

March 20, 2008

Foreign Base Company Sales Income

Proposed Regulations Modify the Manufacturing Exception to Foreign Base Company Sales Income

SUMMARY

On February 27, 2008, the IRS proposed regulations (the “Proposed Regulations”) that would modify the “manufacturing exception” to what constitutes foreign base company sales income for purposes of subpart F of the U.S. Internal Revenue Code. Broadly speaking, the Proposed Regulations:

- provide that income of a controlled foreign corporation qualifies for the “manufacturing exception” in the foreign base company sales income regulations only if the controlled foreign corporation satisfies the specific tests listed in the regulations with its own employees, but
- permit income to qualify for the manufacturing exception if the controlled foreign corporation “substantially contributes” through its own employees to the manufacture of the property that is sold;
- reject the arguments that, under the present regulations
 - any transformation of property that is purchased by a controlled foreign corporation, even if the controlled foreign corporation has little or no role in the transformation, takes the income from the sale out of foreign base company sales income, and
 - activities carried on by employees of a contract manufacturer may be attributed to the controlled foreign corporation in determining whether the manufacturing exception applies;
- set forth rules for determining when a manufacturing branch of a controlled foreign corporation is to be treated as a separate corporation in situations where the controlled foreign corporation has multiple branches involved in manufacturing; and
- make other conforming and clarifying changes to Treasury Regulations § 1.954-3.

While effective only for years beginning on or after publication as final regulations, the Proposed Regulations may be relied on until adoption by taxpayers who elect to apply the regulations in their entirety to all open years.

The preamble to the Proposed Regulations requests comments on a number of specific issues.

BACKGROUND

U.S. federal income tax law requires that a United States shareholder which owns (directly, indirectly or by application of constructive ownership rules) 10% or more of the voting power of a “controlled foreign corporation” (a “CFC”) include in income its share of the CFC’s “subpart F income” each year, whether or not distributed. A CFC is a foreign corporation if more than 50% in voting power or value of its stock is owned by one or more 10% United States shareholders. Subpart F income includes several types of income, but in particular, includes “foreign base company sales income” (“FBCSI”).

In general, FBCSI is income earned by a CFC from buying or selling personal property from or to or on behalf of related persons¹ if the personal property is (A) manufactured, produced, grown or extracted outside of the country in which the CFC is organized and (B) used, consumed or disposed of outside of such country.²

In order to prevent the use of low-taxed branches to avoid the FBCSI rules, a branch of a CFC located outside of the CFC’s country of organization is generally treated as a separate corporation from the CFC if either (i) the effective tax rate applied by the branch’s country to the branch is less than 90% of, and at least 5 percentage points less than, the effective tax rate imposed on the CFC by its country of organization or (ii) in the case of a manufacturing branch, the effective tax rate imposed on the remainder of the CFC by its country of organization is less than 90% of, and at least 5 percentage points less than, the effective tax rate imposed on the manufacturing branch by its country.³ The effect of treating a branch as a separate corporation is to treat its income as FBCSI unless it satisfies the effective tax rate test.⁴

Treasury Regulations originally adopted in 1964 provide two exceptions to FBCSI for income from the sale of manufactured property. First, FBCSI does not include income from the sale or purchase of personal property that is manufactured, produced, constructed, grown or extracted in the CFC’s country of organization (the “Same Country Exception”).⁵ Second, FBCSI does not include income from the sale

¹ More specifically, (i) buying personal property from related persons and selling it to unrelated persons or selling personal property on behalf of related persons or (ii) buying personal property from unrelated persons and selling it to related persons or buying personal property on behalf of related persons.

² Section 954(d) of the U.S. Internal Revenue Code of 1986, as amended (the “Code”).

³ Treas. Regs. § 1.954-3(b)(1).

⁴ As stated in the preamble to the Proposed Regulations, “[a]bsent the branch rule, a CFC could engage in purchasing or manufacturing activities with respect to personal property in a high-tax jurisdiction and selling activities with respect to the property in a low-tax jurisdiction without incurring FBCSI....because the same person would be purchasing or manufacturing the personal property and selling the personal property”.

⁵ Treas. Regs. § 1.954-3(a)(2).

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of personal property that is manufactured, produced or constructed by the CFC from personal property that it has purchased (the “Manufacturing Exception”).⁶

While the IRS at one point took the position that a contract manufacturer in a country outside of the CFC’s country of organization was a branch that was subject to the branch rule, this position was rejected by the courts⁷ and the IRS subsequently ruled that it would not treat a contract manufacturer as a branch.⁸ That ruling, however, did not clarify the extent to which a CFC that used contract manufacturing or similar arrangements for activities outside of its country of organization could qualify for the Manufacturing Exception.

