Final Subpart F Branch Regulations

Treasury and the IRS recently issued final regulations addressing the application of the foreign base company sales income branch rules. The final regulations are generally effective for tax years beginning after June 30, 2009 (the same effective date as the temporary regulations that were finalized).

The final regulations make three clarifying changes, all favorable to taxpayers. There remain a number of unanswered questions concerning the application of the branch rules, and the preamble states that Treasury and the IRS are considering additional guidance.

The branch rules are relevant to the application of subpart F to a U.S. multinational’s foreign supply chain. They apply only if a controlled foreign corporation (CFC) does not have foreign base company sales income (FBCSI) under the general rule of Code Sec. 954(d)(1) and conducts activities in a foreign branch. The general definition of FBCSI does not apply if the CFC does not purchase products from nor sell products to, nor purchase or sell products on behalf of, a related person. In addition, Code Sec. 954(d)(1) does not apply if the CFC manufactures the products it sells.

The definition of manufacturing was significantly expanded by regulations issued in 2008. In addition to physically manufacturing property, a CFC is considered as manufacturing property it sells if it substantially contributes to the physical manufacture of the products by a contract manufacturer. This test is met—and the manufacturing exception applies—if the CFC oversees the manufacturing of the products and its employees perform sufficiently important value-driving functions (e.g., selection of suppliers, demand forecasting and quality control).

A CFC that does not have FBCSI under the general rule can have FBCSI under the branch rules. The branch rules apply when a CFC engages in purchasing, selling or manufacturing activities through a branch outside the CFC’s country of organization and a tax rate disparity test is met. The tax rate disparity test is met if purchasing or selling income is subject to a tax rate that is less than 90 percent of, and at least five percentage points lower than, the hypothetical tax rate in the home office or manufacturing location. Under the branch rules, the branch is treated as a separate CFC and the Code Sec. 954(d)(1) rules are reapplied, generally deeming the purchasing or selling CFC as engaging in related person transactions. The branch rules generally result in a portion of the CFC’s selling or purchasing income becoming FBCSI.
There are two FBCSI branch rules. One applies when a CFC engages in purchasing or selling activities in a foreign branch, and the other applies when the CFC engages in manufacturing activities in a foreign branch. Before the 2008 regulations, the manufacturing branch rule applied only if the CFC physically manufactured the products in a foreign branch. The expansion of the definition of manufacturing to include substantial contribution manufacturing—while beneficial in providing more certainty in satisfying the manufacturing exception—significantly expanded the scope of the manufacturing branch rule, prompting the issuance of a complex set of regulations. For example, the application of the manufacturing branch rule was expanded to potentially apply to a CFC that does not purchase products from nor sell products to related parties (and therefore does not rely on the manufacturing exception), where the CFC has employees in a foreign branch overseeing a contract manufacturer supplying the products and such activities satisfy the new manufacturing definition.4

The final regulations eliminate an obsolete coordination rule between the purchase or sales and manufacturing branch rules;5 That rule is unnecessary in light of the rule in Reg. §1.954-3(b)(1)(ii)(c)(1) (added by the temporary regulations), which provides that if one or more selling or purchasing branches are used in addition to a manufacturing branch, then only the manufacturing branch rule applies (the purchase or sales branch rule does not). For example, if the tax rate disparity test is not met when comparing a sales branch to a manufacturing branch, the sales branch rule would not apply even if there is a tax rate disparity with the home office. In addition, if all manufacturing, purchasing and selling activities occur in one branch, the purchase or sales branch rule would not apply.6

The manufacturing branch rule requires the determination of one manufacturing branch location (e.g., for purposes of applying the tax rate disparity test). If a CFC engages in manufacturing activities in multiple locations and no one location independently satisfies the definition of manufacturing, the temporary regulations provided that the manufacturing location will be deemed to be the location that provides a “demonstrably greater” contribution to the manufacture of the product compared to the contribution of the other locations. The final regulations remove the word “demonstrably” from the test to eliminate any concern that an elevated standard of proof was intended as an evidentiary matter.7

The temporary (now final) regulations provide that, if a branch is treated as a separate corporation under the branch rule, the activities of all locations that do not have a defined effective tax rate disparity relative to the sales or purchase location are aggregated for purposes of determining whether the sales or purchase income is FBCSI. The final regulations clarify this rule to eliminate any implication that the income of various branches is aggregated, as opposed to just the activities. Therefore, the aggregation rule should not affect the amount of income that is tested with respect to a particular sales or purchase location.8 This change makes clear that the aggregation rule can assist with the satisfaction of the manufacturing exception by the purchasing or selling location without causing income not derived by such location to be subject to taxation in the event the income of the purchasing or selling location is FBCSI under the branch rule.

The IRS and Treasury may provide additional FBCSI guidance. Issues that might be addressed include the application of the tax rate disparity test (e.g., reliance on local law),9 the definition of a branch, and the definition of purchase and sales activities.10 Other open issues include the application of the branch rules to partnerships11 and the allocation of income between the home office and a branch or between branches. In addition, the IRS is considering the scope of, and relationship between, FBCSI and foreign base company services income.

ENDNOTES

3 Reg. §1.954-3(a)(4)(iv).
4 See Reg. §1.954-3(b)(1)(ii)(a); T.D. 9438, 73 FR at 79,342-43.
5 The final regulations delete paragraph (d) of Reg. §1.954-3(b)(2)(ii), which provided that income that is FBCSI as a result of the application of Reg. §1.954-3(b)(1)(ii) (purchase or sales branch rule) is not again classified as FBCSI as a result of the application of Reg. §1.954-3(b)(1)(iii) (manufacturing branch rule).
6 See Reg. §1.954-3(b)(2)(ii)(b) & (iii)(b); (b) (4), Ex. 3; 73 FR at 10721. See also Lowell D. Yoder, Limits on the Application of the Subpart F Branch Rules, 38 Tax Mgmt. Int’l J. 366 (June 12, 2009).
7 Reg. §1.954-3(b)(1)(iii)(c)(3); see also -3(b) (4), Ex. 9.
8 Reg. §1.954-3(b)(2)(ii)(a) final regulations added “the activities of” see -3(b)(1)(iii)(c)(3) (v), Ex. 1. An aggregation rule also applies for purposes of determining the location of manufacturing, Reg. §1.954-3(b)(1)(iii)(c)(3)(iii).
9 See LTR 200942034 (July 10, 2009), LTR 200945036 (July 27, 2009) and LTR 201002024 (Oct. 2, 2009). See also Lowell D. Yoder, A Note from the Editor-in-Chief, Local Law Governs Manufacturing Branch Determinations, Int’l Tax J., at 3 (July-Aug. 2010).
10 See The Cooper Companies, Inc., Docket No. 13909-08; TAM 8509004 (Nov. 23, 1984).
11 See LTR 201002024 (Oct. 2, 2009) (considers the partnership’s country rather than the CFC partner’s country, which is a departure from prior understandings of how the branch rules might apply).