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FSA 200220005:
IRS Again Attempts to Void Contract Manufacturing Arrangements Under Subpart F

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U.S.-based multinational corporations with controlled-foreign-corporation ("CFC") subsidiaries implement contract manufacturing arrangements in an attempt to defer U.S. tax. If a CFC qualifies as the manufacturer of its goods for Subpart F purposes, then the manufacturing income qualifies for deferral, because it is not considered "Subpart F income" (the "Manufacturing Exception").[1] An abbreviated summary of the most pertinent background is set forth below.[2]

In Revenue Ruling 75-7 (the "1975 Ruling"),[3] the Internal Revenue Service ("IRS") held that, in certain circumstances, the activities of a contract manufacturer may be attributed to a CFC for purposes of applying the Manufacturing Exception. The 1975 Ruling also held that, if the activities of the contract manufacturer occur outside the country under the laws of which the CFC is formed (the "CFC Country"), those activities cause the CFC to have a branch (or similar establishment) for purposes of the "Branch Rule."[4]

In *Ashland Oil, Inc. v. Commissioner*,[5] and *Vetco, Inc. v. Commissioner*,[6] the Tax Court severely undercut the IRS's position by refusing to treat a contract manufacturer as giving rise to

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[1] Pursuant to Subpart F of the Internal Revenue Code of 1986, as amended (the "Code"), a U.S. shareholder of a CFC is subject to current U.S. tax on its pro rata share of the "Subpart F income" earned by the CFC. Code Sec. 951(a). Subpart F income includes most passive income (*e.g.*, interest, dividends and capital gains), as well as "foreign base company sales income" ("FBCSI"). Code Secs. 952(a)(2) & 954. FBCSI includes certain income from purchases and sales of goods where either the original seller or the ultimate purchaser is related to the CFC. Pursuant to the Manufacturing Exception, FBCSI does not include income from sales of goods manufactured by the CFC. Reg. Sec. 1.954-3(a)(4)(i).

[2] For a fuller exposition of the relevant background, *see* Howard J. Levine, Peter A. Glicklich and Michael J. Miller, *Accessing the Manufacturing Exception to Subpart F Through Contract Manufacturing Arrangements*, 1 J. Tax'n Global Trans. 37 (Fall 2001); Howard J. Levine and Peter A. Glicklich, *Electronic Arts: Taxpayers Appear to Win a Battle on the Subpart F Contract Manufacturing Front*, 2 J. Tax'n Global Trans. 5 (Summer 2002).

[3] 1975-1 CB 244.

[4] Pursuant to the "Branch Rule," set forth in Code Sec. 954(d)(2), if a CFC carries out activities through a branch or similar establishment (sometimes referred to simply as a "branch") located outside the CFC Country, and this is considered to have "substantially the same effect" as if the branch were a wholly-owned subsidiary, then the income attributable to the activities of the branch is treated as if earned by a separate subsidiary of the CFC. In that event, the income of the branch (*i.e.*, the deemed subsidiary) may constitute Subpart F income, even if the income of the CFC (excluding the branch) qualifies as non-Subpart-F income under the Manufacturing Exception.

[5] 95 T.C. 348 (1990) ("*Ashland*").

a branch for purposes of the Branch Rule. In the IRS's view, allowing attribution for purposes of the Manufacturing Exception without treating the contract manufacturer as giving rise to a branch for Branch Rule purposes was unacceptable. Having suffered two defeats on the Branch Rule issue, the IRS sought to avoid this perceived whipsaw by reversing course on the Manufacturing Exception. In Revenue Ruling 97-48 (the "1997 Ruling"),[7] the IRS revoked the 1975 Ruling and held that attribution is not permissible for purposes of the Manufacturing Exception. For pre-1997 years, however, the IRS permitted taxpayers to continue to rely on the 1975 Ruling, provided that they accept the IRS's view of the Branch Rule. In March 1998, the IRS issued proposed regulations that, among other things, would have forbidden attribution for purposes of the Manufacturing Exception. These proposed regulations were withdrawn, however, and, as of the date of this writing, have not been reproposed.

As discussed in prior columns, several recently decided cases, though inconclusive, suggest that attribution will be permitted for purposes of the Manufacturing Exception in at least some circumstances.[8] In that event, the IRS will, of course, seek to circumscribe as narrowly as possible the circumstances in which attribution will be permitted. Field Service Advice 200220005 (the "FSA"), released in February 2002, provides useful insights as to how the IRS will seek to stack the deck against CFC's attempting to access the Manufacturing Exception.

Basic Facts of the FSA

The basic facts of the FSA are set forth below.

DP is the U.S. parent of a multinational group that is in the business of manufacturing, distributing and selling products worldwide. DP owns, directly or indirectly, 100% of Corp 1, a CFC incorporated in Country A. The issue presented in the FSA is whether Corp 1's gain on sales of products outside Country A is FBCSI. All years at issue are prior to 1997.

Corp 1 did not itself manufacture any goods. Its activities generally were limited to sales and marketing, as well as sales support, finance and administrative services. Corp 1's goods were obtained through agreements with contract manufacturers and a manufacturing oversight affiliate, as discussed below.

