

## A Note From the Editor-in-Chief

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### Subpart F: The Same-Country-of-Manufacture Exception

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Under subpart F, income derived by a controlled foreign corporation (CFC) from the sale of products is included in the gross income of its U.S. shareholders currently if such income falls within the definition of foreign base company sales income (FBCSI).<sup>1</sup> FBCSI does not include income from the sale of products manufactured in a CFC's country of organization.<sup>2</sup> The IRS and the Treasury recently released proposed regulations that address this "same country" exception.<sup>3</sup>

The current regulations define manufacturing as the physical transformation, conversion or assembly of purchased property. Specifically, purchased property is considered as manufactured if:

- the property is substantially transformed (*e.g.*, steel rods converted into screws);
- the production operations are substantial in nature and generally considered to constitute manufacturing (*e.g.*, assembly of automobiles); or
- conversion costs are 20 percent or more of costs of goods sold.

Minor assembly and packaging do not qualify as manufacturing.<sup>4</sup> The Tax Court, however, has broadly interpreted this definition of manufacturing (*e.g.*, assembly of sunglasses qualified as manufacturing).<sup>5</sup>

The same-country-of-manufacture exception applies regardless of who manufactures the property. The product may be manufactured by an unrelated or related person. The exception contemplates that the CFC is not involved with the manufacture of the property but engages in selling the property.

For example, CFC1 imports into Country X rough cut diamonds mined in Country Y. CFC1 cuts, polishes and shapes the diamonds in a process that constitutes manufacturing. CFC1 sells the finished diamonds to CFC2, a related person organized in Country X. CFC2 sells the diamonds for use in Country Z. CFC2's sales income is not FBCSI because the finished diamonds were manufactured in Country X.<sup>6</sup>

The manufacture of a product may entail several stages of manufacturing processes. Components may be manufactured in Country A and assembled into a finished product in Country B. Income derived by a Country A CFC that sells the components to a related person should qualify for the same country exception. Similarly, a Country B CFC that sells the finished products to related distributors should qualify for the exception.<sup>7</sup>



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The proposed regulations would add a new definition of manufacturing to the FBCSI regulations that generally applies where a CFC hires a contract manufacturer to manufacture products on its behalf. Under the new definition, a CFC principal in a contract manufacturing arrangement 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. Relevant factors include, but are not limited to 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.<sup>8</sup>

The new definition of manufacturing is provided to determine whether a CFC principal will be considered as manufacturing the product it sells for purposes of the exception that applies to income derived by a CFC from the sale of products that it manufactures (“manufacturing exception”). This new definition does not apply for purposes of the same-country-of-manufacture exception. The preamble states that the new definition could prove difficult to administer if applied to the same-country-of-manufacture exception, because it would require an assessment of activities other than physical manufacturing conducted by an unrelated person.

The proposed regulations also would require that the CFC’s employees engage in the manufacturing activities for purposes of the manufacturing exception, but make clear that such requirement does not apply for purposes of the same country exception. For example, if a CFC hires a contract manufacturer to manufacture a product in the CFC’s country of organization and the CFC does not satisfy the new definition of manufacturing, its sales income nevertheless should qualify for the same-country-of-manufacture exception.<sup>9</sup>

The same country exception applies regardless of whether the CFC is subject to tax in its country of organization. For example, CFC1 manufactures a product in Country A. CFC2 is organized under the laws of Country A, but is tax resident in another country, so it is not subject to tax in Country A (e.g., CFC2 is managed and controlled in Country B). CFC1 sells products to CFC2 for resale. CFC2’s sales income should not be FBCSI because it satisfies the same country exception.<sup>10</sup>

The FBCSI provisions contain a branch rule that may cause a CFC to lose the same country exception. For example, a CFC organized in Country X where products are manufactured sells the products through a branch in Country Y. If the branch rule applies, the branch is treated as a separate CFC organized in country Y, and as a result, its sales income does not qualify for the same country exception.<sup>11</sup> On the other hand, if the branch rule did not apply (e.g., the tax rates in the two countries are similar), then the same country exception should apply to the sales income derived by the Country Y branch.

If a branch is treated as a separate CFC and the products sold by the branch are manufactured in the country where the branch is located, the branch’s sales income should qualify for the same country exception.<sup>12</sup> The branch rule, however, may not be used affirmatively (the proposed regulations add clarifying language to this effect). Accordingly, one must be cautious in electing disregarded entity status for a CFC. For example, if in the first illustration above CFC2, a Country X corporation, became a disregarded entity owned by CFC3, a Country R corporation, CFC2’s income from the sale of finished diamonds manufactured in Country X would not qualify for the same country exception.<sup>13</sup>

In sum, the proposed regulations do not change the application of the same-country-of-manufacture exception. In effect, they reaffirm its application to modern business structures, taking into account the broad application of the definition of manufacture in the current regulations.

## ENDNOTES

<sup>1</sup> Code Sec. 954(d); Reg. §1.954-3.

<sup>2</sup> Code Sec. 954(d)(1)(A); Reg. §1.954-3(a)(2).

<sup>3</sup> REG-124590-07, 73 FR 10,716 (Feb. 28, 2008); RIN 1545-BG11, 73 FR 20,201 (Apr. 15, 2008) (corrections).

<sup>4</sup> Regs. §1.954-3(a)(4). This definition of manufacturing is in the provision that applies the manufacturing exception, but is incorporated by reference in the same country exception.

<sup>5</sup> *Bausch & Lomb, Inc.*, 71 TCM 2031, Dec.

51,160(M), TC Memo. 1996-57.

<sup>6</sup> Reg. §1.954-3(a)(2), Ex. 2.

<sup>7</sup> See Yoder, *Subpart F: LMSB Provides Guidance Concerning the Definition of Manufacturing*, 35 TAX MGMT. INT’L J. 360 (July 14, 2006).

<sup>8</sup> See Lowell D. Yoder, *Proposed Subpart F Contract Manufacturing Regulations*, INT’L TAX J., May-June 2008, at 3.

<sup>9</sup> Proposed Reg. §1.954-3(a)(4)(iv)(c), Ex. 3.

<sup>10</sup> See U.S. Department of Treasury, The

Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study, Dec. 2000, at 66–67.

<sup>11</sup> Reg. §1.954-3(b)(4), Ex. 3.

<sup>12</sup> Reg. §1.954-3(b)(2)(ii)(e); TAM 8509004 (Nov. 23, 1984).

<sup>13</sup> See Lowell D. Yoder, *Code Sec. 954(c)(6) and the Same Country Rules for Sales and Services Income*, J. TAX’N GLOBAL TRANS., Fall 2006, at 3.