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Contract Manufacturing and the Branch Rule

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New Proposed Regulations

- New regulations (“Proposed Regulations”) were issued on February 27, 2008. 73 Fed. Reg. 10,716 (Feb. 27, 2008)
- The regulations are not effective until taxable years beginning on or after the date that they are finalized, but the preamble indicates that:
 - “Until these regulations are finalized, taxpayers may choose to apply these regulations in their entirety to all open tax years as if they were final regulations.” 73 Fed. Reg. 10,722
 - Applied at US shareholder level, product by product, CFC by CFC?
- Will final regulations provide a transition rule?
- Comments submitted and hearing held

Highlights of the Proposed Regulations

- Reject the “its” defense
- Reject the use of “attribution” to satisfy the manufacturing exception
- Embrace the *Electronic Arts* reliance on a CFC’s own activities other than “turning the screws” to satisfy the manufacturing exception (the “substantial contribution” test)
- Provide some guidance on the application of the manufacturing branch rule

The Substantial Contribution Test

- The CFC will be considered to have manufactured or produced the product if the CFC, through its own “employees” makes a “substantial contribution” to the manufacture of the product
- There is no definition of “substantial,” bright line test or safe harbor
- A number of factors are considered; none is controlling
- Proposed regulations list nine non-exclusive factors
- Does not apply for purposes of “same country manufacturing” test

Proposed Factors

1. Oversight and direction of the activities or process (including management of the risk of loss) 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 or generally considered manufacturing tests
3. Control of the raw materials, work-in-process and finished goods

Proposed Factors (cont.)

4. Management of the manufacturing profits
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

Questions Raised by List of Qualifying Activities

- What activities would be “considered in but that are insufficient to” satisfy the other manufacturing tests?
- What about demand planning and capacity management?
- What about production planning?
- Must the CFC actually bear risk of loss (v. “manage”)?
- How important a factor is product design/R&D?

Questions Raised by List of Qualifying Activities (cont.)

- If the CFC has risk of loss, are turnkey situations treated the same as consignment?
 - Any significance to fact that all examples address a consignment manufacturing arrangement?
 - If substantial contribution activities occur within “services model”, could it qualify as manufacturing?
- Expanded definition of manufacturing?
- Superfactors?
- How does IRS assess whether “substantial”?

Insights Gained from Examples

- Examples not very telling about how to measure substantiality
- Examples emphasize activities actually performed and directed
 - Funding is not enough
 - Mere contractual ownership of materials and IP not enough
 - Merely having authority to perform an activity without regular exercise of that authority is insufficient
 - In Ex 2, product design + QC + regular oversight and direction was sufficient
 - In Ex 3, QC + regular oversight + control of materials + control of logistics + vendor selection was sufficient

Multiple Manufacturing Branch Rules

- The introduction of the “substantial contribution” concept increases the number of possible branches, which increases the need for guidance
- Separate property rule: If different branches manufacture separate property:
 - Test each manufacturing branch separately as if it were the only manufacturing branch