CMAs Corp 1 has contract manufacturing arrangements in place with various contract manufacturing affiliates ("CMAs") that are wholly-owned, directly or indirectly, by DP.[9] All of the CMAs have manufacturing plants located in their countries of incorporation. The CMAs employ the personnel that operate their factories. Certain raw materials are purchased by the CMAs and the costs are charged back to Corp 1. All other raw materials are purchased by the CMAs as either a disclosed or undisclosed agent of Corp 1 or on Corp 1's behalf. If the raw materials are purchased in the name of the CMA, it conveys title to Corp 1 immediately upon receipt of the raw materials, so Corp 1 holds title to the materials throughout the manufacturing

[6] 95 T.C. 579 (1990) ("*Vetco*").

[7] 1997-2 CB 89.

[8] *See* Howard J. Levine, Peter A. Glicklich and Michael J. Miller, *Accessing the Manufacturing Exception to Subpart F Through Contract Manufacturing Arrangements*, 1 J. Tax'n Global Trans. 37 (Fall 2001); Howard J. Levine and Peter A. Glicklich, *Electronic Arts: Taxpayers Appear to Win a Battle on the Subpart F Contract Manufacturing Front*, 2 J. Tax'n Global Trans. 5 (Summer 2002).

[9] The FSA refers to these affiliates as the consignment manufacturing affiliates.

process.[10] Raw materials are purchased only from an approved list of suppliers, and purchases in excess of $100,000 require Corp 1 approval.

The CMA charges Corp 1 a processing fee and issue an invoice with each product shipment. Corp 1 guarantees the CMAs a 5% profit (presumably, determined on a cost-plus basis).

Corp 1 utilizes an extensive information management system that begins with market demand and ends with factory raw material orders. Corp 1's marketing personnel input orders into "IS 1," which forecasts product sales. The IS 1 system feeds into "IS 2," which drives the production schedule. The information in IS 2 feeds into "IS 3," which provides information to factories regarding the quantity of raw materials necessary to product the finished products demanded by the markets. Corp 1's marketing personnel can affect and stop production by lowering demand for a finished product.

Corp 1 has the contractual right to control quality of the finished product, but apparently did not exercise this control during the years at issue. Corp 1 personnel apparently did not visit the factories to inspect, advise or perform other quality control activities.

The CMAs bore the risk that products would not meet specifications. According to the contract manufacturing agreements, Corp 1 had the right to return nonconforming products to the CMAs. In addition, the CMAs were responsible for any expenses incurred by Corp 1 in returning defective products.

MOA Corp 1 also has one "manufacturing oversight affiliate" ("MOA"), Corp 2, a wholly-owned, direct or indirect subsidiary of DP. Corp 2 does not own a manufacturing plant. Under Corp 2's agreement with Corp 1, Corp 2 primarily engages in manufacturing oversight and administration of manufacturing activities conducted by unrelated contract manufacturers in "Country F". Under the agreement between Corp 2 and the government of Country F, Corp 2 provides capital equipment for product manufacture, raw materials and component parts, tooling and fixtures, and technical and professional support. The Country F government provides factory buildings, direct labor and operational management. Corp 2 pays the Country F government a processing fee based on labor hours incurred.

Corp 2 purchases most of the raw materials used by the contract manufacturers in its own name. The FSA assumes that Corp 1 held title to the raw materials throughout the production process, and did not merely receive title to the finished goods.

Corp 2 receives a manufacturing fee of cost plus 5%. Corp 2 invoices Corp 1 for raw material and other costs. Processing fees are invoiced with each shipment.

Corp 2 uses IS 2 and IS 3, which apparently integrate with the IS 1 used by Corp 1. The marketing department of Corp 1 can use IS 1 to stop production by decreasing demand of the product.

IRS Analysis

The FSA's analysis is set forth immediately below. A critique follows.

Different Products Argument. The first issue addressed in the FSA is whether FBCSI cannot be generated where a CFC purchases raw materials from an unrelated party and sells the finished product to a related party.

[10] In fact, there was a dispute between the field and the taxpayer as to whether Corp 1 took title to the raw materials or only took title to the finished goods. The FSA assume this issue in favor of the taxpayer, subject to further factual development.

Code Sec. 954(d)(1) provides that, if certain other requirements are satisfied, a CFC's income from "the purchase of personal property from any person and *its* sale to a related person" (emphasis added) will be FBCSI.[11] Arguably, this requirement can only be satisfied if the property sold to the related party is the *same property* that was purchased (the "Different Products Argument").

The FSA rejects the Different Products Argument based on the following legislative history to Subpart F.

> "The 'foreign base company sales income' referred to here means income from the purchase and sale of property, without any appreciable value being added to the product by the selling corporation. This does not, for example, include cases where any significant amount of manufacturing, major assembling, or construction activity is carried on with respect to the product by the selling corporation."[12]

According to the FSA:

> "The legislative history suggests that purchases and sales of raw materials and finished products will constitute FBCSI when the selling corporation, in this case Corp 1, fails to manufacture the finished product."

