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TAX TRANSACTIONS, TAX CONTROVERSY UPDATE

Final and Temporary Contract Manufacturing Regulations Issued by US Treasury Department and IRS

January 7, 2009

On December 24, 2008, the US Treasury and the IRS released final, temporary and proposed regulations relating to the application of the subpart F foreign base company sales income rules to contract manufacturing arrangements.[1] These regulations finalized certain of the proposed regulations relating to this subject that were originally released on February 27, 2008.[2] Also issued were temporary and proposed regulations that modify other of the February 27th proposed regulations. The text of the newly proposed regulations is the same as the corresponding temporary regulations. For purposes of this discussion reference will be made only to the final and temporary regulations released on December 24, 2008 (respectively, "final regulations" and "temporary regulations") and the proposed regulations released on February 27, 2008 (the "proposed regulations").

The final and temporary regulations reflect the significant number of public comments received by Treasury and the IRS and the comments made during the public hearing relating to the proposed regulations. Treasury and the IRS responded very quickly to the comments received and generally provide welcome clarification to the proposed regulations and, in many instances, provide the taxpayer-favorable results requested by commentators.

The final and temporary regulations are effective for taxable years of controlled foreign corporations (CFCs) beginning after June 30, 2009, and for taxable years of United States shareholders in which, or with which, such taxable years of the CFCs end. The temporary regulations will expire on or before December 23, 2011. Subject to certain procedural rules, taxpayers are permitted to apply the final and temporary regulations, in their entirety, retroactively to all of their open taxable years. Treasury and the IRS have requested comments on the temporary regulations by March 30, 2009; a hearing has been scheduled for April 20, 2009.

For purposes of this discussion, a certain degree of familiarity is assumed with regard to the foreign base company sales income rules (FBCSI) and with our February 29, 2008, Client Update, "Proposed Regulations Regarding Application of Foreign Base Company Sales Income Rules to Contract Manufacturing Arrangements" available at http://www.mayerbrown.com/publications/article.asp?id=4268&nid=6. This discussion

will generally describe the differences between the proposed regulations and the final and temporary regulations and certain items of interest for which comments were received by Treasury and the IRS and where no changes were made to the proposed regulations.

The final regulations provide some clarification of the "substantial contribution test" set forth in the proposed regulations. Under this test, a CFC may satisfy the manufacturing exception to the FBCSI rules if its employees perform certain activities that do not themselves constitute the physical transformation of raw materials into finished products. The highlights of the final regulations include:

- Modifying the substantial contribution test to take into account all employee functions, even if the employee only performs a portion of a particular indicia of manufacturing (e.g., only sample testing as part of quality control).
- Clarifying that there are no "super factors" that are required to satisfy the substantial contribution test. Therefore, oversight and direction of the manufacturing process is not necessarily required to satisfy the substantial contribution test.
- Clarifying the meaning of several of the listed activities that indicate that the CFC has substantially contributed to the manufacture of the property.
- Clarifying that buy-sell arrangements qualify under the substantial contribution test.
- Defining the term "employee" to include services performed by certain non-payroll workers.
- Removing the rebuttable presumption that appeared to apply an undefined higher standard for the substantial contribution test in cases where a branch of the CFC satisfied the physical manufacturing test.
- Adding examples to demonstrate that an automated manufacturing arrangement can satisfy the substantial contribution test if industry-sufficient substantial contribution activities are conducted by employees of the CFC.

The temporary regulations provide for several significant modifications of the "branch rule" of section 954(d)(2). Several of the issues addressed in the temporary regulations were discussed in the proposed regulations; however, given the significant changes to those rules, Treasury and the IRS appropriately re-issued those rules as temporary regulations. The highlights of the temporary regulations include:

- Providing some degree of clarity regarding the use of incentive tax rates in calculating a branch's hypothetical effective rate of tax.
- Modifying the "location of manufacture" rules to provide consistency for cases where a branch satisfies the "physical manufacturing" test or the "substantial contribution" test.
- Modifying the location of manufacture rules — in those cases where no branch independently satisfies the physical manufacturing test or the substantial contribution test — to require an analysis of whether any branch location (or the remainder of the CFC) provides a "demonstrably greater amount" of manufacturing activities.

