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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-124590-07]

RIN 1545-BG11

Guidance Regarding Foreign Base Company Sales Income

AGENCY: Internal Revenue Service (IRS), Treasury Department.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance relating to foreign base company sales income, as defined in section 954(d), in cases in which personal property sold by a controlled foreign corporation (CFC) is manufactured, produced, or constructed pursuant to a contract manufacturing arrangement or by one or more branches of the CFC. These regulations, in general, will affect CFCs and their United States shareholders. Certain portions of these proposed regulations restate changes to §1.954-3(a)(4) that were contained in former proposed regulations.

DATES: Written or electronic comments and requests for a public hearing must be received by May 28, 2008.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-124590-07), Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044 or send electronically, via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-121509-00).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Ethan Atticks, (202) 622-3840; concerning submissions of comments, Kelly Banks, (202) 622-0392 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

A. Foreign Base Company Sales Income

Under section 951(a)(1)(A)(i), a United States shareholder of a CFC includes in gross income its pro rata share of the CFC's subpart F income for the CFC's taxable year which ends with or within the taxable year of the shareholder. Section 952(a)(2) defines the term "subpart F income" to mean, in part, "foreign base company income." Section 954(a)(2) defines "foreign base company income" to include foreign base company sales income (FBCSI) for the taxable year. Section 954(d)(1) defines FBCSI to mean income derived by a CFC in

connection with (1) the purchase of personal property from a related person and its sale to any person, (2) the sale of personal property to any person on behalf of a related person, (3) the purchase of personal property from any person and its sale to a related person, or (4) the purchase of personal property from any person on behalf of a related person, provided (in all of these cases) that the property both is manufactured, produced, grown or extracted outside of the CFC's country of organization and is sold for use, consumption or disposition outside of such country.

The Treasury regulations further define FBCSI and the applicable exceptions from FBCSI. These exceptions from FBCSI are contained in §1.954-3(a)(2), which addresses personal property manufactured, produced, constructed, grown, or extracted within the CFC's country of organization (the same country manufacture exception), §1.954-3(a)(3), which addresses personal property sold for use, consumption or disposition within the CFC's country of organization, and §1.954-3(a)(4) which addresses personal property manufactured, produced or constructed by the CFC (the manufacturing exception).

Section 1.954-3(a)(4)(i) provides that FBCSI does not include income of a CFC 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. It then states generally that a foreign corporation is considered to have manufactured, produced, or constructed personal property which it sells if the property sold is in effect not the property which it purchased. Specifically, §1.954-3(a)(4)(i) states that personal property sold will be considered as not being the property purchased if the provisions of §1.954-3(a)(4)(ii) or (iii) are satisfied.

Section 1.954-3(a)(4)(ii) and (iii) set forth two separate tests to determine whether a CFC is considered to manufacture, produce, or construct personal property that it sells. First, §1.954-3(a)(4)(ii) sets forth a "substantial transformation" test, pursuant to which if personal property is substantially transformed prior to sale, the property sold will be treated as having been manufactured, produced, or constructed by the selling corporation. Examples of substantial transformation provided in the regulations include the conversion of wood pulp to paper, steel rods to screws and bolts, and tuna fish to canned tuna. Second, §1.954-3(a)(4)(iii) sets forth a general "substantive test" and a safe harbor that apply when purchased property is used by the CFC as a component part of personal property that is sold by the CFC. Under the substantive test, the sale of 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, production, or construction of the property. The assembly of automobiles from component parts is provided as an example of an activity considered to be substantial in nature and generally considered to constitute the manufacture of a product. Under the safe harbor, without limiting the application of the substantive test, the operations of a selling corporation in connection with the use of purchased property as a component part of the personal property that is sold will be considered to constitute the manufacture of a product if in connection with such property conversion costs (direct labor and factory burden) of such corporation account for 20 percent or more of the total cost of goods sold. Section 1.954-3(a)(4)(iii) makes clear that, in no event,

however, will packaging, prepackaging, labeling, or minor assembly operations constitute the manufacture, production, or construction of property for purposes of section 954(d)(1). For purposes of this preamble, satisfaction of the requirements of §1.954-3(a)(4)(ii) or (iii) will be referred to as satisfaction of the "physical manufacturing test."

B. The Branch Rule

In addition to the general FBCSI rules of section 954(d)(1), section 954(d)(2) provides a special rule for purposes of determining FBCSI if a CFC carries on activities through a branch or similar establishment outside its country of organization and the carrying on of such activities has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation (the branch rule). Under the branch rule, to the extent prescribed by regulations, the income attributable to the carrying on of such activities is treated as income derived by a wholly owned subsidiary of the CFC and constitutes FBCSI of the CFC. Section 1.954-3(b)(1)(i) (addressing sales or purchase branches) and (ii) (addressing manufacturing branches) provide rules on the application of the 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 with respect to personal property in a high-tax jurisdiction and selling activities with respect to the property in a low-tax jurisdiction without incurring FBCSI. In such a case, the sales income would not be FBCSI to the CFC because the same person would be purchasing or manufacturing the personal property and selling the personal property. The branch rule therefore treats a sales, purchase, or manufacturing branch located outside of the country of organization of the CFC 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.

With respect to manufacturing branches, §1.954-3(b)(1)(ii)(a) provides that if a CFC carries on manufacturing, producing, constructing, growing, or extracting activities by or through a branch or similar establishment located outside of its country of organization and the use of that branch or similar establishment for such activities with respect to personal property purchased or sold by or through the remainder of the CFC has substantially the same tax effect as if that branch or similar establishment were a wholly owned subsidiary corporation of such CFC, that branch or similar establishment and the remainder of the CFC will be treated as separate corporations for purposes of determining FBCSI of such CFC. Section 1.954-3(b)(1)(ii)(b) provides that the use of a manufacturing branch or similar establishment will be considered to have substantially the same tax effect as if it were a wholly owned subsidiary corporation of the CFC if the tax imposed on the income derived by the remainder of the CFC satisfies the test set forth in §1.954-3(b)(1)(ii)(b) (the manufacturing branch tax rate disparity test). There is also a separate tax rate disparity test which applies to sales or purchase branches under §1.954-3(b)(1)(i)(b) (the sales branch tax rate disparity test).

For purposes of the manufacturing branch tax rate disparity test, the income considered to be derived by the remainder of the CFC is determined first by applying the rules of §1.954-3(b)(2)(i) which treat the CFC and the manufacturing branch as separate corporations,

and then by determining the income of the CFC that would be FBCSI under section 954(d)(1) and §1.954-3(a)(1) if the CFC and the branch were separate corporations (but without applying the exceptions contained in §1.954-3(a)(2), (3), and (4)).

Specifically, §1.954-3(b)(2)(i)(a) treats the remainder of the CFC and the manufacturing branch as separate corporations. In addition, §1.954-3(b)(2)(i)(b) and (c) deem purchases or sales to be made "on behalf of" a related person to take into account that the remainder of the CFC and the branch are treated as separate corporations. Section 1.954-3(b)(2)(i)(b) addresses sales and purchase branches by treating selling or purchasing activities conducted through a branch or similar establishment with respect to personal property as performed on behalf of the CFC if the CFC manufactures, produces, constructs, grows, extracts, purchases, or sells that same property. Section 1.954-3(b)(2)(i)(c) provides a corollary rule addressing manufacturing branches, pursuant to which the purchase or sale of personal property by the remainder of the CFC is treated as performed on behalf of a branch that manufactures, produces, constructs, grows, or extracts that property. The general rule of §1.954-3(a)(1) is then applied to determine the income that would be FBCSI if the branch and the remainder of the CFC were separate corporations subject to the "on behalf of" related party transactions described above.

Section 1.954-3(b)(1)(ii)(b) provides that the manufacturing branch tax rate disparity test is satisfied if the income that would be FBCSI after applying these special rules is taxed in the year when earned at an effective rate of tax that is less than 90 percent of, and at least 5 percentage points less than, the hypothetical effective rate of tax. The hypothetical effective rate of tax is the effective rate of tax which would apply to such income under the laws of the country in which the manufacturing branch is located, if, under the laws of such country, the entire income of the CFC were considered derived by such CFC from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the CFC were created or organized under the laws of, and managed and controlled in, such country.

If the manufacturing branch tax rate disparity test is satisfied, §1.954-3(b)(1)(ii)(a) then treats the branch and the remainder of the CFC as separate corporations and the special rules of §1.954-3(b)(2)(ii) are applied for purposes of determining FBCSI. Section 1.954-3(b)(2)(ii)(a) through (c) provide separate CFC and related party rules that mirror §1.954-3(b)(2)(i)(a) through (c). Section 1.954-3(b)(2)(ii)(d) through (f) provide special rules to prevent double counting of FBCSI and to align treatment of branches with the treatment of separate CFCs. In particular, §1.954-3(b)(2)(ii)(e) provides that income derived by a branch or similar establishment, or by the remainder of the CFC, will not be FBCSI if the income would not be so considered if it were derived by a separate CFC under like circumstances.

C. Legal Developments

In Rev. Rul. 75-7 (1975-1 CB 244), revoked by Rev. Rul. 97-48 (1997-2 CB 89), the IRS considered a case in which a CFC purchased raw material from related persons outside of its country of organization, contracted with an unrelated manufacturer located outside of its country of organization to process the raw material into a finished

product, and then sold the finished product to unrelated persons outside of its country of organization. Under the terms of the arrangement, the contract manufacturer was paid a conversion fee. The raw material, work in process, and finished product remained the property of the CFC at all times. The CFC alone had complete control over the time and quantity of production as well as complete quality control over the conversion process. The IRS ruled, under these facts, that the performance of the operations by the contract manufacturer whereby the raw material was processed into a finished good was considered to be a performance by the CFC, and the CFC would therefore be treated as having substantially transformed personal property. The ruling further concluded that, because the CFC conducted the manufacturing activity outside of its country of organization, it was considered to do so through a branch or similar establishment. Because the manufacturing branch tax rate disparity test was not satisfied, however, the activities of the "branch" were not considered the activities of a separate CFC and the CFC was therefore entitled to the manufacturing exception from FBCSI. See § 601.601(d)(2)(ii)(b).

