

TEI/SJSU High Technology Tax Institute

BREAKOUT SESSION C

AVOIDING SURPRISES IN THE CONTRACT MANUFACTURING REGULATIONS

*How to deal with the branch rule changes, treatment of R&D,
documentation and more*

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1

Notice

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Today's presenters

- Michael A. DiFronzo, IRS
Deputy Associate Chief Counsel
(International-Technical)
Office of the Chief Counsel
- Channing P. Flynn, Partner
International Tax Services
Ernst & Young LLP
San Jose, CA
+1 (408) 947-5435
- Diana L. Hickey, Partner
Baker & McKenzie LLP
Palo Alto, CA
+1 (650) 856-5548

Today's agenda

- Introduction
- Overview of the final and temporary regulations
- The IRS' perspective
- Substantial contribution – developments & insights
- Branch rules – developments & insights

Introduction

- Proposed contract manufacturing regulations published in February, 2008
- Final, temporary and proposed regulations issued in December, 2008
- Effective for tax years of CFCs beginning after June 30, 2009
- Present many issues unique to global high-technology companies
- Will have a varying impact on taxpayers – some taxpayers lobbied for the substantial contribution test while others may have significant concerns

Overview of the final regulations

- Foreign base company sales income (“FBCSI”) does not include income from the sale of property manufactured by the CFC in whole or in part from property which it has purchased
- Property sold will not be considered the property purchased if:
 - Product is substantially transformed prior to its sale by the CFC - see Treasury Regulation 1.954-3(a)(4)(ii).
 - Activities conducted by the CFC with respect to purchased component parts are substantial in nature and are generally considered to constitute manufacturing, production or construction of property (including a safe-harbor) – see Treasury Regulation 1.954-3(a)(4)(iii).
 - CFC makes a substantial contribution to manufacturing the product through the activities of its employees – see Treasury Regulation 1.954-3(a)(4)(iv).

Overview of the final regulations (cont'd)

- Indicia of manufacturing (Treas. Reg. 1.954-3(a)(4)(iv)(b)):
 - Oversight and direction of the activities or process pursuant to which the property is manufactured
 - Activities considered in, but insufficient to satisfy, the physical manufacturing tests
 - Material selection, vendor selection, or control of raw materials, work-in-process or finished goods
 - Management of manufacturing costs or capacities

Overview of the final regulations (cont'd)

- Indicia of manufacturing (Treas. Reg. 1.954-3(a)(4)(iv)(b)) (cont'd):
 - Control of manufacturing related logistics
 - Quality control (for example, sample testing or establishing quality control standards)
 - Developing, or directing the use or development of, product design and design specifications, as well as trade secrets, technology, or other intellectual property for the purpose of manufacturing, producing, or constructing the personal property

Overview of the final regulations (cont'd)

- Applying the substantial contribution test:
 - Substantial contribution indicia are non-exhaustive
 - No single activity accorded greater weight or required in every case
 - Weight of each factor based on economic significance of functions to the manufacture of the property
 - Purely contractual assumptions of risk not considered
 - All CFC's employee's functions contributing to manufacture considered in the aggregate
 - More than one person can provide a substantial contribution
 - Contributions of other persons not relevant in determining whether CFC satisfies test

Overview of the branch rules

- Branch rules apply when:
 - Manufacturing or sales activities are carried out by a branch of the CFC located outside of the CFC's country of incorporation
 - Sales/purchasing branch: Does the income allocated to the sales or purchasing branch fail the tax rate disparity test when compared to the CFC?
 - Manufacturing branch: Does the income allocated to the CFC fail the tax rate disparity test when compared to the location of the manufacturing branch?
- In substance, these rules are designed to prevent an artificial shift of sales income away from the manufacturing location to take advantage of a lower tax rate

Overview of the branch rules (cont'd)

- Tax rate disparity test:
 - Takes into account actual tax rate with regard to sales income
 - To determine hypothetical tax, uniformly available tax incentives are considered; if affirmative action required, taxpayer must affirmatively obtain incentive
- Unrelated-to-unrelated transactions are covered by these rules
- Multiple manufacturing branch rules have been significantly changed from February 2008 proposed regulations
- Preamble states that the definition of “branch” is beyond scope of regulations

Overview of the branch rules (cont'd)

- Only one location manufactures: that location is the tested location, even if low rate and thus would not result in disparity
- Two or more locations independently manufacture (substantial contribution or physical manufacturing): lowest tax rate is tested location
- If no location manufactures, but CFC as a whole manufactures:
 - First step: Tested location is the one among locations having disparity with sales location that has the lowest rate
 - Second step:
 - Aggregate sales location with all other low-tax locations (“tested sales location”)
 - Aggregate tested location with all other high-tax locations (“tested manufacturing location”)
 - No FBCSI if tested sales location contribution “demonstrably greater” than tested manufacturing location contribution
 - Third step: Does tested sales location substantially contribute?