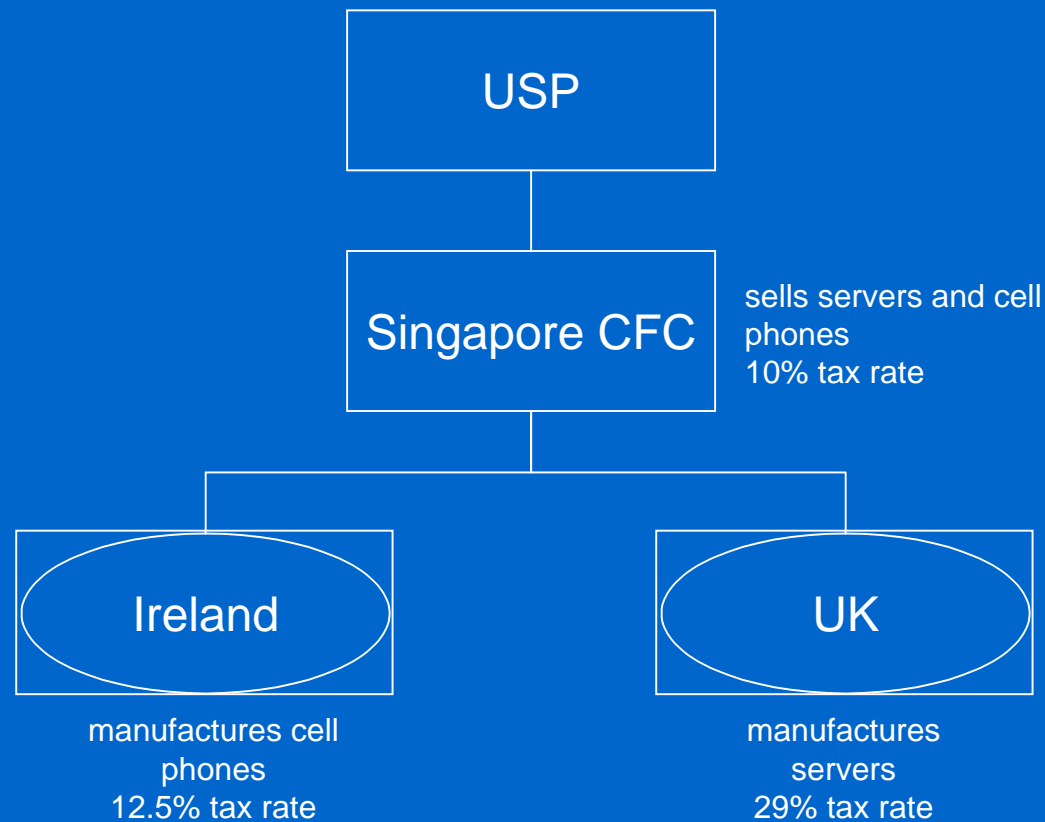
Multiple Manufacturing Branch Rules (cont.)

- Same property rules: If more than one manufacturing location manufactures the same property:
 - A hierarchy of rules applies to determine which manufacturing branch must be tested
 - If only one location (i.e., branch or remainder) meets one of the physical manufacturing tests, presumption that other locations are not manufacturing
 - If more that one location meets one of the physical manufacturing tests, the one that has the lowest effective tax rate on the allocated income is treated as the manufacturing location

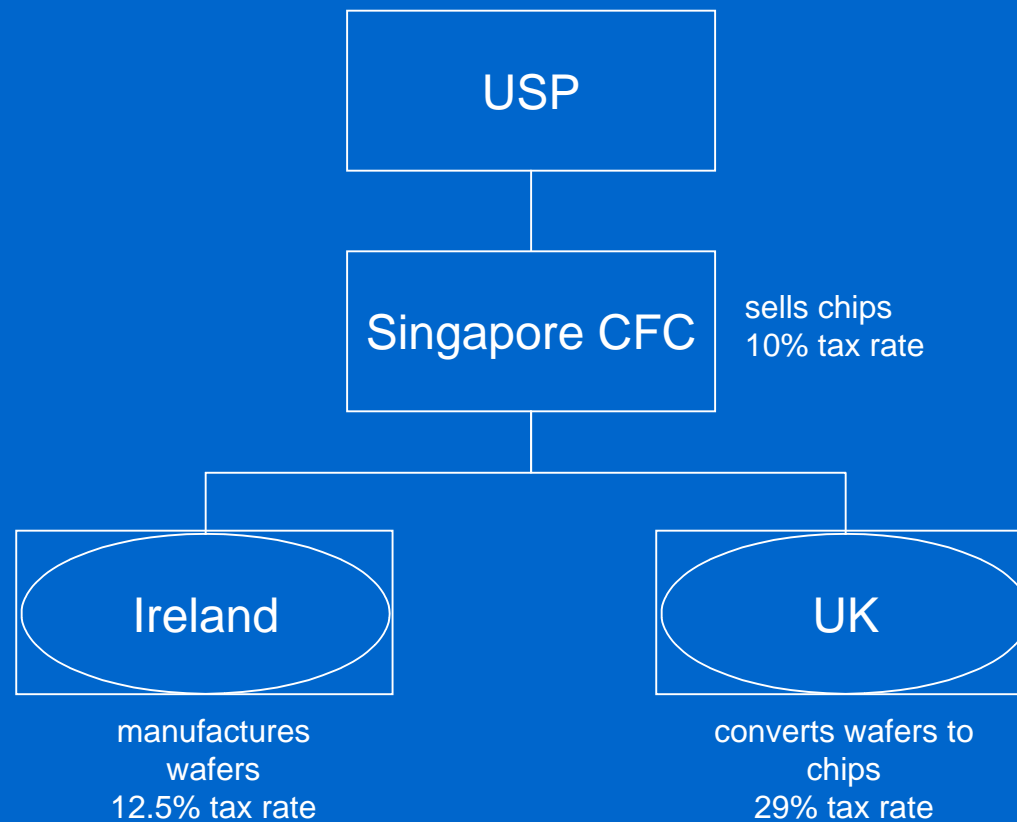
Multiple Manufacturing Branches – Same Property Rules (cont.)

