

THE FABULOUS NEW SUBSTANTIAL CONTRIBUTION TEST IS MADE EVEN MORE FABULOUS

As the authors previously reported in the *Journal*, on February 27, 2008, the IRS and Treasury issued Proposed Regulations (“Proposed Regulations”) providing, *inter alia*, that a CFC/principal company could claim the manufacturing exception to foreign base company sales income if it could demonstrate that it had made a substantial contribution to the manufacturing process (“substantial contribution test”).¹ Under the Proposed Regulations, a CFC/principal company would satisfy the substantial contribution test with respect to personal property if the facts and circumstances showed that the CFC/principal company made a substantial contribution through the activities of its employees to the manufacture of that property.² The Proposed Regulations included a non-

exclusive list of activities (collectively, “indicia of manufacturing”) to be considered in determining whether the CFC/principal company satisfied the substantial contribution test with respect to the manufacture, production, or construction of personal property under all of the facts and circumstances.³

On December 29, 2008, the Proposed Regulations were re-issued as final and Temporary Regulations (TD 9438) (“Final Regulations”). In light of comments that the IRS and Treasury received with respect to the Proposed Regulations,⁴ the Final Regulations make significant taxpayer-friendly revisions and clarifications to the general operation of the substantial contribution test and the indicia of manufacturing (hence, the title of this article). The Final Regulations also

provide helpful guidance with respect to the definition of employee and automated manufacturing.⁵ This article reviews those comments, revisions, and clarifications as reflected in the Final Regulations, concluding with some observations on meeting the requirements of the test.

General Operation of the Substantial Contribution Test

In response to the Proposed Regulations, commenters requested further elaboration of the general operation of the substantial contribution test. For example, they asked for guidance on the amount of activity performed by a CFC's employees that would be necessary to "satisfy" each individual activity listed among the indicia of manufacturing. Several commenters requested clarifications suggesting they believed that a certain threshold of employee activity was required before the activity would be considered in determining whether a CFC satisfied the substantial contribution test.⁶

Commenters also sought guidance on how the indicia of manufacturing should be weighed in relation to each other and whether performing a certain minimum number of activities was required to satisfy the substantial contribution test. Others asked that the Final Regulations explain whether a CFC must perform any particular activity in all cases to satisfy the test (for example, whether a CFC must always perform oversight and direction of the manufacturing process to satisfy the test). Some commenters requested that the Final Regulations emphasize that the importance of each activity would vary by industry and by taxpayer. Commenters also wanted the Final Regulations to make clear that a CFC need not perform all of the indicia of manufacturing to establish a substantial contribution, and that the weight given to activities performed by employees of the CFC will depend on the economic significance of those activities

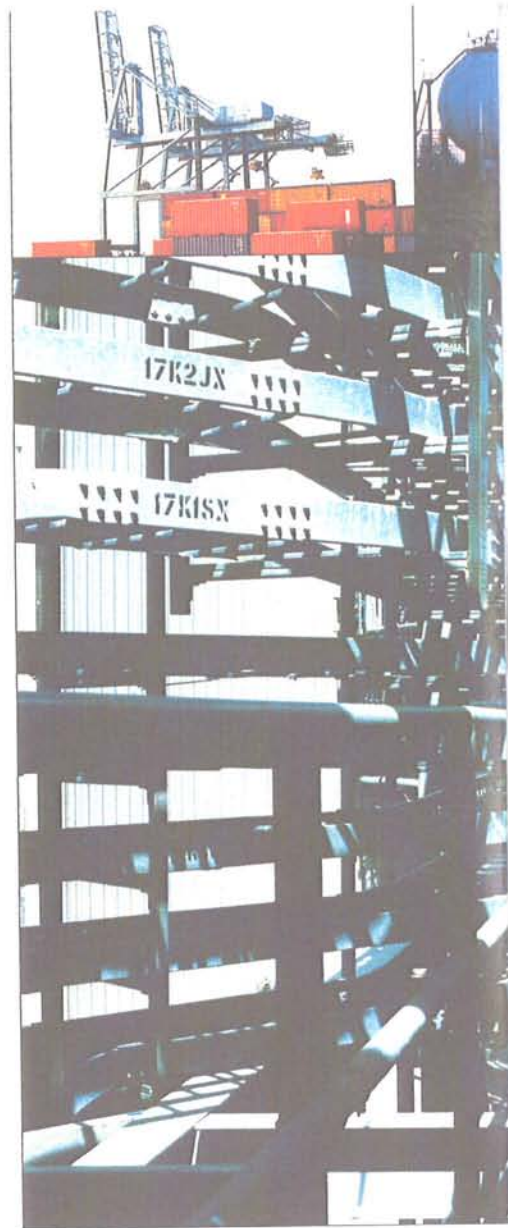
to the taxpayer's business with respect to the product being manufactured.