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

In Rev. Rul. 97-48 the IRS revoked Rev. Rul. 75-7. Rev. Rul. 97-48 states that the IRS will follow *Ashland Oil, Inc. v. Commissioner* and *Vetco, Inc. v. Commissioner*, and therefore confirms that the IRS will not treat a separate contract manufacturer as a branch for purposes of section 954(d)(2). In addition, Rev. Rul. 97-48 rules that the activities of a contract manufacturer cannot be attributed to a CFC for purposes of either section 954(d)(1) or section 954(d)(2) to determine whether the income of a CFC is FBCSI. However, the ruling does not address the circumstances under which the activities of the CFC itself may qualify as manufacturing when a contract manufacturing or similar arrangement is in place. See § 601.601(d)(2)(ii)(b).

D. Business Developments

Final regulations addressing FBCSI were first published in 1964 (TD 6734, 29 FR 6392). Since then, global economic expansion and globalization have led to significant changes in manufacturing. Many multinational groups have extensive manufacturing networks that straddle geographic borders. These cross-border manufacturing networks are created primarily to leverage expertise and cost efficiencies. In addition, the use of contract manufacturing arrangements has become a common way of manufacturing products because of the flexibility and efficiencies it affords. Accordingly, updated rules in this area are important to the continued competitiveness of U.S. businesses operating abroad.

Explanation of Provisions

In response to the growing importance of contract manufacturing and other manufacturing arrangements, the Treasury Department and the IRS propose to modernize the FBCSI regulations in light of current business structures and practices that are inadequately addressed by

the current regulations. Specifically, the proposed regulations address: (1) The application of the manufacturing exception where the physical manufacturing test is not satisfied by the CFC but where the CFC, and/or a branch of the CFC, is involved in the manufacturing process; (2) the application of the branch rule to business structures involving the use of one or more branches engaged in manufacturing, producing, constructing, growing, or extracting activities; and (3) other miscellaneous branch rule issues. Certain portions of these proposed regulations restate changes that were previously proposed in REG-104537-97 (63 FR 14669) and withdrawn in REG-113909-98 (64 FR 37727).

A. Application of the manufacturing exception where the physical manufacturing test is not satisfied by the CFC but the CFC is involved in the manufacturing process - Substantial contribution to manufacturing

Section 954(d)(1) includes, as FBCSI, income from the purchase of personal property from any person and "its" sale to a related person. Some taxpayers argue that use of the word "its" implies that the property sold must be the same property that is purchased for the sales income to be FBCSI. Accordingly, these taxpayers assert that where the personal property purchased by the CFC is manufactured such that the property purchased is not the same as the property sold by the CFC, the property sold by the CFC is not the property purchased and therefore the sale of such property does not generate FBCSI, even if the CFC itself performs little or no part of the manufacture of that property. They further argue that the manufacturing exception under §1.954-3(a)(4)(i) provides a safe harbor but does not define the universe of cases in which personal property sold by a CFC is considered to be different from the property purchased by the CFC for purposes of determining FBCSI. In addition, they argue that §1.954-3(a)(4)(i) supports their view because it states, in part, that "[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."

The Treasury Department and the IRS believe that the position taken by these taxpayers is contrary to existing law, and results from an incorrect reading of section 954(d)(1) and §1.954-3(a)(4)(i). Section 954(d)(1) requires only a purchase of personal property and the sale of that personal property by the CFC with no indication as to form. Moreover, section 954(d)(1)(A) limits FBCSI to income derived in connection with the purchase (or sale) of personal property that is manufactured, produced, grown, or extracted outside of the CFC's country of organization, thereby indicating that section 954(d)(1) is concerned with the segregation of purchase or sales and manufacturing into different jurisdictions, not merely with whether the property was manufactured.

Section 1.954-3(a)(4) provides the only set of rules under which a change in form of personal property is considered relevant for purposes of determining FBCSI. The first sentence of Treas. Reg. §1.954-3(a)(4) sets forth the general rule that "foreign base company sales income does not include income of a CFC 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." The third sentence of that paragraph explains that "the property sold will be considered, for

purposes of this subparagraph, as not being the property which is purchased if the provisions of subdivision (ii) or (iii) of this subparagraph are satisfied." The plain language of the regulation, as well as the examples, clarify that in order to satisfy §1.954-3(a)(4)(ii) or (iii) the relevant manufacturing activities must be performed by the CFC itself. See, for example, *Electronic Arts, Inc. v. Commissioner*, 118 TC 226, 265 (2002) (stating that "petitioner's focus on certain language in section 1.954-3(a)(4), Income Tax Regs., overlooks the regulation's requirement that various actions have been done 'by' the corporation being evaluated"). See also, *Medchem v. Commissioner*, 116 TC 308 (2001).

Further, this regulation was issued shortly after the statute became effective, and is consistent with the legislative history, which contemplates that property sold will be considered different from the property purchased only when the CFC itself manufactures that property. See S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 841, 949 (stating that "[i]n a case in which a controlled foreign corporation purchases parts or materials which it then transforms or incorporates into a final product, income from the sale of the final product would not be foreign base company sales income if the corporation substantially transforms the parts or materials, so that, in effect, the final product is not the property purchased.")

The proposed regulations clarify that for purposes of determining FBCSI personal property sold by a CFC will be considered to be the property purchased by the CFC regardless of whether it is sold in the same form in which it was purchased, in a different form than the form in which it was purchased, or as a component part of a manufactured product, except as specifically provided by the same country manufacture exception contained in §1.954-3(a)(2) and the manufacturing exception contained in §1.954-3(a)(4). Therefore, the only time that the manufacture of a product will affect whether income is FBCSI is when the manufacture of the product is performed by the CFC or performed in the country of organization of the CFC. With respect to the manufacturing exception contained in §1.954-3(a)(4), the proposed regulations clarify that a CFC qualifies for the manufacturing exception from FBCSI only if the CFC, acting through its employees, manufactured the relevant product within the meaning of §1.954-3(a)(4)(i). The proposed regulations also further provide rules to determine whether the activities of a branch or similar establishment outside the country in which the CFC is incorporated have substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation, and thus whether under section 954(d)(2) the income attributable to the branch or similar establishment constitutes FBCSI of the CFC.

The Treasury Department and the IRS recognize, however, that due to business considerations in the global marketplace, personal property may be manufactured pursuant to a contract manufacturing arrangement under which the CFC engages in activities related to the manufacture of the property (for example, oversight, direction and control over the contract manufacturer) but does not satisfy the physical manufacturing test. In certain of these cases, the Treasury Department and the IRS believe that the CFC should qualify for the manufacturing exception to FBCSI. Accordingly, the proposed regulations modify §1.954-3(a)(4) to provide that a CFC that provides a "substantial contribution" with respect to the manufacture, production, or construction of personal property, but that could not

satisfy the physical manufacturing test, may have manufactured such property for purposes of the manufacturing exception. Specifically, proposed §1.954-3(a)(4)(i) provides that, in addition to proposed §1.954-3(a)(4)(ii) and (iii), a taxpayer may qualify for the manufacturing exception by satisfying the "substantial contribution test" in proposed §1.954-3(a)(4)(iv). Pursuant to proposed §1.954-3(a)(4)(iv)(b), a CFC will satisfy the substantial contribution test with respect to personal property only if the facts and circumstances evidence that the controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture of that property.

Factors to be considered in determining whether a CFC makes a substantial contribution to the manufacture of personal property include but are not limited to: (1) Oversight and direction of the activities or process (including management of the risk of loss) pursuant to which the property is manufactured under the principles of §1.954-3(a)(4)(ii) and (iii); (2) performance of manufacturing activities that are considered in, but insufficient to satisfy the tests provided in §1.954-3(a)(4)(ii) or (iii); (3) control of the raw materials, work-in-process and finished goods; (4) management of the manufacturing profits; (5) material selection; (6) vendor selection; (7) control of logistics; (8) quality control; and (9) direction of the development, protection, and use of trade secrets, technology, product design and design specifications, and other intellectual property used in manufacturing the product.

In light of the addition of the new test contained in proposed §1.954-3(a)(4)(iv), the interaction between several existing regulation sections and the new test is clarified. First, the existing manufacturing exceptions under §1.954-3(a)(4)(ii) and (iii) are modified to clarify that the applicability of the tests under §1.954-3(a)(4)(ii) and (iii) are restricted to cases in which physical transformation or physical assembly or conversion of component parts is conducted by the selling corporation.

Second, the definition of manufacturing for purposes of the same country manufacture exception contained in §1.954-3(a)(2) is modified to exclude manufacturing as defined under the substantial contribution test, and to ensure that the modifications to the existing manufacturing exceptions under §1.954-3(a)(4)(ii) and (iii) do not narrow the same country manufacture exception. The Treasury Department and the IRS did not intend these regulations to change the scope of the same country manufacture exception. Section 1.954-3(a)(2) excludes manufacturing as defined under the substantial contribution test because a rule that expanded the definition of manufacturing to include §1.954-3(a)(4)(iv) activities for purposes of the same country manufacture exception could prove difficult to administer. Such a rule could require an assessment of activities other than physical manufacturing conducted by an unrelated person. Modifying §1.954-3(a)(2) ensures that the modifications to the existing manufacturing exceptions under §1.954-3(a)(4)(ii) and (iii) do not narrow the same country manufacture exception by clarifying that property manufactured in the country of organization of the selling corporation will qualify for the same country manufacture exception regardless of whose employees engage in manufacturing activities that satisfy the principles of §1.954-3(a)(4)(ii) or (iii).

Third, the proposed regulations modify §1.954-3(a)(6), which

addresses the application of the manufacturing exception to a CFC's distributive share of partnership income where the partnership manufactures and sells personal property. The reference to "the separate activities or property of the controlled foreign corporation or any other person," in §1.954-3(a)(6) was intended to clarify that the activities of another person could not be attributed to the partnership for purposes of applying the manufacturing exception. Because these proposed regulations clarify that no attribution is allowed for purposes of applying the manufacturing exception that language is now unnecessary and is therefore removed. Section 1.954-3(a)(6) is also modified consistent with the modifications to §1.954-3(a)(4) providing that a CFC may only qualify for the manufacturing exception through the activities of its employees.

