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FOREIGN BASE COMPANY SALES THE **FABULOUS** INCOME NEW “SUBSTANTIAL CONTRIBUTION” TEST

Assuming the requisite “boots on the ground,” the key to success will be **documentation, documentation, documentation.**

Since the IRS revoked Rev. Rul. 75-7, 1975-1 CB 244, with Rev. Rul. 97-48, 1997-2 CB 89, a battle has raged as to whether a controlled foreign corporation (CFC)/principal company can ever claim the manufacturing exception to foreign base company sales income (FBCSI) if it produces a product with the assistance of one of more contract manufacturers.¹

Mercifully, on February 27, 2008, the IRS and Treasury issued Proposed Regulations, which, *inter alia*, answer that question in the affirmative.² Under the Proposed Regulations, a CFC/principal

company will be able to claim the manufacturing exception to FBCSI if it can demonstrate that it has made a “substantial contribution” to the manufacturing process (“substantial contribution” test).

This article first reviews the basics of FBCSI and the manufacturing exception thereto, and then the Proposed Regulations (the Preamble, the fabulous new “substantial contribution” test, and the four illustrative examples). The article concludes with some thoughts and observations as to meeting the requirements of the new test.

FBCSI

In general, if a foreign corporation is a CFC, a person who is a U.S. shareholder must include in gross income its pro rata share of the corporation's Subpart F income.³ For this purpose, "Subpart F income" includes, *inter alia*, foreign base company income.⁴ Foreign base company income includes, *inter alia*, FBCSI.⁵

FBCSI is income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with one of the following:

- The purchase of personal property from a related person and its sale to any person.
- The sale of personal property to any person on behalf of a related person.
- The purchase of personal property from any person and its sale to a related person.
- The purchase of personal property from any person on behalf of a related person where the purchased/sold property is (1) manufactured outside the CFC's country of organization and (2) consumed outside the CFC's country of incorporation.⁶

Thus, FBCSI does not include income derived in connection with the purchase and sale of personal property if that property is manufactured in the CFC's country of incorporation.⁷ FBCSI also does not include income derived in connection with the purchase and sale of personal property if the property is manufactured, produced, or constructed by the CFC in whole or in part from personal property that it has purchased.⁸

Manufacturing Exception

In general, a foreign corporation is considered to have manufactured the personal property that it sells if the property sold is, in effect, not the personal property that it purchased.⁹ Personal property sold will not be considered the property purchased if the provisions of Reg. 1.954-3(a)(4)(ii) or (iii) are satisfied.¹⁰

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Under the "substantial transformation" test of Reg. 1.954-3(a)(4)(ii), if personal property is substantially transformed prior to sale, the property sold will be treated as having been manufactured by the selling corporation. Examples of substantial transformation include the conversion of wood pulp into paper, steel rods into screws, and tuna fish into canned tuna.¹¹

Under the "substantive" test and safe harbor of Reg. 1.954-3(a)(4)(iii), personal property will be treated as the sale of a product manufactured by the CFC (rather than the sale of component parts) if the operations conducted by the CFC in connection with the property are "substantial in nature" and generally considered to constitute the manufacture of the property. Under the safe harbor, without limiting the application of the "substantive" test, the operations of a selling corporation in connection with the use of purchased property as a component part of the personal property that is sold will be considered to constitute the manufacture of a product if, in connection with such property conversion costs (direct labor and factory burden), the costs account for 20% or more of the total cost of goods sold.¹² In no event, however, will mere packaging, prepackaging, labeling, or minor assembly operations constitute the manufacture of personal property.¹³ The assembly of automobiles from component parts is an example of an activity considered "substantial in nature" and generally constitutes the manufacture of a product.¹⁴

Branch Rule

In addition to the general FBCSI rules of Section 954(d)(1), Section 954(d)(2) provides a special rule for determining FBCSI if a CFC carries on activities through a branch (or similar establishment) outside its country of organization and the carrying on of these activities has substantially the same effect as if the branch (or similar establishment) were a wholly owned subsidiary of the CFC ("Branch Rule").

