



“Through the Glass {Even More} Darkly”

LEWIS J. GREENWALD, DOUGLAS S. STRANSKY, AND TENLEY OLDAK

Revisions to the Not-So-Fabulous Branch Rule

Since the promulgation of the first final Regulations under Section 954(d) in 1964, taxpayers (and their advisors) have struggled mightily to understand the contours and application of the branch rule of Reg. 1.954-3(b)—how to apply the “tax rate disparity” test, what is the hypothetical effective tax rate, who is the remainder of the controlled foreign cor-

poration (CFC), etc. (hence, the “not-so-fabulous” branch rule). With the introduction of the check-the-box Regulations and the exponential proliferation of branches, this struggle became more acute.

As we previously reported, on February 27, 2008, the IRS and Treasury issued Proposed Regulations that introduced a

new way for a CFC/principal company to meet the manufacturing exception to foreign base company sales income (FBCSI)—the fabulous new “substantial contribution” test.¹ The Proposed Regulations also provided rules on the application of the “substantial contribution” test when a CFC claimed to satisfy that test with respect to the activities of a

manufacturing branch (Prop. Reg. 1.954-3(b)(2)(ii)(c)(2)). The Proposed Regulations further provided, *inter alia*, new rules with respect to the application of the branch rule to CFCs with more than one manufacturing branch (Prop. Reg. 1.954-3(b)(1)(ii)(c)). These revisions had the effect of heaping new complexity on old complexity.

On December 24, 2008, the Proposed Regulations were re-issued as final, Temporary, and Proposed Regulations (TD 9438; REG-150066-08). Revisions and clarifications were made to the “substantial contribution” test,² and to the branch rules. The IRS plans to provide more changes and guidance to the branch rules in the months ahead, while attempting to deflect the assertion that taxpayers and their advisors must now see through the glass even more darkly than under prior formulations of the manufacturing branch rules.³

This article first reviews FBCSI, the manufacturing exception, and the branch rule (in general). It then examines the IRS and Treasury response to comments and discusses the modifications to the branch rule provided in TD 9438. It concludes with a plea to the IRS and Treasury to scrap the branch rules in their current form and formulate rules that can be complied with (by taxpayers and their advisors) and that can be administered (by the IRS).

FBCSI

In general, if a foreign corporation is a CFC, a person who is a “United States shareholder” must include in gross income its pro rata share of the corporation’s Subpart F income (Section 951(a)(1)).⁴ “Subpart F income” includes, *inter alia*, foreign base company income (Section 952(a)). Foreign base company income includes, *inter alia*, FBCSI (Section 954(a)).

FBCSI is income (in the form of profits, commissions, fees, or otherwise)

LEWIS J. GREENWALD and DOUGLAS S. STRANSKY are tax partners, and TENLEY OLDAK is a tax associate, in the Boston office of Sullivan & Worcester LLP. Mr. Greenwald and Mr. Stransky both practice exclusively in the area of international taxation. Mr. Greenwald is a member of the Board of Advisors of the Journal and a frequent contributor.

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) is consumed outside the CFC’s country of organization (Section 954(d)(1)).⁵

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 (Reg. 1.954-3(a)(2)). 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 (Reg. 1.954-3(a)(4)(i)).⁶ As such, Section 954(d) is designed to prevent the separation of purchasing/selling income and manufacturing income and then locating this purchasing/selling income in a low-tax jurisdiction.

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. 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 (Reg. 1.954-3(a)(4)(i)).

Under the “substantial transformation” test of Reg. 1.954-3(a)(4)(ii), if personal property is substantially transformed prior to sale, it 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



Absent the branch rule, a CFC could engage in purchasing or manufacturing activities in a high-tax jurisdiction, and selling activities in a low-tax jurisdiction, without incurring FBCSI

canned tuna (Reg. 1.954-3(a)(4)(i), Examples 1-3).