B. Application of the branch rule to business structures involving the use of more than one branch engaged in manufacturing

Proposed §1.954-3(b)(2)(ii)(c)(2) creates a rebuttable presumption with respect to the application of the substantial contribution test where a CFC claims to satisfy the substantial contribution test with respect to the activities of a branch of that CFC that satisfies §1.954-3(a)(4)(ii) or (iii). Under this rebuttable presumption, if a branch of a CFC satisfies the physical manufacturing test with respect to personal property sold by the remainder of the CFC, the remainder of the CFC will be presumed not to make a substantial contribution to the manufacture of that personal property unless the CFC can rebut that presumption to the satisfaction of the Commissioner.

The Treasury Department and the IRS believe that these rules are necessary as a backstop to the branch rule. In the absence of the rebuttable presumption, a rule permitting a CFC to qualify for the manufacturing exception based upon its contribution to the manufacturing activities of a branch would prove difficult to administer. Such a rule could encourage a CFC to elect classification of its subsidiaries that engage in manufacturing activities as disregarded entities, obfuscating the division of manufacturing labor and income between the CFC and its branches. Of course, the presumption may be rebutted and any adverse consequences alleviated by incorporating the branch that satisfies the physical manufacturing test.

Although §1.954-3(b)(1)(i)(c) provides a rule addressing the use of multiple sales or purchase branches, §1.954-3(b)(1)(ii) does not provide a corollary rule for the use of multiple manufacturing branches. The Treasury Department and the IRS believe that the lack of a specific rule addressing the use of more than one manufacturing branch does not currently limit the general manufacturing branch rule of §1.954-3(b)(1)(ii)(a) from applying to each manufacturing branch of a CFC in a case where a CFC performs manufacturing activities through more than one branch or similar establishment. Rather, such an application is consistent with the rules regarding multiple sales or purchase branches. Nonetheless, for clarity, the proposed regulations set forth rules addressing the use of multiple manufacturing branches.

The proposed regulations set forth two rules addressing the application of the manufacturing branch tax rate disparity test to multiple manufacturing branches.

Proposed §1.954-3(b)(1)(ii)(c)(2) addresses situations in which multiple branches each perform manufacturing activities with respect to separate items of personal property that are then sold by the CFC. Consistent with the rule for multiple sales branches, the proposed regulations require the separate application of the manufacturing branch tax rate disparity test to each branch that is manufacturing a separate item of personal property.

Proposed §1.954-3(b)(1)(ii)(c)(3) addresses situations in which multiple branches, or one or more branches and the remainder of the CFC, perform manufacturing activities with respect to the same item of personal property that is then sold by the CFC. When multiple branches, or one or more branches and the remainder of the CFC, perform manufacturing activities with respect to the same item of personal property, the manufacturing branch tax rate disparity test is applied by giving satisfaction of the physical manufacturing test precedence over other contributions to manufacturing. Therefore, if only one branch, or only the remainder of the CFC, satisfies the physical manufacturing test of §1.954-3(a)(4)(ii) or (iii), then the location of that branch or the remainder of the CFC will be the location of manufacturing of the personal property for purposes of applying the manufacturing branch tax rate disparity test. If more than one branch, or one or more branches and the remainder of the CFC, each satisfy the physical manufacturing test, then the branch or the remainder of the CFC located or organized in the jurisdiction that would impose the lowest effective rate of tax will be the location of manufacturing of the personal property for purposes of applying the manufacturing branch tax rate disparity test.

If none of the branches nor the remainder of the CFC satisfies the physical manufacturing test, but the CFC as a whole satisfies the substantial contribution test contained in proposed §1.954-3(a)(4)(iv), then the location of manufacturing of the personal property will be the location of the branch or the remainder of the CFC that provides the predominant amount of the CFC's substantial contribution to manufacturing. Whether any branch or the remainder of the CFC provides a predominant amount of the CFC's contribution to manufacturing is determined by applying the facts and circumstances test provided in §1.954-3(a)(4)(iv) to weigh the contribution to manufacturing of each branch or the remainder of the CFC. If a predominant amount of the CFC's contribution to manufacturing is not provided by any one location, the location of manufacturing of the personal property for purposes of applying the manufacturing branch tax rate disparity test will be that place (either the remainder of the CFC or one of its branches) where manufacturing activity is performed and which would impose the highest effective rate of tax when applying either §1.954-3(b)(1)(i)(b) or (ii)(b).

Because the proposed regulations address cases in which two or more branches, or one or more branches and the remainder of the CFC, perform manufacturing activities related to the manufacture of the same item of property, §1.954-3(b)(2)(ii)(a) is modified to clarify the application of the branch rule where manufacturing activities are performed in more than one location. In such cases, proposed §1.954-3(b)(2)(ii)(a) provides that, for purposes of treating the location of sales or purchase income as a separate corporation for purposes of determining whether FBCSI is incurred, that separate corporation will exclude any branch or the remainder of the CFC that would be treated as a separate corporation, if the hypothetical rate

imposed by the jurisdiction of each such branch or the remainder of the CFC were separately tested against the effective rate of tax imposed on the sales or purchase income under the relevant tax rate disparity test.

C. Miscellaneous Branch Rule Issues

The Treasury Department and the IRS also propose to amend certain other aspects of §1.954-3(b) as follows:

1. Definition of a manufacturing branch

While §1.954-3(b)(1)(ii)(a) defines a manufacturing branch as a branch or similar establishment through which a CFC carries on manufacturing activities, it does not explicitly require that §1.954-3(a)(4)(i) be satisfied by the CFC as a whole in order for the manufacturing branch rule to apply. The Treasury Department and the IRS believe that a manufacturing branch only exists with respect to personal property sold by a CFC if the CFC (including any branch of that CFC) has manufactured that property. Accordingly, proposed §1.954-3(b)(1)(ii)(a) clarifies this point by providing that the manufacturing branch rule applies only where a CFC (including any branch of the CFC) satisfies the manufacturing requirement under proposed §1.954-3(a)(4).

2. Modification of §1.954-3(b)(2)(ii)(e)

Section 1.954-3(b)(2)(ii)(e) provides that income derived by a branch or similar establishment, or by the remainder of the CFC, will not be FBCSI if the income would not be so considered if it were derived by a separate CFC under like circumstances. For example, if a branch of a CFC purchases personal property from an unrelated person and sells the property to an unrelated person without any involvement by the remainder of the CFC, the branch rule will not apply to create a related party transaction between the branch and the remainder of the CFC. Therefore the purchase and sale of that personal property by the branch will not generate FBCSI.

The proposed regulations provide that the substantial contribution test generally applies to a CFC that sells personal property where another person (for example, a second CFC) satisfies the physical manufacturing test with respect to that property. However, a negative presumption applies where a CFC claims to satisfy the substantial contribution test with respect to income from the sale of personal property where the physical manufacturing test is satisfied by a branch of that CFC. The effect of these rules is that, where a CFC seeks to rely on the substantial contribution test with respect to the income from the sale of personal property manufactured (within the meaning of §1.954-3(a)(4)(ii) or (iii)) by one or more of its branches, but cannot rebut the negative presumption to the satisfaction of the Commissioner, a branch or the remainder of a CFC may have FBCSI where a separate CFC would not. Therefore, to integrate the rules regarding the substantial contribution test and its application under the branch rule, proposed §1.954-3(b)(2)(ii)(e) excepts from its general rule cases in which a branch satisfies the physical manufacturing test with respect to personal property and the remainder of the controlled foreign corporation fails to rebut the presumption that it does not satisfy the substantial contribution test with respect to the activities of that manufacturing branch.

In addition, consistent with the clarification regarding the scope of the branch rule contained in proposed §1.954-3(b)(1), §1.954-3(b)(2)(ii)(e) is modified to clarify that it applies only for purposes of paragraph (b) of §1.954-3 (that is, the branch rule). This clarifies that in no event will the branch rule cause income not to be FBCSI if that income would otherwise be FBCSI under section 954(d)(1). For example, assume a CFC incorporated in Country Y purchases personal property from a related party and has that property manufactured by a contract manufacturer in Country Z. If the CFC does not perform any other activity with respect to the manufacture of the property, and if the CFC sells the manufactured property through a branch located in Country Z for use, consumption, or disposition outside of Country Y, the income from the sale of that property is FBCSI under section 954(d)(1). If the branch located in Country Z were a separate CFC the income would not be FBCSI because it would be selling personal property manufactured in its country of organization, Country Z. However, because the income would be FBCSI to the CFC under section 954(d)(1), proposed §1.954-3(b)(2)(ii)(e) does not apply to create a different result.

3. Modification of §1.954-3(b)(2)(i)(b), (b)(2)(ii)(b) and (b)(4), Example 3.

Commentators have noted that §1.954-3(b)(2)(i)(b) and (ii)(b) can be read to cause a branch that purchases from unrelated persons and sells to unrelated persons to have FBCSI even where the remainder of the CFC has no connection with the personal property that is sold. Although §1.954-3(b)(2)(ii)(e) should prevent such a result, commentators note that a contrary reading is possible because the sales branch rules of §1.954-3(b)(2)(i)(b) and (ii)(b) apply, in part, with respect to personal property manufactured, produced, constructed, grown, or extracted by, or personal property purchased or sold by the "controlled foreign corporation" (as opposed to by the "remainder" of the controlled foreign corporation). For example, in a case in which a branch both manufactures and sells personal property, the branch could be considered to sell on behalf of the remainder of the CFC because the branch's manufacturing activities would be considered to be manufacturing activities of the CFC, thereby triggering the application of §1.954-3(b)(2)(ii)(b). Further, commentators note that §1.954-3(b)(4), Example 3 appears to support this reading because in that example a branch of a corporation purchases from a related person and sells to an unrelated person, and the branch is treated as selling that property on behalf of the remainder of the CFC, even though the remainder of the corporation does not manufacture, purchase, or sell the personal property.