The purpose of the Branch Rule is to prevent a CFC from using a foreign branch to avoid application of the FBCSI rules. Absent the Branch Rule, a CFC could engage in purchasing or manufac-

turing activities in a high-tax jurisdiction, and selling activities in a low-tax jurisdiction, without incurring FBCSI. In this situation, the sales income would not be FBCSI to the CFC because the same person would be purchasing or manufacturing and selling. As such, the Branch Rule treats a sales, purchase, or manufacturing branch that is located outside the CFC's country of organization as a separate corporation, so as to create a related-party transaction between the branch and the remainder of the CFC for purposes of determining FBCSI.

More specifically, with respect to manufacturing branches, Reg. 1.954-3(b)(1)(ii)(a) provides that if a CFC carries on manufacturing activities by or through a branch outside its country of organization, and the use of that branch has substantially the same tax effect as if the branch were the CFC's wholly owned

subsidiary, the branch and the remainder of the CFC will be treated as separate corporations for purposes of determining FBCSI of the CFC. Reg. 1.954-3(b)(1)(ii)(b) provides that the use of a manufacturing branch will be considered to have substantially the same tax effect as if it were the CFC's wholly owned subsidiary if the tax imposed on the income derived by the remainder of the CFC satisfies the "manufacturing branch tax rate disparity" test.¹⁵

In very general terms, the "manufacturing branch tax rate disparity" test is satisfied if the income earned by the remainder of the CFC is less than 90% of, and at least five percentage points less than, the "hypothetical effective tax rate."¹⁶ The "hypothetical effective tax rate" is the effective tax rate that would apply to this income under the laws of the country where the manufacturing branch is located.¹⁷

Rev. Rul. 75-7, Ashland Oil, Vetco, and Rev. Rul. 97-48

In Rev. Rul. 75-7, the IRS considered a case in which a CFC purchased raw material from related persons outside its country of organization, contracted with an unrelated manufacturer located outside its country of organization to process the raw material into a finished product, and then sold the finished product to unrelated persons outside its country of organization. Under the terms of the arrangement, the contract manufacturer was paid a conversion fee. The raw material, work in process, and finished product remained the property of the CFC at all times. The CFC alone had complete control over the time and quantity of production, as well as complete quality control over the conversion process. The IRS ruled that the performance of the operations by the contract manufacturer, whereby raw material was processed into

a finished good, was considered performance by the CFC. The CFC would, therefore, be treated as having substantially transformed personal property. The Ruling further concluded that, because the CFC conducted the manufacturing activity outside its country of organization, it was considered to do so through a branch or similar establishment. Because the "manufacturing branch tax rate disparity" test was not satisfied, however, the activities of the "branch" were not considered the activities of a separate CFC. The CFC was, therefore, entitled to the manufacturing exception from FBCSI.¹⁸

In *Ashland Oil, Inc.*, 95 TC 348 (1990), the Tax Court held that an unrelated manufacturing corporation in a contract manufacturing arrangement with a CFC cannot be treated as the CFC's branch or similar establishment. In *Vetco, Inc.*, 95 TC 579 (1990), the Tax Court held that a wholly owned subsidiary of a CFC in a contract manufacturing arrangement with the CFC also cannot be treated as the CFC's branch or similar establishment.¹⁹

In Rev. Rul. 97-48, the IRS announced that it would follow the *Ashland Oil* and *Vetco* decisions, although it concluded that the activities of a contract manufacturer cannot be attributed to a CFC to determine whether the CFC's income is FBCSI. Thus, Rev. Rul. 75-7 was revoked. Also, the IRS cautioned that it never viewed Rev. Rul. 75-7 as allowing a contract manufacturer's activities performed outside the CFC's country of organization to be attributed to the CFC without treating those activities as performed through a branch of the CFC.²⁰ That said, the Revenue Ruling does not address the circumstances under which the activities of the CFC (itself) may qualify as manufacturing when a contract manufacturing or similar arrangement is in place.