- If none of the locations by itself satisfies one of the physical manufacturing tests, but the combined activities of the CFC satisfy the substantial contribution test:
 - Compare each country’s aggregate activities to determine which, if any, country’s activities provide the “predominant amount” of the CFC’s substantial contribution
 - “Predominant amount” requires “significantly greater” contribution than any other location
 - Examples suggest “predominant amount” test is a high hurdle
 - If none of the locations meets the “predominant amount” test, the location with the highest effective tax rate is tested

Multiple Physical Manufacturing Locations Making Different Products



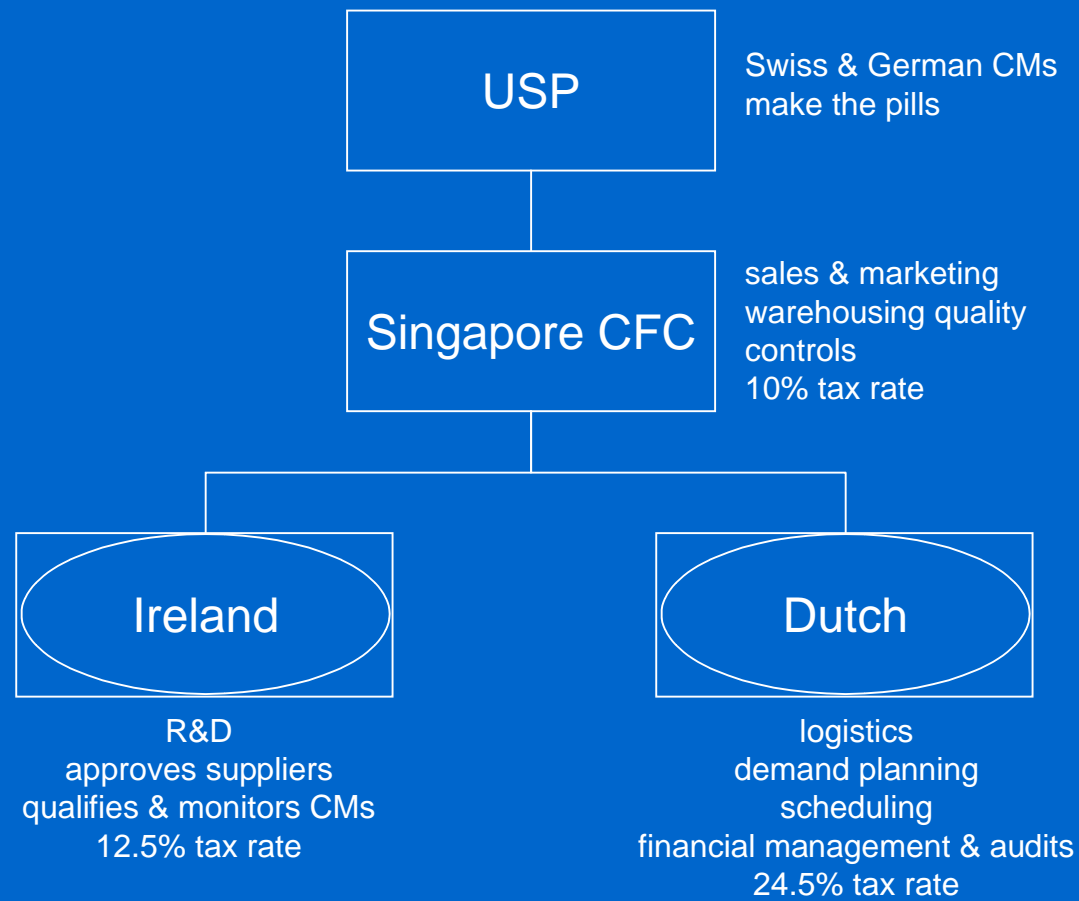
Multiple Physical Manufacturing Locations Making a Single Finished Product