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 oper-

ations 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 the property conversion costs (direct labor and factory burden), the costs account for 20% or more of the total costs of goods sold. In no event, however, will mere packaging, prepackaging, labeling, or minor assembly operations constitute the manufacture of personal property. 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 (Reg. 1.954-3(a)(4)(iii), Example 2).⁷

The Not-So-Fabulous 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 the application of the FBCSI rules. Absent the branch rule, a CFC could engage in purchasing or manufacturing activities in a high-tax jurisdiction, and selling activities in a

¹ For previous coverage of the “substantial contribution” test, see Greenwald, Stransky, and Oldak, “Foreign Base Company Sales Income: The Fabulous New ‘Substantial Contribution’ Test,” 19 JOIT 20 (October 2008).

² The third article in this series of three articles will review the changes and clarifications made by the final and Temporary Regulations with respect to the “substantial contribution” test.

³ Bennett, “IRS to Revisit Contract Manufacturing Rules, Issue More Guidance in Months Ahead,” BNA Daily Tax Rep’t, January 26, 2009, page G-6. At a tax luncheon sponsored by BNA Tax Management and hosted by Buchanan Ingersoll & Rooney in Washington, D.C., on January 23, 2009, Michael DiFronzo, IRS Deputy Associate Chief Counsel (International), said that the IRS “continue[s] to work through these Regs. There are a large portion of them that are temporary, not final. Changes will come ... we will have a

second go at the branch rules.” *Id.* On a live webcast hosted by KPMG on January 14, 2009, Ethan A. Atticks, Senior Technical Reviewer, Branch 2, IRS Office of Associate Chief Counsel (International), said that the IRS “thought it was more appropriate” to issue the revised branch rules in temporary form given the complexity of the subject matter. Nadal, “Drafters of Final and Temporary Contract Manufacturing Regs Share Insight on New Rules,” 2009 WTD 9-1 (January 15, 2009). Mr. DiFronzo defended the complexity of the branch rules at the BNA luncheon, however, stating that “complexity of business necessitates a complex rule.” Stewart, “Drafters of Temporary Branch Regs Defend Rules’ Complexity,” 53 Tax Notes Int’l 408 (February 2, 2009).

⁴ For this purpose, “controlled foreign corporation” 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).

⁵ For this purpose, a person is a related person with respect to a CFC if the person is, *inter alia*, (1) a corporation that controls or is controlled by the CFC; or (2) a corporation that is controlled by the same person or persons that control the CFC. Section 954(d)(3).

⁶ Hereinafter, “manufactured” and “manufacturing” will include “produced” and “producing,” “constructed” and “constructing,” “grown” and “growing,” and “extracted” and “extracting.”

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, 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.⁸

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." 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 (Reg. 1.954-3(b)(1)(ii)(b)).

The Fabulous New "Substantial Contribution" Test

Since the promulgation of the first final Regulations under Section 954(d) in 1964, worldwide economic expansion and globalization have led to significant changes in manufacturing. Many multinational groups have extensive manufacturing networks that straddle geographic borders, and that 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.⁹

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 "physical manufacturing" tests. In some of these instances, Treasury and the IRS now believe that the CFC should qualify for the manufacturing exception to FBCSI.¹⁰

Prop. Reg. 1.954-3(a)(4)(i) provided that, in addition to the "physical manufacturing" tests, a taxpayer could now qualify for the manufacturing exception by satisfying the "substantial contribution" test of Prop. Reg. 1.954-3(a)(4)(iv). Thus, even when the taxpayer cannot satisfy the "physical manufacturing" tests, the taxpayer could be considered to have manufactured personal property for purposes of the manufacturing exception (Prop. Reg. 1.954-3(a)(4)(iv)). Pursuant to Prop. Reg. 1.954-3(a)(4)(iv), a CFC/principal company would satisfy the "substantial contribution" test with respect to personal property only if the facts and circumstances showed that the CFC/principal company had made a substantial contribution through the activities of its employees to the manufacture of that property.

Prop. Reg. 1.954-3(a)(4)(iv)(b) provided that the activities of a CFC's employees that were to be considered in determining whether the CFC/principal company had made a substantial contribution to the manufacture of personal property included, but were not limited to:

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



The February 2008 Proposed Regulations had the effect of heaping new complexity on old complexity

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.