In light of these comments, the IRS and Treasury concluded that additional guidance with respect to the application of the substantial contribution test was warranted. Thus, Final Reg. 1.954-3(a)(4)(iv)(c) was added to the Final Regulations to provide clarification on the application of the substantial contribution test. Under Final Reg. 1.954-3(a)(4)(iv)(c):

- 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 to the manufacture of the personal property through the activities of a CFC's employees.
- No single activity will be accorded more weight than any other activity in every case or will be required to be performed in all cases.
- There is no minimum threshold with respect to functions performed by employees of a CFC before their functions with respect to a given activity may be taken into account as part of the substantial contribution test.

Therefore, all functions performed by a CFC's employees are considered (and given appropriate weight) under the substantial contribution test, even if the CFC's employees perform only some of the functions in connection with any one activity (for example, some, but not all, of the vendor selection). The weight given to any functions performed by employees of the CFC with respect to any activity will be based on the economic significance of those functions to the manufacture of the relevant personal property. Corresponding amendments and additional examples were added to the Final Regulations to illustrate further the application of the substantial contribution test.⁷

Other commenters sought clarification on the extent to which purely contractual assumptions of risk are considered in a substantial contribution analysis. The IRS and Treasury believed that no further clarification in the Final Regulations was necessary to address this point. Both the Proposed and Final Regulations provide that only activities of the CFC's employees are considered in the substantial contri-



bution analysis, so purely contractual assumptions of risk are not considered in the substantial contribution analysis.⁸

In addition, commenters requested that the Final Regulations clarify that more than one person can provide a substantial contribution to the manufacturing process with respect to a given product. In response, the IRS and Treasury amended the Final Regulations to clarify that a CFC will not be precluded from making a substantial contribution to the manufacture of the personal property even if other persons also make a substantial contribution to the manufacture of that property.⁹ The Final Regulations added an example to illustrate this point.¹⁰

Indicia of Manufacturing

The IRS and Treasury received numerous comments with respect to the specific activities listed in the Proposed Regula-

LEWIS J. GREENWALD and DOUGLAS S. STRANSKY are tax partners in the Boston office of Sullivan & Worcester LLP. They practice exclusively in the area of international taxation. TENLEY OLDAK is a tax associate in the Boston office of Sullivan & Worcester LLP. Mr. Greenwald is a member of the Board of Advisors of the JOURNAL and a frequent contributor. Mr. Stransky and Ms. Oldak have written previously.



tions that are considered in determining whether a CFC makes a substantial contribution through its employees to the manufacture of personal property (i.e., the indicia of manufacturing).

Oversight and direction of manufacturing. Commenters requested that the IRS and Treasury clarify certain issues related to the “oversight and direction of the activities or process” pursuant to which personal property is manufactured. Some commenters asked that the Final Regulations provide that oversight and direction of the activities or processes pursuant to which personal property is manufactured be a prerequisite for satisfying the substantial contribution test. Others requested clarification that in certain industries a CFC can make a substantial contribution without its employees engaging in significant oversight and direction. Some commenters focused on an example in the Proposed

Regulations where the CFC was not treated as making a substantial contribution to the manufacture of personal property when the CFC did not “regularly exercise” oversight and direction with respect to the contract manufacturer.¹¹

The importance of oversight and direction of the activities or processes pursuant to which personal property is manufactured will vary based on the facts and circumstances associated with the specific manufacturing process at issue. The IRS and Treasury acknowledged that oversight and direction is likely to be an important element in many, but not all, substantial contribution analyses. Thus, to address taxpayer concerns, the examples in the Final Regulations were amended to make it clear that oversight and direction is not a prerequisite for satisfying the substantial contribution test and that in certain industries a substantial contribution can be made by a CFC without

its employees engaging in oversight and direction.¹² Finally, the examples in the Final Regulations do not use the potentially confusing reference to “regularly” exercising oversight.