Negative Presumption

- Presume in this specific fact pattern (i.e., physical manufacturing occurs through a branch), that the remainder of the CFC does not substantially contribute to the manufacture of the product. Prop. Reg. §1.954-3(b)(2)(ii)(c)(2)
- This presumption can be overcome at the discretion of the secretary. The taxpayer need not show “clear and convincing” evidence to overcome the presumption. The examples do not elucidate how this presumption is to be overcome. Prop. Reg. §1.954-3(b)(2)(ii)(c)(2) Examples 1 and 2

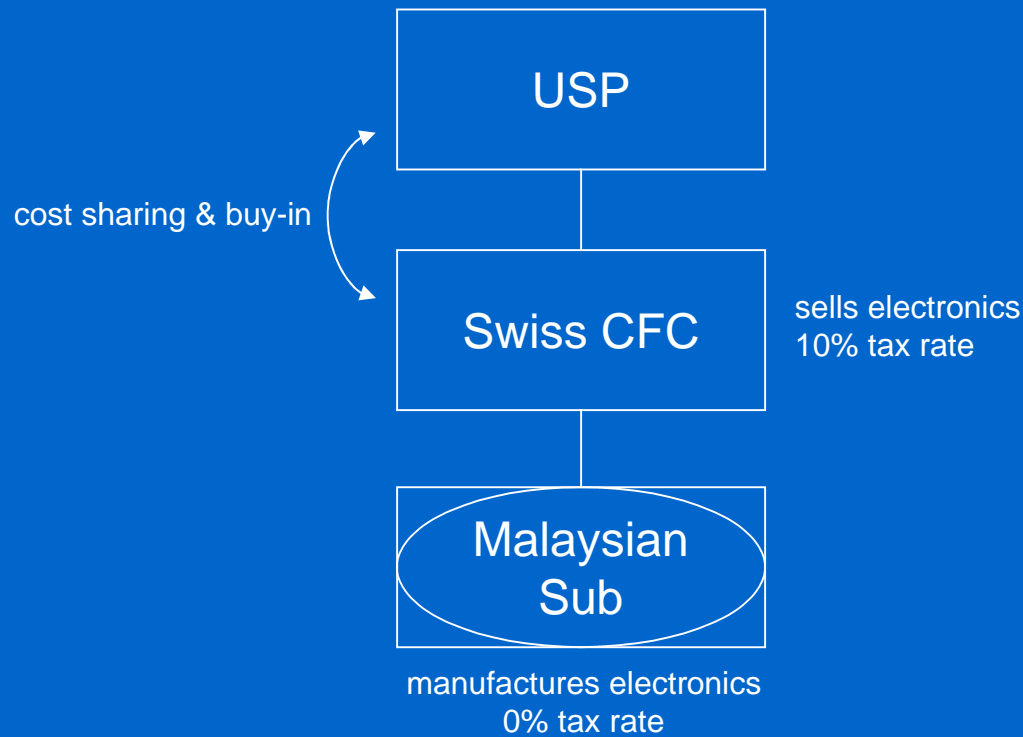
No Physical Manufacturing and No Predominant Contribution



