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TAX TRANSACTIONS AND TAX CONTROVERSY UPDATE

Proposed Regulations Regarding Application of Foreign Base Company Sales Income Rules to Contract Manufacturing Arrangements

February 29, 2008

Executive Summary

On February 27, 2008, the United States Treasury Department and the IRS released much anticipated proposed regulations (the Proposed Regulations) relating primarily to the application of the subpart F foreign base company sales income (FBCSI) rules in situations where a controlled foreign corporation (CFC) sells personal property that has been manufactured pursuant to a contract manufacturing arrangement.[1] With certain exceptions, the Proposed Regulations generally provide welcome clarification of the existing rules to taxpayers with CFCs that have engaged contract manufacturers. However, certain aspects of the rules will need clarification, and other aspects, particularly with respect to changes made to the Branch Rule (as defined below), may provide unexpected pitfalls.

The most important aspects of the Proposed Regulations are as follows:

- Treasury and the IRS reject the so-called "its" defense pursuant to which taxpayers argued that a CFC could satisfy the Manufacturing Exception (as defined below) merely because the property that the CFC sold (i.e., the final product) was different from the property that it purchased (i.e., the raw materials).
- Consistent with Revenue Ruling 97-48, Treasury and the IRS also reject the argument that a CFC can qualify for the Manufacturing Exception by attributing to the CFC the activities of a contract manufacturer (or any other person); rather, the CFC, through the activities of *its own employees*, must satisfy the Manufacturing Exception under either the current manufacturing standards or a new "substantial contribution" standard.
- Under the new standard, a CFC may satisfy the Manufacturing Exception if the CFC, through the activities of its own employees, provides a substantial contribution to the manufacture of property (e.g., by regularly exercising its contractual right to oversee and direct the activities of a contract manufacturer).
  - » The new substantial contribution test would apply if the CFC, through the activities of its own employees, does not meet the Manufacturing Exception under the current rules.

- » Importantly, merely retaining the contractual *right* to perform oversight and direction over the contract manufacturer's activities without actually *doing so* will not assist a CFC in satisfying the Substantial Contribution Test.

- » Nor will the mere ownership or license by the CFC of the intellectual property used in the manufacturing process; rather, the CFC will need to be actively involved in developing and maintaining the relevant intellectual property.

- The Proposed Regulations provide several modifications to the regulations relating to the Branch Rule and significantly alter the current rules for corporations that currently use the activities of disregarded entities or branches to satisfy the Manufacturing Exception. Many of these rules take back the benefits provided by the Substantial Contribution Test.

  - » The Proposed Regulations provide that even though the CFC, as a whole, may be treated as satisfying the Manufacturing Exception, and one or more of its branches conduct certain manufacturing activities, the application of the Branch Rule may result in the CFC deriving FBCSI.

  - » If neither one branch nor the remainder of the CFC provides a significantly greater contribution to the manufacture of the property compared to other branches or the remainder of the CFC, the Proposed Regulations penalize taxpayers utilizing decentralized branches performing manufacturing activities by treating the location of manufacture of the property as occurring in the jurisdiction with the highest effective rate of tax, thereby making it more likely that the Branch Rule will result in FBCSI.

  - » On the other hand, the Proposed Regulations favor structures utilizing multiple branches that each satisfy the current manufacturing standards by treating the location of manufacture of the property as occurring in the jurisdiction that has the lowest effective rate of tax, thereby making application of the Branch Rule to create FBCSI less likely.

  - » As a result, companies — particularly those relying on the activities of several branches to argue that the CFC is manufacturing — may find themselves with FBCSI despite the involvement of all branches in the manufacturing oversight process.

- The Proposed Regulations also provide guidance relating to situations where a CFC itself (rather than through a contract manufacturer) engages in manufacturing activities through one or more branches located outside the CFC's country of incorporation.

- The Proposed Regulations generally will apply to taxable years of a CFC beginning on or after the date they are published as final regulations in the Federal Register. In the meantime, taxpayers may rely on the Proposed Regulations, in their entirety, with respect to all open taxable years. Taxpayers should take stock of their

existing structures to see if it would be beneficial to elect retroactive treatment or to implement changes that will allow compliance in the future.