Thus, the FSA concludes that the Manufacturing Exception set forth in the Treasury Regulations "carves out sales income derived from purchases of raw materials and sales of finished products from FBCSI only to the extent the CFC qualifies as the manufacturer." The FSA observes that, although neither the Code nor the legislative history expressly refer to raw materials, the term "personal property" is broad enough to include raw materials.

The Branch Rule. Prior to discussing the issues presented, the FSA provides the following background on the Branch Rule:

> "The manufacturing exception is limited by the branch rule of section 954(d)(2). Under the branch rule, if the CFC carries on manufacturing or sales through a branch located outside its country of incorporation and the carrying out of those activities through the branch has substantially the same tax effect as if the branch were a wholly-owned subsidiary of the CFC, determined based on a tax rate comparison test, the branch is treated as a subsidiary of the CFC *and its income is FBCSI*." [Emphasis added.]

The highlighted language at the end of the passage appears to conclude that, if the Branch Rule applies, the branch's income will be FBCSI--regardless of whether the branch is a manufacturing branch or a sales branch

The FSA's later discussion of the Branch Rule in connection with the potential applicability of the Manufacturing Exception to Corp 1 appears to be premised upon the same interpretation:

> "Because the branch rule may treat Corp 1's sales income as FBCSI even if the manufacturing exception applies, it is appropriate to first analyze the application of the branch rule.

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[11] Other types of transactions that may generate FBCSI (*i.e.*, certain sales of goods purchased from related persons and purchases of goods on behalf of a related person) are not relevant to this discussion.

[12] S. Rep. No. 1881, 87th Cong., 2d Sess. 84 (1962).

> If the branch rule applied to Corp 1's manufacturing activities carried on through a branch or similar establishment outside its country of incorporation, these manufacturing activities would be treated as subsidiaries if Corp 1 and Corp 1 would be treated as selling on their behalf. Therefore Corp 1's income from selling products manufactured, either directly or through attribution, outside its country of incorporation would be treated as FBCSI, assuming the other requirements of section 954(d)(1) were satisfied."

The FSA does not acknowledge that a portion of Corp 1's income, *i.e.*, the income arising from the deemed sale by the deemed Corp 1 subsidiary (*i.e.*, the manufacturing branch) to Corp 1, would avoid FBCSI characterization pursuant to the Manufacturing Exception. To the contrary, the language quoted above suggests that the IRS thought it logical to address the Branch Rule first, because it might then be unnecessary to address the Manufacturing Exception.[13]

Turning to the application of the Branch Rule to Corp 1, the FSA states without explanation that "[i]f Corp 1 can satisfy the manufacturing exception, either directly or through attribution, activities conducted, or deemed conducted, by Corp 1 in those countries will be sufficient to treat Corp 1 as carrying on those manufacturing activities through a branch or similar establishment for purposes of the branch rule of section 954(d)(2)." The FSA makes no attempt to reconcile this position with the *Ashland* and *Vetco* cases cited above.

The FSA then considers whether Corp 1's (assumed) branches had substantially the same tax effect as if they were CFC subsidiaries, *i.e.*, whether such (assumed) branches were subject to effective rates of tax that are less than 90% of, or at least 5 percentage points less than, the effective rates that would have been imposed on their income if each had been incorporated in the country where the branch operates.[14] For the three years at issue, the figures provided by the agent requesting the FSA indicate that the effective rate of tax imposed on the income of the manufacturing branches ranged from 6% to 9%, in contrast with corporate tax rates ranging from 28%-33%, which would have been imposed if the branches had been incorporated in the countries in which they operated. Based on these figures, the FSA concludes that the Branch Rule applies.[15]

Notably, the FSA states in a footnote that, in determining the effective corporate tax rate that would have applied if a branch had been incorporated in the country in which it is located, "the possibility that a taxpayer may separately be able to negotiate a lower rate of tax with the government of that country is not taken into account."

The Manufacturing Exception.

Corp 1's Own Activities. The FSA first addresses whether Corp 1's own, directly conducted, activities may suffice to cause it to be considered the manufacturer. Observing that Corp 1's own activities were limited to sales and marketing, and sales support, finance, and

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[13] The beginning of the FSA's discussion of the Manufacturing Discussion is to the same effect:

> "If after further factual development, it is determined that the branch rule does not apply to treat Corp 1's sales as FBCSI, it will be necessary to determine whether Corp 1's sales income is excluded from FBCSI under the manufacturing exception."

[14] *See* Reg. Sec. 1.954-3(b)(1)(ii)(*b*).

[15] The FSA points out, however, that the effective rate of tax may differ from the stated corporate tax rate. The FSA assumes the two rates to be equal, but notes that further factual development is needed to verify this assumption.

administrative services, the FSA finds that Corp 1 did not through its own activities manufacturer goods.