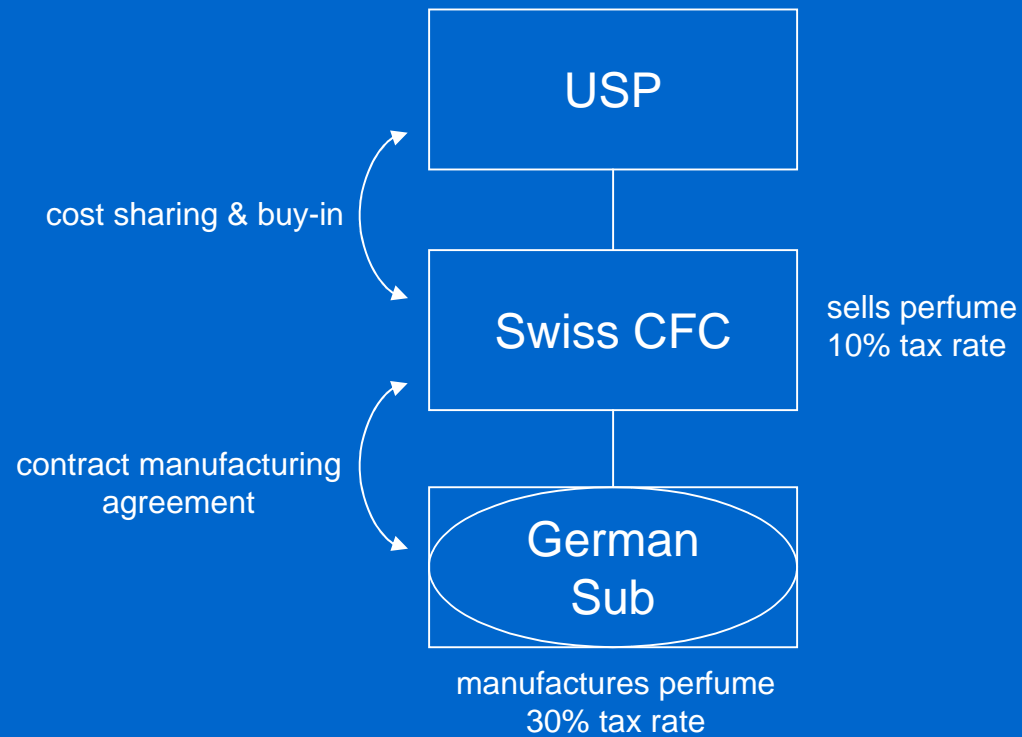
Traps and Uncertainties: Planning Points

- What is a branch and what are employees?
- Whether statutory rate or incentive tax rate applies for purposes of hypothetical tax rate calculation
- How to allocate income among multiple branches
 - Is the FBCSI inclusion limited to income attributable to purchasing and selling activities in the sales branch?
 - Is income from intangibles “manufacturing” income?
 - Does it matter what income is booked by disregarded entities?
- Will final regulations provide any further guidance?