- 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.
- 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.

For purposes of the "substantial contribution" test:

- The weight given to any activity would vary with the facts and circumstances of the particular business.
- The presence or absence of any activity, or of a particular number of activities, would not be dispositive.
- Although other persons made contributions to the manufacture of the personal property prior to sale, the CFC/principal company could still make a substantial contribution to the manufacture of that property through the activities of its employees (Prop. Reg. 1.954-3(a)(4)(iv)(a)).

Revisions to the Not-So-Fabulous Branch Rule

Revisions and clarifications to the branch rules in the final, Temporary, and Proposed Regulations issued on December 24, 2008 are discussed below.

Definition of a manufacturing branch—no definition of "branch."

Although the previous final Regulations defined a manufacturing branch as a branch or similar establishment through which a CFC carried on manufacturing activities, it did not require that the manufacturing exception be satisfied as a whole for the manufacturing branch rule

to apply. Treasury and the IRS believed that a manufacturing branch exists only if the CFC (including any branch of that CFC) has manufactured personal property.¹¹ As such, the Proposed Regulations clarified this point by providing that the manufacturing branch rule applies only where a CFC (including any branches of the CFC) satisfied the manufacturing requirement (Prop. Reg. 1.954-3(b)(1)(ii)(a)).

After the Proposed Regulations were issued, some commenters requested that the Regulations define “branch” for purposes of the branch rule. They suggested various definitions, for instance, that a branch be defined as a permanent establishment, as a business activity in a jurisdiction outside a CFC’s country of organization that has separate books and records, or as a trade or business outside a CFC’s country of organization. Commenters also pointed to precedents in the Regulations under Sections 367 and 987. Alternatively, some commenters requested that the Regulations make clear that de minimis activity outside a CFC’s country of organization (for example, traveling employees) should not constitute a branch. Other commenters warned that requiring too high a level of activity outside a CFC’s country of organization before a CFC was treated as having a “branch” would make it possible for a CFC organized in a lower-tax jurisdiction to contribute substantially

to manufacturing activities in a higher-tax jurisdiction without causing the CFC to operate through a branch. Still other commenters suggested that courts have concluded that the IRS and Treasury lack the regulatory authority to determine what constitutes a branch, and may address only the consequences flowing from the existence of a branch.¹²

The IRS and Treasury determined that defining a branch was beyond the scope of the regulatory project.¹³ The Temporary Regulations retained an example, however, that illustrates that employees of a CFC who travel to a contract manufacturer’s location outside the CFC’s country of organization do not necessarily give rise to a branch in that location.¹⁴

Determination of hypothetical effective tax rate. During the comment period, commenters requested that the Regulations clarify that the “tax rate disparity” tests take into account incentive tax rates and other similar foreign tax relief available to a CFC in calculating the hypothetical effective tax rate.

The IRS and Treasury agreed that the “tax rate disparity” tests should take into account the actual tax rate paid with respect to the sales income by the selling branch or remainder, and that the hypothetical effective tax rate that would be paid by the manufacturing branch (or remainder) on this sales income under the laws of the country in which the

manufacturing branch is located (or, in the event of a remainder, the CFC’s country of organization) if it were derived from sources within that country.

Thus, the IRS and Treasury agreed that tax incentives are to be considered in determining the hypothetical effective tax rate to be used in applying the “tax rate disparity” tests. In contrast, if a sales affiliate in the country of manufacturing can theoretically receive tax relief by taking certain actions (for example, by applying for special treatment pursuant to a ruling process), but the taxpayer has not affirmatively obtained this tax relief for the manufacturing branch (or remainder), the hypothetical effective tax rate that would be paid by the manufacturing branch (or remainder) were it to derive the sales income should be the effective tax rate that would apply in that jurisdiction without the tax relief. The IRS and Treasury believed that no change to the text of the existing Regulations was necessary to address these points. Reg. 1.954-3T(b)(4), Example 8, however, was included in the Temporary Regulations to illustrate that uniformly applicable incentive tax rates are taken into account in determining the hypothetical effective tax rate.