Attribution under the Code and Treasury Regulations. The FSA next concludes in short order that neither the Code or the Treasury Regulations provides an independent basis for attributing the activities of a contract manufacturer to a CFC that hires it. The FSA first states that the legislative history quoted above supports the view that the CFC, itself, must engage in manufacture to come within the Manufacturing Exception.[16] The FSA also relies upon language in the Manufacturing Exception set forth in the Treasury Regulations, which provides that FBCSI of a CFC does not include income "derived in connection with the sale of personal property manufactured *by such corporation* in whole or in part from personal property which it has purchased."[17] The FSA argues that phrase "by such corporation" limits the Manufacturing Exception to a CFC that performs the manufacturing activities itself. The FSA does not attempt to explain why attribution may not be taken into account for purposes of determining whether such activities were conducted by the selling CFC.

Attribution From the CMAs under the 1975 Ruling. The FSA first summarizes the facts of the 1975 Ruling, as follows:

> "X, a CFC, incorporated in Country M, purchased metal ore concentrate in the United States and Canada from related persons. Conversion of the ore concentrate into a ferroalloy was accomplished pursuant to an arm's length contract by Y, an unrelated foreign corporation incorporated in country O. X paid Y a conversion fee. The ore concentrate, before and during processing, and the finished product remained the property of X at all times. X purchased all raw materials necessary for the processing operation and bore the risk of loss. X maintained complete control of the quality and quantity of the product. X was responsible for the negotiation and consummation of the [sale of the] finished product. Y's only interest in the entire transaction was the fee paid by X for the conversion of the ore. The effective tax rate in country M was 46% while the effective tax rate in country O was 38.5%."

The FSA then identifies the following 13 factors in the 1975 Ruling as favoring attribution:

The CFC entered into an arm's length contract with an unrelated contract manufacturer.
The manufacturing process was intricate and involved highly skilled labor, working in accordance with specific controls.
The contract manufacturer's plant was one of the few in the world equipped to accomplish the task.
The contract manufacturer had no present or future plans to have any other affiliation with the CFC.
The contract manufacturer received a conversion fee rather than a share of the profits.
The raw materials remained the property of the CFC at all times.
The CFC alone purchased the raw materials needed to manufacture the product.
The CFC bore the risk of loss at all times in connection with the operation.

[16] As noted above, the legislative history to Subpart F (emphasis added) provides that FBCSI does not arise "where any significant amount of manufacturing, major assembling, or construction activity is carried on with respect to the product *by the selling corporation*."

[17] Reg. Sec. 1.954-3(a)(4)(i) (emphasis added).

The CFC controlled the time and quantity of production.
The CFC controlled the quality of the product by requiring the contract manufacturer to use such processes as were directed by the CFC.
The CFC could send engineers or technicians to the contract manufacturer's plant to inspect, correct or advise with respect to the processing operation.
Negotiation and consummation of the sale of the finished product were solely the responsibility of the CFC.
The finished product was sold to unrelated parties.

Applying these factors to Corp 1's relationship with the CMAs, the FSA concludes that only two of the thirteen factors favor attribution; ten clearly do not support attribution; and one requires further factual development. The FSA therefore held that the manufacturing activities of the CMAs could not be attributed to Corp 1 under the 1975 Ruling.

The only factors that the FSA concedes to be satisfied are number the fifth (receipt of a conversion fee, rather than a profit share) and ninth (CFC control of time and quantity of production). The FSA assumes that Corp 1 satisfies the sixth factor (CFC ownership of raw materials at all times), but notes that this is in dispute.

The first four factors receive virtually no discussion, but the FSA does note that some of the factors favoring attribution in the 1975 Ruling resulted from the CFC's use of an unrelated contract manufacturer. Presumably, this is an oblique reference to factors one (arm's length contract with an unrelated contract manufacturer) and four (no present or future plans to affiliate).

The FSA does not address the seventh factor (CFC alone purchases raw materials), and does not explain the interaction, or overlap, between this factor and the sixth factor (CFC ownership of raw materials at all times).

With respect to the eighth factor, the FSA first divides risk of loss into two components: risk that property will not meet specifications and risk that manufactured products will not be sold (inventory risk). The FSA concludes that the first type of risk is not borne by Corp 1, because it had the right to return nonconforming products to the CMAs.[18] The FSA concludes that the second type of risk is not borne by Corp 1, because, under Corp 1's integrated information and ordering systems, "products were ordered to be manufactured only when there was a customer for that product." Therefore, "Corp 1 would rarely have products on hand that could not be sold."

With respect to the ninth factor, the FSA notes that, although Corp 1 had the contractual right to control the quality of the finished product, it apparently failed to exercise that right. Similarly, with respect to the eleventh factor, the FSA states that Corp 1 did not actually send engineers or technicians to the CMAs' plants to inspect, correct or advise with respect to processing operations.

The FSA does not explain why factors twelve (negotiation and consummation of sales solely the CFC's responsibility) and thirteen (finished product sold to unrelated parties) are not considered to be satisfied.[19]

Attribution from the MOA under the 1975 Ruling. The FSA states that, although the MOA might well be treated as a manufacturer, the 1975 Ruling provides no support for

[18] In addition, the CMAs were liable for any costs incurred by Corp 1 when returning defective products.