Material selection, vendor selection, and control of the raw materials, work-in-process, and finished goods. Some commenters asked if other activities listed among the indicia of manufacturing also represented means of exercising control of the raw materials, work-in-process, and finished goods. The IRS and Treasury acknowledged that some of the activities in the indicia of manufacturing overlapped with other activities in that list. The Final Regulations require a substantial contribution to the manufacture of the personal property through the activities of the CFC’s employees and not satisfaction of any specific activity in the indicia of manufacturing.¹³ Therefore, the IRS and Treasury determined that it was not necessary to clarify whether any particular function might reasonably be included under more than one heading in the indicia of manufacturing. However, to provide clarity, the Final Regulations group material selection, vendor selection, and control of the raw materials, work-in-process, and finished goods as a single activity in the indicia of manufacturing.¹⁴

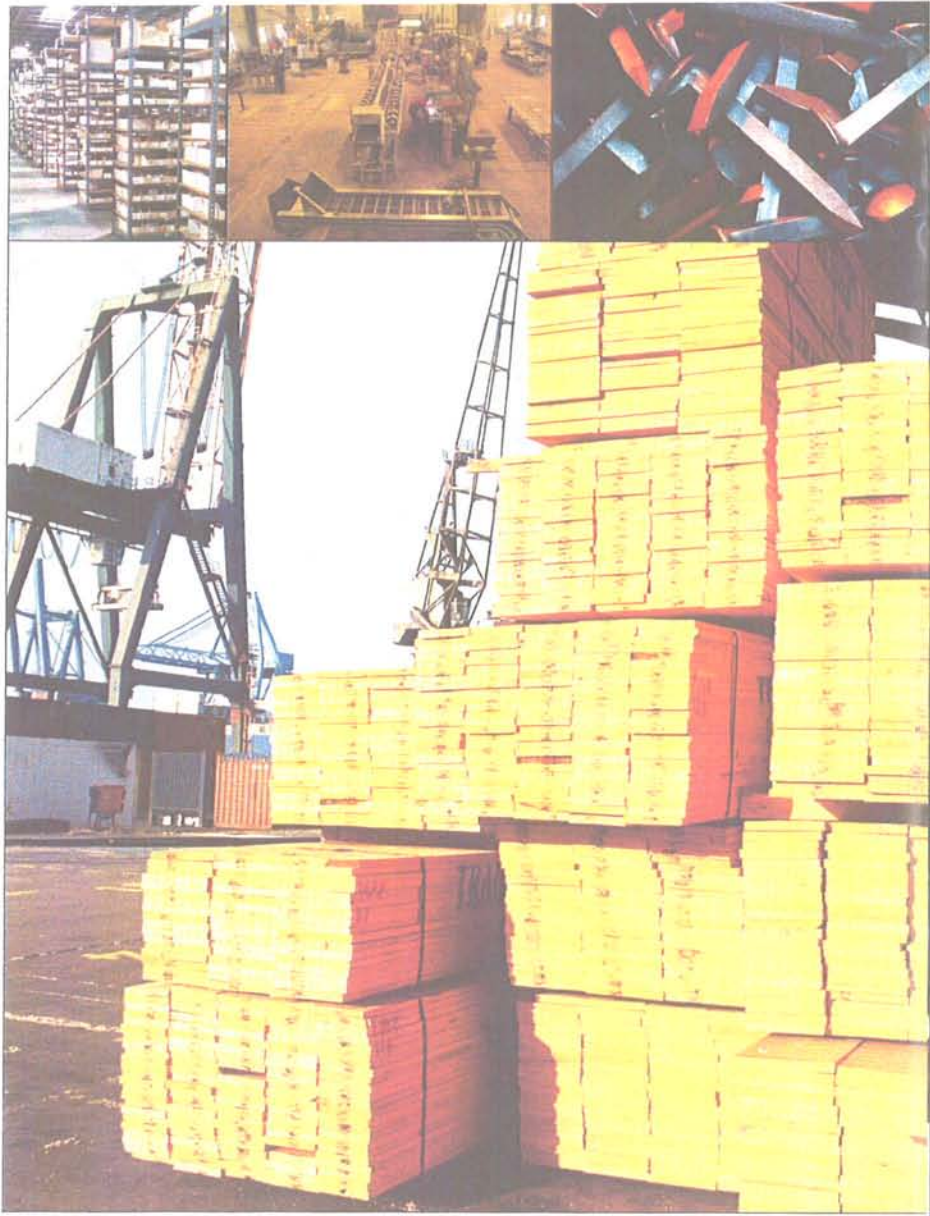
Commenters asked whether the control of the raw materials, work-in-process, and finished goods refers to the CFC having the contractual right to take possession of the personal property, to have title to the property, or to have economic risk of loss with respect to the property. They requested clarification on whether tax ownership of raw materials, work-in-process, and finished goods is required to have control of each. In connection with this question, commenters also asked whether a CFC can satisfy the substantial contribution test when the contract manufacturing arrangement is buy-sell or “turnkey” (that is, when the contract manufacturer purchases the raw materials).