The Fabulous New "Substantial Contribution" Test

Since the promulgation of the first final Regulations under Section 954(d) in 1964, global economic expansion and globalization have led to significant changes in manufacturing. Many multinational groups have extensive manufacturing networks that straddle geographic





borders. These cross-border manufacturing networks are created primarily to leverage expertise and cost efficiencies. In addition, contract manufacturing arrangements have become a common way to manufacture products because of the flexibility and efficiencies that they afford. Accordingly, Treasury and the IRS understood that updated rules were necessary to assure the continuing competitiveness of U.S.-based multinationals.²¹

More specifically, Treasury and the IRS recognized that, due to these business considerations in the global marketplace, personal property can be manufactured pursuant to a contract manufacturing arrangement under which a CFC engages in activities related to the manufacture of the property (e.g., oversight, direction and control over the contract manufacturer), but does not satisfy the “substantial transformation” or “substantive” test. In some of these instances, Treasury and the IRS now believe that the CFC should qualify for the manufacturing exception to FBCSI.²²

Prop. Reg. 1.954-3(a)(4)(i) provides that, in addition to the “substantial transformation” and “substantive” tests, a taxpayer can now qualify for the manufacturing exception by satisfying the “substantial contribution” test of Prop. Reg. 1.954-3(a)(4)(iv). Thus, even where the taxpayer cannot satisfy the “substantial transformation” and “substantive” tests, the taxpayer can be considered to have manufactured personal property for purposes of the manufacturing exception.²³ Pursuant to Prop. Reg. 1.954-3(a)(4)(iv)(b), a CFC/principal company will satisfy the “substantial contribution” test with respect to personal property only if the facts and circumstances evidence that the CFC/principal company makes a substantial contribution through the activities of its employees to the manufacture of that property.

Prop. Reg. 1.954-3(a)(4)(iv)(b) provides that the activities of a CFC’s employees²⁴ that are to be considered in determining whether the CFC/principal company makes a substantial contribution to the manufacture of personal property include, but are not limited to:

- Oversight and direction of the activities or process (including the man-

agement of risk of loss) pursuant to which the property is manufactured, produced, or constructed under the principles of the “substantial transformation” or “substantive” test.²⁵

- Performance of activities that are considered in but are insufficient to satisfy the “substantial transformation” and “substantive” tests.
- Control of the raw materials, work-in-process, and finished goods.
- Management of the manufacturing profits.²⁶
- Material selection.
- Vendor selection.
- Control of logistics.
- Quality control.
- Direction of the development, protection, and use of trade secrets, technology, product design, and design specification, and other intellectual property used in the manufacturing of the product.²⁷

For purposes of the “substantial contribution” test:

- The weight given to any activity will vary with the facts and circumstances of the particular business.
- The presence or absence of any activity, or of a particular number of activities, is not dispositive.
- Although other persons make contributions to the manufacture of personal property prior to sale, the CFC/principal company can still make a substantial contribution to the manufacture of that property through the activities of its employees.²⁸

“Substantial contribution” test

examples. The application of the “substantial contribution” test is illustrated by four examples in Prop. Reg. 1.954-3(a)(4)(iv)(c).

Example 1: No substantial contribution to manufacturing. (1) *Facts.* FS, a CFC, purchases raw materials from a related person. CM, an unrelated corporation that performs the physical conversion outside FS’s country of organization, manufactures the raw materials into Product X, pursuant to a contract manufacturing arrangement. FS then sells Product X for use outside FS’s country of organization. At all times, FS retains control of the raw material, work-in-process, and finished goods, as well as the intan-

¹ Compare FSA 200220005 (February 5, 2002) with, e.g., Brewer, “Logic Does Not Resolve Rev. Rul. 97-48 Controversy,” 78 Tax Notes 121 (January 5, 1998); Dolan, “Contract Manufacturing: Is It Dead or Alive?” 26 Tax Mgmt. Int’l J. 195 (1997); Dolan, “Battle Over IRS Revocation of Rev. Rul. 75-7 Continues,” 77 Tax Notes 1177 (December 8, 1997); Daub, “From the Editor,” 8 JOIT 531 (December 1997); Yoder, “New IRS Ruling Rocks the Contract Manufacturing Boat,” 9 JOIT 6 (February 1998); and Yoder, “Contract Manufacturing Proposed Regs. Add Fuel to the Fire—What Changed?,” 9 JOIT 10 (May 1998). See also “TEI Roundtable on the Biggest Issues in International Tax,” 19 JOIT 24 (March 2008).