Finally, the IRS and Treasury concluded that other questions and requests in this area, including further clarification of the methodology for calculating hypothetical tax rates and changes to the assumptions used in applying the

“tax rate disparity” tests and determining the hypothetical effective tax rate, were beyond the scope of the regulatory project. However, they continue to study these questions and welcome comments.¹⁵

Multiple branches engaged in manufacturing. The issues here are determining the (1) location of manufacturing, (2) location of activities, and (3) remainder of the CFC when activities are performed in multiple locations.

Location of manufacturing. Prior to the Proposed Regulations, the Section 954(d)(2) Regulations did not address situations where a CFC had more than one manufacturing branch.¹⁶ The Proposed Regulations contained two rules for applying the manufacturing branch “tax rate disparity” test to multiple manufacturing branches (Prop. Regs. 1.954-3(b)(1)(ii)(c)(2), (3)).¹⁷

The first rule addressed situations in which multiple branches each perform manufacturing activities with respect to separate items of personal property that were then sold by the CFC. Consistent with the rule for multiple sales branches, the Proposed Regulations required the separate application of the manufacturing branch “tax rate disparity” test to each branch that was manufacturing a separate item of personal property (Prop. Reg. 1.954-3(b)(1)(ii)(c)(2)).

The second rule addressed situations in which multiple branches (or one or

more branches and the remainder of the CFC) performed manufacturing activities with respect to the same item of personal property that was then sold by the CFC (Prop. Reg. 1.954-3(b)(1)(ii)(c)(3)). In these instances, the “manufacturing branch tax rate disparity” test was applied by giving satisfaction of the “physical manufacturing” test precedence over other contributions to manufacturing:

- If only one branch (or only the remainder of the CFC) satisfied the “physical manufacturing” test, the location of that branch (or the remainder of the CFC) would be the location of the manufacturing for purposes of applying the “manufacturing branch tax disparity” test.
- If more than one branch (or one or more branches and the remainder of the CFC) each satisfied the “physical manufacturing” test, the branch or the remainder of the CFC located or organized in the jurisdiction that would impose the lowest effective tax rate would be the location of manufacturing for purposes of applying the “manufacturing branch tax disparity” test (“lowest-of-all-rates” rule).
- If none of the branches (or the remainder of the CFC) satisfied the “physical manufacturing” test, but the CFC as a whole satisfied the “substantial contribution” test, the location of manufacturing would be the location of the branch (or the remainder of

the CFC) that provided the predominant amount of the CFC’s substantial contribution to manufacturing. If a predominant amount of the CFC’s contribution to manufacturing was not provided by any one location, the location of manufacturing would be the place (either the remainder of the CFC or one of its branches) where manufacturing activity was performed and that would impose the highest effective tax rate (“highest-of-all-rates” rule) (Prop. Reg. 1.954-3(b)(1)(ii)(c)(3)).¹⁸

The IRS and Treasury received multiple comments regarding the “lowest- and highest-of-all-rates” rules. For example, commenters asked why the “lowest-of-all-rates” rule should apply when more than one branch (or one or more branches and the remainder of the CFC) independently satisfy the “physical manufacturing” test, whereas the “highest-of-all-rates” rule should apply when none of the branches or the remainder of the CFC independently satisfies the “physical manufacturing” tests but the CFC as a whole satisfies the “substantial contribution” test. Commenters suggested that satisfaction of the “physical manufacturing” test and the “substantial contribution” test should be treated equally under the Regulations and, therefore, having the same rule in both circumstances. They proposed a “lowest-of-all-rates” rule or use of a weighted average of the tax rate of each

⁷ See also *Dave Fishbein Manufacturing 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 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). The “substantial transformation” test and the “substantive” test are hereinafter collectively referred to as the “physical manufacturing” tests.

⁸ The “sales branch tax rate disparity” test (which applies to sales or purchase branches) is under Reg. 1.954-3(b)(1)(i)(b).

