

## A Note From the Editor-in-Chief

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### Proposed Regs Address Application of Subpart F Branch Rule Where All Activities Are Conducted in a Branch

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 it falls within the definition of foreign base company sales income (FBCSI).<sup>1</sup> The definition of FBCSI does not apply where the CFC does not purchase the products from or on behalf of, nor sell the products to or on behalf of, a related person. In addition, FBCSI does not include income derived from the sale of products manufactured in, or sold for use in, the CFC's country of organization, or income derived by a CFC from the sale of products that it manufactured.<sup>2</sup>

A CFC that qualifies for one of the above exceptions may nevertheless have FBCSI under the branch rule. The regulations apply the branch rule where a CFC carries on purchasing, selling or manufacturing activities outside of its country of organization through a branch or similar establishment, and a tax rate disparity test is satisfied. The tax rate disparity test is met where the CFC's income derived from purchasing or selling activities is taxed at an effective rate that is both less than 90 percent of, and at least five percentage points less than, the effective tax rate that would apply to such income in the CFC's country of organization (purchase or sales branch) or in the country where the products are manufactured (manufacturing branch).<sup>3</sup>

If the branch rule applies, then the branch and the remainder of the CFC are treated as separate CFCs for purposes of applying the FBCSI rules. The branch is considered as organized under the laws of the country where it is located, and each separate CFC is considered as conducting only its own activities. In addition, the purchasing or selling activities generally are considered as performed on behalf of a related person.

Proposed regulations "clarify" that purchasing or selling activities performed through a branch will not be treated as performed "on behalf of" the remainder where the remainder does not engage in any manufacturing, selling or purchasing activities.<sup>4</sup> Accordingly, the branch rule would not operate to create a related-party transaction.

For example, CFCX, a Country X corporation, carries on all of its activities through Branch Y located in Country Y. Branch Y purchases products from unrelated persons and sells the products to unrelated persons. Country X has a 30-percent effective tax rate but does not tax the income of Branch Y, and Branch Y's income is taxed at a five-percent rate in Country Y, satisfying the tax rate



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disparity test. Accordingly, Branch Y is treated as a separate CFC organized in Country Y for purposes of applying the FBCSI rules. The proposed regulations expressly provide that since the remainder of CFCX does not engage in any purchasing, selling or manufacturing activities, Branch Y is not treated as purchasing or selling the products on behalf of the remainder CFC. Therefore, Branch Y's sales income is not FBCSI because it does not purchase products from, nor sell products to, a related person.<sup>5</sup>

It should be noted that the branch rule can apply when all activities are conducted in a branch. Accordingly, the branch rule can result in FBCSI even where the "on behalf of" treatment does not apply.

For example, assume Branch Y purchases the products it sells from related persons, but does not have FBCSI under the general rule because the products are manufactured in Country X (where CFCX is organized). The branch rule applies to treat Branch Y as a separate Country Y corporation, even though CFCX conducts all of its activities in Branch Y. Thus, the sales income derived by Branch Y would no longer qualify for the same-country-of-manufacture exception. Since Branch Y purchases the products from a related person, its sales income would be FBCSI to the extent the products are sold for use outside Country Y.<sup>6</sup>

Branch Y may acquire raw materials and components from related and unrelated persons and physically manufacture products in Country Y for sale to customers. Under the general rule, CFCX would qualify for the manufacturing exception. Furthermore, even if the branch rule applied, the sales income derived by Branch Y, treated as a separate CFC, should qualify for the manufacturing exception.

Alternatively, Branch Y may purchase finished products from an unrelated contract manufacturer and sell the products to unrelated persons. As described above, Branch Y's income should qualify for the unrelated-to-

unrelated exception. The same analysis should apply if Branch Y acquired raw materials and components from unrelated suppliers, consigned them to a related contract manufacturer to manufacture products, and then sold the finished products to unrelated persons.

Under the proposed regulations, Branch Y would be considered as manufacturing the product it sells if it substantially contributes to the manufacture of the product pursuant to a contract manufacturing arrangement. If this definition of manufacturing applies, Branch Y's sales income should qualify for the manufacturing exception, regardless of whether the branch rule applies. In addition, Branch Y's income should not be FBCSI even if it has a related person transaction.<sup>7</sup>

Apparently, if any selling, purchasing or manufacturing activities are carried on in the remainder or another branch, Branch Y is treated as purchasing or selling property "on behalf of" a related person. Accordingly, the unrelated-to-unrelated exception would no longer apply. On the other hand, other locations engaging in different activities, such as financing or licensing activities, should not cause the "on behalf of" construct to apply. In addition, activities in other locations with respect to different products should not be taken into account for this purpose.<sup>8</sup>

In sum, the proposed regulations are helpful in clarifying that the "on behalf of" construct does not apply where the CFC does not engage in any purchasing, selling or manufacturing activities outside of the branch with respect to the particular products sold. Accordingly, the unrelated-to-unrelated exception applies to the purchase and sale of finished product and applies to contract manufacturing arrangements where there is no related person transaction. Furthermore, the FBCSI rules do not apply to products manufactured and sold by the same branch, whether physically manufactured or manufactured based on the substantial contribution test under the proposed regulations.

## ENDNOTES

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

<sup>2</sup> Reg. §1.954-3(a)(2), (3) & (4).

<sup>3</sup> Reg. §1.954-3(b).

<sup>4</sup> Proposed Reg. §1.954-3(b)(2)(i)(b) and (ii)(b), REG-124590-07, 73 FR 10,716 (Feb. 28, 2008). See also 73 FR at 10,721 ("Section 1.954-3(b)(2)(i)(b) and (ii)(b) are intended to apply only to purchasing or selling by a branch with respect to personal property manufactured, purchased, or sold by 'the

remainder of the CFC ...").

<sup>5</sup> Proposed Reg. §1.954-3(b)(4), Example 3.

<sup>6</sup> The branch rule cannot be used affirmatively, but only applies if the CFC otherwise does not have FBCSI under the general rules. Proposed Reg. §1.954-3(b)(2)(e). Thus, careful consideration should be given when deciding to elect to classify a lower-tier CFC as a disregarded entity. See Lowell D. Yoder, A Note from the Editor-in-Chief, Code Sec.

954(c)(6) and the Same Country Rules for Sales and Services Income, J. TAX'N GLOBAL TRANS., Fall 2006, at 3.

<sup>7</sup> Proposed Reg. §1.954-3(a)(4)(iv); -3(b)(4), Example 3; see also Reg. §1.954-3(b)(1)(ii)(c)(3)(f), Example 6; TAM 8509004 (Nov. 23, 1984).

<sup>8</sup> See Lowell D. Yoder, Subpart F: The Proposed Non-Physical Manufacturing Branch, 37 TAX MGMT. INT'L J. 494 (Aug. 2008).

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