

IRS applies manufacturing exception to CFC that does not own and pass title to products sold

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In brief

In private letter ruling (PLR) 201325005, the IRS addressed the application of the manufacturing exception to a branch (Branch) of a foreign partnership (Foreign Partnership), which was wholly owned by several related controlled foreign corporations (CFCs) (the Partners). The PLR concludes that Branch's income derived in connection with the sale of products that it at no point holds or passes legal title to is not foreign base company sales income (FBCSI) because Branch makes a substantial contribution to the manufacture of the products sold within the meaning of Treas. Reg. Sec. 1.954-3(a)(4)(iv) despite the fact that the regulation applies to property "sold" by the CFC.

In detail

Summary of key issue

The PLR focuses on the use of the words "sale" and "sells" in the manufacturing exception in Treas. Reg. Sec. 1.954-3(a)(4)(i), and the use of the word "sale" in the substantial contribution exception under Treas. Reg. sec. 1.954-3(a)(4)(iv). Both regulation sections could be read to apply the manufacturing exception only to property that the CFC sells. In the PLR, Branch derives income from performing sales activities, rather than deriving income from actually selling the products. The PLR clarifies that the references in Treas. Reg. Sec. 1.954-3(a)(4)(i) and (iv) to a CFC being a selling entity should be construed

consistently with the FBCSI statutory definition to refer to any case in which the CFC derives income from selling activities that would otherwise be FBCSI. Therefore, having legal title or ownership of the products sold is not a requirement for applying the manufacturing exception under the FBCSI rules.

Observation: Although the purpose of the analysis in this PLR is for characterizing the CFC partners' distributive shares of partnership income, absent the application of the branch rule under Section 954(d)(2), the discussion about whether legal title is required for applying the manufacturing exception, and the PLR's conclusion, equally apply to a

CFC that satisfies the substantial contribution test and performs selling activities on behalf of a related party.

Observation: The PLR's analysis and conclusion equally apply to a foreign partnership with CFC partners, or a CFC, that satisfies the physical manufacturing exception and performs selling activities, without taking or passing legal title to the property sold.

Facts

Taxpayer, the domestic parent of a US based multinational group, and one of its wholly-owned domestic subsidiaries, jointly own FSub-1, a Country S corporation. FSub-1 wholly owns FSub-2, a Country T corporation. FSub-2 wholly

owns FSub-3, which is also a Country T corporation.

In addition, Taxpayer owns, directly and indirectly, several other foreign corporations that are the sole partners in Foreign Partnership, a Country V entity that elected to be treated as a partnership for US federal income tax purposes. Foreign partnership operates a legal branch in Country U. All of the Partners are organized in jurisdictions other than Country T and Country U.

Taxpayer, through its subsidiaries, manufactures and sells products. Specifically, with respect to products sold in Country T, FSub-3 purchases raw materials from related and unrelated suppliers and performs manufacturing activities to turn the raw materials into finished products. FSub-3's manufacturing activities qualify as manufacturing under Treas. Reg. Sec. 1.954-3(a)(4)(ii) or (iii) (physical manufacturing tests). Branch, through the activities of its employees in Country U, also performs manufacturing activities with respect to the products. Those activities qualify as a substantial contribution to the manufacture of the products within the meaning of Treas. Reg. Sec. 1.954-3(a)(4)(iv). FSub-3 then sells the manufactured products to FSub-2, at a price that allows FSub-3 to earn a cost-plus manufacturing return. Fsub-2 sells the products to unrelated third party dealers in Country T for use, consumption, or disposition in Country T within the meaning of Treas. Reg. Sec. 1.954-3(a)(3). Branch performs selling activities in Country U with respect to the sale of products in Country T. Branch never takes legal title to the raw materials, work in process, or finished goods for products sold in Country T. It is compensated for its role in the manufacturing, marketing, and selling of products by FSub-2 in the form of payments equal to a

percentage of the proceeds, which can vary, from the sale of products in Country T.

Discussion

Taxpayer, a US shareholder with respect to each Partner, is required to include in income under Section 951(a)(1) its pro rata share of Partners' FBCSI. Income from the payments received by Branch is included in Foreign Partnership's gross income. Unless exceptions apply, FBCSI includes income derived in connection with the sale of personal property to any person on behalf of a related person.

