for purposes of the tax rate disparity test, and therefore the CFC would be unlikely to generate FBCSI.

We suggest consideration of a weighted average tax rate to be applied to physical manufacturing as well as substantial contributions (or, alternatively, a proportionately small

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[49] As noted earlier, informal discussions with the IRS have indicated that it is the highest qualitative level of contribution, even if that contribution is less than the majority of the contribution level.

branch be excluded) to apply greater parity to physical manufacturers and substantial contributors.

11. Hypothetical Tax Rate Calculation.

As previously noted, the use of a manufacturing branch or similar establishment will be considered to have substantially the same tax effect as if it were a wholly-owned subsidiary corporation of the CFC if the income that would be considered earned on behalf of a related person (that is, the sales income) is taxed in the year when earned at an effective rate of tax that is less than 90% of, and at least 5 percentage points less than, the "hypothetical effective tax rate."

The hypothetical effective tax rate is the effective tax rate that the country in which the manufacturing branch is located would apply if, under that country's laws, (1) all of the CFC's income was considered derived from sources within, and from doing business through a permanent establishment in the country, received in the country and allocable to such permanent establishment, and (2) the CFC was treated as created or organized under the laws of, and managed and controlled in, the country.[50]

However, the calculation may not appropriately take into account certain rate holidays. For example, suppose that the country in which a manufacturing branch is located, such as Singapore, provides a tax holiday for manufacturing income. In this instance, we believe that the hypothetical rate should be calculated after giving effect to such anticipated tax holiday.[51] We understand that this methodology is consistent with industry practice. However, to prevent possible whipsaw, we suggest that the taxpayer be obligated to provide a statement with its

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[50] Treas. Reg. § 1.954-3(b)(1)(ii)(b).

[51] There are additional related issues that need to be addressed, including how to deal with tax attributes of the hypothetical entity being tested as well as the impact of tax rate reductions on distributions.

return indicating that it has made such a calculation and be prepared to provide documentation regarding the calculation of the rate.[52]

12. Allocation of Income Within a CFC.

As discussed, the "sales branch rule" provides that the use of a sales branch will have substantially the same tax effect as a subsidiary if the income allocated to the branch is taxed at an effective rate that is less than 90% of, and at least 5 percentage points lower than, the effective tax rate at which such income would be taxed under the laws of the country in which the CFC is created or organized if, under the laws of such country, the entire income of the CFC were considered derived by the corporation from sources within such country by doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the corporation were managed and controlled in such country.[53] If the sales branch rule applies, income attributable to the branch's sales activities is treated as derived from the sale of products on behalf of a related person that, in turn, could be classified as FBCSI.

If the manufacturing occurs in a branch then the manufacturing branch prong of the tax disparity rules applies. The manufacturing branch rule test is met if the sales income of a CFC is, by statute, treaty obligation or otherwise, taxed in the year when earned at an effective rate of tax that is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income under the laws of the country in which the manufacturing branch or similar establishment is located.[54] If the manufacturing branch rule applies, income

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[52] We note that while this is consistent with industry practice, it does not appear to have been followed in FSA 2002-20005 (Feb. 5, 2002), 2002 TNT 97-10 at footnote 5.

[53] Treas. Reg. § 1.954-3(b)(1)(i).

[54] Treas. Reg. § 1.954-3(b)(1)(ii).

attributable to the CFC's sales activities is treated as derived from the sale of products on behalf of a related person that, in turn, could be classified as FBCSI.

Neither the existing final regulations nor the Proposed Regulations explain how a CFC should allocate income derived by a manufacturing branch, a sales branch or by its remainder for purposes of determining FBCSI. They do provide that the use of a branch has substantially the same tax effect as if the branch were a wholly-owned subsidiary if the branch results in a significant reduction in the effective rate of tax imposed on the sales income. The regulations are, therefore, intended to require an inclusion under subpart F where "mobile" sales income is subject to a lower effective rate of taxation under local law. This test appears, therefore, to compare one local rate to another.

We recommend that, for purposes of applying the tax disparity tests, the final regulations expressly state that income is allocated to a branch or the remainder of the CFC based on the books and records for local tax purposes. As a matter of policy, this approach seems consistent with the intent of section 954(d) to require the subpart F inclusion to match the sales income as computed in accordance with the local country books and records.

13. Treatment of Disregarded Payments by a Branch to the Head Office.

It is unclear whether disregarded payments are treated as FBCSI under the Proposed Regulations. Consider the following example:

> Example. Assume that a CFC ("FS") has entered into a cost-sharing agreement with its U.S. parent so that FS owns the foreign rights to intangibles used in the manufacture and design of Product X. The tax rate in FS's country of incorporation is 0%. Further assume FS owns 100% of an entity that has elected to be treated as disregarded for U.S. tax purposes and which is taxed at a rate of 20% in its home country ("Principal"). In addition, FS owns 100% of a sales entity which has elected to be treated as disregarded for U.S. tax purposes (*i.e.*, the "Sales Branch") and which is taxed at a rate of 10% in its home country. Assume also that Principal "substantially contributes" to the manufacturing process of Product X under Proposed Treasury Regulation section 1.954-

3(a)(4)(iv) and sells the product to the sales entity for $95. Assume that the physical manufacturing takes place outside of FS's country of incorporation. Principal pays the head office of FS $85 in royalties in connection with the manufacturing and design of Product X. Finally, Sales Branch sells Product X for $100 to customers for use outside of FS's country of incorporation.

Since the Sales Branch rate of 10% is greater than that of the FS's rate of 0% in its country of incorporation, the sales branch rule should not apply. As a result no income from any sales should be characterized as FBCSI. Under the manufacturing branch rule in the Proposed Regulations, since there is no physical manufacturing and Principal provides the predominant contribution to the manufacturing process, Principal is treated as the manufacturing branch. However, since the Sales Branch rate of 10% is less than 90% of Principal's manufacturing branch rate of 20%, and the rate is 5 percentage points less than 20%, the manufacturing branch rate disparity test will apply to treat the remainder of the FS (*i.e.*, the head office) as earning FBCSI. However, the amount of FBCSI is unclear. Is $5 of the head office's income FBCSI (representing the income from sales of the product) or is $90 (representing both the sales income and the royalty)? The regulations should clarify this question.

On balance, we believe that only the $5 of sales income should be FBCSI. On the one hand, since the royalty is disregarded for U.S. tax purposes, $95 has been shifted to a low-tax jurisdiction and, because the remainder of FS, through the check-the-box activities of the Sales Branch, engages only in sales activity for U.S. tax purposes, the entire $95 might be treated as sales income.

On the other hand, the FBCSI rules are concerned only with the shifting of high-tax manufacturing income to low-tax jurisdictions to avoid foreign tax. While the payment of the royalty to the head office reduces the effective rate of Principal, this reduction arises solely as a result of the characterization of that income as a deductible royalty for foreign tax purposes and not a shift of what Principal's jurisdiction would view as manufacturing income to FS's head

office. Under this theory, the royalty should not give rise to FBCSI. (Likewise, if the head office loaned funds to Principal and Principal paid deductible interest to the head office, the interest should not be treated as FBCSI.)

The final regulations support this approach. Treasury Regulation section 1.954-3(b)(2)(ii)(c) provides that, "with respect to manufacturing activities performed by a branch, purchasing or selling activities performed by or through the remainder" of the CFC with respect to the property "shall be treated as performed on behalf of the branch or similar establishment." Thus, only the income relating to the selling activity (and not manufacturing or royalty income) appears to be treated as subpart F income.