Both the Proposed and Final Regulations provide that only activities of the CFC’s employees are considered in the substantial contribution analysis.¹⁵ Thus, mere contractual rights, legal title, tax ownership, or assumption of economic

risk are not considered in the substantial contribution analysis.¹⁶ That said, to provide clarity, the Final Regulations deleted “purchased by a controlled foreign corporation” in the first sentence of Prop. Reg. 1.954-3(a)(4)(iv)(a) to eliminate any inference that a CFC needs to own the raw materials that are used in the manufacturing process.¹⁷ In addition, examples in the Final Regulations clarify that buy-sell or turnkey contract manufacturing arrangements may satisfy the substantial contribution test.¹⁸

Management of manufacturing profits and risk of loss. Commenters requested clarification on which functions would qualify as “management of the manufacturing profits” or “management of the risk of loss.”¹⁹ Some commenters expressed concerns regarding the term “management of the manufacturing profits.” Others suggested that it would add clarity if “management of the risk of loss” were deleted from Prop. Reg. 1.954-3(a)(4)(iv)(b)(1) and included with “management of manufacturing profits” in a single item in the indicia of manufacturing. Some commenters noted that the term “management of the risk of loss” implicitly excluded all other risk management functions. One commenter articulated the view that the indicia of manufacturing should include reference to management of enterprise risk, other than risks pertaining exclusively to sales and marketing functions. Some commenters suggested that management of the manufacturing profits might refer to such activities as the management of risks related to the raw materials and the use of plant capacity, but others thought it might encompass the finance function of a company.

The IRS and Treasury agreed that further clarification was needed as to the functions labeled “management of the manufacturing profits” and “management of the risk of loss” in the Proposed Regulations. The IRS and Treasury intend that the substantial contribution test recognize contributions by a CFC’s employees to the manufacturing process through functions that help to ensure that a plant is run in an economically efficient manner, such as optimization of plant capacity and reduction of waste. Not all corporate manager-



¹ See Greenwald, Stransky, and Oldak, “The Fabulous New ‘Substantial Contribution’ Test,” 19 *JOIT* 20 (October 2008).

² Prop. Reg. 1.954-3(a)(4)(iv)(a).

³ *Id.* Hereinafter, “manufacture,” “manufactured,” and “manufacturing” include “produce,” “produced,” and “producing,” “construct,” “constructed,” and “constructing,” “grow,” “grown,” and “growing,” and “extract,” “extracted,” and “extracting.”

⁴ Unless otherwise stated, the source of the comments on the Proposed Regulations is the Preamble to TD 9438. See Daub, Hickey, and Peterson, Jr., “New Contract Manufacturing Regulations Will Have a Major Effect on Supply Chain Structures,” 20 *JOIT* 18 (June 2009).

⁵ The Preamble further discusses comments (and the reactions of the IRS and Treasury to those comments) regarding (1) the proposed anti-abuse rule and safe harbor; (2) further guidance on product grouping, treatment of partnerships, documentation of activities, and the “its” argument; (3) the “same country manufacture” exception; and (4) further modifications to the “murky” branch rule.

⁶ Commenters requested, for example, clarification on whether the “vendor selection” activity is satisfied if the CFC provides a contract manufacturer with an approved list of vendors but allows the contract manufacturer to make the final determination regarding the vendors to be used.

⁷ See Final Reg. 1.954-3(a)(4)(iv)(d). For technical corrections to the examples, see *Ann.* 2009 30, 2009-15 IRB 794.