- Providing that traveling employees activities count for purposes of the substantial contribution test, but only count for purposes of determining the location of manufacture if those activities occur in a branch (or remainder) jurisdiction.
- Treating certain unrelated purchase and sale transactions as generating FBCSI by reason of the application of the branch rule.
- Extensive examples that illustrate these rules.

Treasury and the IRS also requested comments regarding several items that were beyond the scope of the original regulation project. For instance, comments were solicited to further discuss the methodology for calculating hypothetical tax rates and for determining whether activities performed by a partnership's employees are counted for purposes of the substantial contribution test.

Final Regulations

GENERAL OPERATION OF THE SUBSTANTIAL CONTRIBUTION TEST

The proposed regulations established a substantial contribution test for the purpose of determining whether a CFC, through certain activities of its employees, could qualify for the manufacturing exception from FBCSI, notwithstanding the fact that the CFC fails to meet one of two physical manufacturing tests. The proposed regulations were unclear with respect to whether such employees were required to conduct all aspects of one of the listed indicia of manufacturing described in the proposed regulations, or whether any amount of employee activity with respect to such indicia of manufacturing was credited for purposes of applying the substantial contribution test.

Treasury and the IRS have added Treas. Reg. §1.954-3(a)(4)(iv)(c) to the final regulations to clarify that all CFC employee functions contributing to the manufacture of the personal property will be considered in the aggregate. In this regard, the final regulations provide that no single indicia of manufacturing (e.g., oversight and direction of the manufacturing process) will be accorded more weight than any other, and that no single activity would be required to be performed in all cases. Moreover, Treasury and the IRS clarified that there is no minimum threshold with respect to the functions performed by an employee before such functions are taken into account for purposes of the substantial contribution test. Therefore, all functions performed by a CFC's employees are considered under the substantial contribution test, even if the CFC's employees perform only some of the functions in connection with any one activity considered under the substantial contribution test. Treasury and the IRS also clarified that the weight given to an employee's functions will be based on the economic significance of that function in the manufacture of the property. Several examples were added to Treas. Reg. §1.954-3(a)(4)(iv)(d) to illustrate these principles.

Commentators also questioned whether more than one person can provide a substantial contribution to the manufacturing process with respect to a given product. In response to these comments, Treasury and the IRS also amended the final regulations to provide that a CFC may make a substantial contribution to the manufacture of the personal property even if another person also makes a substantial contribution to the manufacture of that property.

Treas. Reg. §1.954-3(a)(4)(iv)(d) Example 9 illustrates this principle.

The proposed regulations did not address whether the substantial contribution test could be applied to a buy-sell contract manufacturing arrangement. The final regulations add several examples illustrating that the substantial contribution test would also apply to buy-sell arrangements. See Treas. Reg. §1.954-3(a)(4)(iv)(d) Examples 3 and 9.

INDICIA OF MANUFACTURING

Treasury and the IRS received numerous comments relating to different aspects of the nine indicia of manufacturing described in the proposed regulations. Many of these comments were adopted in the final regulations and are discussed below. The changes resulted in the final regulations containing seven indicia of manufacturing, which cover many of the same activities as the original nine.

Oversight and Direction of the Manufacturing Process

Treasury and the IRS acknowledged in the preamble to the final regulations that the importance of oversight and direction of the manufacturing process will vary based on the facts and circumstances associated with the property at issue, and that it is likely to be an important element in many, but not all, substantial contribution analyses. Accordingly, the final regulations make clear that oversight and direction is not a prerequisite for satisfying the substantial contribution test, and may not be necessary in certain industries to satisfy the substantial contribution test. See Treas. Reg. §1.954-3(a)(4)(iv)(d) Example 10.