[19] It may be inferred, however, that the thirteenth factor was not considered satisfied because Corp 1 sold to related as well as unrelated parties.

attributing those activities to Corp 1. The FSA does not engage in a detailed application of the thirteen factors to Corp 1's relationship with the MOA, but notes the lack of any evidence that Corp 1 sent any personnel to the Country F factories to oversee production or perform quality control.

Attribution under an Agency Theory. The FSA assumes for the sake of discussion that the CMAs are agents of Corp 1, although it notes that more facts are needed to reach this conclusion.[20] Observing that the principal in an agency relationship need have no active involvement in the activities conducted by its agent, the FSA concludes that attribution on agency grounds "would create a result contrary to the purposes of Subpart F." The conclusion applies with respect to both the CMAs and the MOA.

> "Subpart F is aimed at 'income of a selling subsidiary (whether acting as principal or agent) which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income.' S. Rep. No. 1881, 87th Cong., 2d Sess. 84 (1962). If a CFC could satisfy the manufacturing exception by merely hiring an agent to perform manufacturing or manufacturing oversight activities on its behalf without any active involvement on its own, such a CFC could easily use an agent to separate sales from manufacturing activity to obtain a lower rate of tax on the sales income. Therefore, an agency theory, alone, is not a sufficient basis for attribution of manufacturing activities."

The FSA also states that, if an agency theory *were* considered a sufficient basis for attribution, such theory would also support treating the activities of the agent as a branch or similar establishment for purposes of the Branch Rule. Again, the FSA makes no reference to *Ashland* or *Vetco*.

Attribution under the Case Law. The FSA then addresses whether the case law would permit attribution for purposes of the Manufacturing Exception. The FSA distinguishes several cases that have attributed the activities of contract manufacturers to taxpayers for purposes of various provisions of the Code, on the ground that none of those cases addressed Subpart F. "Because the purposes of Subpart F differ from those of the statues analyzed in those cases, those cases do not provide support in the subpart F context."

The most significant cases addressed by the FSA are *MedChem (P.R.) Inc. v. Commissioner* ("*Medchem*")[21] *and* Suzy's *Zoo v. Commissioner ("Suzy's Zoo")*[22] In *Medchem*, the Tax Court held that, for purposes of the active trade or business requirement of Code Sec. 936,[23] "the services underlying a manufacturing contract may be imputed to a taxpayer only to the extent that the performance of those services is adequately supervised by the taxpayer's own employees."[24] The FSA distinguishes *Medchem* on the ground that the Tax Court's opinion "provides no analysis that safeguards the purposes of subpart F." In *Suzy's Zoo*, a domestic corporation sold greeting cards and other paper products bearing the image of licensed cartoon

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[20] Presumably, the failure to make the same assumption as to the MOA was an oversight, since the FSA's analysis clearly applied to the MOA as well as the CMAs

[21] 116 T.C. No. 25 (2001), *aff'd.* 295 F.3d 118 (1st Cir. 2002).

[22] 114 T.C. 1 (2001), *aff'd.* 273 F.3d 875 (9th Cir.).

[23] Code Sec. 936 provides a "possessions tax credit" to a domestic corporation that conducts an active trade or business within a possession of the United States and that satisfies certain additional requirements.

[24] *Medchem* at ___.

characters. The corporation argued that it merely resold those products after purchasing them from the printers, and therefore was not a producer subject to the uniform capitalization rules of Code Sec. 263A.

The Tax Court found the taxpayer to be the producer, based in large part on its finding that the printers' act of reproducing the artist's drawing onto greeting cards was "mechanical in nature in that it involves little independence on the printers' part and is subject to petitioners' control, close scrutiny, and approval."[25] The Tax Court did not consider it determinative that the printers bore the risk of loss during the printing process. Notably, the Tax Court did *not* rely on a rule pursuant to which property produced under contract for a taxpayer is treated as produced by the taxpayer for purposes of Code 263A.

The FSA distinguishes *Suzy's Zoo* on the ground that the art work performed by the taxpayer was the most important part of the production process (as well as the taxpayer's active involvement in the manufacturing processes carried on by the contract manufacturers) and on the ground that Code Sec. 263A's broad definition of the term "produce" does not effectuate the purposes of Subpart F.

The FSA also addresses certain cases that have attributed the activities of a contract manufacturer to the taxpayer for excise tax purposes.[26] Again, the FSA distinguishes these cases on the ground that the statutes at issue have legislative purposes that differ from those of Subpart F. The FSA notes that, in the excise tax cases, a narrower interpretation of the term "manufacturer" would have allowed the statute to be easily avoided. "In the case of subpart F, however, avoidance of the statute is made easier by a broad interpretation of manufacturing. Thus, the interpretation of manufacturing for excise tax purposes should not control for purposes of subpart F."