⁸ Final Reg. 1.954-3(a)(2), Prop. Reg. 1.954-3(a)(4)(iv)(a).

⁹ Final Reg. 1.954-3(a)(4)(iv)(c).

¹⁰ Final Reg. 1.954-3(a)(4)(iv)(d), Ex. 9.

¹¹ See Prop. Reg. 1.954-3(a)(4)(iv)(c), Ex. 1.

¹² See Final Reg. 1.954-3(a)(4)(iv)(d), Ex. 10.

¹³ Final Reg. 1.954-3(a)(4)(iv)(c).

¹⁴ Final Reg. 1.954-3(a)(4)(iv)(b)(3).

¹⁵ Final Reg. 1.954-3(a)(2); Prop. Reg. 1.954-3(a)(4)(iv)(a).

¹⁶ *Id.*

¹⁷ Final Reg. 1.954-3(a)(4)(iv)(a).

¹⁸ See Final Reg. 1.954-3(a)(4)(iv)(d), Fxs. 3, 9.

¹⁹ See Prop. Reg. 1.954-3(a)(4)(iv)(b)(1) (“management of the risk of loss”), (4) (“[m]anagement of the manufacturing profits”).

²⁰ Final Reg. 1.954-3(a)(4)(iv)(b)(4).

²¹ *Id.*

²² Final Reg. 1.954-3(a)(4)(iv)(b)(5).

²³ See Prop. Reg. 1.954-3(a)(4)(iv)(b)(9).

²⁴ Final Reg. 1.954-3(a)(4)(iv)(b)(7).

²⁵ See Final Reg. 1.954-3(a)(4)(iv)(c).

²⁶ See Prop. Reg. 1.954-3(a)(4)(iv)(b)(9); Final Reg. 1.954-3(a)(4)(iv)(b)(7).



al decisions, however, are intended to be considered in the substantial contribution test, because many such decisions are not directly related to the manufacture of the personal property with respect to which the substantial contribution analysis is being performed. For example, the IRS and Treasury do not intend that corporate finance decisions be considered in the substantial contribution test. Similarly, the IRS and Treasury do not intend that the general management of enterprise risk be considered in the substantial contribution test.

The IRS and Treasury concluded that the term “management of the manufacturing costs or capacities” more accurately reflects the type of functions originally contemplated by “management of the manufacturing profits” in the Proposed Regulations and is also related to the types of functions contemplated by the “management of the risk of loss.” Accordingly,

the activity labeled “management of the manufacturing profits” in the Proposed Regulations was replaced in the Final Regulations with an activity entitled “management of manufacturing costs or capacities.”²⁰ Further, the Final Regulations include a parenthetical list of functions (managing the risk of loss, cost reduction or efficiency initiatives associated with the manufacturing process, demand planning, production scheduling, or hedging raw material costs) to elaborate on the meaning of the activity.²¹

Control of logistics. Commenters asked for clarification on the scope of logistical functions that will contribute towards a substantial contribution by a CFC. This activity is intended, for example, to include arranging for delivery of raw materials to a contract manufacturer but to exclude delivery of finished goods to a customer. The Final Regulations provide clarity on this issue by revising the activity to read “control of manufacturing related logistics.”²²

Development, protection, and/or use. Commenters noted that the “and” in the description “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” in the Proposed Regulations could be read to mean that directing the “development, protection, and use” of intellectual property are all required for this activity to be considered in the substantial contribution analysis.²³ They requested that these activities be stated in the disjunctive. The IRS and Treasury adopted this comment by replacing “and” with “or” in the Final Regulations.²⁴ This clarification is consistent with the idea that all functions performed by a CFC’s employees are considered (and given appropriate weight) under the substantial contribution test.²⁵ Thus, as noted above, the CFC’s employees’ activities are considered regardless of whether they perform all or only some of the functions listed in any enumerated item in the indicia of manufacturing.

In addition, the term “protection” was deleted in the Final Regulations.²⁶ The IRS and Treasury were concerned that absent this clarification, the Final Regulations could be read to provide that legal work

performed by a CFC’s in-house legal staff was considered under the substantial contribution test, including cases where, for example, litigation success could be heavily correlated to profitability or business failure with respect to a particular product. Further, the IRS and Treasury modified the description of the activity in the Final Regulations to clarify that developing, or directing the use or development of, trade secrets, technology, or other intellectual property, are considered under the substantial contribution test, but only when activities of this nature are undertaken for the purpose of the manufacture of the personal property.²⁷

Commenters asked whether the intellectual property referred to in the Proposed Regulations included marketing intangibles.²⁸ The activity as described in both the Proposed and Final Regulations is with respect to intellectual property used in the manufacture of the personal property. Thus, developing, or directing the use or development of, marketing intangibles is not intended to be considered in a substantial contribution analysis.