Additionally, the final regulations removed the potentially confusing word "regularly" in the phrase "regularly exercise oversight and direction" contained in Prop. Reg. §1.954-3(a)(4)(iv)(c) Example 1 describing the level of CFC oversight needed. Therefore, the final regulations clarify that there is no minimum level of oversight and direction required in order to satisfy this requirement.

We note that selection of the contract manufacturer is not explicitly identified by Treasury or the IRS as a factor to be considered in applying the substantial contribution test. Nevertheless, Treas. Reg. §1.954-3(a)(4)(iv)(d) Example 6 provides an illustration that this activity is considered in determining whether the CFC has satisfied the substantial contribution test.

Activities That Are Considered in, But Are Insufficient to Satisfy, the Physical Manufacturing Tests

The final regulations made no material changes to this indicia of manufacturing.

Material Selection, Vendor Selection, or Control of the Raw Materials, Work-in-Process or Finished Goods

In order to address certain comments, Treasury and the IRS grouped the following activities as a single activity: material selection, vendor selection, and control of the raw materials, work-in-process, or finished goods. Similarly, in order to address certain comments questioning whether

the proposed regulations apply to buy-sell arrangements, the final regulations deleted from Prop. Reg. §1.954-3(a)(4)(iv)(a) the phrase "purchased by a controlled foreign corporation," in order to eliminate any inference that a CFC needs to own, or bear the economic risk with respect to, the raw materials used in the manufacturing process. Additionally, examples in the final regulations clarify that buy-sell and turnkey manufacturing arrangements may satisfy the substantial contribution test. See Treas. Reg. §1.954-3(a)(4)(iv)(d) Examples 3 and 9.

Management of Manufacturing Costs or Capacities

Several commentators expressed uncertainty regarding the meaning of "management of manufacturing profits" and "management of the risk of loss" as used in the proposed regulations. Accordingly, the final regulations utilize a new term, "management of the manufacturing costs or capacities," to describe the contributions made by a CFC's employees to the manufacturing process through the functions that help to ensure that a plant is run in an economically efficient manner, such as optimization of plant capacity and reduction of waste. To elaborate on the meaning of this term, the final regulations contain a parenthetical list of examples of functions that includes: managing the risk of loss, cost reduction or efficiency initiatives associated with the manufacturing process, demand planning, production scheduling, and hedging raw material costs. Treasury and the IRS do not intend that corporate finance decisions or general management of enterprise risk should be considered in the substantial contribution test.

Control of Manufacturing Related Logistics

In response to comments received with respect to the proposed regulations, Treasury and the IRS clarified the scope of logistical functions that contribute towards a substantial contribution by a CFC. The final regulations revised this activity to read "control of manufacturing related logistics," which is intended to include, for example, arranging for delivery of raw materials to a contract manufacturer, but excludes delivery of finished goods to a customer.

Quality Control

Specific examples of quality control activities set forth in the final regulations are sample testing and the establishment of quality control standards. In response to certain comments relating to the question of traveling employees, discussed below in the temporary regulations section, Treasury and the IRS added an example to the final regulations that illustrates the application of the quality control factor. In Treas. Reg. § 1.954-3(a)(4)(iv)(d) Example 11, certain CFC employees travel to the contract manufacturer location to perform certain quality control activities for one week per quarter. The example concludes that the activities performed by the CFC employees would be considered when determining whether the CFC satisfied the substantial contribution test, and that those employees would be considered to have performed the necessary quality control functions

to the extent that such level of quality control is sufficient to control the quality of manufacturing in the CFC's particular industry.

Developing, or Directing the Use or Development of, Product Design and Design Specifications, Trade Secrets, Technology, or Other Intellectual Property Used in Manufacturing the Product

Treasury and the IRS made certain modifications to the final regulations to address various comments relating to the use and protection of intellectual property used in the manufacturing process. The final regulations changed the description of this activity to the disjunctive by replacing the "and" with an "or" to indicate that development, protection and use are not all required in order to satisfy this requirement. This is consistent with the concept that all activities of a CFC's employees are considered for purposes of the substantial contribution test, regardless of whether such employees perform all or only some of the functions listed in any enumerated item in the indicia of manufacturing.