Section 1.954-3(b)(2)(i)(b) and (ii)(b) are intended to apply only to purchasing or selling by a branch with respect to personal property manufactured, purchased, or sold by "the remainder of" the CFC (including any branch treated as the remainder of the CFC). For example, the branch rule could apply in a case where personal property is manufactured by the CFC in the country of organization of the CFC and then sold by a branch of the CFC located outside of the country of organization of the CFC. However, the branch rule does not apply where, for example, a branch of the CFC purchases personal property from an unrelated party and sells it to an unrelated party without any involvement by the remainder of the CFC. Accordingly, the proposed regulations amend §1.954-3(b)(2)(i)(b) and (ii)(b) by adding the words "remainder of" before each place where the words "controlled foreign corporation" appear in those paragraphs and by

adding the words "(or by any branch treated as the remainder of the CFC)" after each place where the words "controlled foreign corporation" appear in those paragraphs. Consistent with this change, the proposed regulations revise the rationale for the result in §1.954-3(b)(4), Example 3 as described below.

In §1.954-3(b)(4), Example 3, a branch of a second-tier CFC purchases finished goods from the first-tier CFC and sells 90 percent of the product for use, consumption, or disposition outside of the country in which the branch is located and the country of organization of the second-tier CFC. The remainder of the second-tier CFC does not engage in any manufacturing or selling activities. The sales branch tax rate disparity test is met in comparison to the effective tax rate of the second-tier CFC (the first-tier CFC and second-tier CFC are organized in the same country). The example concludes that since the sales branch tax disparity test is met, the branch is treated as a separate CFC and is treated as selling personal property on behalf of the second-tier CFC and therefore the 90 percent of sales made for use, consumption, or disposition outside of the branch's country is FBCSI.

The rationale of the example is incorrect because the branch is not selling on behalf of the second-tier CFC because the remainder of the second-tier CFC (not including the branch) does not manufacture, purchase, or sell the personal property. Therefore, §1.954-3(b)(2)(i)(b) and (ii)(b) do not apply. However, the result is correct because the branch, treated as a separate corporation, is purchasing from a related person, the first-tier CFC, organized outside of the branch's country and selling to persons outside the branch's country and the branch is located in a jurisdiction that satisfies the sales branch tax rate disparity test with respect to the income from the sale of the personal property. Accordingly, the proposed regulations revise §1.954-3(b)(4), Example 3 to provide the correct rationale for the result. In addition, the result in §1.954-3(b)(4), Example 3 is further revised to add two alternative factual scenarios (purchase from an unrelated party, and manufacture within the meaning of proposed §1.954-3(a)(4)(iv) by the selling branch) to illustrate the point that, in general, a branch will not have FBCSI if a separate CFC would not have FBCSI under like circumstances.

Proposed Effective/Applicability Date

These regulations will apply to taxable years of CFCs beginning on or after the date they are published as final regulations in the Federal Register, and for taxable years of United States shareholders in which or with which such taxable years of the CFCs end.

Reliance on Proposed Regulations

Until these regulations are finalized, taxpayers may choose to apply these regulations in their entirety to all open tax years as if they were final regulations.

Request for Comments

The Treasury Department and the IRS request comments on all aspects of these proposed regulations, including comments regarding the substantial contribution test, and the activities listed in §1.954-3(a)(4)(iv)(b). In particular, comments are requested on whether one or more safe harbors should be added to the substantial

contribution test. In drafting the proposed regulations, the Treasury Department and the IRS considered a number of approaches to a safe harbor but ultimately chose to request comments in this regard because of difficulties in fashioning a safe harbor that would be flexible enough to apply across various industries and across a range of different types of manufacturing arrangements. Among the safe harbors considered in drafting the proposed regulations were: (1) A list of mandatory activities; (2) a cost based test; (3) a compensation based test; (4) a value based test; (5) a tax rate disparity based test; and (6) a percentage based test comparing the compensation paid to employees of the CFC for performing activities related to the manufacturing process vs. the total cost for all activities related to the manufacturing process (that is, including costs paid to a contract manufacturer but excluding the cost of raw materials and marketing intangibles). In addition, the Treasury Department and the IRS request comments as to whether the requirement, under the manufacturing exception from foreign base company sales income, that the activities of the CFC be performed by its employees, should permit commercial arrangements where individuals performing services for the CFC, while not on its payroll, are nevertheless controlled by employees of the CFC.

Comments are also requested on whether it would be appropriate to add an anti-abuse rule similar to the foreign base company services substantial assistance test announced in Notice 2007-13 to prevent a CFC from qualifying for the manufacturing exception based on the application of the substantial contribution test in cases in which substantially all of the direct or indirect contributions to the manufacture of personal property provided collectively by the CFC and any related United States person is provided by one or more related United States persons. Such a rule might provide, for example, that where (1) the United States parent of a CFC provides 45 percent of the manufacturing contribution, (2) the CFC provides 5 percent of the manufacturing contribution, and (3) an unrelated contract manufacturer provides 50 percent of the manufacturing contribution to the personal property, the CFC does not make a substantial contribution to the manufacture of that property because a related United States person provides 80 percent or more of the contribution to the manufacture of the property (90 percent in this case, 45/50) provided collectively by the CFC and any related United States person. Such a rule was considered but ultimately not included in the proposed regulations and comments are requested on whether or not such a rule should be added to the final regulations. See §601.601(d)(2)(ii)(b).

In addition, comments are requested on the multiple manufacturing branch rules. First, comments are requested on whether the negative presumption rule concerning cases in which the selling branch or the remainder of the CFC performs activities described in proposed §1.954-3(a)(4)(iv) is more appropriate than an alternative rule that would deny the use of the test contained in proposed §1.954-3(a)(4)(iv) in cases in which a branch of the CFC manufactures the property within the meaning of proposed §1.954-3(a)(4)(ii) or (iii). Second, comments are requested on the consequences of and possible alternatives to proposed §1.954-3(b)(1)(ii)(c)(3)(e), which provides that if a predominant amount of the CFC's substantial contribution is not provided by any one location, the location of manufacturing of the personal property will be considered to be that location (either the remainder of the CFC or one of its branches) which imposes the highest effective rate of tax that would be imposed

on the sales income, among those locations where manufacturing activity related to the generation of that income is performed. The Treasury Department and the IRS considered a rule that would allow taxpayers to alternatively use the mean effective rate of tax among the locations where manufacturing activity is performed, so long as that effective rate of tax was within a set number of percentage points of the highest effective tax rate that would be imposed by any jurisdiction in which a manufacturing branch or the remainder of the CFC was located or organized. However, the Treasury Department and the IRS were concerned about the complexity of such a rule. The Treasury Department and the IRS request comments on whether this or other alternatives to the highest rate test would be appropriate. Finally, comments are requested on whether any modifications to §1.954-3(b)(1)(i)(b) and (b)(1)(ii)(b) should be adopted to make the rules concerning the comparison of effective rates of tax easier to apply.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and because the proposed regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. Ch. 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and the IRS request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the Federal Register.

Drafting Information

The principal author of these regulations is Ethan Atticks, Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income Taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for 26 CFR part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.954-3 is amended by:

1. Adding a new sentence after the first sentence of paragraph (a)(1)(i), and by revising the second sentence of Example 1 in paragraph (a)(1)(iii), and the first sentence of Example 2 in paragraph (a)(1)(iii).
2. Revising the third sentence of paragraph (a)(2).
3. Revising paragraph (a)(4)(i), and the first sentences of paragraphs (a)(4)(ii) and (iii), and by adding paragraph (a)(4)(iv).
4. Revising the text of paragraph (a)(6)(i).
5. Adding a new sentence to the end of paragraph (b)(1)(ii)(a).
6. Redesignating the text of paragraph (b)(1)(ii)(c) as paragraph (b)(1)(ii)(c)(1), and adding a paragraph heading to newly designated paragraph (b)(1)(ii)(c)(1).
7. Adding paragraphs (b)(1)(ii)(c)(2), and (c)(3).
8. Revising paragraph (b)(2)(i)(b).
9. Adding a new sentence to the end of paragraph (b)(2)(ii)(a), and revising paragraph (b)(2)(ii)(b).
10. Redesignating the text of paragraph (b)(2)(ii)(c) as paragraph (b)(2)(ii)(c)(1), adding a paragraph heading to newly redesignated paragraph (b)(2)(ii)(c)(1), adding paragraph (b)(2)(ii)(c)(2), and revising paragraph (b)(2)(ii)(e).
11. Revising Example 3 in paragraph (b)(4).
12. Adding paragraph (d).

The additions and revisions read as follows:

§1.954-3 Foreign base company sales income.

(a) * * *

(1) In general--(i) General rules. * * * For purposes of the preceding sentence, except as provided in paragraphs (a)(2) and (a)(4) of this section, personal property sold by a controlled foreign corporation will be considered to be the same property that was purchased by the controlled foreign corporation regardless of whether the personal property is sold in the same form in which it was purchased, in a different form than the form in which it was purchased, or as a component part of a manufactured product. * * *

* * * * *

Example 1. * * * Corporation A purchases from M Corporation, a

related person, articles manufactured in the United States and sells the articles to P, not a related person, for delivery and use in foreign country Y. * * *

Example 2. Corporation A in Example 1 also purchases from P, not a related person, articles manufactured in country Y and sells the articles to foreign corporation B, a related person, for use in foreign country Z. * * *

* * * * *

(2) * * * The principles set forth in paragraphs (a)(4)(i), (a)(4)(ii), and (a)(4)(iii) of this section apply under this paragraph (a)(2) in determining what constitutes manufacture, production, or construction of personal property, excluding, in the case of manufacture, production, or construction by a person other than the controlled foreign corporation, the requirement set forth in paragraph (a)(4)(i) of this section that the provisions of paragraphs (a)(4)(ii) and (a)(4)(iii) of this section may only be satisfied through the activities of that person's employees. * * *

* * * * *

(4) Property manufactured, produced, or constructed by the controlled foreign corporation--(i)--In general. 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 controlled foreign corporation will have manufactured, produced, or constructed personal property which the corporation sells only if such corporation satisfies the provisions of paragraphs (a)(ii), (a)(iii), or (a)(iv) of this section through the activities of its employees with respect to such property. A controlled foreign corporation will not be treated as having manufactured, produced, or constructed personal property which the corporation sells merely because the property is sold in a different form than the form in which it was purchased. For rules of apportionment in determining foreign base company sales income derived from the sale of personal property purchased and used as a component part of property which is not manufactured, produced, or constructed, see paragraph (a)(5) of this section.