- Treasury and the IRS have solicited a number of specific comments on the Proposed Regulations, some of which shed light on the various issues that Treasury and the IRS considered in drafting the Proposed Regulations, including how certain aspects of the Proposed Regulations might be intended to apply.

Background

For purposes of this discussion, a certain degree of familiarity on the part of the reader with the FBCSI rules is presumed. For more detailed background, please contact any of the authors listed at the end of this Client Update.

MANUFACTURING EXCEPTION

FBCSI excludes income of a CFC from the sale of property that was "manufactured, produced, or constructed by such corporation, in whole or in part, from personal property which it has purchased" (the "Manufacturing Exception").[2] In general, a CFC is considered to have manufactured, produced, or constructed personal property that it sells "if the property sold is in effect not the property which it purchased."[3] More specifically, the property sold will not be considered the property purchased if purchased property is either: (1) "substantially transformed" prior to sale (the "Substantial Transformation Test"),[4] or (2) "used as a component part of personal property which is sold, … [provided that] the operations conducted by the selling corporation in connection with the property purchased and sold are substantial in nature and are generally considered to constitute the manufacture, production, or construction of property" (the "Substantive Test").[5] The preamble to the Proposed Regulations, as well as this memorandum, refers to a CFC that satisfies either the Substantial Transformation Test or the Substantive Test as having satisfied the "Physical Manufacturing Test."

The application of the Manufacturing Exception under the current regulations is not clear when a CFC engages a related or an unrelated contract manufacturer to manufacture the personal property that is subsequently sold by the CFC. Some have argued that a CFC may satisfy the Manufacturing Exception by virtue of attributing the contract manufacturer's activities to the CFC.[6] In many cases, the CFC will perform certain important activities and assume certain significant responsibilities relating to the manufacturing process, but such activities may be insufficient, by themselves, to qualify the CFC for the Manufacturing Exception without also attributing the contract manufacturer's activities to the CFC. Others have argued that, based on a literal reading of section 954(d)(3) and Treas. Reg. § 1.954-3(a)(4)(i), a CFC may satisfy the Manufacturing Exception if the property sold by the CFC is different from the property that it purchased. The latter argument is often referred to as the "its" defense.[7]

BRANCH RULE

Section 954(d)(2) provides that the manufacturing exception does not apply if "the carrying on of activities by [a CFC]

through a branch or similar establishment outside the country of incorporation of the [CFC] has substantially the same effect as if such branch or similar establishment were a wholly-owned subsidiary corporation deriving such income" (the "Branch Rule"). The regulations employ an effective rate of tax comparison test for these purposes. A slightly different test applies depending on whether the activities of the branch relate to sales activities or manufacturing activities.[8] Very generally, if the activities of a CFC in a foreign country constitute a manufacturing branch and the effective rate of tax comparison test is met, the manufacturing branch and the "remainder of the [CFC]" are treated as separate corporations.[9] The purchasing or selling activities performed by the remainder of the CFC with respect to property manufactured, produced, constructed, grown, or extracted by or through the branch are treated as performed on behalf of a related person.[10] Therefore, the income derived by the remainder of the CFC from its sales of property for use, consumption, or disposition outside the CFC's country of incorporation generally can give rise to FBCSI.[11]

The Proposed Regulations

OVERVIEW

In the preamble to the Proposed Regulations, Treasury and the IRS recognize that, since the promulgation of the current regulations in 1964, "the use of contract manufacturing arrangements has become a common way of manufacturing products because of the flexibility and efficiencies it affords."[12] Thus, Treasury and the IRS explain that the FBCSI regulations must be "modernize[d]" in light of "current business structures and practices that are inadequately addressed by the current regulations" and that such updated rules "are important to the continued competitiveness of US businesses operating abroad."[13]

The Proposed Regulations attempt to clarify the application of the Manufacturing Exception in situations where a CFC has engaged a contract manufacturer, as follows:

- *Expansion of the Manufacturing Exception to Include a New Substantial Contribution Test:* The Proposed Regulations provide an alternative test (the "Substantial Contribution Test") pursuant to which a CFC may satisfy the Manufacturing Exception even if it does not satisfy the Physical Manufacturing Test.
- *Explicit Rejection of the Attribution Argument:* In amending the Manufacturing Exception, the Proposed Regulations explicitly provide that only the activities of the CFC's *own employees* are to be considered in determining whether the CFC satisfies the Manufacturing Exception (i.e., a contract manufacturer's activities (or the activities of any other person) may not be attributed to the CFC for purposes of determining whether the CFC meets either the Physical Manufacturing Test or the Substantial Contribution Test).[14]
- *Explicit Rejection of the "Its" Defense:* The Proposed Regulations also explicitly reject the "its" defense.[15]
- *Amendments to the Branch Rule:* The Proposed Regulations also amend the Branch Rule in ways that could trigger the application of the Branch Rule to the existing structures of many taxpayers,

particularly those with branches (including corporations that have elected to be classified as disregarded entities for US federal tax purposes) in one or more countries that are engaged in manufacturing activities.

THE SUBSTANTIAL CONTRIBUTION TEST

As explained above, the Proposed Regulations provide an alternative test to the Physical Manufacturing Test – the Substantial Contribution Test – pursuant to which a CFC may qualify for the Manufacturing Exception. The Substantial Contribution Test is intended to address the situation where personal property is manufactured pursuant to a contract manufacturing arrangement under which the CFC, through the activities of its own employees, engages in certain activities relating to the manufacture of the property (e.g., quality control) but those activities are not sufficient to enable the CFC, through the activities of its own employees, to satisfy the Physical Manufacturing Test. Treasury and the IRS have requested comments on several aspects relating to the Substantial Contribution Test, which are described more fully below.

In general, a CFC will satisfy the Substantial Contribution Test "only if the facts and circumstances evidence that the [CFC] makes a substantial contribution through the activities of its own employees to the manufacture, production, or construction of the personal property sold [by the CFC]."[16] More specifically, the activities of a CFC, through its own employees, that are to be considered in determining whether the CFC satisfies the Substantial Contribution Test include, but are not limited to: (1) Oversight and direction of the activities or process (including management of the risk of loss)[17] pursuant to which the property is manufactured, produced, or constructed; (2) Performance of activities that are considered in, but that are insufficient to satisfy, the Substantial Transformation Test or the Substantive Test; (3) Control of the raw materials, work-in-process and finished goods; (4) Management of the manufacturing profits;[18] (5) Material selection; (6) Vendor selection; (7) Control of logistics; (8) Quality control; and (9) Direction of the development, protection, and use of trade secrets, technology, product design and design specifications, and other intellectual property used in manufacturing the product.[19] The weight given to any particular activity (whether or not included in the above list) will "vary with the facts and circumstances of the particular business."[20] The presence or absence of any activity, or of a particular number of activities, is not determinative.[21] Moreover, the fact that other persons (e.g., a related person or an unrelated person) contribute to the manufacture of the property will "not necessarily" preclude the CFC from satisfying the Substantial Contribution Test.

The Proposed Regulations set forth four examples applying the Substantial Contribution Test.[22] The examples generally stand for the proposition that the mere ownership of materials and intellectual property and the right to exercise power and control over the manufacturing process without actually regularly exercising such right are insufficient to satisfy the Substantial Contribution Test. Based on the proposed regulations and the examples, it seems that, for a given criterion to carry much weight in the facts-and-circumstances analysis, the CFC's employees must be

actively involved in the activity. This should cause concern, for example, for CFCs that rely on a cost-sharing or license arrangement to claim that they should get the benefit of owning or controlling intellectual property. Without CFC involvement in the actual "direction of the development, protection, and use" of the intellectual property, the CFC may not receive any "credit" for meeting the intellectual property factor. An example contained in the Proposed Regulations under the Branch Rule indirectly confirms this need for active involvement in the process by holding that a CFC does not satisfy the Substantial Contribution Test even though it (1) controls the raw materials, work-in-process, and the finished product, (2) manages the risk of loss relating to the manufacture of the product, (3) manages the manufacturing profits, (4) controls logistics, (5) selects vendors, and (6) oversees coordination between its two branches.[23]

AMENDMENTS TO THE BRANCH RULE

In General

The Proposed Regulations provide several rules relating to the application of the Branch Rule where more than one branch of a CFC is engaged in manufacturing.[24] In particular, the Proposed Regulations provide two rules addressing the application of the manufacturing branch tax rate disparity test to multiple manufacturing branches.[25] These rules show a strong preference for CFCs to be involved in the physical manufacturing of property rather than relying on the Substantial Contribution Test. They may also create traps for the unwary, particularly in situations where multiple branches are involved in and contribute to the manufacturing process. Additionally, the Proposed Regulations create a rebuttable presumption that prohibits the concurrent application of the Substantial Contribution Test by a CFC in instances where one or more branches satisfy the Physical Manufacturing Test.[26]