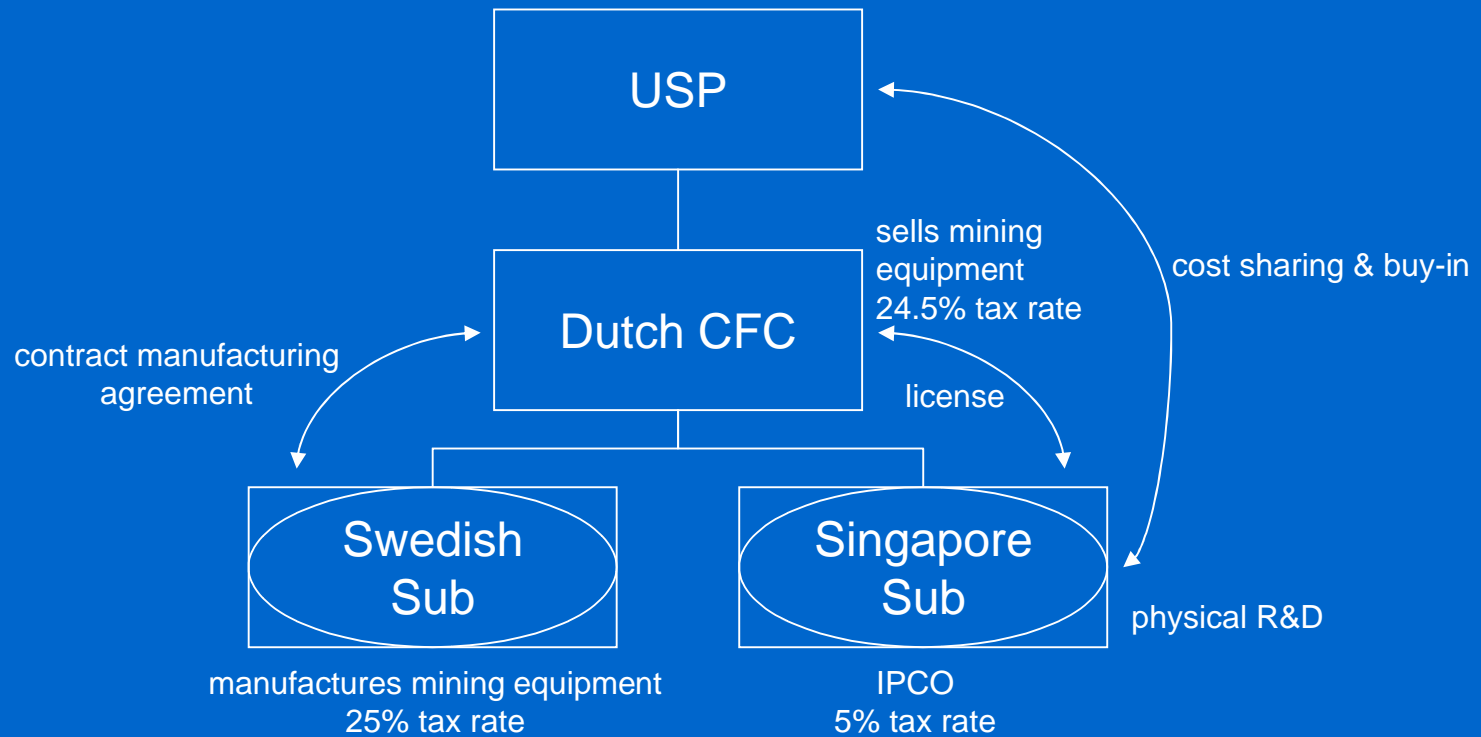
Treatment of Incentives



Income Allocation



Income Allocation



Traps and Uncertainties: Planning Points

- Uncertainty in determining when activities meet substantial contribution test creates planning challenges
- Dangerous to combine physical manufacturing with “substantial contribution”
 - How can “rebuttable presumption” be overcome?
- Superfluous branch could cause taxpayers to trip default-to-highest-effective-rate-location rule if “predominant amount” test not satisfied
- Possible manufacturing branch rule issue where “substantial contribution” test met in structures relying on third party purchase and sale defense
- Can avoid multiple branch problems by separately incorporating substantial contribution activities
 - Conflicts with typical planning objectives for subpart F, § 482 and ECI purposes