(ii) * * * If personal property purchased by a foreign corporation is substantially transformed by such foreign corporation prior to sale, the property sold by the selling corporation is manufactured, produced, or constructed by such selling corporation. * * *

(iii) * * * If purchased property is used as a component part of personal property which is sold, the sale of the property will be treated as the sale of a manufactured product, rather than the sale of component parts, if the assembly or conversion of the component parts into the final product by the selling corporation involves activities that are substantial in nature and generally considered to constitute the manufacture, production, or construction of property. * * *

(iv) Substantial contribution to manufacturing of personal property--(a)--In general. This paragraph (a)(4)(iv) applies only if a controlled foreign corporation does not satisfy paragraph

(a)(4)(ii) or (a)(4)(iii) of this section, but the personal property purchased by a controlled foreign corporation would be considered to be manufactured, produced, or constructed prior to sale (under the principles of paragraphs (a)(4)(ii) or (iii) of this section) by the controlled foreign corporation if the manufacturing, producing, and constructing activities undertaken with respect to the property prior to sale were undertaken by the controlled foreign corporation through the activities of its employees. If this paragraph (a)(4)(iv) applies, the personal property sold by the controlled foreign corporation is manufactured, produced, or constructed by such controlled foreign corporation only if the facts and circumstances evidence that the controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture, production, or construction of the personal property sold. The determination of whether a controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture, production, or construction of the personal property sold will involve, but will not necessarily be limited to, consideration of the activities set forth in paragraph (a)(4)(iv)(b) of this section. The weight given to any activity (whether or not set forth) will vary with the facts and circumstances of the particular business. The presence or absence of any activity, or of a particular number of activities, is not determinative. Further, the fact that other persons make contributions to the manufacture, production, or construction of personal property prior to sale does not necessarily prevent the controlled foreign corporation from making a substantial contribution to the manufacture, construction, or production of that property through the activities of its employees.

(b) Activities. Activities of a controlled foreign corporation's employees to be considered in determining whether a controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture, construction, or production of personal property include but are not limited to--

(1) Oversight and direction of the activities or process (including management of the risk of loss) pursuant to which the property is manufactured, produced, or constructed under the principles of paragraphs (a)(4)(ii) or (iii) of this section;

(2) Performance of activities that are considered in but that are insufficient to satisfy the tests provided in paragraphs (a)(4)(ii) and (a)(4)(iii) of this section;

(3) Control of the raw materials, work-in-process and finished goods;

(4) Management of the manufacturing profits;

(5) Material selection;

(6) Vendor selection;

(7) Control of logistics;

(8) Quality control; and

(9) Direction of the development, protection, and use of trade secrets, technology, product design and design specifications, and other intellectual property used in manufacturing the product.

(c) The rules of this paragraph (a)(iv) are illustrated by the following examples:

Example 1. No substantial contribution to manufacturing. (i) Facts. FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are then manufactured (under the principles of paragraph (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation that performs the physical conversion outside of FS's country of organization, pursuant to a contract manufacturing arrangement. Product X is then sold by FS for use outside of FS's country of organization. At all times, FS retains control of the raw material, work-in-process, and finished goods, as well as the intangibles used in the conversion process. FS retains the right to oversee and direct the physical conversion of Product X by CM but does not regularly exercise, through its employees, its powers of oversight or direction.

(ii) Result. FS does not satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section because FS does not, through the activities of its employees, substantially transform, convert or assemble personal property into Product X. However, Product X was manufactured (by CM), and therefore this paragraph (a)(4)(iv) applies. FS does not satisfy the test under this paragraph (a)(4)(iv) because it does not make a substantial contribution through the activities of its employees to the manufacture of Product X. Mere contractual ownership of materials and intellectual property and contractual rights to exercise powers of direction and control (without the exercise of those powers) are not sufficient to satisfy this paragraph (a)(4)(iv). Therefore, FS is not considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 2. Substantial contribution to manufacturing, unrelated manufacturer. (i) Facts. Assume the same facts as in Example 1, except for the following. FS, through its employees, is engaged in product design and quality control. Employees of FS regularly exercise the right to oversee and direct the activities of CM in the manufacture of Product X.

(ii) Result. FS does not satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X because FS does not, through the activities of its employees, substantially transform, convert or assemble personal property into Product X. However, Product X was manufactured (by CM), and therefore this paragraph (a)(4)(iv) applies. FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore FS is considered to have manufactured Product X. The analysis and conclusion in this Example 2 would be the same if CM were a corporation that was related to FS.

Example 3. Employees of another person. (i) Facts. FS, a controlled foreign corporation organized in Country M, purchases raw materials from a related person. The raw materials are then manufactured (under the principles of paragraph (a)(4)(iii) of this section) into Product X by CM, an unrelated contract manufacturer located in Country C. CM uses employees of another corporation to operate its manufacturing plant and convert the raw materials into Product X. Apart from the physical conversion of the raw materials into Product X, employees of FS perform all of the other activities with respect to the

manufacture of Product X (for example, oversight and direction of the manufacturing process, control of raw materials, control of logistics, vendor selection, quality control). FS sells Product X for use, consumption or disposition outside Country M.

(ii) Result. If the manufacturing activities undertaken with respect to Product X between the time the raw materials were purchased and the time Product X was sold were undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X. If CM's manufacturing plant were located in Country M, the test in paragraph (a)(2) of this section could be satisfied even if CM did not manufacture Product X through the activities of its employees.

Example 4. Automated manufacturing. (i) Facts. FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are then manufactured (under the principles of paragraph (a)(4)(ii) of this section) into Product X by CM, an unrelated corporation located outside of FS's country of organization, pursuant to a contract manufacturing arrangement. Product X is then sold by FS to related and unrelated persons for use outside of FS's country of organization. Under the contract manufacturing arrangement, CM is responsible for the physical transformation of the raw materials into Product X. At all times, FS retains ownership of the raw material, work-in-process, and finished goods. FS retains the right to oversee and direct the physical conversion of Product X by CM but does not regularly exercise, through its employees, its powers of oversight or direction. FS is the owner of sophisticated software and network systems that remotely and automatically (without human involvement) take orders, route them to CM, order raw materials, and perform quality control. FS has a small number of computer technicians who monitor the software and network systems to ensure that they are running smoothly and to apply any necessary patches or fixes. The software and network systems were developed by employees of DP, the U.S. corporate parent of FS, pursuant to a cost sharing agreement between DP and FS. DP employees regularly supervise the computer technicians, evaluate the results of the automated manufacturing business, and make ongoing operational decisions, including with regard to acceptable performance of the manufacturing process, stoppages of that process, and product and process redesign and updates to meet the needs of the business and its customers. DP employees develop and provide to FS all of the upgrades to the software and network systems. DP also has employees who control the other aspects of the manufacturing process such as product design, vendor and material selection, management and retention of the manufacturing profits, and the selection of CM.

(ii) Result. FS does not satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X because FS does not, through the activities of its employees, substantially transform, convert or assemble personal property into Product X. If the manufacturing activities undertaken with respect to Product X between the time the raw materials were purchased and the time Product X was sold were undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in

paragraph (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. FS does not satisfy the test under this paragraph (a)(4)(iv) because it does not make a substantial contribution through the activities of its employees to the manufacture of Product X. Mere contractual ownership of materials and intellectual property together with contractual rights to exercise powers of direction and control and a small number of technical employees are not sufficient to satisfy this paragraph (a)(4)(iv). FS's primary contribution to the manufacture of Product X is the provision of the software and network systems to CM. Substantial operational responsibilities and decision making are exercised by DP employees who direct the activities of the FS employees. Therefore, FS is not considered to have manufactured Product X.

* * * * *

(6) * * * (i) * * * To determine the extent to which a controlled foreign corporation's distributive share of any item of gross income of a partnership would have been foreign base company sales income if received by it directly, under §1.952-1(g), the property sold will be considered to be manufactured, produced or constructed by the controlled foreign corporation, within the meaning of paragraph (a)(4) of this section, only if the manufacturing exception of paragraph (a)(4) of this section would have applied to exclude the income from foreign base company sales income if the controlled foreign corporation had earned the income directly, determined by taking into account the activities of the employees of, and property owned by, the partnership.

* * * * *

(b) * * *

(1) * * *

(ii) * * *

(a) * * * The provisions of this paragraph (b)(1)(ii)(a) will not apply unless the controlled foreign corporation (including any branches or similar establishments of such controlled foreign corporation) manufactures, produces, or constructs such personal property within the meaning of paragraph (a)(4)(i) of this section.

* * * * *

(c) Use of more than one branch--(1) Use of one or more sales or purchase branches in addition to a manufacturing branch. * * *

(2) Use of more than one branch to manufacture, produce, construct, grow, or extract separate items of personal property. If a controlled foreign corporation carries on manufacturing, producing, constructing, growing, or extracting activities with respect to separate items of personal property by or through more than one branch or similar establishment located outside the country under the laws of which such corporation is created or organized, then paragraphs (b)(2)(ii)(b) and (c) of this section will be applied separately to each such branch or similar establishment (by treating such branch or similar establishment as if it were the only branch or similar establishment of the controlled foreign corporation and as if

any such other branches or similar establishments were separate corporations) in determining whether the use of such branch or similar establishment has substantially the same tax effect as if such branch or similar establishment were a wholly owned subsidiary corporation of the controlled foreign corporation. The application of this paragraph (b)(1)(ii)(c)(2) is illustrated by the following example:

Example. Multiple branches that satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section. (i) Facts. FS is a controlled foreign corporation organized in Country M. FS operates two branches, Branch A and Branch B located in Country A and Country B, respectively. Branch A and Branch B each manufacture separate items of personal property (Product X and Y respectively) within the meaning of paragraph (a)(4)(ii) or (iii) of this section. Raw materials used in the manufacture of Product X and Product Y are purchased by FS from an unrelated person. FS engages in activities in Country M to sell Product X and Product Y to a related person for use, disposition or consumption outside of Country M. Employees of FS located in Country M perform only sales functions. The effective rate imposed on the income from the sales of Product X and Product Y is 10%. Country A imposes an effective rate of tax on sales income of 20%. Country B imposes an effective rate of tax on sales income of 12%.