Where One or More Branches and the Remainder of the CFC Satisfy the Manufacturing Exception with Respect to a Single Item of Property

Prop. Treas. Reg. § 1.954-3(b)(1)(ii)(*c*)(*3*) provides several rules relating to the determination of the location of the manufacturing activities for purposes of applying the Sales and Manufacturing Branch Tax Disparity Tests of Treas. Reg. §§ 1.954-3(b)(1)(i)(*b*) and (ii)(*b*) (the "Tax Disparity Tests") where more than one branch of a CFC[27] each engages in manufacturing activities with respect to the same item of personal property sold by the CFC.

Application of the Physical Manufacturing Test. In the case where only one branch (or only the remainder of a CFC) satisfies the Physical Manufacturing Test with respect to an item of personal property, then that branch (or the remainder) will be the location of manufacturing of that property for purposes of applying the Tax Disparity Tests.[28] On the other hand, if more than one branch each independently satisfies the Physical Manufacturing Test with respect to an item of personal property, then the location of the manufacturing of that property for purposes of applying the Tax Disparity Tests will be the branch (or the remainder) that satisfies the Physical Manufacturing Test and which is located or organized in the jurisdiction that would impose the lowest

effective rate of tax on the income allocated to such branch under the Tax Disparity Tests.[29]

Application of the Substantial Contribution Test – Satisfies the Predominant Contribution Test. In the case where neither the remainder of the CFC nor its branches satisfies the Physical Manufacturing Test with respect to an item of personal property but the CFC as a whole satisfies the Substantial Contribution Test, the branch (or the remainder) that makes the "predominant amount" of the CFC's substantial manufacturing contribution will be the location of the manufacturing for purposes of the Tax Disparity Tests ("the Predominant Contribution Test").[30] To make the predominant amount of the contribution, a branch (or the remainder) must make a "significantly greater contribution" to the manufacture of that property than any other branch (or the remainder).[31] Each location's relative manufacturing contribution is weighed by applying the facts-and-circumstances test provided in the Substantial Contribution Test.[32] The activities of multiple branches located in a single jurisdiction are aggregated for this purpose.[33] For purposes of deciding whether an activity is conducted in a particular branch or in the remainder of the CFC, the location of any activity with respect to the manufacture of property is where the CFC makes a contribution through its employees to such activity.[34] For instance, the location of activities concerning intangible property is determined by reference to the location where employees of the CFC develop, protect, and direct the use of the intangible.[35]

Application of the Substantial Contribution Test – Predominant Contribution Test Not Satisfied. In the case where a branch (or the remainder) does not satisfy the Physical Manufacturing Test, and no branch (or the remainder) satisfies the Predominant Contribution Test, but the CFC as a whole satisfies the Substantial Contribution Test, then, for purposes of the Tax Disparity Tests, the location of manufacturing will be the jurisdiction of that contributing branch (or remainder) that would impose the *highest* effective rate of tax on the income allocated to such branch (or such remainder).[36] Thus, in the case of a CFC with multiple branches involved in satisfying the Substantial Contribution Test, the Tax Disparity Tests are more likely to create FBCSI (by using the highest manufacturing tax rate) than in the case of a CFC with multiple branches involved in physically manufacturing the property (which uses the lowest manufacturing tax rate).

Rebuttable Presumption Where One or More Branches Satisfy the Physical Manufacturing Test and the Remainder of the CFC Claims to Have Satisfied the Substantial Contribution Test

The Proposed Regulations also create a rebuttable presumption with respect to the application of the Substantial Contribution Test where a CFC seeks to satisfy the Substantial Contribution Test while a branch of the CFC satisfies the Physical Manufacturing Test with respect to an item of personal property.[37] Thus, the CFC will be presumed to have not satisfied the Substantial Contribution Test

if a branch of the CFC has satisfied the Physical Manufacturing Test with respect to the same item of property, *unless* the CFC can demonstrate to the satisfaction of the Commissioner that the CFC makes a substantial contribution with respect to the manufacture of such property and that the CFC is treated as a separate corporation apart from the manufacturing branch.[38]