Planning Response: Taxpayer Previously Relying on “Its” or Attribution

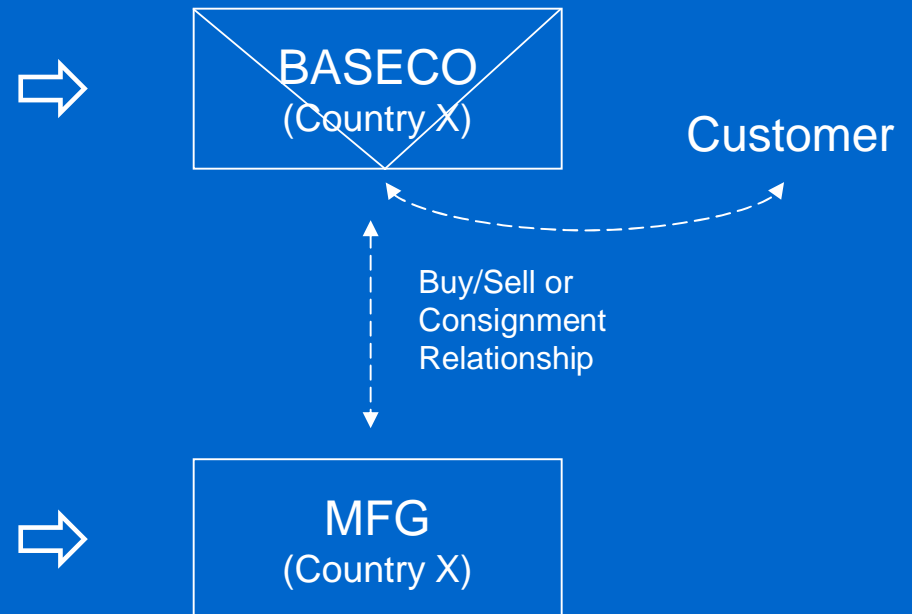
- Modify structure to obtain substantial contribution
 - Quality more important than quantity of employees
 - The examples arguably suggest that the taxpayer should attempt to demonstrate that a majority of substantial contribution activities are performed by the principal CFC (or branches that do not satisfy the tax rate disparity test)
 - Depends on the industry, but emphasis should likely be on oversight and quality control. *See Medchem (P.R.), Inc. v. Commissioner*, 116 T.C. 308 (2001), aff'd 295 F.3d 118 (1st Cir. 2001)
- Create a “same country” match through reverse hybrid or dual resident company?

Reverse Hybrids

Provided that BASECO's activities are sufficiently minimal, BASECO could potentially avoid tax in Country X

Because BASECO sells products manufactured in Country X, it has a same country match and no FBCSI

MFG would continue to manufacture Products as it is doing currently.



* BASECO need not own MFG. Companies can be brother-sister or even unrelated. The primary obstacle here will be ensuring that BASECO is not subject to Country X taxation on its activities

Dual Resident Companies

- Works very much like a reverse hybrid: Once again relying on the same country exception
- Need a country of incorporation that determines tax residency based on factors other than place of incorporation (e.g., “management and control”)
- Need to be resident in a low tax place and/or base erode with deductible royalties

Planning Response: Taxpayer Engaged in Physical Manufacturing Concerned About Branch Rule

- To the extent that there is an issue, consider unchecking the box on physical manufacturing activities to avoid the negative presumption that the remainder of the CFC is not substantially contributing
- Consider moving activities to enhance the ability to demonstrate substantial contribution

Planning Response: Taxpayer Concerned About Branch Rule in “Unrelated” Structure

- Consider restructuring or using check-the-box elections to trim the CFC of superfluous branches
 - Hive off high-tax locations with substantial contribution activities
 - Hive off problematic low tax locations with purchasing and selling activity (to the extent possible)
- Typical Goals
 - Eliminate the highest tax rate locations
 - Concentrate substantial contribution activities to satisfy predominant amount test
 - Even if rate test is satisfied, ensure substantial contribution defense in remainder

Planning Response: Taxpayer Concerned About Branch Rule in “Unrelated” Structure (cont.)

- Consider impact of restructuring/checking the box on foreign material participation defense to ECI/PE
 - Create new separate entity and transfer non-substantial contribution assets and employees?