² Prop. Reg. 1.954-3 (REG-124590-07), 73 Fed. Reg. 10716 (February 28, 2008).

³ Section 951(a)(1). For this purpose, “controlled foreign corporation” (CFC) means any foreign corporation if more than 50% of (1) the voting power of all classes of shares of the corporation, or (2) the value of the stock of the corporation, is owned (under Section 958(a)) or is deemed owned (under Section 958(b)) by “United States

shareholders.” Section 957(a). “United States shareholder” means, with respect to any foreign corporation, a “United States person” (as defined in Section 957(c)) who owns (under Section 958(a)) or is deemed to own (under Section 958(b)), 10% or more of the voting power of all classes of shares of the foreign corporation. Section 951(b).

⁴ Section 952(a).

⁵ Section 954(a).

⁶ Section 954(d)(1). For this purpose, a person is a related person with respect to a CFC if (1) the person is, *inter alia*, a corporation that controls or is controlled by the CFC; or (2) the person is, *inter alia*, a corporation that is controlled by the same person or persons that control the CFC. Section 954(d)(3).

⁷ Reg. 1.954-3(a)(2).

⁸ Reg. 1.954-3(a)(4)(i). Hereinafter, “manufactured” and “manufacturing” will include “produced” and “producing,” “constructed” and “constructing,” “grown” and “growing,” and “extracted” and “extracting.”

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*, Examples (1), (2), and (3).

¹² Reg. 1.954-3(a)(4)(iii).

¹³ *Id.*

¹⁴ *Id.*, Example 2. See also Dave Fischbein Mfg. Co., 59 TC 338 (1972), *acq.* 1973-2 CB 2 (CFC’s assembly of bag-closing machines was substantial in nature and generally considered to constitute manufacturing); Bausch & Lomb, Inc., TCM 1996-57 (assembly operations of Irish and Hong Kong CFCs found to be substantial because the assembly workers received 13 weeks of training and, in each location, the CFC (1) leased production facilities to assemble sunglasses and warehouses to store finished goods; (2) employed management teams to prepare production plans and order parts from their suppliers; (3) hired and trained necessary personnel to carry out their operations; (4) inspected purchased parts for defects and prepared those parts for assembly; (5) assembled sunglass parts into finished

sunglasses; (6) inspected finished sunglasses for cosmetic and functional defects; and (7) cleaned and packaged sunglasses to prepare them for distribution).

¹⁵ The “sales branch tax rate disparity” test (which applies to sales or purchase branches) is under Reg. 1.954-3(b)(1)(i)(b).

¹⁶ Reg. 1.954-3(b)(1)(ii)(b).

¹⁷ *Id.*

¹⁸ See Ltr. Rul. 8413062; TAM 8509004.

¹⁹ See Yoder, *supra* note 1.

²⁰ In Rev. Rul. 97-48, the IRS also noted that, with the revocation of Rev. Rul. 75-7, its positions on the treatment of contract manufacturing for purposes of Section 954(d) and Section 863(b) were now harmonized. Under Reg. 1.863-3(c), production activity is limited to activity conducted directly by the taxpayer.

²¹ Preamble to Prop. Reg. 1.954-3, 73 Fed. Reg. 10716 (February 28, 2008).

²² *Id.*

²³ Prop. Reg. 1.954-3(a)(4)(iv).

gibles used in the conversion process. FS retains the right to oversee and direct the physical conversion of Product X by CM, but does not regularly exercise, through its employees, its powers of oversight or direction. (2) *Result.* FS does not satisfy the “substantial transformation” or “substantive” test because FS does not, through the activities of its employees, substantially transform, convert, or assemble personal property into Product X. However, Product X was manufactured (by CM), so the “substantial contribution” test applies. FS does not satisfy the “substantial contribution” test in this example because it does not make a substantial contribution through the activities of its employees to the manufacture of Product X. Mere contractual ownership of materials, intellectual property, and contractual rights to exercise powers of direction and control (without the exercise of those powers) are not sufficient. Therefore, FS is not considered to have manufactured Product X under the “substantial contribution” test.