(ii) Result. Pursuant to this paragraph (b)(1)(ii)(c)(2), paragraph (b)(1)(ii)(b) of this section is separately applied to Branch A and Branch B with respect to the sales income of FS attributable to Product X (manufactured by Branch A) and Product Y (manufactured by Branch B). Because the effective rate of tax on FS's sales income from the sale of Product X in Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in which Branch A is located (20%), the use of Branch A has substantially the same tax effect as if Branch A were a wholly owned subsidiary corporation of FS. Because the effective rate of tax on FS's sales income from the sale of Product Y in Country M (10%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in which Branch B is located (12%), the use of Branch B does not have substantially the same tax effect as if Branch B were a wholly owned subsidiary corporation of FS. Consequently, only Branch A is treated as a separate corporation apart from the remainder of FS for purposes of determining foreign base company sales income.

(3) Use of more than one manufacturing branch, or one or more manufacturing branches and the remainder of the controlled foreign corporation, to manufacture, produce, construct, grow, or extract the same property--(a)--In general. This paragraph (b)(1)(ii)(c)(3) applies to determine the location of manufacturing, producing, constructing, growing or extracting of personal property for purposes of applying paragraphs (b)(1)(i)(b) or (ii)(b) of this section where more than one branch of a controlled foreign corporation, or one or more branches of a controlled foreign corporation and the remainder of the controlled foreign corporation, each engage in manufacturing, producing, constructing, growing or extracting activities with respect to the same item of personal property which is then sold by the controlled foreign corporation.

(b) Physical manufacture, production, or construction in one or more locations. If only one branch or only the remainder of a controlled

foreign corporation satisfies either paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to an item of personal property, then that branch or the remainder of the controlled foreign corporation will be the location of manufacturing, producing, or constructing of that property for purposes of applying paragraph (b)(1)(i)(b) or (ii)(b) of this section to the income from the sale of that property. See §1.954-3(b)(1)(ii)(c)(3)(f) Example 1. If more than one branch, or one or more branches and the remainder of the controlled foreign corporation, each independently satisfy either paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to an item of property, then the location of manufacturing, producing, or constructing of that property for purposes of applying paragraph (b)(1)(i)(b) or (ii)(b) of this section will be that branch or the remainder of the controlled foreign corporation that satisfies paragraph (a)(4)(ii) or (a)(4)(iii) of this section and that is located or organized in the jurisdiction that would, after applying paragraph (b)(1)(ii)(b) of this section to such branch or paragraph (b)(1)(i)(b) of this section to the remainder of the controlled foreign corporation, impose the lowest effective rate of tax on the income allocated to such branch or the remainder of the controlled foreign corporation under such paragraph (that is, either paragraph (b)(1)(ii)(b) or (b)(1)(i)(b) of this section), if, under the laws of such country, the entire income of the controlled foreign corporation were considered derived by such corporation from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the corporation were created or organized under the laws of, and managed and controlled in, such country. See §1.954-3(b)(1)(ii)(c)(3)(f) Example 2.

(c) Predominant contribution. If none of the branches nor the remainder of a controlled foreign corporation satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to an item of personal property, but the controlled foreign corporation as a whole makes a substantial contribution to the manufacture, production, or construction of that property within the meaning of paragraph (a)(4)(iv) of this section, then for purposes of applying paragraph (b)(1)(i)(b) or (ii)(b) of this section, the branch or the remainder of the controlled foreign corporation that makes the predominant amount of the controlled foreign corporation's substantial contribution with respect to the manufacture, production, or construction of that property will be the location of manufacturing, producing, or constructing with respect to that property. See §1.954-3(b)(1)(ii)(c)(3)(f) Example 3. Whether any branch or the remainder of the controlled foreign corporation provides a predominant amount of the controlled foreign corporation's substantial contribution is determined by weighing each branch's or the remainder of the controlled foreign corporation's relative contribution to the manufacture of the item of property as determined by applying the facts and circumstances test provided in paragraph (a)(4)(iv) of this section. If multiple branches are located in a single jurisdiction, then the activities of those branches will be aggregated for purposes of determining the branch or the remainder of the controlled foreign corporation that makes the predominant amount of the controlled foreign corporation's substantial contribution with respect to the manufacture, production, or construction of an item of property. For purposes of this paragraph (b)(1)(ii)(c)(3)(c), a branch or the remainder of the controlled foreign corporation makes a predominant amount of the controlled foreign corporation's substantial contribution with respect to the manufacture, production,

or construction of an item of personal property only if it makes a significantly greater contribution to the manufacture, production, or construction of that property than any other branch or the remainder of the controlled foreign corporation. The location of any particular activity (that is, for purposes of deciding whether that activity is conducted in a particular branch or in the remainder of the controlled foreign corporation) will be determined by applying the principles of paragraph (b)(1)(ii)(c)(3)(d) of this section.

(d) Location of activity. The location of any activity with respect to the manufacture, production, or construction of an item of personal property is where the controlled foreign corporation makes a contribution through its employees to such activity. For example, the location of any activities concerning intangible property is not determined based on the formal assignment of intangible property, but on where employees of the controlled foreign corporation develop, protect, and direct the use of the intangible.

(e) Where no branch or the remainder of the controlled foreign corporation provides a predominant contribution. If neither a branch nor the remainder of a controlled foreign corporation independently satisfies paragraph (a)(4)(ii) or (iii) of this section and neither a branch nor the remainder of the controlled foreign corporation provides a predominant amount of the controlled foreign corporation's contribution to the manufacture of an item of personal property, but the controlled foreign corporation as a whole makes a substantial contribution to the manufacture of that property within the meaning of paragraph (a)(4)(iv) of this section, then for purposes of applying paragraph (b)(1)(i)(b) or (ii)(b) of this section, the location of manufacturing of that property will be that branch or remainder of the controlled foreign corporation that provides a contribution to the manufacture of the property and that is located or organized in the jurisdiction that would, after applying paragraph (b)(1)(ii)(b) of this section to such branch or (b)(1)(i)(b) of this section to such remainder of the controlled foreign corporation, impose the highest effective rate of tax on the income allocated to such branch or such remainder of the controlled foreign corporation under that paragraph, if, under the laws of such country, the entire income of the controlled foreign corporation were considered derived by such corporation from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the corporation were created or organized under the laws of, and managed and controlled in, such country. See §1.954-3(b)(1)(ii)(c)(3)(f) Example 4.

(f) Examples. The following examples illustrate the application of this paragraph (b)(1)(ii)(c)(3):

Example 1. Multiple branches that contribute to the manufacture of a single product, only one branch that satisfies paragraph (a)(4)(ii) or (a)(4)(iii) of this section. (i) Facts. FS is a controlled foreign corporation organized in Country M. FS operates three branches, Branch A, Branch B, and Branch C, located respectively in Country A, Country B, and Country C. Branch A, Branch B, and Branch C each performs different manufacturing activities with respect to the manufacture of Product X. Branch A, through the activities of its employees, designs Product X. Branch B, through the activities of its employees, provides quality control and oversight. Branch C, through the activities of its employees, manufactures Product X (within the

meaning of paragraph (a)(4)(iii) of this section) using the designs of Branch A and under the oversight of the quality control personnel of Branch B. The activities of Branch A and B do not satisfy either paragraph (a)(4)(ii) or (a)(4)(iii) of this section. Employees of FS located in Country M purchase the raw materials used in the manufacture of Product X from a related person and control the work-in-process and finished goods throughout the manufacturing process. Employees of FS located in Country M also manage the risk of loss from the manufacture of Product X and the manufacturing profits from the sales of Product X. Further, employees of FS located in Country M control logistics, select vendors and raw materials, and oversee the coordination between the branches. Employees of FS located in Country M sell Product X to unrelated persons for use, consumption or disposition outside of Country M. The sales income from the sale of Product X is taxed in Country M at an effective rate of tax of 10%. Country C imposes an effective rate of tax of 20% on sales income.

(ii) Result. Because only the activities of Branch C satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section, paragraph (b)(1)(ii)(b) of this section is applied by considering only the effective rate of tax that would apply in Country C. The effective rates of tax in Country A and Country B are not considered, because Branch A and Branch B do not satisfy either paragraph (a)(4)(ii) or (a)(4)(iii) of this section. Because the effective rate of tax on the sales income (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in which Branch C is located (20%), the use of Branch C has substantially the same tax effect as if Branch C were a wholly owned subsidiary corporation of FS. Therefore sales of Product X by the remainder of FS are treated as sales on behalf of Branch C. Pursuant to paragraph (b)(2)(ii)(c)(2) of this section, FS will only qualify for the manufacturing exception under paragraph (a)(4)(iv) of this section if FS successfully rebuts, to the satisfaction of the Commissioner, the presumption that FS does not provide a substantial contribution to the manufacture of Product X. For this purpose, the activities of FS include the activities of Branch A or Branch B if either of those branches would not be treated as a separate corporation under paragraph (b)(1)(ii)(b) of this section, if that paragraph were applied to each of Branch A and Branch B.

Example 2. Multiple branches satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to the same product sold by the controlled foreign corporation. (i) Facts. Assume the same facts as in Example 1, except for the following. In addition to the design of Product X, Branch A also manufactures (within the meaning of paragraph (a)(4)(ii) of this section) a part of Product X. Branch C then combines that part with other parts to complete Product X. The activities of Branch C are sufficient to qualify as manufacturing under paragraph (a)(4)(iii) of this section with respect to Product X. Country A imposes an effective rate of tax of 12% on sales income.

