

# WNTS *Insight*

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## Final contract manufacturing regulations address key issues for CFCs with branches

The IRS on December 15 issued final regulations under section 954 that address the application of the foreign base company sales income (FBCSI) rules to controlled foreign corporations (CFCs) with branches or similar establishments. The regulations, often referred to as the contract manufacturing regulations, finalize proposed regulations and withdraw temporary regulations issued in December 2008 with minor clarifying changes.

The regulations apply to tax years of CFCs beginning after June 30, 2009, and for tax years of U.S. shareholders in which or with which such tax years of the CFCs end. Taxpayers may choose to apply the final regulations retroactively with respect to open tax years that began prior to July 1, 2009, if and only if the taxpayer and all members of its affiliated group apply the final regulations, in their entirety, to the earliest tax year of each CFC that ends with or within a taxpayer's open tax year and all subsequent tax years.

The IRS also announced that it will study additional FBCSI issues and is considering whether to issue additional guidance.

### *Background*

The proposed and temporary regulations issued in 2008 provided modifications and additions to the branch rule regulations under section 954(d)(2). In particular, those regulations:

(1) clarified the manufacturing branch rule application to cases in which more than one branch, or one or more branches and the remainder of the CFC, perform manufacturing activity with respect to an item of property,



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(2) provided for the aggregation of branches that do not have tax rate disparity with one another for determining FBCSI,

(3) clarified that if the manufacturing branch rule applies with respect to an item of property then the sales branch rule does not apply, and

(4) modified and added examples clarifying the branch rule application in certain contexts.

When more than one branch, or one or more branches and the remainder, perform manufacturing activities, the regulations provided priority rules to determine the manufacturing location for purposes of applying the manufacturing branch tax rate disparity test in Reg. sec. 1.954-3(b)(1)(ii). The regulations also clarified that the manufacturing branch rule only applies if the CFC as a whole conducts sufficient activity to qualify as manufacturing under one of the manufacturing tests in Reg. sec. 1.954-3(a)(4) or carries on growing or extracting activities.

Under the priority rules, if more than one branch or one or more branches and the remainder each independently satisfy one of the manufacturing tests, the manufacturing location will be the location that imposes the lowest effective tax rate. If no branch or remainder independently satisfies one of the manufacturing tests, but the CFC as a whole makes a substantial contribution to the manufacture of personal property, the manufacturing location will be the "tested manufacturing location" unless the "tested sales location" provides a "demonstrably greater" contribution.

This rule effectively tests to see whether the majority of the manufacturing activity with respect to an item of personal property is performed in countries that have tax rate disparity with the location of sale. If the majority of the activity is performed in countries that have tax rate disparity with the country of sale, the location of sale will not qualify for the manufacturing exception because it will not be treated as the manufacturing location and will have tax rate disparity with that location. The regulations also clarified that the location of any activity is the location where the CFC's employees perform such activity. In addition, the activities of any branches located in the same jurisdiction are aggregated to determine whether a branch or remainder of the CFC manufactures personal property under Reg. sec. 1.954-3(a)(4)(i).

The regulations also clarified that an item of personal property refers to an individual unit of personal property rather than to a type or class of personal property. In addition, the regulations clarified that if a branch or the remainder of the CFC is treated as a separate corporation after application of a tax rate disparity test, that branch or remainder will include any other branch or remainder that would not be treated as a separate corporation (apart from such branch or remainder) after applying the tax rate disparity test. **Observation:** This rule effectively applies the manufacturing exception of Reg. sec. 1.954-3(a)(4)(i) to a tested branch or remainder by considering not only the activities of the tested branch or remainder but also the activities of any branch or remainder that does not have tax rate disparity with such tested branch or remainder.

When a CFC purchases or sells property through a branch that is manufactured through another branch, the proposed regulations also clarified that only the manufacturing branch rule, and not the sales branch rule, applies. If there is no tax rate disparity between the purchasing or selling branch and the manufacturing branch, the purchasing or selling branch will not be treated as a separate corporation

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even if tax rate disparity exists between the purchasing or selling branch and the remainder of the CFC.

## *Final regulations*

The final regulations (Reg. sec. 1.954-3(b)) modify the proposed and temporary regulations in three ways:

- (1) Reg. sec. 1.954-3T(b)(1)(ii)(c)(3)(iii) provided that, if no branch independently satisfies a manufacturing test but the CFC as a whole makes a substantial contribution, the "location of manufacture" will be the manufacturing location for purposes of applying the tax rate disparity test unless the "tested sales location" provides a "demonstrably greater" contribution.

The final regulations modified this section by removing the word "demonstrably" to clarify that the rule does not require an elevated standard of proof.

- (2) Reg. sec. 1.954-3T(b)(2)(ii)(a) provided for grouping of branches that do not have tax rate disparity with one another for purposes of determining whether a branch, treated as a separate corporation, has FBCSI (thereby allowing the activities of branches that do not have tax rate disparity with the branch to be considered in determining whether the branch satisfies the manufacturing exception).

The final regulations added the phrase "the activities of" to clarify that the rule applies only to group the activities, and not the income, of the branches.

- (3) Reg. sec. 1.954-3(b)(2)(ii), provided that income that is FBCSI as a result of Reg. sec. 1.954-3(b)(1)(i) (the purchasing/selling branch rules) is not again classified as FBCSI as a result of Reg. sec. 1.954-3(b)(1)(ii) (the manufacturing branch rules).

The final regulations removed this section. It is no longer needed because of the addition of Reg. sec. 1.954-3(b)(1)(ii)(c)(1), which provides that only the manufacturing branch rules apply if one or more purchase or sales branches are used in addition to a manufacturing branch.

**Observation:** The preamble to the final regulations states that these are clarifying changes made at the request of taxpayers rather than substantive changes intended to alter the application of the rules. Therefore, these changes presumably do not affect the manner in which the IRS had been applying the regulations prior to finalization.

## *Possible future guidance*

Future FBCSI guidance could cover a variety of additional issues, such as when a branch should be treated as a separate corporation under section 954(d)(2), and the scope of, and relationship between, FBCSI and foreign base company services income (FBCSvI). The IRS welcomes comments on these issues.

**Observations:** The final regulations do not indicate specifically what issues the IRS is studying, but there are a number of possible issues that the IRS could consider.

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Guidance on when to treat a branch as a separate corporation could address:

- the definition of a "branch or similar establishment";
- the allocation of income to a branch for purposes of determining the amount of FBCSI; and
- the determination of the effective tax rate for purposes of applying the tax rate disparity tests in Reg. sec. 1.954-3(b)(1)(i).

Guidance on the definition of "branch or similar establishment" could address:

- generally what type of presence, activity, or other connection in, or with, a country constitutes a branch or similar establishment for purposes of applying the branch rule of section 954(d)(2); and
- specifically, whether partnerships should be treated as branches either generally or in certain contexts.

Guidance addressing allocation of income to branches could explain what principles apply in dividing a CFC's income among its branches and remainder when calculating FBCSI.

Guidance for applying the tax rate disparity tests could clarify the interaction of U.S. and foreign tax principles in the computation of the effective tax rates.

Guidance concerning the scope of, and relationship between, FBCSI and FBCSvI could:

- address what types of income properly fall within each category;
- address a priority between the two rules when income potentially could be categorized as either; and
- clarify that income is properly categorized as either services or purchasing/sales and not both such that only one subpart F income category (FBCSI or FBCSvI) is potentially applicable to any particular item of income.

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