The IRS' perspective

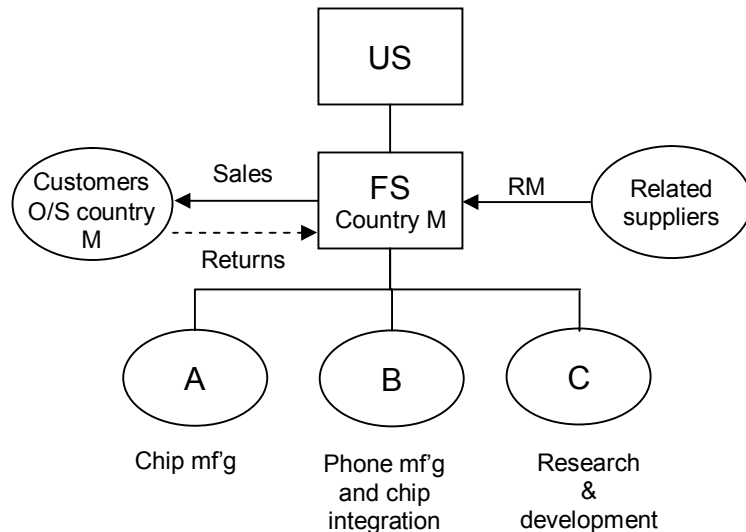
- In general:
 - Application of the final and temporary regulations
 - Interaction with the Administration's tax proposals
- Specific issues:
 - Documentation for substantial contribution and income allocation
 - Ongoing examinations & closing agreements
 - Issue resolution through pre-filing agreements and/or letter rulings

Substantial contribution

- Developments and insights:
 - Definition of “substantial”
 - Application to split manufacturing models and assembled equipment
 - Research & development activities
 - Same-country manufacturing exception – why limited to related parties where using substantial contribution exception
 - Activities conducted before regulations became final

Substantial contribution (cont'd)

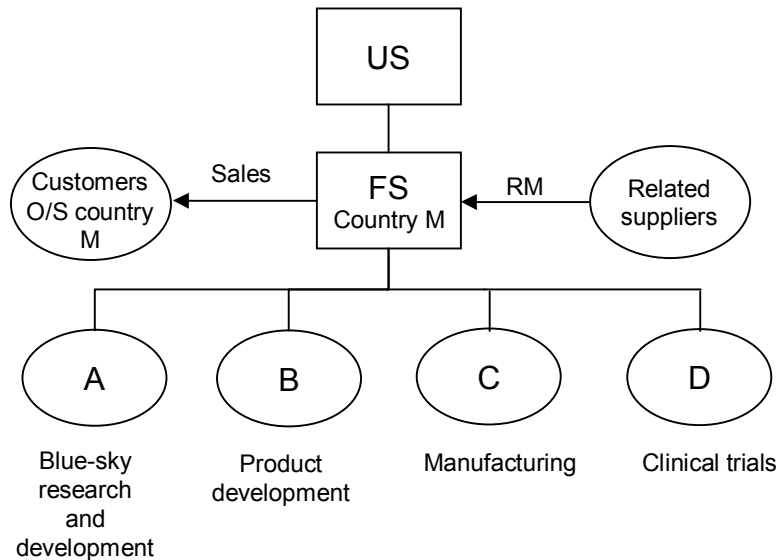
Consideration – Meeting substantial contribution requirements in a split manufacturing model:



- US is a global cell phone manufacturer with a CFC, FS, in Country M
- Assume none of the branches have a tax rate disparity with FS.
- FS manufactures the chips in Country A; manufactures the cell phones and integrates the chips into cell phones in Country B; and conducts research & development in Country C
- Branch A substantially contributes to the manufacture of chips; Branch B substantially contributes to the manufacture of the cell phones and uses the chips as component parts
- Also, what if the customer purchases a replacement chip from FS?

Substantial contribution (cont'd)

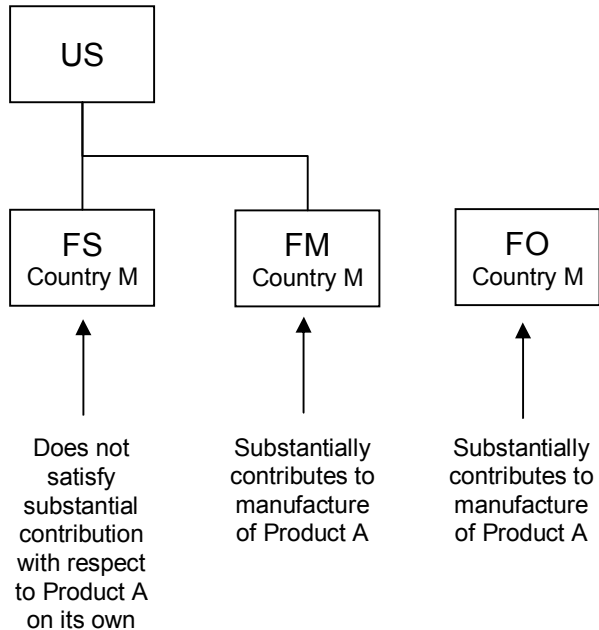
Example – Blue-sky research & development:



- US is a global pharmaceutical company with a CFC, FS, in Country M
- Assume none of the branches have a tax rate disparity with FS.
- FS conducts blue-sky research, product development, manufacturing and clinical trials in different locations
- Can the activities within Branch A be viewed as “substantially contributing” to the manufacture of the ultimate product? Assume that, but for such research, the final product wouldn’t exist – is that a sufficient connection?
- If yes, does this mean there is a manufacturing branch issue to consider?

Substantial contribution (cont'd)

Consideration – Qualifying for the same-country manufacturing exception in an unrelated-party context:



- FS does not, on its own, satisfy the substantial contribution test
- FM, in the same country as FS and related to FS, substantially contributes to the manufacture of product A
- FO, in the same country as FS and FM but unrelated to both, also substantially contributes to the manufacture of Product A
- Why would the same-country exception only include the activities of FM in this case?
- Would the result differ if FO satisfied a physical manufacturing test instead of the substantial contribution test?

Branch rules

- Developments and insights:
 - Definition of a branch
 - Rate disparity test & allocation of income / transfer pricing
 - See PLR 200942034 (October 16,2009)
 - The complexity of the multiple manufacturing and sales location rules in complex global supply chains
 - Unrelated to unrelated supply chains
- Specific software development activities