In order to clarify that the work performed by in-house legal staff should not be considered under the substantial contribution test, Treasury and the IRS deleted the term "protection" from the final regulations. Moreover, the final regulations modified the description of this activity to clarify that developing, or directing the use or development of, product design and design specifications, trade secrets, technology, or other intellectual property, is considered under the substantial contribution test only when activities of this nature are undertaken for the purpose of the manufacture of property. Finally, the preamble of the final regulations clarifies that marketing intangibles are excluded from the term "intangible property" for purposes of determining whether the CFC's employees are developing or directing the use or development of intellectual property for purposes of the substantial contribution test.

In response to our comment letter, Treasury and the IRS also added an example in the final regulations to illustrate that, in certain circumstances, a CFC's direction of the development, protection, use or ownership of intellectual property may not be a relevant factor in determining whether such CFC substantially contributed to the manufacture of property. See Treas. Reg. §1.954-3(a)(4)(iv)(d) Example 8.

ANTI-ABUSE RULE AND SAFE HARBOR

Treasury and the IRS did not include any anti-abuse rule that prevents a CFC from satisfying the substantial contribution test in cases where other persons, related or unrelated, contribute to the manufacturing process. The final regulations include examples that illustrate that the contributions of other persons to the manufacture of a product are not relevant to the analysis of whether a CFC makes a substantial contribution to the manufacturing process. See Treas. Reg. §1.954-3(a)(4)(iv)(d) Examples 6, 7 and 9.

Additionally, no safe harbor is contained in the final regulations because Treasury and the IRS were unable to determine a set of circumstances that could be fairly applied across the range of industries potentially subject to these rules.

DEFINITION OF "EMPLOYEE"

In response to numerous comments, including our own comment letter, relating to the absence of a definition of employee in the proposed regulations, Treasury and the IRS clarified the meaning of the term "employee" in the final regulations to include activities performed by certain non-payroll workers. In this regard, the final regulations provide that the term "employee" means any individual who, under Treas. Reg. §31.6121(d)-1(c), has the status of an employee for US federal tax purposes. The preamble to the final regulations provides that this may encompass certain seconded workers, part-time workers, workers on the payroll of a related employment company whose activities are directed and controlled by CFC employees, and contractors, so long as those individuals are deemed to be employees of the CFC under Treas. Reg. §31.6121(d)-1(c).

Treas. Reg. §31.3121(d)-1(c)(1) provides that every individual is an employee if, under the usual common law rules, the relationship between him and the person for whom he performs services is the legal relationship of employer and employee. Such a relationship generally exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.

The regulations also provide that it is not necessary that the employer actually direct or control the manner in which the services are performed: it is sufficient if the employer has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work, and not as to the means and methods for accomplishing the result, that individual is an independent contractor.

Accordingly, this change in definition may result in an individual being treated as an employee of two or more entities simultaneously.

PRODUCT GROUPING

Commentators requested that the substantial contribution test be analyzed on the basis of a group or line of related products rather than on a product-by-product basis. In the preamble to the final regulations, Treasury and the IRS explain that the substantial contribution test must be met with respect to each product and that, for this purpose, whether manufactured goods are separate or single products "is determined by reference to the distinctions or lack thereof made by the CFC in its business operations and in its books and records, rather than by reference to a third party's definition or an industry product classification system." In this regard, Treasury and the IRS "recognize that some activities taken into account under the substantial contribution test are not

performed with respect to each individual unit of a particular product manufactured under a contract manufacturing arrangement." The final regulations contain an example to illustrate this point. See Treas. Reg. §1.954-3(a)(4)(iv)(d) Example 11 (where employees of a CFC travel to the contract manufacturer's manufacturing facility to perform quality control for one week per quarter).