Many taxpayers currently rely on CFCs with activities in multiple branches to support a claim that the CFC is manufacturing, either physically or through a contract manufacturing arrangement. The proposed changes to the Branch Rule will require an analysis of existing structures to determine whether the application of the Branch Rule could apply in previously unanticipated ways to such structures. In instances in which a CFC relies on the Substantial Contribution Test, a careful analysis of the implications of the Proposed Regulations is necessary. The effect of the Predominant Contribution Test and the related rule that aggregates branch activities in a single jurisdiction suggests a preference for contract manufacturing structures that centralize manufacturing activities. Moreover, it would seem that a CFC or branch that cannot satisfy the Predominant Contribution Test is effectively penalized by the rule that applies when no branch or CFC individually satisfies the Predominant Contribution Test (e.g., the location of the manufacturing is deemed to occur in the country with the highest effective rate of tax).

With regard to the rebuttable presumption relating to the concurrent use of the Substantial Contribution Test by a CFC when a branch satisfies the Physical Manufacturing Test with respect to the same item of property, the preamble suggests that its purpose is to provide a "backstop" to the Branch Rule. It would appear that this rule serves, generally, as an anti-abuse rule in instances where disregarded entities conduct activities that, on their own, satisfy the Physical Manufacturing Test, while the CFC uses the branches' activities along with certain of the CFC's own activities (e.g., ownership of intellectual property) to satisfy the Substantial Contribution Test. As this presumption may be rebutted by a showing that the CFC is, in fact, substantially conducting manufacturing activities through the use of its own employees, the utility of this rule may be somewhat limited in application.

REQUEST FOR COMMENTS

Treasury and the IRS have asked for comments, to be submitted in writing by May 28, 2008, on all aspects of the Proposed Regulations, specifically including.[39]

- *Use of Safe-Harbor Tests*: Whether one or more safe-harbor tests should be *added* to the Substantial Contribution Test. In drafting the Proposed Regulations, Treasury and the IRS considered adopting, among other safe-harbor tests, a list of mandatory activities, a cost-based test, a compensation-based test, a value-based test, a tax rate disparity-based test, and a percentage-based test comparing the compensation paid to employees of the CFC for performing activities related to the manufacturing process vs. the total cost for all activities related to the manufacturing process (that is, including costs paid to a contract manufacturer

but excluding the cost of raw materials and marketing intangibles).[40] Treasury and the IRS ultimately rejected adopting any of these safe-harbor tests "because of difficulties in fashioning a safe harbor that would be flexible enough to apply across various industries and across a range of different types of manufacturing arrangements." This language is consistent with the manner in which the Substantial Contribution Test is currently drafted (i.e., by giving more or less weight to any particular activities depending on the industry in which the CFC operates). Taxpayers (and practitioners) might prefer the certainty of a safe-harbor test that would provide a list of mandatory activities for various components of the manufacturing industry (e.g., software, automobiles, etc.).[41]

- *Limited attribution*: Whether the requirement that the activities of the CFC be performed by its employees (i.e., not taking into account the activities of a contract manufacturer or those of any other person) "should permit commercial arrangements where individuals performing services for the CFC, while not on its payroll, are nevertheless controlled by employees of the CFC." Such an approach would be welcome and would seem to allow a CFC to take into account, for purposes of determining whether the CFC satisfies the Manufacturing Exception, the activities of an individual who, although not employed by the CFC, is under the direct supervision and control of the CFC's employees (e.g., under a secondment agreement or similarly supervised arrangement). Just as contract manufacturing arrangements have become more common, so have secondment arrangements.
- *Material participation of a US-related person's activities*: Whether the Proposed Regulations should include an anti-abuse rule pursuant to which a CFC would be precluded from satisfying the Substantial Contribution Test where "substantially all" (for example, 80 percent or more) of the direct or indirect contributions to the manufacture of personal property provided collectively by the CFC and any related US person is provided by one or more related US persons. Such a rule seems unnecessary in light of the language in the Proposed Regulations that requires the CFC, "through the activities of its employees," to provide a substantial contribution to the manufacture of the property.
- *Negative presumption rule or blanket prohibition*: Whether the negative presumption rule, relating to instances in which the CFC claims to satisfy the Substantial Contribution Test while one or more branches also satisfy the Physical Manufacturing Test, is more appropriate than simply prohibiting a CFC from claiming that it satisfied the Substantial Contribution Test when one or more of its branches also satisfied the Physical Manufacturing Test.
- *Alternatives to Predominant Contribution Test*: A description of alternatives to, and the consequences of, the Predominant Contribution Test where neither a branch nor the remainder of the CFC provides a significantly greater contribution to the manufacture of the item of property. Treasury and the IRS had considered a rule that would permit taxpayers to alternatively use the mean effective rate of tax among the locations where manufacturing