⁹ Preamble to Prop. Reg. 1.954-3, 73 Fed. Reg. 10716 (February 28, 2008).

¹⁰ *Id.*

¹¹ REG-124590-07, Preamble.

¹² TD 9438, Preamble. See, e.g., *Ashland Oil, Inc.*, 95 TC 348 (1990) (unrelated manufacturing corporation in a contract manufacturing arrangement with a CFC cannot be treated as the CFC’s branch or similar establishment); *Vetco, Inc.*, 95 TC 579 (1990) (wholly owned subsidiary of a CFC in a contract manufacturing arrangement with the CFC cannot be treated as the CFC’s branch or similar establishment).

¹³ TD 9438, Preamble.

¹⁴ See Temp. Reg. 1.954-3T(b)(1)(iii)(c)(3)(v), Example 6.

¹⁵ TD 9438, Preamble.

¹⁶ While final Reg. 1.954-3(b)(1)(i)(c) provides a rule addressing use of multiple sales or purchase branches, final Reg. 1.954-3(b)(1)(ii) did not include a corollary rule for use of multiple manufacturing branches. The IRS and Treasury believed that the lack of a specific rule on use of more than one manufacturing branch did not limit the general manufacturing branch rule of Reg. 1.954-

3(b)(1)(ii)(a) from applying to each manufacturing branch of a CFC where the CFC performs manufacturing activities through more than one branch (such application being consistent with the rules regarding multiple sales or purchase branches). However, for clarity, the Proposed Regulations include new rules on use of multiple manufacturing branches. See Preamble to Prop. Reg. 1.954-3, 73 Fed. Reg. 10716.

¹⁷ In addition, the Proposed Regulations had created a rebuttable presumption where a CFC claimed to satisfy the “substantial contribution” test with respect to the activities of a branch. Prop. Reg. 1.954-3(b)(2)(ii)(c)(2). Under this presumption, if a branch of a CFC satisfied the “physical manufacturing” test with respect to personal property sold by the remainder of the CFC, the remainder of the CFC is presumed *not* to make a substantial contribution to the manufacture of the same item unless the CFC could rebut that presumption to the satisfaction of the Commissioner. *Id.* With respect to the presumption, commenters suggested that satisfaction of the “physical manufacturing” and “substantial contribution” tests should be treated equally under the Regulations. *Id.* They also expressed the view that the standard required to rebut the presump-

tion was either too subjective, imposed an improperly high standard, or both. TD 9438, Preamble. They recommended that if a presumption was retained, the standard required to rebut it should be clear and convincing evidence. *Id.* On further study, the IRS and Treasury concluded that the “substantial contribution” test could be administered without the benefit of a rebuttable presumption. *Id.* Thus, the final and Temporary Regulations do not contain the presumption. The IRS and Treasury took into account the request for parity of treatment with respect to the “physical manufacturing” test and the “substantial contribution” test in reaching this conclusion. *Id.*

¹⁸ For this purpose, whether any branch or the remainder of the CFC provided a predominant amount of the CFC’s contribution to manufacturing was determined by applying the facts-and-circumstances test of Prop. Reg. 1.954-3(a)(4)(iv) to weigh the contribution to manufacturing of each branch or the remainder of the CFC (hereinafter, “predominant place rule”).

¹⁹ TD 9438, Preamble.

²⁰ *Id.*

²¹ At the BNA luncheon, Mr. DiFronzo responded to practitioner concerns regarding this rule by stat-

ing that he expected that it would be “of pretty limited application.” See Bennett, *supra* note 3.

²² TD 9438, Preamble.

²³ *Id.*

²⁴ See Temp. Reg. 1.954-3T(b)(1)(ii)(c)(3)(v), Example 6; TD 9438, Preamble.

²⁵ TD 9438, Preamble.