REBUTTABLE PRESUMPTION

The proposed regulations contained a rebuttable presumption that a CFC would not satisfy the substantial contribution test when the activities of a branch of the CFC satisfied the physical manufacturing test. The final regulations do not retain this rebuttable presumption because Treasury and the IRS concluded that the substantial contribution test could be administered without it.

AUTOMATED MANUFACTURING

Several commentators questioned whether the automated manufacturing example, Prop. Reg. §1.954-3(a)(4)(iv)(c) Example 4, appropriately took into account certain manufacturing processes that best occur without human involvement, such as certain high technology industries in which human involvement may be counterproductive. Treasury and the IRS agree that a CFC may provide a substantial contribution to a largely automated manufacturing process through its employees and have accordingly modified the examples in the final regulations to clarify this point. The examples illustrate that the evaluation of whether a CFC makes a substantial contribution through its employees is determined based on whether industry-sufficient substantial contribution activities are conducted by employees of the CFC. See Treas. Reg. §1.954-3(a)(4)(iv)(d) Examples 5, 6 and 7.

SAME COUNTRY MANUFACTURING EXCEPTION

In response to certain comments, the final regulations permit the application of the substantial contribution test for purposes of applying the same country manufacture exception. However, in light of Treasury's and the IRS's concerns regarding administration of this rule in cases where substantial contribution is performed by an unrelated party, the final regulations limit this rule to instances where a related person provides a substantial contribution to the manufacture of the personal property in the CFC's country of organization.

DEFINITION OF BRANCH

Commentators requested that Treasury and the IRS define the term "branch." The final regulations do not provide a definition of this term. However, the final regulations revised Prop. Reg. §1.954-3(b)(1)(ii)(c)(3)(f) Example 3 to illustrate that employees of a CFC that travel to a contract manufacturer's location outside the CFC's country of incorporation do not necessarily give rise to a branch in that location. See Treas. Reg. § 1.954-3(b)(1)(ii)(c)(3)(f) Example 6.

Temporary Regulations

As mentioned above, the various changes to the regulations under section 954(d)(2),

relating to the branch rule, have been issued as temporary regulations (which will expire on or before December 23, 2011) and were also issued as proposed regulations with respect to which the IRS has requested comments and has scheduled a hearing for April 20, 2009.

DETERMINATION OF HYPOTHETICAL EFFECTIVE TAX RATE

The proposed regulations contained very little useful guidance on the application of the hypothetical effective tax rate for branch rule purposes. In response to commentators' requests, Treasury and the IRS have clarified the application of the hypothetical effective tax rate test with respect to widely available tax incentives in certain jurisdictions. The preamble to the final regulations provides that uniformly available tax incentives are to be considered in determining the hypothetical effective tax rate used in applying the tax rate disparity tests. However, specially negotiated rates of tax that may be obtained pursuant to a ruling process, but which have not been obtained for a manufacturing branch, are not considered in determining the hypothetical effective tax rate for such branch. The temporary regulations contain an example illustrating this point. See Treas. Reg. §1.954-3T(b)(4) Example 8.

It is not entirely clear whether and to what extent the IRS would permit a taxpayer to claim that a uniformly available tax incentive is considered in determining the hypothetical effective rate of tax when such a taxpayer must apply for such rate or otherwise comply with certain procedural requirements. It is possible that the temporary regulations were intended to prohibit taking into account only those incentive rates that are separately negotiated with the local tax authorities by means of an Advance Pricing Agreement (APA) or through a similar ruling process.

MULTIPLE MANUFACTURING BRANCH RULES

Determination of the Location of Manufacturing

The proposed regulations, particularly Prop. Reg. § 1.954-3(b)(1)(ii)(c)(3), provided a basis to determine the location of manufacture and, accordingly, which jurisdiction's rate of tax would be applied when multiple branches each provided the basis for the CFC to have satisfied the substantial contribution test. Under that rule, where more than a single branch, or a branch and the remainder of the CFC, satisfied the physical manufacturing test, for purposes of applying the tax rate disparity test, the location of manufacture was that jurisdiction in which the lowest rate of tax applied to such manufacturing profits (the "lowest rate of tax test"). On the other hand, where none of the branches or the remainder of the CFC satisfied the physical manufacturing test, for purposes of applying the tax rate disparity test, the location of manufacture was determined to be the jurisdiction that provided the predominant amount of the CFC's substantial contribution to the manufacture of the personal property