Example 2: Substantial contribution to manufacturing, unrelated manufacturer. (1) *Facts.* Same as in Example 1, except that FS, through its employees, is engaged in product design and quality control. FS’s employees regularly exercise the right to oversee and direct CM’s activities in the manufacture of Product X. (2) *Result.* FS does not satisfy the “substantial transformation” or “substantive” test with respect to Product X because FS does not, through its employees’ activities, substantially transform, convert, or assemble personal property into Product X. However, Product X was manufactured (by CM), so the “substantial contribution” test applies. FS satisfies the “substantial contribution” test because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X. This would be the same conclusion even if CM were a corporation that was related to FS.

Example 3: Employees of another person. (1) *Facts.* FS, a CFC organized in Country M, purchases raw materials from a related person. CM, an unrelated contract manufacturer located in Country C, manufactures the raw materials into

Product X. CM uses employees of another corporation to operate its manufacturing plant and convert the raw materials into Product X. Apart from the physical conversion of the raw materials into Product X, employees of FS perform all of the other activities with respect to the manufacture of Product X (for example, oversight and direction of the manufacturing process, control of raw materials, control of logistics, vendor selection, quality control). FS sells Product X for use, consumption, or disposition outside Country M. (2) *Result.* If the manufacturing activities undertaken with respect to Product X between the time that the raw materials were purchased and the time that Product X was sold were undertaken by FS through its employees’ activities, FS would have satisfied the “substantive” test with respect to Product X. Therefore, the “substantial contribution” test applies. FS satisfies this test because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Thus, FS is considered to have manufactured Product X. If CM’s manufacturing plant were located in Country M, the “substantial contribution” test could still be satisfied even if CM did not manufacture Product X through its employees’ activities.

Example 4: Automated manufacturing. (1) *Facts.* FS, a CFC, purchases raw materials from a related person. CM, an unrelated corporation located outside FS’s country of organization, manufactures the raw materials (under the principles of the “substantial transformation” test) into Product X, pursuant to a contract manufacturing arrangement. FS then sells Product X to related and unrelated persons for use outside FS’s country of organization. Under the contract manufacturing arrangement, CM is responsible for the physical transformation of the raw materials into Product X. At all times, FS retains ownership of the raw material, work-in-process, and finished goods. FS retains the right to oversee and direct the physical conversion of Product X by CM, but does not regularly exercise, through its employees, its powers of oversight or direction. FS is the owner of sophisticated software and network systems that remotely and automatically (without human involve-

ment) take orders, route them to CM, order raw materials, and perform quality control. FS has a small number of computer technicians who monitor the software and network systems to ensure that they are running smoothly and to apply any necessary patches or fixes. Employees of DP, the U.S. corporate parent of FS, developed the software and network systems pursuant to a cost-sharing agreement between DP and FS. DP employees regularly supervise the computer technicians, evaluate the results of the automated manufacturing business, and make ongoing operational decisions, including, with regard to acceptable performance of the manufacturing process, stoppages of that process and product and process redesign and updates to meet the needs of the business and its customers. DP



employees develop and provide to FS all upgrades to the software and network systems. DP also has employees who control the other aspects of the manufacturing process, such as product design, vendor and material selection, management and retention of the manufacturing profits, and selection of the CM. (2) *Result.* FS does not satisfy the “substantial transformation” or “substantive” test with respect to Product X because FS does not, through its employees’ activities, substantially transform, convert or assemble personal property into Product X. If the manufacturing activities undertaken with respect to Product X between the time that the raw materials were purchased and the time that Product X was sold were undertaken by FS through the activities of its employees, FS would have satisfied the “substantive” test with respect to Product X. Therefore, the “substantial contribution” test applies. FS does not satisfy the “substantial contribution” test because it does not make a substantial contribution through its employees’ activities to the manufacture of Product X. Mere contractual ownership of materials and intellectual property together with contractual rights to exercise powers of direction and control and a small number of technical employees are not sufficient to satisfy the “substantial contribution” test. FS’s primary contribution to the manufacture of Product X is the provision of the software and network systems to CM. Substantial operational responsibilities and decision-making are exercised by DP employees who direct the activities of the FS employees. Thus, FS is not considered to have manufactured Product X.