²⁶ As with the rule in the Proposed Regulations, this new rule is intended to provide that the activities of all branch locations (or, for a remainder, the activities in the jurisdiction under the laws of which the CFC is organized) that do not have tax rate disparity relative to the sales or purchase branch location (or, for a purchasing or selling remainder, the jurisdiction under the laws of which the CFC is organized) may be taken into account together with the activities of the sales or purchase branch (or, for a purchasing or selling remainder, activities of the remainder of the CFC in the jurisdiction under the laws of which the CFC is organized) for purposes of applying the separate corporation analysis required under the Regulations and determining whether the sales income of the sales or purchase branch (or remainder) is FBCSI. The determination will depend on

whether the “substantial contribution” test is satisfied by the combined activities of the sales or purchase branch (or remainder) and the other locations aggregated with the sales or purchase branch (or remainder). See TD 9438, Preamble.

²⁷ TD 9438, Preamble.

²⁸ *Id.* One open question raised at the KPMG webcast (see note 3, *supra*) concerned whether the existence of a sales branch is determined by reference to whether income is earned or whether sales activities occur. Mr. Atticks responded that if a branch is booking sales income, the IRS will argue that it is a sales branch based on the aim of the branch rules to prevent deflection of income to a lower-rate jurisdiction. See Nadal, *supra* note 3.

²⁹ See Reg. 1.954-3(b)(1)(i)(c). Mr. Atticks remarked during the KPMG webcast that “it is definitely [the Service’s] position that both the sales and manufacturing rules should not apply,” adding, “to the extent there is some additional cleanup work that needs to be done to make that point consistent, hopefully we can do that in technical correction.” See Nadal, *supra* note 3.

branch or remainder of the CFC in both instances.

The IRS and Treasury generally agreed with these comments, and adopted the suggestion of taxpayers that the same rule should apply consistently when a branch (or remainder) independently manufactures, regardless of whether it satisfies the “physical manufacturing” tests or the “substantial contribution” test. As such, the Temporary Regulations provide that the “lowest-of-all-rates” rule will apply whenever a branch (or remainder) independently satisfies either the “physical manufacturing” tests or the “substantial contribution” test (Temp. Reg. 1.954-3T(b)(1)(ii)(c)(3)). All that said, the IRS and Treasury were quick to point out that providing parity of treatment does not answer the question of the location of manufacturing when a CFC satisfies the “substantial contribution” test but a branch (or remainder) does not independently do so.

Commenters also questioned how to treat branches making contributions to the manufacture of the personal property when no branch (or remainder) independently satisfies the “substantial contribution” test. In that regard, some commenters expressed concern that it would be difficult to compare the relative contributions of various locations to determine which branch (or remainder of the CFC) made the predominant contribution under the “predominant place” rule. Others requested greater guidance regarding the meaning of “predominant contribution.” Many commenters suggested that the “highest-of-all-rates” rule could lead to arbitrary results when no predominant contributor could be identified.¹⁹

The IRS and Treasury generally agreed with these comments.²⁰ Under the Temporary Regulations, if a “demonstrably” greater amount of manufacturing activity occurs in jurisdictions without tax rate disparity relative to the sales or purchase branch, the location of the sales or purchase branch will be deemed to be the location of manufacture of the personal property (Temp. Reg. 1.954-3T(b)(1)(ii)(c)(3)(iii)).²¹ Otherwise, the location of manufacture of the personal property will be deemed to be the location of a manufacturing branch

(or remainder) that has tax rate disparity relative to the sales or purchase branch.

Location of activities. The Proposed Regulations provided that, for purposes of the multiple manufacturing branch rules, the location of any activity with respect to the manufacture of the personal property was where the CFC’s employees engaged in that activity (Prop. Reg. 1.954-3(b)(1)(ii)(c)(3)(d)). Commenters suggested that in some instances the Proposed Regulations left it unclear, for purposes of determining the location of manufacturing, which jurisdiction was accorded credit for activities performed by an employee who is traveling temporarily to a foreign jurisdiction. Some commenters suggested that the location of activity rule should be removed or that the Regulations should clarify that, for instance, the activities of employees of a CFC based in the jurisdiction under the laws of which the CFC is organized, even while traveling outside the CFC’s country of organization, would generally be credited toward establishing that the jurisdiction under the laws of which the CFC is organized provided a predominant amount of a CFC’s substantial contribution.