(the "predominant place rule"). In cases where no branch or the remainder of the CFC provided a predominant amount of the CFC's contribution to the manufacture of the personal property, then the location of manufacture was the place where manufacturing activity would be subject to the highest rate of tax (the "highest rate of tax test"). Commentators suggested that the satisfaction of the physical manufacturing test and the substantial contribution test should be treated equally under the regulations and that the use of the lowest rate of tax test and the highest rate of tax test did not provide for such equal treatment.

Treasury and the IRS generally agreed that the same rule should apply consistently when a branch or remainder independently satisfies Treas. Reg. §1.954-3(a)(4)(i), regardless of whether it satisfies the physical manufacturing test or the substantial contribution test. Therefore, the temporary regulations provide that the lowest-of-all rates rule will apply whenever more than one branch, or one or more branches and the remainder, each independently satisfy Treas. Reg. § 1.954-3(a)(4)(ii), (iii) or (iv). However, a different rule will apply in cases where a CFC as a whole satisfies the substantial contribution test, but no branch (or remainder) independently satisfies Treas. Reg. §1.954-3(a)(4)(iv).

The temporary regulations revise the rules used for determining the manufacturing location of the personal property when more than one branch (or one or more branches and the remainder) contributes to the manufacture of the personal property but where no branch (or remainder) independently satisfies the physical manufacturing test or the substantial contribution test. Treasury and the IRS state in the preamble that the branch rule should apply in situations where purchase or sale activities with respect to the personal property are separated from manufacturing activities conducted by the CFC such that a demonstrably greater amount of manufacturing activity with respect to that property occurs in jurisdictions with tax rate disparity relative to the sales or purchase branch (or, in the case of a purchasing or selling remainder, the demonstrably greater amount of manufacturing activity with respect to the personal property occurs in jurisdictions with tax rate disparity relative to the purchasing or selling remainder). The temporary regulations therefore provide that if a demonstrably greater amount of manufacturing activity occurs in jurisdictions without tax rate disparity relative to the sales or purchase branch, the location of the sales or purchase branch will be deemed to be the location of manufacture of the personal property. In such a case, the purchase or sales activities with respect to the property purchased or sold by or through the sales or purchase branch of the CFC will not be deemed to have substantially the same tax effect as if a branch were a wholly owned subsidiary corporation of the CFC. Otherwise, the location of manufacture of the personal property will be deemed to be the location of a manufacturing branch (or remainder) that has tax rate disparity relativeto the sales or purchase branch and the purchase or sales activities will be deemed to have substantially the same tax

effect as if a branch were a wholly owned subsidiary corporation of the CFC for purposes of applying the FBCSI regulations.

Similar rules apply in the case of purchase or sales activity being conducted through the jurisdiction under the laws of which the CFC is organized. In such cases, the analysis focuses on whether the demonstrably greater amount of manufacturing activity with respect to the personal property occurs in jurisdictions that do or do not have tax rate disparities relative to the CFC's jurisdiction. The temporary regulations provide examples under Treas. Reg. §1.954-3T(b)(1)(ii)(c)(3)(v) to illustrate the application of these rules.

LOCATION OF ACTIVITIES

The proposed regulations were unclear with respect to how or whether the activities of an employee were credited to the CFC for purposes of the substantial contribution test when the employee performed activities outside of the CFC's country of incorporation. The temporary regulations clarify this point in Treas. Reg. §1.954-3T(b)(1)(ii)(c)(3)(iv) by providing that an employee's activities performed when traveling are credited to the location in which the activities are conducted, if there is a branch or remainder of the CFC in that jurisdiction. Treas. Reg. §1.954-3T(b)(1)(ii)(c)(3)(v) provides examples to illustrate this result.