(ii) Result. Because the activities of Branch A and Branch C satisfy the requirements of paragraph (a)(4)(ii) and (iii) of this section respectively, paragraph (b)(1)(ii)(b) of this section is applied by comparing the effective rate of tax imposed on the income from the sales of Product X against the lowest effective rate of tax that would apply to the sales income in either Country A or Country C if paragraph (b)(1)(ii)(b) of this section were applied separately to Branch A and Branch C. The effective rate of tax in Country B is not

considered because Branch B does not satisfy either paragraph (a)(4)(ii) or (a)(4)(iii) of this section. Because the effective rate of tax on the sales income of FS from the sale of Product X (10%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in which Branch A is located (12%), neither Branch A nor Branch C is treated as a separate corporation and sales of Product X by the remainder of the controlled foreign corporation are not treated as made on behalf of any branch.

Example 3. Predominant contribution by employees located in the country of organization of the controlled foreign corporation, traveling employees, paragraph (a)(4)(iii) of this section satisfied by an unrelated contract manufacturer. (i) Facts. FS, a controlled foreign corporation organized in Country M, purchases raw materials from a related person. The raw materials are then manufactured (under the principles of paragraph (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation located in Country C that performs the physical conversion pursuant to a contract manufacturing arrangement. Employees of FS located in Country M sell Product X to unrelated persons for use, consumption or disposition outside of Country M. Employees of FS located in Country M engage in design, testing, quality control and oversight with respect to the manufacture of Product X. Employees of FS located in Country M also direct the use of intellectual property used in the manufacture of Product X from Country M. At all times, employees of FS located in Country M control the raw material, work-in-process and finished goods. Employees of FS located in Country M also control logistics, select vendors, and manage the risk of loss from the manufacture of Product X and the manufacturing profits from Product X. Quality control and oversight of the manufacturing process is conducted by employees of FS who are employed in country M but who regularly travel to Country C. Branch A, located in Country A, is the only branch of FS. Design work with respect to Product X conducted by Branch A is supplemental to the bulk of the design work, which is done by employees of FS located in Country M. FS as a whole (including Branch A) provides a substantial contribution to the manufacture of Product X within the meaning of paragraph (a)(4)(iv) of this section.

(ii) Result. FS qualifies for the exception to foreign base company sales income contained in paragraph (a)(4) of this section with respect to income from the sale of Product X because FS satisfies the test contained in paragraph (a)(4)(iv) of this section by providing a substantial contribution through the activities of its employees to the manufacture of Product X. The fact that employees of FS travel to the location of CM to perform some of the activities considered in determining whether a controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacturing of an item of personal property does not prevent activities of such employees while located in Country M from being considered in determining the applicability of paragraph (a)(4)(iv) of this section to FS. In addition, paragraph (b) of this section does not apply to treat a branch of FS as having substantially the same tax effect as if the branch were a wholly owned subsidiary corporation, because FS, as opposed to Branch A, provides the predominant contribution with respect to Product X.

Example 4. Multiple branches perform manufacturing activities, no branch makes a predominant contribution, paragraph (a)(4)(iii) of

this section is satisfied by an unrelated contract manufacturer. (i) Facts. FS, a controlled foreign corporation organized in Country M, purchases raw materials from a related person. The raw materials are then manufactured (under the principles of paragraph (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation located in Country C that performs the physical conversion pursuant to a contract manufacturing arrangement. Employees of FS located in Country M sell Product X to unrelated persons for use, consumption or disposition outside of Country M. FS has two branches, Branch A and Branch B, located in Country A and Country B respectively. FS (including Branch A and Branch B) makes a substantial contribution within the meaning of paragraph (a)(4)(iv) of this section with respect to the manufacture of Product X. Branch A, through the activities of its employees, designs Product X. Branch B, through the activities of its employees, provides quality control and oversight of the manufacturing process. At all times, FS controls the raw materials, work-in-process and the finished Product X through employees located in Country M. FS also manages the risk of loss related to the manufacture of Product X and the manufacturing profits from the sales of Product X through employees located in Country M. Further, employees of FS located in Country M control logistics, select vendors, and oversee the coordination between the branches. Country M imposes an effective rate of tax on sales income of 10%. Country A imposes an effective rate of tax on sales income of 20% and Country B imposes an effective rate of tax on sales income of 24%.

(ii) Result. Based on the facts, neither the remainder of FS (through activities of its employees in Country M), nor Branch A, nor Branch B, provide a predominant amount of the controlled foreign corporation's substantial contribution to the manufacture of Product X. FS, Branch A, and Branch B each provide a contribution through the activities of their employees to the manufacture of Product X. Accordingly, paragraph (b)(1)(ii)(b) of this section is applied by comparing the effective rate of tax imposed on the income from the sales of Product X against the effective rate of tax that would apply to the sales income in Branch B, which is located in the jurisdiction that would impose the highest effective rate of tax on the sales income (24%). Because the effective rate of tax imposed on the sales income by Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country B (24%) the remainder of FS is treated as selling on behalf of Branch B. Further, for purposes of determining whether the remainder of FS qualifies for any exception from foreign base company sales income, applying paragraph (b)(2)(ii)(a) of this section, the remainder of FS includes any branch of FS that would not, after the application of paragraph (b)(1)(ii)(b) of this section to such branch, be treated as a separate corporation. In this case, the effective rate of tax imposed on the sales income by Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country A (20%). Therefore, for purposes of determining foreign base company sales income, the remainder of FS does not include the activities of Branch A. The remainder of FS does not qualify for the manufacturing exception from foreign base company sales income contained in paragraph (a)(4)(iv) of this section. Because Product X is sold for use, consumption, or disposition outside of Country M, the income from the sale of Product X is foreign base company sales income.

Example 5. Multiple branches contribute to the manufacture of a

single product, one branch sells the product, the remainder of the controlled foreign corporation does not participate. (i) Facts. FS is a controlled foreign corporation organized in Country M, a country that imposes a 0% effective rate of tax on sales income. FS operates two branches, Branch A and Branch B, located respectively in Country A, a country that imposes a 30% effective rate of tax on income, and Country B, a country that imposes a 0% effective rate of tax on income. Branch A and Branch B each perform different activities with respect to the manufacture of Product X. Branch A, through the activities of a large number of its employees working at a state of the art facility, expends significant time and resources to design a sophisticated product, Product X. Branch B, through the activities of its employees, purchases raw materials from a related person and contracts with CM, an unrelated corporation located in Country C, to manufacture Product X. The raw materials are then manufactured (under the principles of paragraph (a)(4)(iii) of this section) into Product X by CM. Branch A, through the activities of its employees, directs the use of intellectual property it developed, including product designs, to provide quality control and oversight to CM with respect to the manufacture of Product X. Branch B controls the raw materials, work in process, and the finished Product X. Branch B manages the risk of loss with respect to Product X throughout the manufacturing process. Branch B also controls logistics and selects vendors in connection with Product X. Branch B then sells Product X to unrelated persons for use, consumption or disposition outside of Country M. FS (including Branch A and Branch B) provides a substantial contribution within the meaning of paragraph (a)(4)(iv) of this section with respect to the manufacture of Product X. FS does not provide a contribution to the manufacture of Product X through employees located in Country M.

(ii) Result. Based on the facts, neither Branch A nor Branch B provides the predominant amount of FS's contribution to the manufacture of Product X. Further, Branch A and Branch B each provide a contribution through the activities of its employees to the manufacture of Product X. Accordingly, paragraph (b)(1)(ii)(b) of this section is applied by comparing the effective rate of tax imposed on the income from the sales of Product X against the effective rate of tax that would apply to the sales income in Branch A, which is located in the jurisdiction that would impose the highest effective rate of tax on the sales income (30%). Because the effective rate of tax in Country B with respect to the sales income (0%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country A (30%), the seller, Branch B, is treated as selling on behalf of Branch A, which is treated as the remainder of FS pursuant to paragraph (b)(1)(ii)(c) of this section. Further, for purposes of determining whether the remainder of FS qualifies for any exception from foreign base company sales income, Branch B, treated as the remainder of FS, includes any branch or remainder of FS that would not, after the application of paragraph (b)(1)(ii)(b) of this section to such branch or (b)(1)(i)(b) of this section to such remainder of FS, be treated as a separate corporation. In this case, the effective rate of tax (0%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country A (30%), but not country M (0%). Therefore, for purposes of determining foreign base company sales income, Branch B, treated as the remainder of FS, does not include the activities of Branch A, but does include the activities of the remainder of FS located in Country M. However, since the remainder of FS in Country M

does not perform any activities related to the manufacture of Product X, the inclusion of the remainder of FS does not qualify Branch B for any exception from foreign base company sales income. Since the location of manufacturing of Product X is considered to be the location of Branch A rather than Branch B, Branch B, treated as the remainder of FS, does not qualify for the manufacturing exception from foreign base company sales income contained in paragraph (a)(4) of this section. Since the sale of Product X is for use, consumption, or disposition outside of Country B, the income from the sale of Product X is foreign base company sales income.

Example 6. Multiple branches contribute to the manufacture of a single product, the selling branch is located in the higher tax jurisdiction, the remainder of the controlled foreign corporation does not participate. (i) Facts. Assume the same facts as in Example 5 except that Branch B rather than Branch A is located in the jurisdiction that would impose the higher effective rate of tax on income from the sales of Product X.

(ii) Result. Based on the facts, neither Branch A nor Branch B provides the predominant amount of FS's contribution to the manufacture of Product X. Since Branch B is located in the jurisdiction that would impose the higher effective rate of tax on income from the sale of Product X, Branch B is considered to be the location of manufacturing of Product X for purposes of applying paragraph (b) of this section. Because all of the income from the sale of Product X is already taxed in Country B, the use of Branch B is not treated as having substantially the same tax effect as if Branch B were a wholly owned subsidiary corporation of FS, and therefore Branch B and the remainder of FS are not treated as separate corporations under paragraph (b)(1)(ii)(a) of this section for purposes of determining foreign base company sales income.