Definition of Employee

The IRS and Treasury requested comments on whether the requirement in the Proposed Regulations that the activities of the CFC be performed by its employees should take into account commercial arrangements where individuals performing services for the CFC, while not on its payroll, are nevertheless controlled by employees of the CFC.²⁹ Commenters asked that the Final Regulations expand the definition of the term “employee” to include various commercial or economic arrangements where individuals perform services for a CFC under the CFC’s direction and control, but are not necessarily the CFC’s employees under local law. In particular, they suggested that “employee” could be defined for purposes of the substantial contribution test using the definition in Section 3121(d)(2).³⁰ Other commenters asked that “employee” be defined more broadly to include anyone in an agency relationship with a CFC.

The IRS and Treasury agreed that clarification of “employee” would promote

more effective application of the Final Regulations, and that activities performed by certain non-payroll workers should be considered in determining whether the CFC provides a substantial contribution through "its employees." They concluded, however, that it would be inappropriate to broaden the definition of employee to include anyone in an agency relationship with a CFC, because it could create unintended branch rule issues for taxpayers (for example, as a result of employees of a contract manufacturer being treated as employees of the CFC under such a definition). Thus, the Final Regulations provide that "employee" means any individual who, under Reg. 31.3121(d)-1(c), has the status of an employee for U.S. federal tax purposes.³¹ This definition of "employee" may encompass certain seconded workers, part-time workers, workers on the payroll of a related employment company the activities of which are directed and controlled by CFC employees, and contractors, so long as those individuals are deemed to be employees of the CFC under Reg. 31.3121(d)-1(c). This definition of "employee" may result in an individual being treated as an employee of two or more entities simultaneously.

Automated Manufacturing

Several comments were received concerning Prop. Reg. 1.954-3(a)(4)(iv)(c), Example 4, in which a CFC owns software and network systems that remotely and automatically (without human involvement) order raw materials for use by the contract manufacturer, take customer orders and route them to the contract manufacturer, and perform quality control. Although the CFC has a small number of computer technicians monitoring the software and network systems, those systems were developed by employees of DP, the CFC's domestic parent corporation. Those DP employees supervise the CFC's computer technicians, evaluate the results of the automated manufacturing business, make ongoing operational decisions related to the performance of the manufacturing process, redesign and update the products and the manufacturing process, and develop all of the upgrades and patches for the software

and network systems owned by the CFC. The example concluded that the CFC did not provide a substantial contribution to the manufacture of Product X.

Commenters expressed concern that Prop. Reg. 1.954-3(a)(4)(iv)(c), Example 4, did not recognize the importance of automated manufacturing in modern business practices. They noted the following: (1) manufacturing processes are increasingly automated; (2) in some high-tech industries, automated manufacturing processes are the only way to manufacture and test the quality of certain products; and (3) in these industries, human involvement in various parts of the manufacturing process could be counterproductive. Some commenters were concerned that Prop. Reg. 1.954-3(a)(4)(iv)(c), Example 4, penalized such automated manufacturing processes under the substantial contribution test.

