A Note From the Editor-in-Chief

The Subpart F Physical Manufacturing Exception

Under subpart F, income derived by a CFC from the sale of products that it manufactures is excluded from the definition of foreign base company sales income (FBCSI), subject to the branch rule.¹ The current regulations provide that purchased property is considered as manufactured if:

- the property is substantially transformed (e.g., steel rods converted into screws);
- the production operations are substantial in nature and generally considered to constitute manufacturing (e.g., assembly of automobiles); or
- conversion costs are 20 percent or more of costs of goods sold.

Minor assembly and packaging do not qualify as manufacturing.² The Tax Court, however, has broadly interpreted this definition of manufacturing (e.g., assembly of sunglasses qualified as manufacturing).³

Proposed regulations that address the manufacturing exception would retain the definition of manufacturing contained in the current regulations (which is referred to as “physical manufacturing”).⁴ They would require, however, that only the activities of the employees of the CFC may be taken into account in determining whether a CFC is considered as manufacturing the property it sells.⁵

For example, suppose an Irish CFC assembles products in Ireland and sells the products to related and unrelated persons for distribution throughout the world. The CFC purchases components from related and unrelated suppliers. All of the CFC’s income is subject to tax in Ireland at a 12.5-percent rate. Provided the assembly activities of the employees of the Irish CFC satisfy the above broad definition of physical manufacturing, the CFC’s income from the sale of the products qualifies for the manufacturing exception.

A CFC that qualifies for the manufacturing exception may nevertheless have FBCSI under the branch rule. The regulations apply the branch rule where a CFC carries on purchasing, selling or manufacturing activities outside of its country of organization through a branch or similar establishment, and a tax rate disparity test is satisfied. The tax rate disparity test is met where the CFC’s income derived from purchasing or selling activities is taxed at an effective rate that is both less than 90 percent of, and at least five percentage points less than, the effective tax rate that would apply to such income.
in the CFC’s country of organization (purchase or sales branch) or in the country where the products are manufactured (manufacturing branch).

If the branch rule applies, then the branch and the remainder of the CFC are treated as separate CFCs for purposes of applying the FBCSI rules. The branch is considered as organized under the laws of the country where it is located, and each separate CFC is considered as conducting only its own activities. In addition, the purchasing or selling activities generally are considered as performed on behalf of a related person.

For example, the above Irish manufacturing and sales operations may be conducted in an Irish disregarded entity (DE) owned by a Luxembourg CFC. Because the operations are conducted in a foreign branch of the CFC, the branch rule may potentially apply. Nevertheless, since all of the activities related to the manufacture and sale of the products are conducted in the Irish branch, the branch rules should not cause the Irish DE’s income to be FBCSI.

Assume in addition that the Irish DE sells some products to a Netherlands DE also owned by the Luxembourg parent. The Luxembourg parent is a DE owned by a Bermuda CFC. The Netherlands DE sells the products to related and unrelated persons throughout Europe. The sales income derived by the Netherlands DE is subject to a 25-percent effective tax rate in the Netherlands. The branch rule should not apply under these circumstances because the Netherlands DE’s sales income is subject to a tax rate greater than the tax rates in Ireland and Bermuda. Even if the branch rule applied, income derived by the Irish branch should qualify for the manufacturing exception.

The same results above apply if a portion of the manufacturing activities is carried on in another country in a branch of the Bermuda CFC. For example, assume the Irish DE hires a German DE owned by the Luxembourg DE to provide subassembly services. The Irish DE pays a service fee to the German DE, and the German DE is subject to a 35-percent effective tax rate on its income. Under these circumstances, if the activities of the German DE do not qualify as manufacturing in and of themselves, then the Bermuda CFC should not be considered as having a manufacturing branch in Germany. In any event, even if the German DE is considered as a manufacturing branch, the priority rule in the proposed regulations should nonetheless treat Ireland as the location of manufacturing, since its income is subject to a lower effective tax rate. As a result, the rate disparity test should not apply to the sales income derived by the Netherlands DE (when compared to the Irish tax rate). Also, the income derived by the German DE should not be subject to the branch rule because it is not purchasing or selling income.

As another illustration, assume that all purchasing, manufacturing and sales activities are carried on by the Irish DE in Ireland. The Irish DE pays a “royalty” to the Luxembourg DE for use of the intellectual property, and the royalty income is subject to a four-percent tax rate in Luxembourg. For U.S. tax purposes, the royalty payment is disregarded. The manufacturing exception should apply to the sales income derived by the Bermuda CFC based on the activities conducted in the Irish branch. In addition, the branch rule should not apply because the CFC is not conducting purchasing or sales activities outside of Ireland.

In sum, income derived by a CFC or a branch in a country where the CFC physically manufactures the property should not be FBCSI. Where all purchasing and sales activities occur in the country of manufacture, income derived outside the country of manufacture also should not be FBCSI. Even when the branch rule applies, income derived in the country of physical manufacture should not be FBCSI.

ENDNOTES

1 Code Sec. 954(d); Reg. §1.954-3.
2 Reg. §1.954-3(a)(4).
4 Proposed Reg. §1.954-3(a)(4)(ii); REG-124590-07, 73 FR 10,716 (Feb. 28, 2008).
6 Reg. §1.954-3(b).
10 The IRS has retreated from its past attempts to apply the FBCSI branch rule concepts to disregarded royalties. See Lowell D. Yoder, Proposed Subpart F Hybrid Entity Regulations: A Further Retreat, But No White Flag, 28 TAX MGMT. INT’L J. 707 (Nov. 12, 1999).