The IRS and Treasury believe that the text of the Proposed Regulations makes it clear that when an employee travels to perform activities, those activities are credited to the location where the activities are conducted if there is a branch or remainder of the CFC in that jurisdiction.²² This point was further clarified in the examples (Temp. Reg. 1.954-3T(b)(1)(ii)(c)(3)(v), Example 6).

Other commenters asked which location was accorded credit, if any, for activities performed by traveling employees of the CFC while located in a country where there is no branch or remainder of the CFC.²³ In that regard, the Temporary Regulations provide that the location of any manufacturing activity is where the employees of the CFC perform that activity (Temp. Reg. 1.954-3T(b)(1)(ii)(c)(3)(iv)). Thus, the activities of employees while traveling to a country where the CFC does not maintain a branch or remainder are not credited to the branch or remainder (where the traveling employees are regularly



Some commenters requested that the Regulations define “branch” for purposes of the branch rule but the IRS and Treasury determined that a definition was beyond the scope of the project

employed) for purposes of determining the location of manufacturing under the branch rule. However, these activities can be taken into account for purposes of satisfying the “physical manufacturing” tests and the “substantial contribution” test.²⁴

Determining remainder of the CFC when activities are performed in multiple locations. The Proposed Regulations

provided that when treating the location of sales or purchase income as a separate corporation for purposes of determining whether FBCSI is realized, that separate corporation will exclude any branch or the remainder of the CFC that would be treated as a separate corporation, if the hypothetical tax rate imposed by the jurisdiction of each

branch or the remainder of the CFC were separately tested against the effective tax rate imposed on the sales or purchase income under the relevant “tax rate disparity” test (Prop. Reg. 1.954-3(b)(2)(ii)(a)). Commenters suggested that the application of this rule (for determining the remainder of the CFC) when activities are performed in multi-

ple locations was unclear.²⁵ As such, the Temporary Regulations were revised to describe what is included in the remainder, rather than what is excluded from the remainder (for purposes of determining whether there is FBCSI, after it is determined that a manufacturing branch should receive treatment as a separate corporation for purposes of applying the Regulations) (Temp. Reg. 1.954-3T(b)(2)(ii)(a)).²⁶

Coordination of sales and manufacturing branch rules. Commenters requested guidance on how the sales or purchase branch rules interact with the manufacturing branch rules. The current manufacturing branch rules contemplate the existence of a sales or purchase branch and a manufacturing branch, and in such an instance, the sales or purchase branch is treated as the remainder of the CFC for purposes of applying the “tax rate disparity” test (Reg. 1.954-3(b)(1)(i)(c)). Under the existing Regulations, however, the sales or purchase branch rules do not indicate that those rules do not apply where the manufacturing branch rules are applied (Reg. 1.954-3(b)(1)(i)). Commenters were concerned that the manufacturing branch rules would be applied in addition to, rather than in lieu of, the sales or purchase branch rules.²⁷

The IRS and Treasury agreed that if one or more sales or purchase branches are used in addition to a manufacturing branch, the sales or purchase branch rules do not also apply to determine whether that income is FBCSI.²⁸ The Temporary Regulations attempt to clarify this point.²⁹

“Unrelated to unrelated” transactions. Commenters suggested that there was uncertainty as to whether a substantial contribution to the manufacture of personal property by a CFC could cause the CFC to earn FBCSI where, absent the “substantial contribution” test, some taxpayers had taken the position that they were outside the scope of the FBCSI rules. Some commenters expressed concern that transactions that are not currently subject to the existing Regulations may become subject to them as a result of the interaction (*Continued on page 63*)

Branch Rule

(Continued from page 37) of the “substantial contribution” test and the manufacturing branch rule. Other commenters suggested more generally that it was unclear if the “substantial contribution” test might create a branch through which a CFC carries on activities in a contract manufacturer’s jurisdiction. Commenters also suggested that taxpayers should be exempted from the manufacturing branch rule by providing that the rule applies only if the CFC is relying on the manufacturing exception for purposes of determining FBCSI under Section 954(d)(1) or, alternatively, that the “substantial contribution” test should be elective.³⁰