Under the existing Manufacturing Exception, property is treated as manufactured by the CFC if either (i) the property is substantially transformed (and examples include the conversion of wood pulp to paper) or (ii) the property is used as a component part of personal property and the CFC conducts substantial operations in connection with the purchased property that are generally considered to constitute the manufacture, production or construction of property (either (i) or (ii), or both, the “Physical Manufacturing Test”).⁹ The Proposed Regulations primarily amend the rules relating to the Manufacturing Exception to (i) set out the circumstances in which a CFC that uses contract manufacturing may qualify for this exception and (ii) to reject any argument that (a) any transformation of property, even if not involving the CFC, will take income out of FBCSI and (b) a CFC may qualify for the Manufacturing Exception by attribution of the activities of one or more contract manufacturers. The Proposed Regulations also detail how the branch rules are to be applied in cases where multiple branches contribute to the manufacturing activities of the CFC.

THE PROPOSED REGULATIONS

Clarification of the Scope of the Manufacturing Exception

The Proposed Regulations “clarify” that the only manufacturing exceptions to FBCSI treatment are the Same Country Exception and the Manufacturing Exception.¹⁰ The Proposed Regulations go on to “clarify” that a CFC qualifies for the Manufacturing Exception only if the activities that constitute

⁶ Treas. Regs. § 1.954-3(a)(4).

⁷ Rev. Rul. 75-7, 1975-1 C.B. 244, which was rejected by the Tax Court in *Ashland Oil, Inc. v. Comm’r*, 95 T.C. 348 (1990) and *Vetco, Inc. v. Comm’r*, 95 T.C. 579 (1990).

⁸ Rev. Rul. 97-48, 1997-2 C.B. 89, which stated that the “activities of a contract manufacturer cannot be attributed to a controlled foreign corporation for the purposes of” determining when income was FBCSI or to treat the CFC as having a branch outside its country of organization.

⁹ Treas. Regs. § 1.954-3(a)(4)(ii) and (iii).

¹⁰ Prop. Regs. § 1.954-3(a)(1).

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manufacturing are performed through the CFC's own employees.¹¹ Taxpayers have in the past argued that there is no FBCSI if the property purchased or sold by the CFC is different from the property sold or purchased by the CFC because the property is transformed, through manufacturing or otherwise, even if this manufacturing or other transformation occurs outside of a CFC's jurisdiction and the CFC performs little or no part of the manufacturing or other transformation. The preamble specifically states that the Treasury Department and the IRS believe that this position is contrary to current law.

Substantial Contribution Test

The Proposed Regulations add a new test (the "Substantial Contribution Test") that, if satisfied by a CFC, would allow income of the CFC to qualify for the Manufacturing Exception even though the CFC does not physically manufacture the product through its own employees (*i.e.*, the CFC does not satisfy either prong of the Physical Manufacturing Test of the present regulations). This new test is intended by Treasury as a "response to the growing importance of contract manufacturing and other manufacturing arrangements" in today's global economy.

- Under the Substantial Contribution Test, income from the sale of personal property will qualify for the Manufacturing Exception if the CFC makes a substantial contribution through the activities of its employees to the manufacture, production or construction of the personal property.¹²
- The Substantial Contribution Test will be applied only in circumstances where the manufacturing activities with respect to the personal property that is sold would have qualified for the Manufacturing Exception had the CFC's own employees performed such activities.¹³
- The Proposed Regulations set out the following activities as examples of activities to be considered in determining whether the Substantial Contribution Test is satisfied:
 - Oversight and direction of the manufacturing, construction or production activities or process.
 - Performance of activities that are considered in, but not sufficient to satisfy, the Physical Manufacturing Test.
 - Control of raw materials, work-in-process and finished goods.
 - Management of the manufacturing profits.
 - Material selection.
 - Vendor selection.
 - Control of logistics.
 - Quality control.
 - Direction of the development, protection and use of trade secrets, technology, designs and other intellectual property.¹⁴

¹¹ Prop. Regs. § 1.954-3(a)(4)(i).

¹² Prop. Regs. § 1.954-3(a)(4)(iv)(a).

¹³ Prop. Regs. § 1.954-3(a)(4)(iv)(a).

¹⁴ Prop. Regs. § 1.954-3(a)(4)(iv)(b).

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- The Substantial Contribution Test is presumed to be inapplicable to a CFC that has a branch which:
 - satisfies the Physical Manufacturing Test; and
 - is treated as a separate corporation under the branch rules described in more detail below.