The FSA, which is dated February 5, 2002, does not address *Electronic Arts v. Commissioner*,[27] which was decided on January 16, 2002. As discussed previously in this column,[28] the Tax Court in *Electronic Arts* rejected the proposition that the activities of a contract manufacturer cannot be attributed to a taxpayer for purposes of Code Sec. 954(d)(1).[29]

Critique of the IRS Analysis

Different Products Argument. The FSA's analysis of the Different Products Argument is not persuasive. The legislative history quoted above, and on which the FSA relies, provides that the CFC must add appreciable value to a product to avoid characterization of its sales gain as FBCSI.[30] From this, the FSA concludes that the CFC must be the manufacturer. The FSA does not address whether a CFC that engages a third party to transform raw materials into finished products might be considered to add additional value for this purpose.

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[25] *Suzy's Zoo* at ___.

[26] *Carbon Steel Co. v. Lewellyn*, 251 U.S. 501 (1920); *Polaroid Corp. v. United States*, 235 F.2d 276 (1st Cir. 1956).

[27] 118 T.C. No. 13 (2002) ("*Electronic Arts*").

[28] *See* Howard J. Levine and Peter A. Glicklich, *Electronic Arts: Taxpayers Appear to Win a Battle on the Subpart F Contract Manufacturing Front*, 2 J. Tax'n Global Trans. 5 (Summer 2002).

[29] *Electronic Arts* was not a Subpart F case, but Sec. 936(h)(5)(B) permits a possessions corporation to compute its income with respect to a product under a profit-split method only if, among other requirements, the possessions corporation is considered to manufacture or produce the product, within the meaning of Code Sec. 954(d)(1).

[30] This passage assumes that the other requirements for FBCSI characterization, *e.g.*, purchase from or sale to a related party, are satisfied.

The FSA's abbreviated discussion of the Manufacturing Exception set forth in the Treasury Regulations is also inadequate. Notably, this portion of the FSA fails even to quote the language of the regulation that it purports to interpret. The Treasury Regulations provide in part as follows:

> "Foreign base company sales income does not include income of a controlled foreign corporation derived in connection with the sale of personal property manufactured, produced, or constructed by such corporation in whole or in part from personal property which it has purchased. *A foreign corporation will be considered, for purposes of this subparagraph, to have manufactured, produced, or constructed personal property which it sells if the property sold is in effect not the property which it purchased.*"[31]

The authors are not as bullish as some commentators,[32] but the highlighted language above can be read to support the Different Products Argument. Under this view, a CFC that purchases raw materials and sells finished products that differ significantly from those raw materials apparently would be *deemed* the manufacturer for purposes of the Manufacturing Exception.[33] The FSA's failure to adequately address this argument is unfortunate.

The Branch Rule. As noted above, the FSA appears to take the view that, if the Branch Rule applies, *all* of Corp 1's sales income would then be treated as FBCSI, including any income considered to be attributable to the manufacturing branch.

If indeed that is what the FSA means to say, this is extremely troubling, since this would represent a failure to grasp the basic principles of the Branch Rule. If the Branch Rule applies, the branch is treated as a separate CFC (a subsidiary of the actual CFC) and the income of *both* the CFC and its deemed subsidiary is then tested for FBCSI characterization.[34] The Treasury Regulations expressly provide that the FBCSI arising under this recharacterization cannot exceed the FBCSI that would have arisen if the branch actually had been incorporated as a separate CFC subsidiary:

> "Income derived by the branch or similar establishment, or by the remainder of the controlled foreign corporation, shall not be considered foreign base company sales income if the income would not be so considered if it were derived by a separate controlled foreign corporation under like circumstances."[35]

Unquestionably, if a CFC manufactured products and sold them to its parent (also a CFC) for distribution, the income earned by the subsidiary would be excluded from FBCSI under the Manufacturing Exception, regardless of the character the parent's sales income. As made clear by the Treasury Regulation quoted above, such exclusion is not lost if the manufacturing is performed by a branch instead of a CFC subsidiary. If the FSA reaches the contrary proposition, it simply is incorrect. It is not clear from the FSA whether such a contrary proposition is being

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[31] Reg. Sec. 1.954-3(a)(4).

[32] *See* Gregg D. Lemein & John D. McDonald, *FSA 200220005: The IRS Attacks Contract Manufacturing*, 80 Taxes 5, 9-10 (July 2002) (strongly advocating the Different Products Argument).

[33] But query whether a CFC that uses a contract manufacturer, but is *not* considered the manufacturer, must therefore be treated as having *purchased* the finished product from the CFC. Under that view, the property sold would be the same as the property purchased, and the Different Products Argument could not prevail.

[34] Implicit in this scheme is that an appropriate allocation of profits must be made.

[35] Reg. Sec. 1.954-3(a)(4)(i).

stated or whether the FSA simply did not purport to focus on the income of the manufacturing branch.