(2) * * *

(i) * * *

(b) Activities treated as performed on behalf of the remainder of corporation. With respect to purchasing or selling activities performed by or through the branch or similar establishment, such purchasing or selling activities will--

(1) With respect to personal property manufactured, produced, constructed, grown, or extracted by the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation); or

(2) With respect to personal property (other than property described in paragraph (b)(2)(i)(b)(1) of this section) purchased or sold, or purchased and sold, by the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation), be treated as performed on behalf of the remainder of the controlled foreign corporation.

(ii) * * *

(a) Treatment as separate corporations. * * * For purposes of applying the rules of this paragraph (b)(2)(ii), a branch or similar establishment of a controlled foreign corporation treated as a separate corporation purchasing or selling on behalf of the remainder

of the controlled foreign corporation under paragraph (b) (2) (ii) (b) of this section, or the remainder of the controlled foreign corporation treated as a separate corporation purchasing or selling on behalf of a branch or similar establishment of the controlled foreign corporation under paragraph (b) (2) (ii) (c) of this section, will exclude any other branch or similar establishment or remainder of the controlled foreign corporation that would be treated as a separate corporation (apart from the branch or similar establishment of a controlled foreign corporation that is treated as a separate purchasing or selling corporation under paragraph (b) (2) (ii) (b) of this section or the remainder of the controlled foreign corporation that is treated as a separate purchasing or selling corporation under paragraph (b) (2) (ii) (c) of this section) if the effective rate of tax imposed on the income of the purchasing or selling branch or similar establishment, or purchasing or selling remainder of the controlled foreign corporation, were tested against the effective rate of tax that would apply to such income if it were earned in the jurisdiction of such other branch or similar establishment or the remainder of the controlled foreign corporation under §1.954-3(b) (1) (i) (b) or (ii) (b) of this section.

(b) Activities treated as performed on behalf of the remainder of corporation.

With respect to purchasing or selling activities performed by or through the branch or similar establishment, such purchasing or selling activities will--

(1) With respect to personal property manufactured, produced, constructed, grown, or extracted by the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation); or

(2) With respect to personal property (other than property described in paragraph (b) (2) (ii) (b) (1) of this section) purchased or sold, or purchased and sold, by the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation), be treated as performed on behalf of the remainder of the controlled foreign corporation.

(c) Treatment of the use of a manufacturing branch by a controlled foreign corporation--(1) Activities treated as performed on behalf of branch. * * *

(2) Presumption where a controlled foreign corporation claims to satisfy the substantial contribution test and its own branch satisfies the physical manufacturing test. If a branch or similar establishment is considered to manufacture, produce, or construct an item of personal property under paragraph (a) (4) (ii) or (a) (4) (iii) of this section, the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation) will be presumed not to manufacture, produce, or construct that same item of personal property under paragraph (a) (4) (iv) of this section (even if it would have otherwise satisfied paragraph (a) (4) (iv) of this section with respect to such property). However, if a controlled foreign corporation demonstrates, to the satisfaction of the Commissioner, that the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation) makes a substantial contribution to the manufacture of that item of personal property

within the meaning of paragraph (a)(4)(iv) of this section, then the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation), if treated as a separate corporation apart from its manufacturing branch under paragraph (b)(2)(ii)(a) of this section, will be considered to manufacture, produce, or construct that item of personal property under paragraph (a)(4)(iv) of this section. The application of this paragraph (b)(2)(ii)(c)(2) may be illustrated by the following examples:

Example 1. Manufacturing branch, paragraph (b)(1)(ii)(b) satisfied.

(i) Facts. FS, a controlled foreign corporation organized in Country M, a country that imposes a 0% effective rate of tax on sales income, purchases raw materials from a related person. FS has one branch, Branch A, organized in Country A, a country that imposes a 30% effective rate of tax on sales income. The raw materials are manufactured (within the meaning of paragraph (a)(4)(iii) of this section) into Product X by Branch A. FS sells Product X for use, consumption, or disposition outside of Country M. Absent the application of paragraph (b)(2)(ii)(c)(2) of this section, the remainder of FS would also be considered a manufacturer of Product X under paragraph (a)(4)(iv) of this section. FS proves to the satisfaction of the Commissioner that the remainder of FS makes a substantial contribution to the manufacture of Product X.

(ii) Result. Since the effective rate of tax (0%) imposed on the sales income is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the jurisdiction of Branch A (30%), the seller, the remainder of FS is treated as a separate corporation selling on behalf of Branch A. The remainder of FS (not including Branch A) does not satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. If the manufacturing activities undertaken with respect to Product X between the time the raw materials were purchased and the time Product X was sold were undertaken by the remainder of FS (not including Branch A) through the activities of its employees, the remainder of FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(iii) of this section with respect to Product X. Therefore, paragraph (a)(4)(iv) of this section applies. Because FS has successfully rebutted the presumption of paragraph (b)(2)(ii)(c)(2) of this section by proving to the satisfaction of the Commissioner that the remainder of FS makes a substantial contribution to the manufacture (within the meaning of paragraph (a)(4)(iv) of this section) of Product X, it qualifies for the exception in paragraph (a)(4)(iv) of this section with respect to Product X. Therefore income from the sale of Product X, when treated as sold by the remainder of FS on behalf of Branch A, is not determined to be foreign base company sales income.

Example 2. Manufacturing branch, paragraph (b)(1)(ii)(b) is not satisfied. (i) Facts. Assume the same facts as in Example 1, except that Branch A is located in Country B, a country that imposes a 3% rate of tax on sales income.

(ii) Result. Paragraph (b)(1)(ii)(b) of this section is not satisfied, because the effective rate of tax imposed on the sales income in Country M (0%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the jurisdiction of Branch A (3%). Therefore, Branch A is not treated as a separate corporation for purposes of

determining foreign base company sales income. FS qualifies for the manufacturing exception in paragraph (a)(4) of this section because FS (including Branch A) satisfies paragraph (a)(4)(iii) of this section with respect to income from the sales of Product X.

* * * * *

(e) Comparison with ordinary treatment. With the exception of cases in which a controlled foreign corporation seeks to rely on paragraph (a)(4)(iv) of this section and is unsuccessful in rebutting the presumption created by paragraph (b)(2)(ii)(c)(2) of this section, income derived by a branch or similar establishment, or by the remainder of the controlled foreign corporation, will not be determined to be foreign base company sales income under paragraph (b) of this section if the income would not be so considered if it were derived by a separate controlled foreign corporation under like circumstances.

* * * * *

(4) * * *

Example 3. (i) Facts. Corporation E, a controlled foreign corporation incorporated under the laws of foreign Country X, is a wholly owned subsidiary of Corporation D, also a controlled foreign corporation incorporated under the laws of Country X. Corporation E maintains Branch B in foreign Country Y. Both corporations use the calendar year as the taxable year. In 1964, Corporation E's sole activity, carried on through Branch B, consists of the purchase of articles manufactured in Country X by Corporation D, a related person, and the sale of the articles through Branch B to unrelated persons. 100 percent of the articles sold through Branch B are sold for use outside Country X and 90 percent are also sold for use outside of Country Y. The income of Corporation E derived by Branch B from such transactions is taxed to Corporation E by Country X only at the time Corporation E distributes such income to Corporation D and is then taxed on the basis of what the tax (a 40 percent effective rate) would have been if the income had been derived in 1964 by Corporation E from sources within Country X from doing business through a permanent establishment therein. Country Y levies an income tax at an effective rate of 50 percent on income derived from sources within such Country, but the income of Branch B for 1964 is effectively taxed by Country Y at a 5 percent rate since under the laws of such country, only 10 percent of Branch B's income is derived from sources within such country. Corporation E makes no distributions to Corporation D in 1964.

(ii) Result. In determining foreign base company sales income of Corporation E for 1964, Branch B is treated as a separate wholly owned subsidiary corporation of Corporation E, the 5 percent rate of tax being less than 90 percent of, and at least 5 percentage points less than the 40 percent rate. Income derived by Branch B, treated as a separate corporation, from the purchase from a related person (Corporation D), of personal property manufactured outside of Country Y and sold for use, disposition, or consumption outside of Country Y constitutes foreign base company sales income. If, instead, Corporation D were unrelated to Corporation E, none of the income would be foreign base company sales income because Corporation E would be purchasing from and selling to unrelated persons and if Branch B were treated as a separate corporation it would likewise be

purchasing from and selling to unrelated persons. Alternatively, if Corporation D were related to Corporation E, but Branch B manufactured the articles prior to sale under the principles of paragraph (a)(4)(iv) of this section in conjunction with the manufacture of the articles (within the meaning of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) by an unrelated contract manufacturer, then the income would not be foreign base company sales income because Branch B, treated as a separate corporation, would qualify for the manufacturing exception under paragraph (a)(4)(i) of this section.

* * * * *

(d) Effective/applicability date. The second sentence of paragraph (a)(1)(i), the second sentence of paragraph (a)(1)(iii) Example 1, the first sentence of paragraph (a)(1)(iii) Example 2, the third sentence of paragraph (a)(2), paragraph (a)(4)(i), the first sentence of paragraph (a)(4)(ii), the first sentence of paragraph (a)(4)(iii), paragraph (a)(4)(iv), the last sentence of paragraph (a)(6), the last sentence of paragraph (b)(1)(ii)(a), paragraph (b)(1)(ii)(c)(2), paragraph (b)(1)(ii)(c)(3), paragraph (b)(2)(i)(b), the last sentence of paragraph (b)(2)(ii)(a), paragraph (b)(2)(ii)(b), paragraph (b)(2)(ii)(c)(2), paragraph (b)(2)(ii)(e), and paragraph (b)(4) Example 3 shall apply to taxable years of controlled foreign corporations beginning on or after the date these rules are published as final regulations in the Federal Register, and for taxable years of United States shareholders in which or with which such taxable years of the controlled foreign corporations end.

Linda E. Stiff,

Deputy Commissioner for Services and Enforcement.

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