This presumption can be rebutted by demonstrating to the IRS that the remainder of the CFC (or other branches of the CFC) do in fact make a substantial contribution to the manufacture of that item of property.¹⁵

Multiple Branches Engaged in Manufacturing

As described above, a branch of a CFC outside of the CFC's country of organization is treated, under certain circumstances, as a separate corporation for determining whether income is FBCSI. The Proposed Regulations set forth rules clarifying when branches are treated as separate corporations in situations where multiple branches (and/or the remainder of the CFC) are engaged in manufacturing. For purposes of this discussion, "branch" generally includes a remainder of a CFC.

- If each branch manufactures separate items of property, the tests to determine whether a branch should be treated as a separate corporation are separately applied to each branch.¹⁶
- Where multiple branches of a CFC jointly manufacture the same items of property, the location of the manufacturing for purposes of determining whether any branch should be treated as a separate corporation is:
 - Where only one branch satisfies the Physical Manufacturing Test, that branch.¹⁷
 - Where more than one branch independently satisfies the Physical Manufacturing Test, the branch with the lowest tax rate that satisfies the Physical Manufacturing Test.¹⁸
 - Where none of the branches satisfy the Physical Manufacturing test but the CFC as a whole satisfies the Substantial Contribution Test, the branch that provides the predominant amount of the CFC's contribution to manufacturing (determined by weighing each branch's relative contribution based on the facts and circumstances test of the Substantial Contribution Test).¹⁹
 - Where no single branch provides a predominant amount of the CFC's contribution to manufacturing but the CFC as a whole satisfies the Substantial Contribution Test, the branch that provides some contribution to manufacturing and that is subject to the highest tax rate.²⁰
- The Proposed Regulations also state that a non-manufacturing branch treated as a separate corporation will not include any other branch that would be treated as a separate corporation if tested against such non-manufacturing branch.²¹

¹⁵ Prop. Regs. § 1.954-3(b)(2)(ii)(c)(2).

¹⁶ Prop. Regs. § 1.954-3(b)(1)(ii)(c)(2).

¹⁷ Prop. Regs. § 1.954-3(b)(1)(ii)(c)(3)(b).

¹⁸ Prop. Regs. § 1.954-3(b)(1)(ii)(c)(3)(b).

¹⁹ Prop. Regs. § 1.954-3(b)(1)(ii)(c)(3)(c).

²⁰ Prop. Regs. § 1.954-3(b)(1)(ii)(c)(3)(e).

²¹ Prop. Treas. Regs. § 1.954-3(b)(2)(ii)(a).

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Other Conforming and Clarifying Changes

The Proposed Regulations make some other conforming and clarifying changes.

- Conforming changes are made to the Same Country Exception to ensure that it is not affected by the changes made to the Manufacturing Exception.²²
- The Proposed Regulations clarify that a manufacturing branch can exist only if the CFC is treated as satisfying the Manufacturing Exception, and therefore provisions relating to branches cannot cause income that is FBCSI to be treated as not FBCSI.²³
- The Proposed Regulations also clarify that a branch that purchases from an unrelated person and sells to an unrelated person does not generate FBCSI where the rest of the CFC has no connection with the property sold.²⁴

Effective Date

The Proposed Regulations will apply to taxable years of CFCs beginning on or after the date the Proposed Regulations are published as final regulations and for taxable years of United States shareholders in which or with which such taxable years of the CFCs end. However, taxpayers may, until the adoption of final regulations, rely on the Proposed Regulations if they are applied in their entirety to all open tax years.

Request for Comments

The Treasury Department is requesting comments generally on the Proposed Regulations, but in particular, comments are requested on:

- Whether safe harbors (such as mandatory activities, value, cost and/or compensation based tests or tax rate based tests) should be added to the Substantial Contribution Test.
- Whether activities performed by individuals not on a CFC's payroll but controlled by employees of the CFC should be treated as performed by employees of the CFC.
- Whether an anti-abuse rule should be added to the Substantial Contribution Test to address situations where a United States person that is related to the manufacturing CFC provides a significant contribution to the manufacture of the property.
- Whether a CFC with a branch that satisfies the Physical Manufacturing Test should be permitted to rebut the presumption that the remainder of the CFC satisfies the Substantial Contribution Test.
- The consequences of, and alternatives to, the provision dealing with multiple branches of a CFC where no branch provides a predominant amount of the CFC's contribution to manufacturing. One alternative considered by Treasury was the use of an average effective tax rate rather than the highest effective tax rate.

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²² Prop. Regs. § 1.954-3(a)(2).

²³ Prop. Regs. § 1.954-3(b)(1)(ii)(a) and (b)(2)(ii)(e).

²⁴ Prop. Regs. § 1.954-3(b)(2)(ii)(e). Modifications are also proposed to §1.954-3(b)(2)(i)(b), (b)(2)(ii)(b) and (b)(4), Example 3 to address taxpayer concerns in this regard.

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