

TEI-SJSU HIGH TECH TAX INSTITUTE

RECENT SUBPART F DEVELOPMENTS NOVEMBER 9, 2015

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Topics

1. Substantial Contribution to Manufacturing
 - a. Emerging Controversies
 - b. Application of Substantial Contribution Rule to Commissions
 - c. Manufacturing Branch Rule
2. Tax Rate Disparity Test
3. Foreign Personal Holding Company Regulations

Substantial Contribution To Manufacturing

Overview of the Manufacturing Exception in the Regulations (2009).

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 (“manufactured”) by the CFC. Treas. Reg. §1.954-3(a)(4).

A CFC will have manufactured property which it sells only if it either: (1) substantially transforms property; (2) engages in activities generally considered to constitute manufacture, which are substantial in nature; or (3) makes a substantial contribution, through its employees, to the manufacture of personal property.

Substantial Contribution To Manufacturing

Substantial Contribution to Manufacturing.

There are two aspects to this test.

- (1) If an **item of personal property would be considered manufactured prior to sale by a CFC** if all the manufacturing prior to sale had been undertaken by the CFC through the activities of its employees, (the “manufacturing requirement’), then the substantial contribution rule will potentially apply.
- (2) Whether the substantial contribution rule causes the CFC to be treated as a manufacturer of personal property depends upon whether **the CFC makes a substantial contribution to manufacturing through its employees.**

Substantial Contribution To Manufacturing

Substantial Contribution to Manufacturing.

CFC Activities

The determination of whether a CFC makes a substantial contribution through the activities of its employees to the manufacture of the personal property sold involves, but will not necessarily be limited to seven activities.

Substantial Contribution To Manufacturing

Substantial Contribution to Manufacturing.

CFC Activities.

The seven activities Treasury identified as non-exclusive examples are as follows:

- (1) Oversight and direction of manufacturing;
- (2) Substantial transformation and manufacture of a product comprised of components;
- (3) Material selection, vendor selection, or control of raw materials, work-in-process or finished goods;
- (4) Management of manufacturing costs or capacities;
- (5) Control of manufacturing related logistics;
- (6) Quality control;
- (7) Developing, or directing use or development of product design, and design specifications, as well as trade secrets, technology, or other intellectual property for the purpose of manufacturing.

Substantial Contribution To Manufacturing

a. Emerging Controversies

- Common Exam arguments include:
 - Erroneous “autonomous contribution” test
 - Erroneous time or experience requirements
 - Erroneous “ultimate decision-making” arguments
 - Erroneous use of relativity
- Exam frequently challenging who qualifies as an “employee”
 - Exam asserts that it is not sufficient for individual to physically move – the employment relationship must change
 - Secondment arrangements subject to increased scrutiny
- Taxpayers bear the burden; contemporaneous documentation is critical