Proposed Planning Approach

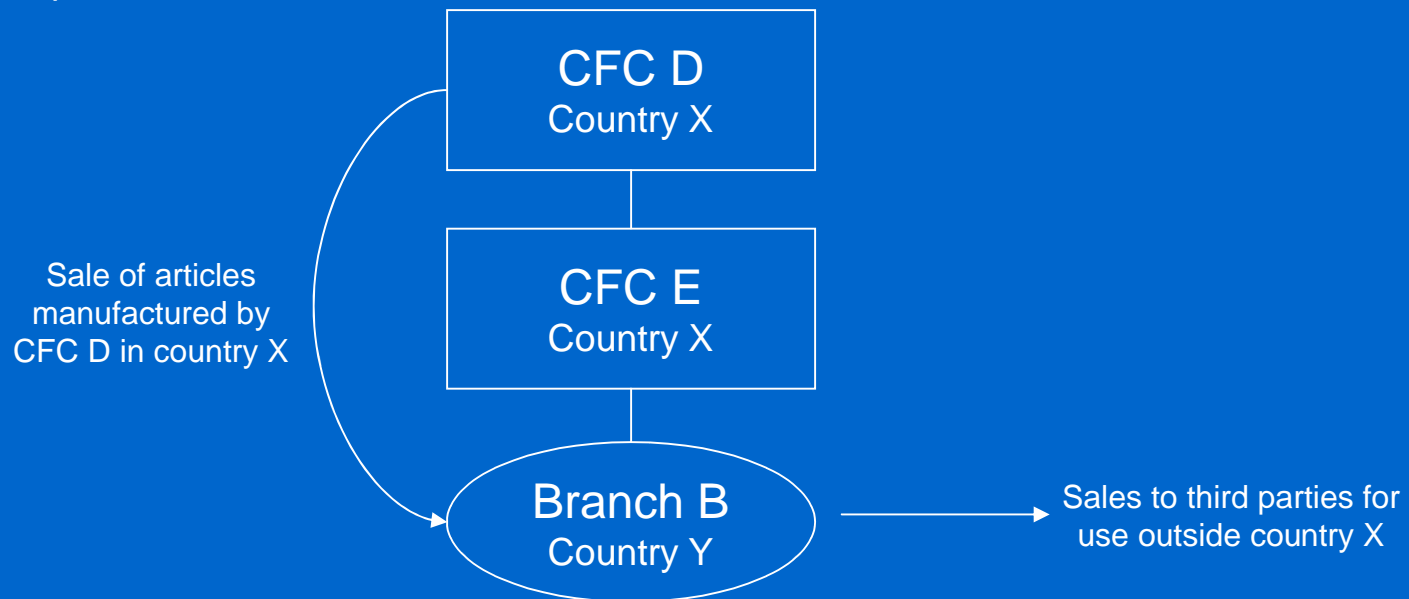
- Identify and measure all locations within CFC where substantial contribution activities occur
- Evaluate which would be tested manufacturing location under the Proposed Regulations
 - Predominant amount?
 - Highest tax location?
- Identify purchasing and selling locations within CFC and apply tax rate disparity test to each

Proposed Planning Approach (cont.)

- Even if rate disparity test satisfied, does the remainder have a substantial contribution defense?
 - Must disregard any manufacturing activities taking place in a location within the CFC that meets the rate disparity test vis-à-vis the tested purchasing/selling location. See Prop. Reg. § 1.954-3(b)(2)(ii)(a)
- Develop restructuring/check-the-box solutions (per prior slides)

Changes to Controversial Example 3

- Branch B income still FBCSI – this conclusion seems questionable
- If CFC D and CFC E unrelated, no FBCSI – buying unrelated and selling unrelated
- If Branch B “manufactures” under substantial contribution test, no FBCSI – qualifies for manufacturing exception
- What is impact of TAM 8509004?



FIN 48 Considerations

- Issues result from what type of structure company has today and will target under proposed regulations
- Transition plan – until final regulations issued
 - Early adoption?
 - May not affect recognition (unless early adoption)
 - Likely will affect measurement
- Once final regulations are issued
 - Analysis and effect in quarter in which company adopts, or regulations issued
 - Assess effect of transition rule if any
- Timing, scope, complexity of analysis by company, advisors and auditors