

# A Note From the Editor-in-Chief

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## Final and Temporary Subpart F Contract Manufacturing Regulations

The IRS and the Treasury recently issued regulations concerning contract manufacturing arrangements involving controlled foreign corporations (CFCs).<sup>1</sup> Final regulations address the application of the subpart F manufacturing exception and temporary regulations modify the branch rules.

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), subject to the branch rule.<sup>2</sup> For many years, the regulations defined manufacturing as the transformation, conversion or assembly of purchased property (“physical manufacturing”), and the Tax Court broadly interpreted this definition (e.g., assembly of sunglasses).<sup>3</sup> In addition, taxpayers have treated a CFC principal that hires a contract manufacturer and provides the intellectual property, has the risk of loss, and controls the manufacturing process as being attributed with the manufacturing activities of the contract manufacturer.<sup>4</sup>

On February 27, 2008, the IRS released proposed regulations that would add a new definition of manufacturing that applies to contract manufacturing arrangements.<sup>5</sup> This definition was adopted in final regulations issued on December 24, 2008, with a number modifications reflecting written comments.

Under the final regulations, a CFC principal that has a contract manufacturer produce products on its behalf will be considered as manufacturing the property it sells if, acting through its own employees, the CFC makes a “substantial contribution” to the manufacture of the property sold (“non-physical manufacturing”).<sup>6</sup> Relevant activities taken into account include (1) oversight and direction of the physical manufacturing activities; (2) material selection, vendor selection, or control of raw materials, work-in-process or finished goods; (3) management of manufacturing costs or capacities; (4) control of manufacturing-related logistics; (4) quality control; and (5) developing, or directing the use or development of, intellectual property for the purpose of manufacturing property. The manufacturing definition must be satisfied on a product-by-product basis.

Other indicia of manufacturing are relevant and the weight given to any particular activity will depend on the economic significance of those functions to the manufacture of the relevant property. The presence or absence of any particular activity (e.g., oversight and direction), or of a particular number of activities, will not be determinative, and more than



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one company may satisfy the substantial contribution definition with respect to the same product. The new definition may be satisfied when the manufacturing is largely automated where the employees conduct “industry-sufficient” substantial contribution activities. The final regulations make clear that the new definition is available for both 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 and a tax rate disparity test is met. The rate disparity test generally is met where the purchasing or selling income is subject to a relatively low tax rate compared with 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 a five-percent tax rate, where the property is manufactured by its branch in Germany with a tax rate of 35 percent, may have FBCSI under the manufacturing branch rule.

The branch rule applies only where the CFC has a branch in a different country; e.g., the branch rule should not apply where employees travel to the contract manufacturer’s country but the CFC principal does not have a branch in that country. The temporary regulations do not modify the definition of a branch nor do they change the basic operation of the tax rate disparity test.<sup>8</sup> Importantly, they affirm that only the activities of the CFC’s employees are relevant, not those of the contract manufacturer, for purposes of applying the manufacturing branch rule.<sup>9</sup>

Unlike the prior regulations, the temporary regulations provide that nonphysical manufacturing activities may cause the manufacturing branch rule to apply. A CFC will have a manufacturing branch in the country where its employee activities independently satisfy

the definition of manufacturing, and if there is more than one such country, for purposes of applying the hypothetical rate test the location of manufacture is the lowest rate country. Where no branch location independently satisfies the definition of manufacturing, but the CFC as a whole satisfies the substantial contribution definition, the CFC will have a manufacturing branch in the country where substantial contribution activities are carried out and there is a tax rate disparity with the sales location. However, the branch rule will not apply where a demonstrably greater amount of manufacturing activity occurs in the sales location, taking into account manufacturing activities occurring in other branches where there is no rate disparity when compared with the sales country.

Under the final regulations, a CFC principal that does not purchase property from, nor sell property to, related persons, and therefore does not have FBCSI under current law, could be subject to the manufacturing branch rule taking into account non-physical manufacturing activities, and, in such case, be deemed to sell products on behalf of a related person. This should not result in FBCSI if the substantial contribution activities occur in the same country as the purchasing and selling activities. Also, application of the branch rule should be avoided by having the particular substantial contribution activities performed by a separate CFC.

The final and temporary regulations are effective for tax years beginning after June 30, 2009, although taxpayers have the option to apply them retroactively. Since the new rules provide opportunities as well as potential concerns, it is advisable for taxpayers to review their structures and make modifications as necessary to conform with the rules. In addition, it will be important for taxpayers to document the facts demonstrating compliance with the new manufacturing definition.

## ENDNOTES

<sup>1</sup> REG-15066-08, T.D. 9438, 73 FR 79,334 (Dec. 29, 2008), as corrected 74 FR 11,843 (Mar. 20, 2009).

<sup>2</sup> Code Sec. 954(d); Reg. §1.954-3(a)(4) & (b).

<sup>3</sup> *Bausch & Lomb, Inc.*, 71 TCM 2031, Dec. 51,160(M), TC Memo. 1996-57. See also Lowell D. Yoder, *Subpart F: LMSB Provides Guidance Concerning the Definition of Manufacturing*, 35 TAX MGMT. INT’L J. 360 (July 14, 2006).

<sup>4</sup> The IRS disagrees with this position (Rev. Rul. 97-48, 1997-2 CB 89), although the government’s view is widely considered as an incorrect application of the relevant

statute, regulations, and case law. See, e.g., *Electronic Arts*, 118 TC 226, Dec. 54,680 (2002); Lowell D. Yoder, A Note from the Editor-in-Chief, *Senate Passes Tax Bill Without Contract Manufacturing Provision*, J. TAX’N GLOBAL TRANS., Summer 2004, at 3.

<sup>5</sup> REG-124590-07, 73 FR 10,716 (Feb. 28, 2008), corrected at 73 FR 20,201 (Apr. 15, 2008). See Lowell D. Yoder, A Note from the Editor-in-Chief, *Proposed Subpart F Contract Manufacturing Regulations*, INT’L TAX J., May–June 2008, at 3.

<sup>6</sup> The general definition of “employee” for federal income tax purposes applies, and

such term may include seconded workers and employees of related entities. Reg. §§1.954-3(a)(4)(i) & 31.3121(d)-1(c); Rev. Rul. 87-41, 1987-1 CB 296.

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

<sup>8</sup> The temporary regulations affirm that “uniformly applicable incentive tax rates” should be taken into account for purposes of the hypothetical rate test, but the government declined to modify the hypothetical assumptions as beyond the scope of the regulations.

<sup>9</sup> *Ashland Oil*, 95 TC 348, Dec. 46,899 (1990); *Vetco, Inc.*, 95 TC 579, Dec. 47,001 (1990).