Request for comments. In the Preamble to the Proposed Regulations, Treasury and the IRS requested comments, *inter alia*, with respect to the “substantial contribution” test and the activities listed in Prop. Reg. 1.954-3(a)(4)(iv)(b). In particular, comments were requested on whether one or more safe harbors should be added to the “substantial contribution” test. In drafting the Proposed Regulations, Treasury and the IRS considered several approaches to a safe harbor but ultimately requested comments because of difficulties in fashioning a safe harbor that would be (Continued on page 64)

²⁴ Taxpayers have raised concerns as to the definition of “employee” for this purpose. At the International Tax Institute lunch in New York City on April 22, 2008, Michael DiFronzo, Deputy Associate Chief Counsel (International), said that “employees” means “somebody, not just some binder on the shelf ... people clearly within the control of the CFC, boots on the ground, performing services at the direction of the CFC.” Mr. DiFronzo also noted that many CFC/principal companies, which hold valuable intangibles, are in safe low-tax jurisdictions like Switzerland and Singapore that require employees in order for taxpayers to be eligible for their lower tax rates. See Sheppard, “Boots on the Ground: IRS Official Expands Contract Manufacturing Comments,” 2008 TNT 79-1 (April 22, 2008).

²⁵ Taxpayers have queried the IRS as to whether this factor (“oversight and direction of activities and process”) is the “super”/most important factor. At a luncheon sponsored by the District of Columbia Bar Taxation Section’s International Tax Committee in Washington on April 14, 2008, Ethan Atticks, Senior Technical Reviewer, Branch 2, Office of Associated Chief Counsel (International), explained that oversight is important and that the government was going to make it a mandatory factor, but decided against that because there could be situations where all of the other activities are present but the oversight

is not there. See Nadal, “Activities Listed in New Substantial Contribution Test Not Exclusive, Officials Say,” 2008 TNT 73-6 (April 14, 2008).

²⁶ At a conference sponsored by Boston University School of Law, BNA, and DLA Piper in New York City, Mr. DiFronzo indicated that “managing the manufacturing profits” includes tasks such as hedging the raw materials costs, or guaranteeing the use of the contract manufacturer’s plant capacity. See Sheppard, “Going Naked: IRS Official Expands Contract Manufacturing Comments,” 2008 TNT 102-14 (May 21, 2008).

²⁷ In light of the list, taxpayers have wondered if the concept of “substantial” is quantitative or qualitative. Mr. DiFronzo stated (note 24, *supra*): “Quantitative is not going to hurt you if you have eight or nine factors, but the key driver is qualitative—what’s the value added?... The weight is on the value that comes to the process.” See Sheppard, *supra* note 24. When pressed on this point at the Boston conference, *supra* note 26, Mr. DiFronzo noted that Prop. Reg. 1.954-3(a)(4)(iii) states that absorbing 20% of conversion costs is enough to make a CFC the physical manufacturer of a product. See Sheppard, *supra* note 26. Query whether Mr. DiFronzo has identified the safe harbor for purposes of Prop. Reg. 1.954-3(a)(4)(iv).

²⁸ Prop. Reg. 1.954-3(a)(4)(iv)(a).