The IRS and Treasury agree that taxpayers may be subject to the FBCSI rules as a result of CFC employees performing indicia of manufacturing activities through a branch outside the country of organization of a CFC. They believe that this result is clear in the Proposed Regulations, so no modifications were made to the text of the Temporary Regulations to further clarify it. The IRS and Treasury noted that many commenter criticized the Proposed Regulations for drawing inappropriate distinctions between satisfaction of the “physical manufacturing” test and satisfaction of the “substantial contribution” test, and argued that updating the manufacturing exception in the context of modern business enterprise models required treating with equal importance and weight physical manufacturing and activities satisfying the “substantial contribution” test. The IRS and Treasury adopted this comment in both the final and Temporary Regulations and so did not incorporate in the Temporary Regulations an excep-

tion regarding activities performed through a branch located outside the country of organization of a CFC for instances in which, absent the “substantial contribution” test, some taxpayers had taken the position that they were outside the scope of the FBCSI rules.

Branch rule examples. The Proposed Regulations provided examples illustrating the new manufacturing branch rules; the Temporary Regulations modify the examples in some instances. In one example in the Proposed Regulations, the remainder of the CFC performed seven activities listed in the indicia of manufacturing of the Proposed Regulations, whereas Branch A performed only one activity (design) and Branch B performed only two activities (Prop. Reg. 1.954-3(b)(1)(ii)(c)(3)(f), Example 4). Treasury and the IRS intended that the example would show that in a CFC’s particular industry, the weight accorded to the activities performed by each branch can be comparable, even though a different number of activities occur in different locations, because the economic significance of the activities conducted in each location is comparable. Commenters expressed concern, however, that the facts of the example ascribed most substantial contribution activities to the remainder, but determined that the remainder had not met the “substantial contribution” test.³¹ The IRS and Treasury recognized that the example had perplexed taxpayers and, therefore, revised the allocation of activities in the example (Temp. Reg. 1.954-3T(b)(1)(ii)(c)(3)(v), Example 3).

The Temporary Regulations also added one example to illustrate how the “substantial contribution” test and the branch rules operate in situations involving multiple manufacturing branches

and multiple sales branches (Temp. Reg. 1.954-3T(b)(2)(ii)(c)(3)(v), Example 5), and included an example illustrating the operation of the “location of manufacture” rules and the application of the “substantial contribution” test when a tested manufacturing location has been determined to have tax rate disparity with a sales location (Temp. Reg. 1.954-3T(b)(4), Example 9).

Effective dates. Several commenters requested that the new 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 whose structures require modification to accommodate the new Regulations.³²

One commenter noted that while there are strong policy reasons for the “substantial contribution” test and the branch rules to apply to “unrelated to unrelated” transactions, the IRS and Treasury should consider a special delayed effective date to allow taxpayers in this position time to restructure their operations in light of the Regulations. The commenter argued that these taxpayers had been outside the scope of the FBCSI rules prior to these Regulations and should be provided reasonable time to restructure.

Accordingly, the final and Temporary 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 the tax years of the CFCs end (Temp. Reg. 1.954-3T(e)). Thus, the final and Temporary Regulations will become applicable January 1, 2010, for tax calendar-year CFCs. In addition, a taxpayer may apply the final and Temporary Regulations retroactively for open tax years (Temp. Reg. 1.954-3T(f)).³³

Conclusion

For now, taxpayers and their advisors continue to see through the glass darkly while awaiting additional guidance and revisions to the branch rules from the IRS. ●

³⁰ TD 9438, Preamble. In this context, commenters noted that placing a CFC’s substantial contribution activities, which are performed outside the country where the sales activities are performed, in a separately incorporated entity could prevent the CFC from having a branch that is subject to the manufacturing branch rule as a result of the activities.

³¹ TD 9438, Preamble.

³² *Id.*

³³ The taxpayer may so choose if and only if it and all members of its affiliated group apply both

the final and Temporary 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.