As noted above, the FSA states that, if Corp 1 is considered the manufacturer, it *must* therefore be considered to have a branch for Branch Rule purposes. That the FSA takes this view is unsurprising; indeed, this has been the IRS's position dating back at least to the 1975 Ruling. The failure to acknowledge *Ashland* and *Vetco*, which squarely hold to the contrary, however, seems inappropriate.[36]

As noted above, the FSA also states that, in determining the effective corporate tax rate that would have applied if a branch had been incorporated in the country in which it is located, the possibility of negotiating a lower rate of tax must be disregarded. This conclusion is questionable, and it is notable that FSA provides no authority therefor.[37]

The Manufacturing Exception

Corp 1's Own Activities. The FSA's conclusion that Corp 1 did not directly manufacture goods is difficult to disagree with. Clearly, Corp 1 did not, through its own employees, operate a factory or produce goods.

Attribution under the Code and Treasury Regulations. As noted above, the FSA seeks to treat references in the legislative history and the Treasury Regulations to manufacturing activities conducted "by the selling corporation" or "by such corporation" as evidence that the CFC must *itself* conduct manufacturing activity in order for the Manufacturing Exception to apply. The FSA does not attempt to explain why attribution should not be taken into account in determining whether manufacturing activities have been conducted by the selling CFC. Accordingly, the FSA's "analysis" of the Code and Treasury Regulations is unpersuasive.

Attribution From the CMAs under the 1975 Ruling. The FSA's application of the thirteen-factor test drawn from the 1975 Ruling is flawed in a variety of respects. First, the FSA's elevation of the facts of the 1975 Ruling to a litmus test for attribution is devoid of any apparent rationale.[38]

Moreover, the FSA's application of several factors is questionable. For example, the FSA does not address the seventh factor (CFC alone purchases raw materials), even though it assumes satisfaction of the sixth factor (CFC ownership of raw materials at all times). The purpose of the seventh factor may be to accord preferential treatment to a CFC that purchases raw materials through its own employees, rather than through the contract manufacturer, but if the CFC bears the entire cost of the raw materials (so that the risk of inventory cost is borne by the CFC), it is unclear why this distinction might be considered important. In any event, the FSA's failure to provide a rationale as to the seventh factor is unfortunate.

In addition, the FSA's application of the risk of loss factor seems unreasonably narrow. As noted above, the FSA concludes that Corp 1 does not bear inventory risk, because its

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[36] As noted above, the FSA concludes that the activities of the CMAs may be attributed to Corp 1, if at all, only pursuant to the terms of the 1975 Ruling. The FSA's discussion of the Branch Rule may be premised upon the IRS's (optimistic) assumption that attribution would not be permitted under the Code, the Treasury Regulations, an agency theory, or the case law. If so, an express statement to this effect would have been helpful.

[37] *Compare* PLR 8749060 (Sept. 8, 1987), which notes that the effective rate of tax imposed under the laws of the Shenzhen economic zone, created within the People's Republic of China, was 15%. It seems likely that such 15% rate was the "going rate" to which the Chinese tax authorities were willing to agree, rather than a rate prescribed by statute.

[38] Indeed, we are not aware that anyone, even the IRS, has previously taken this approach.

integrated ordering and sales systems generally should enable Corp 1 to avoid having products on hand that cannot be sold. The fact that Corp 1 effectively manages production so as to minimize risk, however, would appear to be irrelevant. As between Corp 1 and its CMAs, the inventory risk unquestionably is borne by Corp 1. If that risk is low, this might militate towards ascribing less weight to it, but treating risk of inventory loss as counting against attribution would appear to be overkill.[39]

The FSA does not explain why the twelfth factor (negotiation and consummation of the sale of the finished product solely the responsibility of the CFC) is not satisfied. Inasmuch as the FSA describes Corp 1 as having a marketing department that forecasted demand, the FSA's failure to concede this point is puzzling. The IRS may be concerned that Corp 1 did not (in the IRS's view) bear any risk of loss, but if that is the sole concern, then the thirteenth factor is duplicative. Counting risk of loss against the taxpayer *twice* would seem to be an inappropriate double dip.

Finally, the importance ascribed by the FSA to the CFC's being unrelated to the contract manufacturers (factors one and four) and to the purchasers of finished products (factor thirteen) lacks any apparent justification. Moreover, even if affiliation between a CFC and its contract manufacturer, for example, did militate against attribution, the FSA nevertheless would again be guilty of double-dipping, by treating Corp 1 as failing *two* factors on account of such affiliation.[40]

Attribution Under an Agency Theory. As noted above, the FSA states that permitting attribution based on agency principles would create a result contrary to the purposes of Subpart F. In significant part, the FSA relies on language in legislative history to Subpart F to the effect that Subpart F is aimed at "income of a selling subsidiary (whether acting as principal or agent) which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income."[41] This language provides background for why the income of the *selling* subsidiary should be treated as FBCSI (regardless of whether the selling subsidiary purchases and sells for its own account of sells on behalf of its manufacturing affiliate), but has absolutely nothing to do with the manufacturing activities themselves and the application to them of the Manufacturing Exception. The relevance of this argument is unclear.

The FSA's fallback argument that, if agency principles are sufficient to justify attribution, then the activities of the agent should constitute a branch for Branch Rule purposes would not be unreasonable, but for the failure to acknowledge *Ashland* and *Vetco*, which squarely hold to the contrary.