Substantial Contribution To Manufacturing

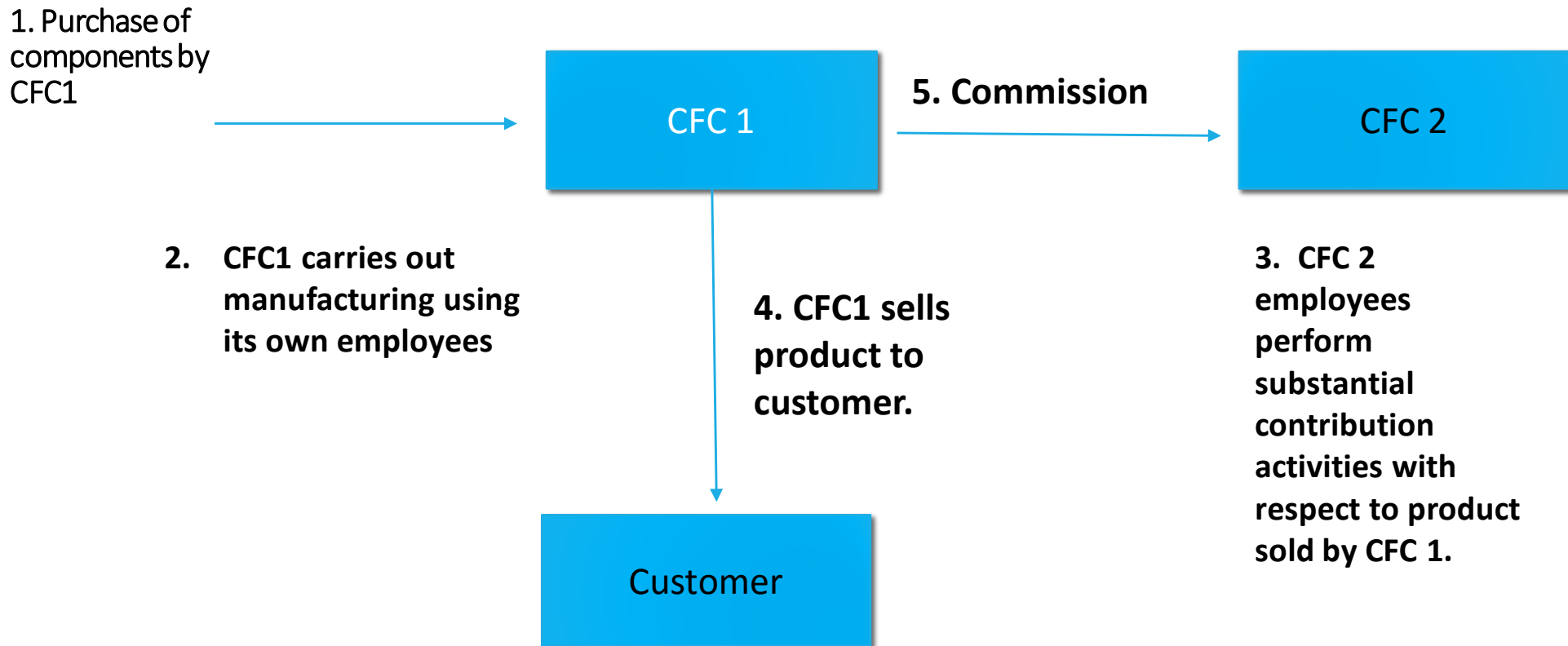
a. Emerging Controversies

- Appeals is now considering first wave of cases under the substantial contribution regulations
 - Understanding Appeals' assessment of the "hazards of litigation" important for taxpayers in both controversy and planning contexts
- National office involvement and potential for additional published guidance
- The battle lines are being drawn
- Litigation will likely be required to correct Exam's narrow interpretation of "substantial contribution"

Substantial Contribution To Manufacturing

b. Application of Substantial Contribution Rule To Commissions

What Does the Regulation Mean When it Refers to Substantial Contribution Activities “Prior to sale by [the] CFC”?



Substantial Contribution To Manufacturing

b. Application of Substantial Contribution Rule to Commissions

Substantial Contribution to Manufacturing in Commission Situations

Substantial Contribution Activities “Prior to sale by [the] CFC”

That question was answered by PLRs 201325005 and PLR 201332007. Those rulings held that if a CFC that receives sales commission income (or procurement commission income) performs substantial assistance through its employees with respect to property that is otherwise manufactured, then such commission income may avoid being treated as foreign base company sales income.