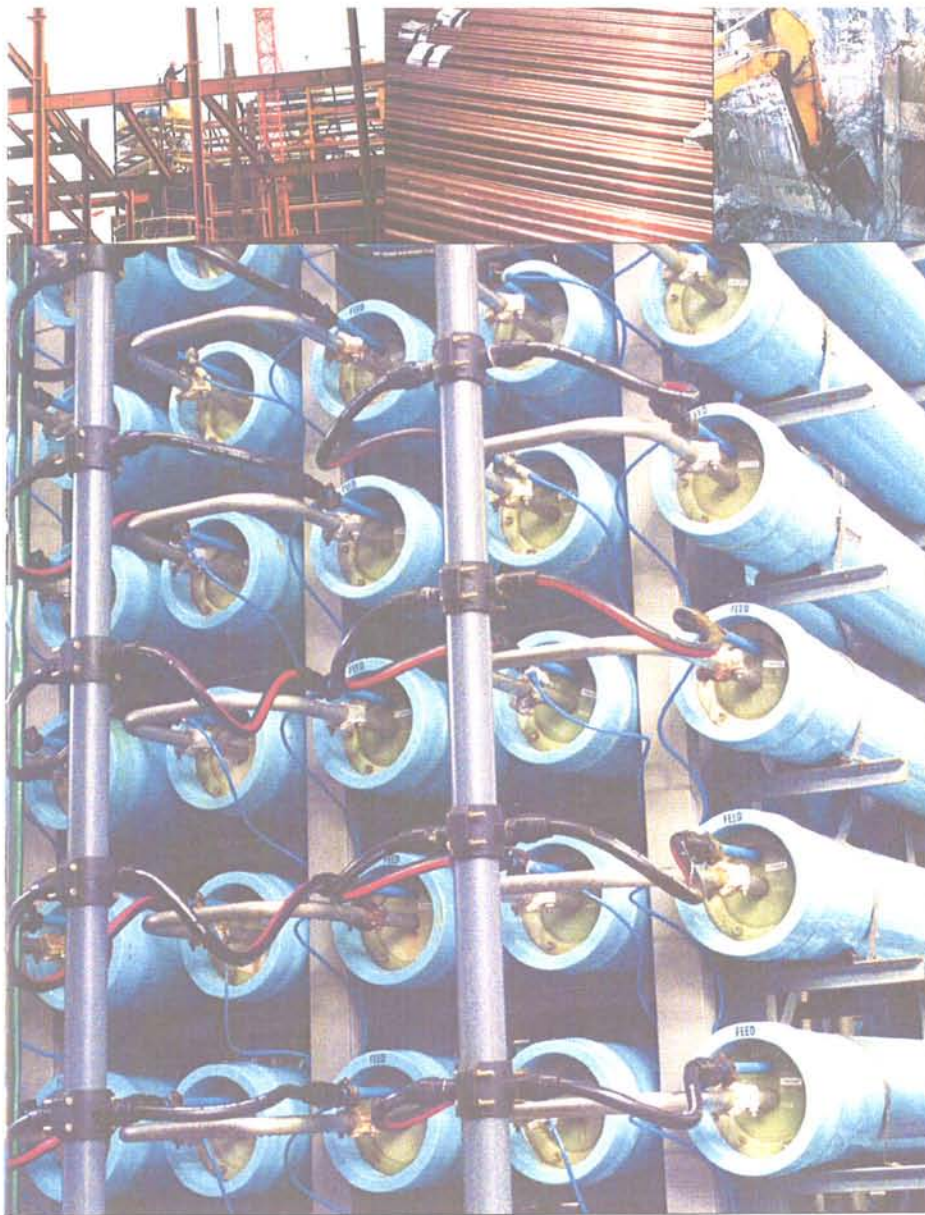
The IRS and Treasury agreed that a CFC can provide a substantial contribution to a largely automated manufacturing process through its employees. Final Reg. 1.954-3(a)(4)(iv)(d), Example 5, contains the same facts as Prop. Reg. 1.954-3(a)(4)(iv)(c), Example 4. Under those facts, substantial operational responsibilities and decision-making by humans are required for the manufacturing process, but they are not performed by the CFC. The Final Regulations include an additional example. Final Reg. 1.954-3(a)(4)(iv)(d), Example 6, illustrates that a CFC the employees of which perform most of the functions that DP's employees perform in Final Reg. 1.954-3(a)(4)(iv)(d), Example 5, makes a substantial contribution to the manufacturing process. This result applies even though DP's employees also contribute to the manufacturing process. Final Reg. 1.954-3(a)(4)(iv)(d), Example 7, further illustrates that the CFC can make a substantial contribution through the activities of its employees regardless of whether the software and network systems were purchased by the CFC. These examples show that the evaluation of whether a CFC makes a substantial contribution through its employees is determined based on whether the CFC's employees conduct industry-sufficient substantial contribution activities.



Effective Date

Several commenters requested that the Final Regulations provide for a delayed effective date to allow taxpayers to implement supply chain and structural changes that may be required to satisfy the substantial contribution test and the branch rules. The IRS and Treasury agreed that a delayed effective date is appropriate for taxpayers with structures that require modification to accommodate the new Regulations.