activity is performed, provided such mean effective rate was within a specified range (e.g., within a certain number of percentage points) but were concerned about the complexity of such a rule. Comments were requested on whether this or other alternatives to the highest rate test would be appropriate.

- *Simplification of branch tax rate disparity tests*: Whether additional modifications to the sales and manufacturing branch tax rate disparity tests should be adopted to make the rules relating to the comparison of effective rates of tax easier to apply.

Endnotes

1 REG-124590-07, 73 Fed. Reg. 10,716 (Feb. 28, 2007).

2 Treas. Reg. § 1.954-3(a)(4)(i).

3 Treas. Reg. § 1.954-3(a)(4)(i).

4 Treas. Reg. § 1.954-3(a)(4)(ii).

5 Treas. Reg. § 1.954-3(a)(4)(iii). Under a safe harbor rule, substantial manufacturing is deemed to occur if direct labor costs and factory burden are at least 20 percent of the cost of goods sold. *Id.* However, under no circumstances are "packaging, repackaging, labeling, or minor assembly" considered to constitute the manufacturing of property. *Id.*

6 *See, e.g.*, Rev. Rul. 75-7, 1975-1 C.B. 244, *revoked by* Rev. Rul. 97-48, 1997-2 C.B. 89.

7 Section 954(d)(1) defines FBCSI as income derived in connection with the purchase of personal property from a related (or an unrelated person) and *"its"* sale to an unrelated person (or a related person). Proponents of the "its" defense argue that a CFC may qualify for the Manufacturing Exception if the property that is purchased by the CFC (i.e., raw materials) is different from the property that it sells (i.e., the finished product), regardless of who (i.e., the CFC or a contract manufacturer) actually performs the manufacturing activities.

8 More specifically, a sales branch is treated as a separate corporation if the effective rate of foreign tax on the sales branch is less than 90 percent of, and at least 5 percentage points less than, the effective rate of tax that would have been imposed by the country of manufacture (or the country of incorporation if the sales branch is outside of the CFC's country of incorporation) on such sales income had it been earned in such country of incorporation by a company incorporated therein. Treas. Reg. § 1.954-3(b)(1)(i). In the case of a manufacturing branch, a similar analysis applies except that the hypothetical tax is based on the tax rate of the country where the manufacturing branch is located. The manufacturing branch and the remainder of the CFC are treated as separate corporations if the income allocated to the remainder of the CFC is taxed at an effective rate of tax that is both less than 90 percent and at least five percentage points less than the effective rate of tax that would apply to such income under the laws of the country in which the manufacturing branch is located. Treas. Reg. § 1.954-3(b)(1)(ii).

9 Treas. Reg. §§ 1.954-3(b)(1)(ii)(*a*) and (b)(2)(ii)(*a*).

10 Treas. Reg. § 1.954-3(b)(2)(ii)(*c*).

11 Treas. Reg. §§ 1.954-3(b)(3) and -3(b)(4), ex. 2.

12 73 Fed. Reg. 10,716, at 10,718.

13 *Id.*

14 *See, e.g.*, Prop. Treas. Reg. § 1.954-3(a)(4)(i) ("A [CFC] will have manufactured … property which [it] sells only if [the CFC] satisfies [the Physical Manufacturing Test or the Substantial Contribution Test] *through the activities of its employee*s with respect to such property." (Emphasis added)).

15 Prop. Treas. Reg. § 1.954-3(a)(4)(i) ("A [CFC] will not be treated as having manufactured … property which [the CFC] sells merely because the property is sold in a different form than the form in which it was purchased.").