On the other hand, when a traveling employee performs activities in a location where no branch exists, the activity is not credited to the branch or remainder of the CFC where the employee is regularly employed for purposes of determining the location of manufacture under the branch rule. However, the activities of the traveling employee will be considered for purposes of determining whether the CFC has satisfied the substantial contribution test. See Treas. Reg. §1.954-3T(b)(1)(ii)(c)(3)(v) Example 6.

CLARIFYING APPLICATION OF THE RULE FOR DETERMINING THE REMAINDER OF THE CFC WHEN ACTIVITIES ARE PERFORMED IN MULTIPLE LOCATIONS

The temporary regulations clarify the application of Prop. Reg. §1.954-3(b)(2)(ii)(a), which provides that the sales or purchase income of a branch that is deemed to be a separate corporation excludes any branch or the remainder of the CFC that would be treated as a separate corporation for purposes of determining whether FBCSI is realized. The temporary regulations revise the proposed regulations in order to describe what is included in the remainder, rather than what is excluded from the remainder, for purposes of determining whether there is FBCSI. This rule is intended to provide that the activities of all branch locations (or, in the case of the remainder, the activities in the CFC's jurisdiction) that do not have tax rate disparity relative to the sales or purchase branch location (or, in the case of the remainder, the CFC's jurisdiction) may be taken into account together with the activities of the sales or purchase branch (or, in the case of a purchasing or selling remainder, activities of the remainder of the CFC in the CFC's jurisdiction) for purposes of applying the separate corporation analysis required under the regulations and determining whether the sales income of

the sales or purchase branch (or remainder) is FBCSI. This determination will depend on whether the substantial contribution test is satisfied by the combined activities of the sales or purchase branch (or remainder) and the other locations aggregated with the sales or purchase branch (or remainder).

COORDINATION OF SALES AND MANUFACTURING BRANCH RULES

Commentators were concerned that existing regulations suggest that the sales or purchase branch rules could be applied in addition to, rather than in lieu of, the sales or purchase branch rules. The temporary regulations clarify that when one or more sales or purchase branches are used in addition to a manufacturing branch and Treas. Reg. §1.954-3T(b)(1)(ii)(c)(1) (use of one or more sales or purchases branches in addition to a manufacturing branch) is applied with respect to income from the sale of an item of personal property, then the sales or purchasing branch rules do not also apply to determine whether that income is FBCSI. See Treas. Reg. §1.954-3T(b)(1)(i)(c).

UNRELATED TO UNRELATED TRANSACTIONS

Several commentators expressed concern that certain transactions could generate FBCSI when the substantial contribution rules apply. Taxpayers had taken the position that those transactions were outside the scope of the FBCSI rules, absent the application of the substantial contribution test. Treasury and the IRS state in the preamble that taxpayers may be subject to the FBCSI rules as a result of CFC employees performing indicia of manufacturing activities through a branch outside of the CFC's jurisdiction. Treasury and the IRS maintain that this result is clear in the proposed regulations and, thus, no changes are made to the temporary regulations to otherwise clarify the point. Treasury and the IRS indicated that, because the substantial contribution test and the physical manufacturing test are afforded equal weight, no exception is incorporated in the temporary regulations regarding activities performed through a branch located outside the CFC's jurisdiction for cases in which, in the absence of the substantial contribution test, some taxpayers had taken the position that they were outside the scope of the FBCSI rules.

BRANCH RULE EXAMPLES

The temporary regulations contain several modifications to clarify examples contained in the proposed regulations. Several clarifications are described below.

Commentators expressed confusion over the application of Prop. Reg. §1.954-3(b)(1)(ii)(c)(3)(f) Example 4, in which most substantial contribution activities were performed by the remainder of the CFC, yet the example concluded that the remainder had not met the substantial contribution test. Treasury and the IRS stated in the preamble to the temporary regulations that, although in that example the remainder of the CFC performed seven activities, the example was intended to illustrate that the weight accorded to the activities performed by each branch can be comparable. This was so even though a different number of activities occur in different locations,

because the economic significance of the activities conducted in each location was comparable. Accordingly, that example in the proposed regulations has been revised in Treas. Reg. §1.954-3T(b)(1)(ii)(c)(3)(v) Example 3.