The PLR first discusses the subpart F rules for characterizing a CFC's distributive share of partnership income, as applied to the facts in the PLR. Each Partner's distributive share of gross income of Foreign Partnership is FBCSI to the extent the item of income would have been FBCSI if received by the Partner directly. Treas. Reg. Sec. 1.954-1(g)(1). For purposes of applying this characterization rule, a determination of whether an entity is a related person, within the meaning of Section 954(d)(3), or whether an activity occurred within or outside the country under the laws of which the CFC is created or organized, is made by reference to the CFC partner and not the partnership. Treas. Reg. Sec. 1.954-1(g)(1). However, for purposes of applying the manufacturing exception to a CFC partner's distributive share, only the activities of the employees of, and property owned by, the partnership are considered to determine whether the CFC partner will be treated as having manufactured, produced or constructed the product sold. Treas. Reg. Sec. 1.954-3(a)(6).

Branch receives payments from FSub-2 in compensation for Branch's role in the manufacturing, marketing and

selling of products in Country T. FSub-2 and Partners are related persons because FSub-2 is controlled by the same person (Taxpayer) that controls the Partners. Section 954(d)(3). Thus, applying the above-stated rules, the PLR provides that unless the substantial contribution exception in Treas. Reg. Sec. 1.954-3(a)(4)(iv) applies, each Partner's distributive share of income from the payments received by Branch would meet the definition of FBCSI even though Branch does not take title to the products because the income is derived in connection with a sale on behalf of a related person, and the products are both physically manufactured and sold for use, consumption or disposition in Country T, and therefore outside of the countries of organization of the Partners.

The PLR next discusses the application of the manufacturing exception, specifically the substantial contribution exception, and whether having title to the products is relevant for that exception to apply. Treas. Reg. Sec. 1.954-3(a)(4)(i) provides that FBCSI does not include income of a CFC derived in connection with the "**sale**" of personal property manufactured, produced or constructed by the corporation. That regulation further provides that a CFC will have manufactured, produced or constructed personal property that "**the corporation sells**" only if the corporation satisfies the exceptions set forth in Treas. Reg. Sec. 1.954-3(a)(4)(ii),(iii) or (iv). Similarly, Treas. Reg. Sec. 1.954-3(a)(4)(iv) provides that the substantial contribution exception applies if a CFC makes a substantial contribution to the manufacture, production or construction of property "**prior to sale by the CFC**". The references in the regulations to the CFC being the selling entity could be construed to

require that the CFC hold legal title to the property sold. However, the PLR does not adopt this view. Instead, it looks to the statutory definition of FBCSI, which includes any case in which the CFC derives income from selling activities, and concludes that “sale”, “sells” and “sold” in Treas. Reg. Sec. 1.954-3(a)(4)(i) and (iv) should be interpreted to include the performance of sales activities on behalf of a related person.

Conclusion

The PLR concludes that although Branch does not take or pass legal title to products sold in Country T, the income from the payments received by Branch from the sale of the products is excluded from FBCSI pursuant to Treas. Reg. Sec. 1.954-3(a)(4)(i) because Branch makes a substantial contribution through the activities of its employees to the manufacture, production or construction of the products within the meaning of Treas. Reg. Sec. 1.954-3(a)(4)(iv).

Observation: The PLR includes a representation that, in all cases in which a CFC owned by Taxpayer derives income (whether in the form of profits, commission, fees or otherwise) in connection with the sale of personal property to any person on behalf of a related person or the purchase of personal property from any person on behalf of a related person, Taxpayer will treat the income as FBCSI within the meaning of Section 954(d), subject to the applicable exceptions in Section 954(d) and the regulations thereunder, including Treas. Reg. Sec. 1.954-3(a)(4)(iv), regardless of whether the income could constitute foreign base company services income (FBCSvI) within the meaning of Section 954(e) (without taking into account any exceptions in Section 954(e)). It is not clear what, if anything, this representation accomplishes as it does not elaborate on what deriving income in connection with the sale or purchase of property on behalf of a related

person means or when such income might not otherwise be treated as FBCSI. The representation appears to be targeted at resolving potential uncertainties surrounding the characterization of income as sales or services income that can arise in certain contexts.

The takeaway

The PLR provides helpful insight into how the IRS views the application of the manufacturing exception. Under the interpretation adopted in the PLR, a company in the supply chain can derive income from the sale of personal property where it does not pass title but only engages in supporting sales activities and can still qualify for the manufacturing exception. This could occur, as it did under the facts of the PLR, where a principal company provides manufacturing and sales support to the supply chain and is compensated based on a percentage of the proceeds from the ultimate sale of the finished products.

Let's talk

For a deeper discussion, please contact:

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