

## A Note From the Editor-in-Chief

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### Proposed Subpart F Contract Manufacturing Regulations

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The IRS and the Treasury recently released proposed regulations concerning contract manufacturing arrangements involving controlled foreign corporations (CFCs).<sup>1</sup> They address the application of the subpart F manufacturing exception and the manufacturing branch rule.

Income derived by a CFC from the sale of products that it manufactures is excluded from the definition of foreign base company sales income (FBCSI).<sup>2</sup> The current regulations define manufacturing as the physical transformation, conversion or assembly of purchased property, and the Tax Court has broadly interpreted this definition (*e.g.*, assembly of sunglasses).<sup>3</sup>

Neither the Code nor the current regulations directly address the application of the manufacturing exception to sales income derived by a CFC that hires a contract manufacturer to manufacture, on its behalf, the property sold. For many years, the IRS, based on general tax principles, treated a CFC principal that provides the intellectual property, has the risk of loss, and controls the manufacturing process as engaging in the manufacturing activities of the business manufacturer (*i.e.*, "attribution").<sup>4</sup> Although there were no changes to the Code or regulations, the IRS reversed itself in Rev. Rul. 97-48,<sup>5</sup> asserting that the activities of a contract manufacturer cannot be attributed to a CFC principal for purposes of the manufacturing exception. Nevertheless, this is widely considered as an incorrect application of the relevant statute, regulations and case law. Indeed, the Tax Court has expressed a view contrary to Rev. Rul. 97-48, and in 2004 the then-Chairman of the Senate Finance Committee stated that the IRS position may not be sustainable under current law.<sup>6</sup>

The proposed regulations would add a new definition of manufacturing that applies to contract manufacturing arrangements. A CFC principal will be considered as manufacturing the property it sells if, acting through its own employees, it makes a "substantial contribution" to the manufacture of the property sold ("non-physical manufacturing"). Relevant factors taken into account include, but are not limited to the following: oversight and direction of the physical manufacturing activities or process (including management of risk of loss); control of raw materials, work-in-process and finished goods; management of logistics; materials and vendor selection; quality control; and direction of the development, protection, and use of intellectual property used in manufacturing the product.



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The weight given to any particular activity will vary based on the facts and circumstances of the particular business, and the presence or absence of any particular activity, or of a particular number of activities, will not be determinative. Government officials have publicly confirmed that the substantial contribution test may apply both to consignment and buy-sell contract manufacturing arrangements.

A CFC that qualifies for the manufacturing exception may nevertheless have FBCSI under the branch rule. The branch rule applies where a CFC carries on purchasing, selling or manufacturing activities outside its country of organization through a "branch or similar establishment," and a tax rate disparity test is satisfied. The rate disparity test generally applies where the purchasing or selling income is subject to a relatively low tax rate compared to the tax rate in the country where the CFC manufactures the property.<sup>7</sup> For example, a Swiss CFC that derives income from selling property that is subject to an eight-percent tax rate, where the property is manufactured by its branch in Germany, may have FBCSI under the manufacturing branch rule.

The Tax Court has held that a separate corporate contract manufacturer, whether related or unrelated, cannot be treated as a manufacturing branch for purposes of the branch rule.<sup>8</sup> Accordingly, under the current regulations, the manufacturing branch rule does not apply where the CFC is considered as manufacturing the product it sells as a result of attributing to such CFC the physical manufacturing activities of a contract manufacturer.

The proposed regulations do not modify the definition of a branch nor do they change the basic operation of the tax rate disparity test. Importantly, they affirm the above case law that the activities of a contract manufac-

turer's employees are irrelevant for purposes of applying the manufacturing branch rule. This is the case even though in order for a CFC to be considered as satisfying the new non-physical definition of manufacturing, it must be considered as physically manufacturing the property taking into account the activities of the contract manufacturer as if the CFC's employees engaged in the contract manufacturer's activities. In other words, the activities of a contract manufacturer are in no way attributed to the CFC for purposes of the manufacturing branch rule, even though such activities are attributed to the CFC for purposes of applying the physical manufacturing prerequisite of the manufacturing exception.

Unlike the current regulations, the proposed regulations provide that the non-physical substantial contribution activities of a CFC may cause the manufacturing branch rule to apply. If the CFC satisfies the new manufacturing definition, then it is considered as manufacturing in the country where the predominant amount of such activities occur. If no such location exists, then the manufacturing location will be that jurisdiction in which the substantial contribution activities are performed that imposes the highest effective tax rate. The non-physical definition of manufacturing and the multiple branch rule may effectively broaden the application of the manufacturing branch rule, although combining the income and predominant activities in the same country generally should avoid adverse results.<sup>9</sup>

The proposed regulations will apply when finalized, but taxpayers may elect to apply them retroactively to open years. Since the proposed rules may indicate the current views of the government concerning contract manufacturing arrangements, it may be advisable for taxpayers to modify their structures to conform with the rules.

#### ENDNOTES

<sup>1</sup> REG-124590-07, 73 FR 10,716 (Feb. 28, 2008); RIN 1545-BG11, 73 FR 20,201 (Apr. 15, 2008) (corrections to proposed regulations).

<sup>2</sup> Reg. §1.954-3(a). For a detailed analysis of the manufacturing exception, see Lowell D. Yoder, 928 T.M., *CFCs—Foreign Base Company Income (Other than FPHCI)*, BNA TAX MANAGEMENT FOREIGN INCOME PORTFOLIOS, at VII.

<sup>3</sup> *Bausch & Lomb, Inc.*, 71 TCM 2031, Dec. 51,160(M), TC Memo. 1996-57. See also Lowell Yoder, *Subpart F: LMSB Provides Guidance Concerning the Definition of Manufacturing*, 35 TAX MGMT. INT'L J. 360,

July 14, 2006.

<sup>4</sup> Rev. Rul. 75-7, 1975-1 CB 244 (considered in GCM 33357 and GCM 35961); TAM 8333008 (July 13, 1982), TAM 8509004 (Nov. 23, 2984) and TAM 8739003 (June 17, 1987); LTR 6412105700A (Dec. 10, 1964), LTR 8413062 (Dec. 29, 1983) and LTR 8749060 (Sept. 8, 1987).

<sup>5</sup> 1997-2 CB 89.

<sup>6</sup> *Electronic Arts*, 118 TC 226, Dec. 54,680 (2002); see Lowell Yoder, *Senate Passes Tax Bill Without Contract Manufacturing Provision*, J. TAX'N GLOBAL TRANS., Summer 2004, at 3.

<sup>7</sup> Code Sec. 954(d)(2); Reg. §1.954-3(b).

<sup>8</sup> *Ashland Oil*, 95 TC 348, Dec. 46,899 (1990); *Vetco, Inc.*, 95 TC 579, Dec. 47,001 (1990).

<sup>9</sup> One possible unfavorable consequence of the proposed regulations is that a CFC principal that does not purchase from or sell to related parties, and therefore does not have FBCSI under current law, arguably may become subject to the manufacturing branch rule taking into account non-physical manufacturing activities, and accordingly be deemed to sell products on behalf of a related person (although this result should be avoided by having the particular activities performed by a separate CFC).

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