Foreign Base Company Sales Income

(Continued from page 27) flexible enough to apply across various industries and a range of different types of manufacturing. Among the safe harbors considered were (1) a list of mandatory activities; (2) a cost-based test; (3) a compensation-based test; (4) a value-based test; (5) a tax-rate-disparity-based test; and (6) a percentage-based test comparing the compensation paid to employees of the CFC for performing activities related to the manufacturing process vs. the total cost for all activities related to the manufacturing process (including cost paid to a contract manufacturer but excluding the cost of raw materials and marketing intangibles).²⁹

In addition, Treasury and IRS requested comments on whether the requirement under the manufacturing exception (that the employees of the CFC perform its activities) should be expanded to include individuals that are not on the CFC's payroll but are controlled by the CFC's employees.³⁰

Finally, comments were requested on whether it would be appropriate to add an anti-abuse rule (similar to the one in Notice 2007-13, 2007-5 IRB 410)³¹ to prevent a CFC/principal company from meeting the "substantial contribution" test where one or more related U.S. persons supply substantially all of the direct or indirect contributions to the manufacturing process. Such a rule might provide, for example, that where (1) the U.S. parent of a CFC provides 45% of the manufacturing contribution; (2) the CFC provides 5% of the manufacturing contribution; and (3) an unrelated contract manufacturer provides 50% of the manufacturing contribution, the CFC does not make a substantial contribution because a related U.S. person provided

80% or more of the manufacturing contribution (90% here—45/50). Treasury and the IRS considered such a rule but ultimately did not include it in the Proposed Regulations. Comments were requested on whether such a rule should be added to the final Regulations.³²

Effective date. The Proposed Regulations will be effective for tax years of a CFC/principal company that begin on or after the date that the Proposed Regulations are published as final Regulations.³³ Until then, taxpayers have the option of applying them (in their entirety) to all open tax years as if they were final Regulations.³⁴

Thoughts and Observations on Meeting the Fabulous New "Substantial Contribution" Test

Now that we have the fabulous new "substantial contribution" test, the immediate question that arises is how to ensure success. What activities and what amount of activities will be enough to be "substantial"?

As Mr. DiFronzo rightly noted,³⁵ "boots on the ground," coupled with the exercise of significant decision making authority, is required to secure the tax benefits in countries such as Ireland and Switzerland. U.S. taxpayers that have established principal companies in those jurisdictions should be very familiar with these requirements. Having met the local-country requirements, these U.S. taxpayers should already have gone a long way toward satisfying the "substantial contribution" test.

Further, although IRS officials have consistently denied that "oversight and direction of the manufacturing activities or process" is the most important/"super" factor,³⁶ a showing that the CFC/principal



company has regularly exercised oversight and direction over the manufacturing activities or process should be very helpful. Similarly, even though IRS officials have insisted that the "substantial contribution" test is qualitative, not quantitative,³⁷ a bundle of activities should also be very helpful.³⁸ And while there are currently no safe harbors, the contribution by the CFC/principal company should never fall below 20% of conversion costs (the Prop. Reg. 1.954-3(a)(4)(iii) test),³⁹ and the contribution by related U.S. persons should never exceed 80% of total conversion costs.⁴⁰

Finally, assuming the requisite "boots on the ground," the key to success will be documentation, documentation, documentation. 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. When applicable, logs/diaries of trips to the contract manufacturer (where oversight and direction was exercised) should also be in the files.

Conclusion

The fabulous new "substantial contribution" test provides significant planning opportunities for U.S.-based multinationals. As with all U.S. tax planning, if getting it right is meaningful (i.e., if the "substantial contribution" test must be met to avoid FBCSI), actions/tweaks to existing structures/legal relationships must be taken to ensure success. ●

²⁹ See note 21, *supra*.

³⁰ *Id.*

³¹ Under Notice 2007-13, a CFC will not be deemed to have received substantial assistance (from its U.S. parent or U.S. affiliates) if more than 20% of the cost of the contract is attributable to services furnished by related-party CFCs. See Rollinson, O'Connor, Gordon, and Kiltthau, "Notice 2007-13 and the Substantial Assistance Rules—A Good Start but More Clarification Required," 19 JOIT 18 (January 2008).

³² See note 21, *supra*.

³³ Prop. Reg. 1.954-3(a)(4)(iv)(d).

³⁴ See note 21, *supra*.

³⁵ See note 24, *supra*.

³⁶ See note 25, *supra*.

³⁷ See note 27, *supra*.

³⁸ Prop. Reg. 1.954-3(a)(4)(iv)(c), Example 3.

³⁹ See note 27, *supra*.

⁴⁰ See discussion above under "Request for Comments."