Prop. Reg. §1.954-3(b)(1)(ii)(c)(3)(f) Examples 4, 5 and 6 have been restructured in the temporary regulations to be consistent with the revisions to the branch rules. Specifically, Examples 4 and 5 are amended in the temporary regulations to be consistent with section 954(d)(2), which provides that income attributable to the carrying on of purchase or sales activities by a branch may be FBCSI.

The temporary regulations contain a new example, Treas. Reg. §1.954-3T(b)(1)(ii)(c)(3)(v) Example 5, to illustrate how the substantial contribution test and the branch rules operate in cases involving multiple manufacturing branches and multiple sales branches.

Treas. Reg. §1.954-3T(b)(4) Example 9 illustrates the operation of the location of manufacture rules under Treas. Reg. §1.954-3T(b)(1)(ii)(c)(3), and the application of the substantial contribution test when a tested manufacturing location has been determined to have tax rate disparity with a tested sales location. Specifically, Example 9 illustrates that a tested sales location can satisfy the substantial contribution test for purposes of determining FBCSI once it has been determined that a tested manufacturing location should be treated as a separate corporation for purposes of determining FBCSI. Example 9 concludes that the CFC does not have FBCSI from the sale of the personal property because, after applying the aggregation rules of Treas. Reg. §1.954-3T(b)(2)(ii)(a), the tested sales location satisfies Treas. Reg. §1.954-3(a)(4)(iv).

Effective Date

The final and temporary regulations contain a delayed effective date in order to permit taxpayers to implement supply chain and structural changes that may be required to satisfy the substantial contribution test and branch rules. Accordingly, the final and temporary regulations will apply to taxable years of CFCs beginning after June 30, 2009 and for taxable years of United States shareholders in which or with which such taxable years of the CFCs end. For example, the final and temporary regulations will be applicable on January 1, 2010 for CFCs whose taxable year is the calendar year. The temporary regulations will expire on or before December 23, 2009.

Additionally, a taxpayer may choose to apply the final and temporary regulations retroactively with respect to its open taxable years. A taxpayer may do so only if the taxpayer and all members of the taxpayer's affiliated group apply both the final and temporary regulations, in their entirety, to the earliest taxable year of each CFC that ends with or within an open taxable year of the taxpayer and to all subsequent taxable years. A taxpayer that chose to apply the proposed regulations to its open taxable years may choose to continue to apply the proposed regulations in their entirety with respect to all of the taxpayer's open taxable years that begin prior to July 1, 2009.

Request for Comments

Treasury and the IRS have requested written comments on the temporary regulations by March 30, 2009.

TREATMENT OF PARTNERSHIPS

The preamble to the final regulations requests comments regarding whether and to what extent employees of a partnership should be treated as employees of the CFC for purposes of determining whether the CFC's relative economic interest in the partnership should be relevant in determining whether the CFC satisfies the substantial contribution test.

DETERMINATION OF HYPOTHETICAL EFFECTIVE TAX RATE

Treasury and the IRS continue to welcome comments relating to further clarification of the methodology for calculation of hypothetical tax rates and for changes to the assumptions used in applying the tax rate disparity tests and determining the hypothetical effective tax rate.

Endnote

1 T.D. 9438, 73 Fed. Reg. 79,334 (Dec. 29, 2008) available at http://edocket.access.gpo.gov/2008/pdf/E8-30727.pdf (final and temporary regulations); 73 Fed. Reg. 79,421 (Dec. 29, 2008) available at http://edocket.access.gpo.gov/2008/pdf/E8-30729.pdf (proposed regulations).

2 73 Fed. Reg. 10,716 (Feb. 28, 2008) available at http://edocket.access.gpo.gov/2008/pdf/E8-3557.pdf (proposed regulations).

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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