Attribution under the Case Law. The FSA's principal reason for distinguishing various cases permitting attribution to a taxpayer of the activities of a contract manufacturer is that the legislative purposes of the Code provisions at issue in these cases differs from the purposes of Subpart F. As noted above, the FSA notes that "[i]n the case of subpart F, avoidance of the statute is made easier by a broad interpretation of manufacturing." In contrast, a broad interpretation of manufacturing in the excise tax cases was appropriate, according to the FSA, because this also prevented tax avoidance.

[39] As noted above, the FSA also states that the risk of producing nonconforming goods is borne by the contract manufacturer. The FSA does not provide sufficient information to verify this conclusion.

[40] Of course, related party transactions will give rise to transfer pricing issues, particularly if the income of one party is eligible for deferral and the income of another party is taxed currently, but this clearly is separate from the issue of whether a contract manufacturer's activities may be attributed to a CFC.

[41] S. Rep. No. 1882, 87th Cong. 84 (1962).

The FSA's approach is profoundly unconvincing. First, the focus on legislative purpose rests upon the unproven assumption that there are not, and ought not be, consistent guiding principles for determining when the manufacturing or production activities of one taxpayer will be attributed to another.[42] If such a uniform approach were adopted, the legislative purpose of any particular Code provision generally would not be relevant.[43] Moreover, even if the FSA's ad hoc approach were adopted, the FSA provides no coherent rationale for why attribution ought be prohibited for Subpart F purposes. The ritualistic incantation that permitting attribution would facilitate "tax avoidance" begs the question. Without more, the only principle to be drawn from the FSA on this point is that attribution should apply if, and only if, the result to the taxpayer is unfavorable--in order to provide for maximum prevention of tax-avoidance. Such an extremely (though bright-line) rule is unlikely to survive even superficial judicial scrutiny.

Moreover, as noted above, the FSA does not address *Electronic Arts*, which was decided prior to release of the FSA and which expressly rejected a rule prohibiting attribution for purposes of the Manufacturing Exception.[44] In any event, the FSA's failure to address *Electronic Arts* casts still further doubt on the FSA's analysis which, as noted, was already unpersuasive.

Conclusion

Overall, the FSA reflects a determined, if less than stellar, effort to prevent CFCs from satisfying the Manufacturing Exception through attribution. Preparing for the possibility that the courts will definitively reject a per se rule barring attribution for this purpose,[45] the FSA attempts to extract a thirteen-factor test from the 1975 Ruling. As discussed above, both the choice of factors and the FSA's analysis of several factors seem designed to stack the deck against Subpart F contract manufacturing arrangements. Whether the courts accept many of the thirteen factors drawn from the 1975 Ruling as important, or even relevant, to the attribution issue is doubtful.

Nevertheless, several of the factors that were adverse to the taxpayer in the FSA may be important. For example, the FSA reasonably concluded that placing risk of loss on nonconforming goods with the contract manufacturer may be regarded by the courts as an adverse factor.[46] It would have been more helpful for the taxpayer if it had placed this risk on the CFC.[47]

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[42] It is understood that terms such as manufacturing and production have varying meanings throughout the Code, but whether there should be a uniform standard for attributing the manufacturing or production activities of one person to another person for U.S. tax purposes is a separate issue.

[43] Of course, the drafters of any particular Code provision or Treasury Regulation would be at liberty to provide specific rules as to when attribution would be permitted, or required.

[44] It is unclear whether the author of the FSA was unaware of the *Electronic Arts* case, or simply preferred not to address it. There is also the theoretical possibility that the author was aware of *Electronic Arts* but did not consider it sufficiently on point to merit discussion.

[45] Indeed, *Electronic Arts* appears to reach exactly this conclusion, albeit in the context of a possessions tax credit case under Code Sec. 936.

[46] If the contract manufacturer is compensated on a cost-plus basis and the cost of replacing the nonconforming goods is charged back to the CFC, however, then it would appear that the risk of producing nonconforming goods is borne by the CFC, no matter what the contract purports to provide.

[47] Presumably any losses attributable to the contract manufacturer's failure to follow the CFC's instructions, however, would be borne by the CFC.

In addition, the FSA observed that, notwithstanding Corp 1's contractual arrangement with the CMAs, it did not actually monitor and control quality nor did it send engineers or technicians to the manufacturing plants to inspect, correct or advise with respect to processing operations. The FSA reasonably treats this as a negative factor, and it would not be surprising if the courts ultimately did as well. As we noted following the *Medchem* decision, a CFC that fails to adequately supervise and control its contract manufacturer may be less likely to qualify for attribution.[48] A CFC seeking to access the Manufacturing Exception through a contract manufacturing arrangement should play an active role in overseeing, inspecting, and controlling the activities of its contract manufacturer. Merely having the right to do so may well be insufficient.

[48] *See* Howard J. Levine, Peter A. Glicklich and Michael J. Miller, *Accessing the Manufacturing Exception to Subpart F Through Contract Manufacturing Arrangements*, 1 J. Tax'n Global Trans. 37 (Fall 2001).