Accordingly, the Final Regulations will 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.³² Thus, the Final Regulations will apply from January 1, 2010, for calendar-year CFCs unless a taxpayer chooses to apply the Final Regulations retroactively with respect to its open tax years.³³



Conclusion

As noted above, the Final Regulations have made the substantial contribution test even more fabulous. Now, *inter alia*, in determining whether a substantial contribution is made to the manufacture of the personal property:

- All CFC employee functions contributing to the manufacture of the personal property will be considered.³⁴
- No single activity will be accorded more weight than any other activity.³⁵
- There is no minimum threshold with respect to functions performed by employees of a CFC.³⁶
- Oversight and direction are not prerequisites for satisfying the substantial contribution test.³⁷
- A CFC need not own the raw materials used in the manufacturing process.³⁸
- The revised activities “management of manufacturing costs or capacities” and “control of manufacturing related logistics” have been explained more clearly than in the Proposed Regulations and have been expanded in scope.³⁹
- “Employee” is defined to mean any individual who, under Reg. 31.3121(d)-1(c), has the status of an employee for U.S. federal tax purposes.⁴⁰

As we previously reported, assuming the requisite “boots on the ground,”⁴¹ the key to success will be *documentation, documentation, documentation.*⁴² Minuted board meetings, where the directors have made decisions with respect to vendor selection, contract manufacturer selection, and the manufacturing process, should be in the files. And although oversight and direction are not prerequisites for satisfying the substantial contribution test, where applicable, the files should also include logs/diaries of trips to the contract manufacturer.

As with all U.S. tax planning, if getting the substantial contribution test right is meaningful (i.e., if the test must be met to avoid foreign base company sales income (FBCSI)), actions/tweaks to existing structures/legal relationships should be taken to ensure success. ●

²⁷ Final Reg. 1.954-3(a)(4)(iv)(b)(7). On April 23, 2009, at a conference co sponsored by New York University and KPMG in New York, Michael DiFronzo, IRS Deputy Associate Chief Counsel (International), discussed the seventh substantial contribution factor (“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”). He confirmed that “product design [is] part of the manufacturing function that would be included in the [Code Section] 954(d) analysis.” Tandon, “IRS Official Describes Scope of Contract Manufacturing Rules,” 54 Tax Notes Int’l 391 (May 4, 2009). Thus, the “seventh factor” is not limited to the development of intellectual property related to the production process.

²⁸ Prop. Reg. 1.954-3(a)(4)(iv)(b)(9).

²⁹ Preamble to Prop. Reg. 1.954-3, 73 Fed. Reg. 10716.

³⁰ Section 3121(d)(2) defines an employee as “any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.”

³¹ Final Reg. 1.954-3(a)(4)(i).

³² Final Reg. 1.954-3(c).

³³ Final Reg. 1.954-3(d). The taxpayer may so choose 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 an open tax year of the taxpayer and to all subsequent tax years. Final Reg. 1.954-3(d). A taxpayer that chose, prior to December 24, 2008, to apply Prop. Reg. 1.954-3 in its entirety to all of the taxpayer’s open tax years in which or with which a tax year of a CFC of the taxpayer ended, may continue to apply Prop. Reg. 1.954-3 in its entirety with respect to all of the taxpayer’s open tax years that begin prior to July 1, 2009. TD 9438, Preamble. For a technical correction regarding the effective date of the Final Regulations, see Ann. 2009-30, *supra* note 7.

³⁴ Final Reg. 1.954-3(a)(4)(iv)(c).

³⁵ *Id.*

³⁶ *Id.*

³⁷ See Final Reg. 1.954-3(a)(4)(iv)(d), Ex. 10.

³⁸ Final Reg. 1.954-3(a)(4)(iv)(a).

³⁹ Final Reg. 1.954-3(a)(4)(iv)(b)(4).

⁴⁰ Final Reg. 1.954-3(a)(4)(i).

⁴¹ See Sheppard, “Boots on the Ground: IRS Official Expands Contract Manufacturing Comments,” 2008 TNT 79-1 (April 22, 2008) (comments of Mr. DiFronzo).

⁴² The IRS and Treasury demurred when commenters asked for guidance in the Final Regulations on how taxpayers should document their activities for purposes of the substantial contribution test.