16 Prop. Treas. Reg. § 1.954-3(a)(4)(iv)(*a*).

17 It is not clear what is intended by "management of the risk of loss." In the context in which it appears, the phrase might be intended to mean that the CFC should be involved in overseeing the contract manufacturer's risk of loss relating to the manufacturing process (e.g., by ensuring that the contract manufacturing has checks in place to ensure that the product being manufactured is not defective). If this is a correct interpretation of the phrase, then it might have been better to include the phrase within the context of the quality-control activity. It will be interesting to see how "management of the risk of loss" will be applied in practice by taxpayers and the IRS or whether further guidance will be issued when the regulations are finalized.

18 It is also not clear what activities a CFC would need to perform to be viewed as managing the manufacturing profits (e.g., would this include making decisions on how to invest the profits derived by the CFC in connection with its sale of property?).

[19] Prop. Treas. Reg. § 1.954-3(a)(4)(iv)(*b*).

[20] Prop. Treas. Reg. § 1.954-3(a)(4)(iv)(*a*).

[21] *Id.*

[22] Prop. Treas. Reg. § 1.954-3(a)(4)(iv)(*c*).

[23] Prop. Treas. Reg. § 1.954-3(b)(1)(ii)(*c*)(*3*)(*f*), ex. 4.

[24] *See* Prop. Treas. Reg. § 1.954-3(b)(1)(ii)(*c*). In addition, in instances in which a CFC carries on manufacturing activities with respect to separate items of personal property by or through more than one branch outside the CFC's country of incorporation, Prop. Treas. Reg. § 1.954-3(b)(1)(ii)(*c*)(*2*) provides that the manufacturing branch tax rate disparity test will be applied separately to each branch in determining whether the Branch Rule applies to create FBCSI. In our view, it is not a significant departure from the current regulations.

[25] *See* Prop. Treas. Reg. §§ 1.954-3(b)(1)(ii)(*c*)(*2*) and (*3*).

[26] *See* Prop. Treas. Reg. § 1.954-3(b)(2)(ii)(*c*)(*2*).

[27] For ease of reference, when we refer to more than one branch of a CFC, we also include instances involving one or more branches of a CFC and the remainder of the CFC.

[28] Prop. Treas. Reg. § 1.954-3(b)(1)(ii)(*c*)(*3*)(*b*). *See* Prop. Treas. Reg. § 1.954-3(b)(1)(ii)(*c*)(*3*)(*f*), ex. 1.

[29] Prop. Treas. Reg. § 1.954-3(b)(1)(ii)(*c*)(*3*)(*b*). *See* Prop. Treas. Reg. § 1.954-3(b)(1)(ii)(*c*)(*3*)(*f*), ex. 2.

[30] Prop. Treas. Reg. § 1.954-3(b)(1)(ii)(*c*)(*3*)(*c*). *See* Prop. Treas. Reg. § 1.954-3(b)(1)(ii)(*c*)(*3*)(*f*), ex. 3.

[31] Prop. Treas. Reg. § 1.954-3(b)(1)(ii)(*c*)(*3*)(*c*).

[32] *Id.*

[33] *Id.*

[34] Prop. Treas. Reg. § 1.954-3(b)(1)(ii)(*c*)(*3*)(*d*).

[35] *Id.*

[36] Prop. Treas. Reg. § 1.954-3(b)(1)(ii)(*c*)(*3*)(*e*). *See* Prop. Treas. Reg. § 1.954-3(b)(1)(ii)(*c*)(*3*)(*f*), ex. 4.

[37] Prop. Treas. Reg. §1.954-3(b)(2)(ii)(*c*)(*2*).

[38] *Id.* Prop Reg. §1.954-3(b)(2)(ii)(2)(*a*) provides rules for determining when a CFC is treated as a separate corporation apart from its manufacturing branch.

[39] 73 Fed. Reg. 10,716, at 10,722.

[40] The exclusion from the test for a CFC's cost of raw materials and marketing intangibles would facilitate the CFC's ability to meet a percentage-based test.

[41] If Treasury and the IRS were to adopt such an approach, it should not be so restrictive as to render it unlikely that a CFC could ever meet the safe harbor test.

If you have any questions regarding the above or would like to discuss the submission of comments to Treasury and the IRS, please contact the attorneys listed here.

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