

IRS Issues Final and Temporary Regulations on Controlled Foreign Corporations' Contract Manufacturing Arrangements

US parent companies and certain other US shareholders of “controlled foreign corporations” (CFCs) are currently taxable on income earned by the CFC from related party purchases and sales of personal property (“foreign base company sales income”). A broad exception to this regime applies where the sales income arises from property “manufactured” by the CFC.

On December 24, 2008, the IRS issued final and temporary regulations that provide guidance on the treatment of arrangements entered into by a CFC that does not directly perform physical manufacturing of property, but instead engages a contract manufacturer to perform the manufacturing activity. The final and temporary regulations adopt a “substantial contribution” test that, if satisfied, allows a CFC to qualify as a “manufacturer” of property for purposes of excluding sales income with respect to such property from its foreign base company sales income that otherwise would be currently included in a US shareholder’s income.

The principal elements of the final and temporary regulations are highlighted below.

“**Substantial contribution**” test. The new regulations include a non-exclusive list of activities (“indicia of manufacturing”) to be considered in determining whether a CFC has made a “substantial contribution” to the manufacture of personal property. A CFC can satisfy these tests only through the activities of its own employees. In response to requests for further elaboration of this test, the new regulations provide additional guidance, including the following:

- In addition to any activities involved in physical manufacturing of property, other “indicia of manufacturing” include (1) oversight and direction of the manufacturing process; (2) selection or control of vendors, raw materials or work-in-process; (3) management of manufacturing costs or capacities; (4) control of manufacturing logistics; (5) quality control; and (6) developing or directing the use of intellectual property used in the manufacturing process.
- No single activity is determinative or will necessarily be given greater weight than the others. For example, in certain industries, a CFC can make a substantial contribution to manufacturing without engaging in “oversight and direction.”
- All CFC employee functions contributing to the manufacture of the personal property will be considered in the aggregate when determining whether a “substantial” contribution is made through the activities of a CFC’s employees.
- Purely contractual assumptions of risk, legal title, tax ownership, or assumption of economic risk will not be considered in the analysis.
- The new regulations clarify that the term “employee” may encompass certain seconded workers, part-time workers, and workers on the payroll of a related employment company whose activities are directed and controlled by the CFC.
- No general rules of documentation or objective safe harbors are provided, because the IRS and Treasury believe such rules would prove impracticable and would not allow for enough flexibility in application of the substantial contribution test.

Manufacturing branch rules. Under the CFC “branch rules,” the exclusion from foreign base company sales income for property manufactured by a CFC may be lost if the manufacture and sales functions are separated in different branches that have a significant effective tax rate differential. The final and temporary regulations provide additional guidance on the application of the manufacturing branch rules, including the following:

- CFC employees that travel to a contract manufacturer’s location do not necessarily give rise to a separate branch in that location, however, the Treasury reiterated that taxpayers may be subject to the foreign base company sales income rules as a result of CFC employees performing indicia of manufacturing activities through a branch outside the CFC’s country of organization.
- IRS and Treasury confirmed that uniformly applicable incentive tax rates will be taken into account in comparing the relevant effective tax rates for purposes of the tax rate disparity tests.

Rejection of the “Its” argument. Some taxpayers have taken the position that the foreign base company sales income rules do not apply to related party transactions where the property purchased by the CFC is sold in a different form. For example, a component purchased from a related party by the CFC and sold as part of a finished product arguably does not constitute “its” sale, even if a contract manufacturer and not the CFC wholly performed the manufacture of the finished product. In the preamble to the new regulations, the IRS and Treasury Department reiterate their rejection of this position under current law. In summary, sales income realized by the CFC may trigger the subpart F regime unless the CFC engages in sufficient activities to satisfy the physical manufacturing or substantial contribution tests with respect to the property at issue.

Effective date. The final and temporary regulations will apply to tax years of CFCs beginning after June 30, 2009, and for tax years of US shareholders in which, or with which, the tax years of the CFCs end. As a result, the final and temporary regulations will become applicable on January 1, 2010 for CFCs with calendar tax years.

Contact Ropes & Gray

Ropes & Gray would be pleased to assist clients in evaluating their CFC manufacturing operations under the new rules and in assuring that pre-existing contract manufacturing arrangements conform to the new regulations. If you have any questions or comments about these regulations or other international tax issues, please contact any member of the Tax & Benefits Department of Ropes & Gray.

*This alert should not be construed as legal advice or a legal opinion on any specific facts or circumstances.
This alert is not intended to create, and receipt of it does not constitute, a lawyer-client relationship.
The contents are intended for general informational purposes only, and you are urged to consult your own
lawyer concerning your own situation and any specific legal questions you may have.*