Substantial Contribution To Manufacturing

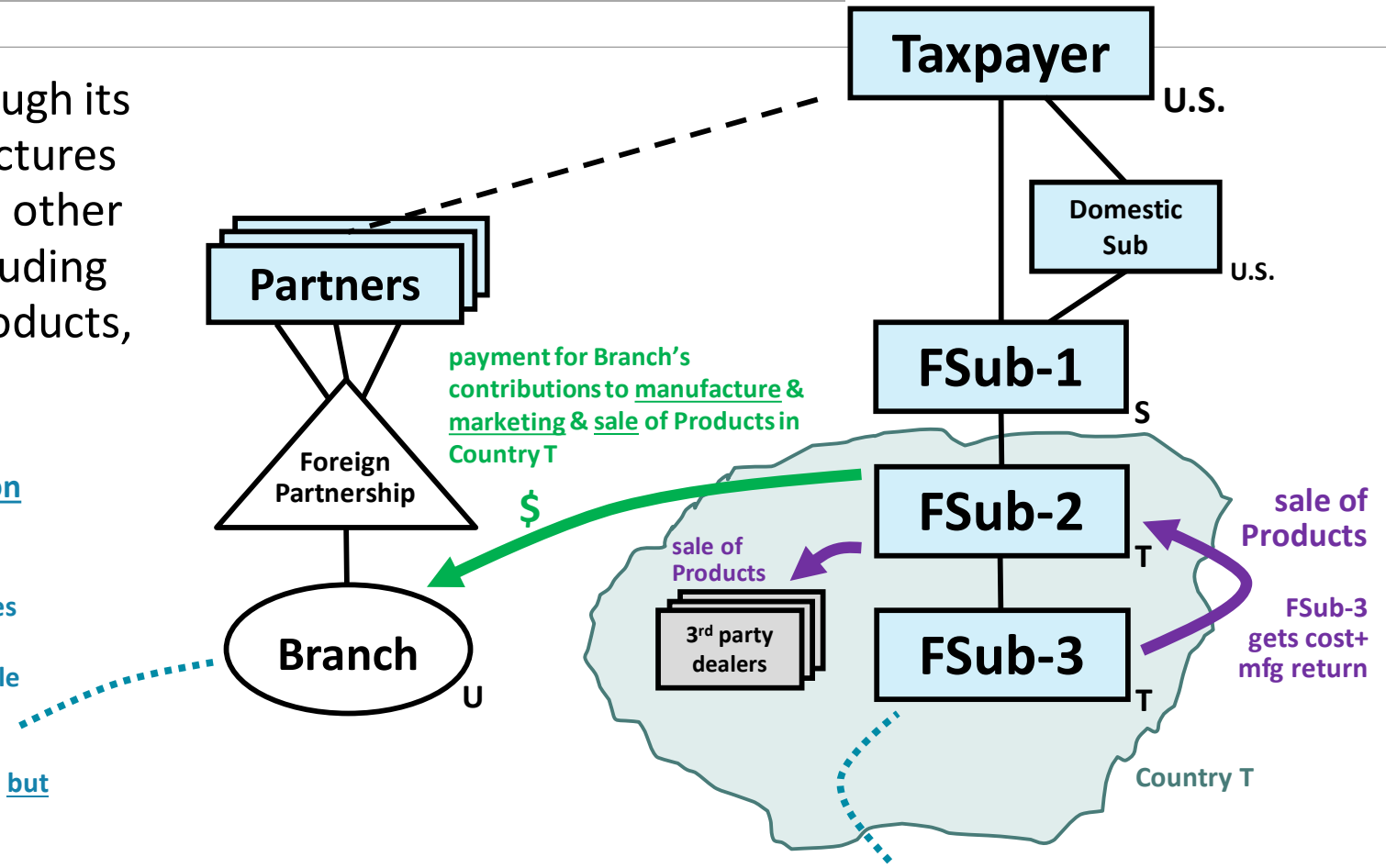
b. Application of Substantial Contribution Rule to Commissions

LTR 201325005—substantial contribution

- Taxpayer through its subs, manufactures Products, and other products, including Additional Products, in Country T.

Branch makes a substantial contribution to manufacture of Products sold in Country T—

- ◇ Country U employees perform mfg activities wrt Products [-]
- ◇ “Branch performs selling activities [wrt] sale of the Products in Country T”
- ◇ Branch is “significantly involved” in mfg, marketing, & selling activities wrt Product, but Branch doesn’t take “legal title” to raws materials, W-I-P, or finished goods for Products sold in Country T



Performs §§ 1.954-3(a)(4)(ii) & (iii) physical manufacturing with respect to Products sold in Country T

Substantial Contribution To Manufacturing

Substantial Contribution to Manufacturing in Commission Situations

Substantial Contribution Activities “Prior to Sale” by [the] CFC.

PLR 201325008

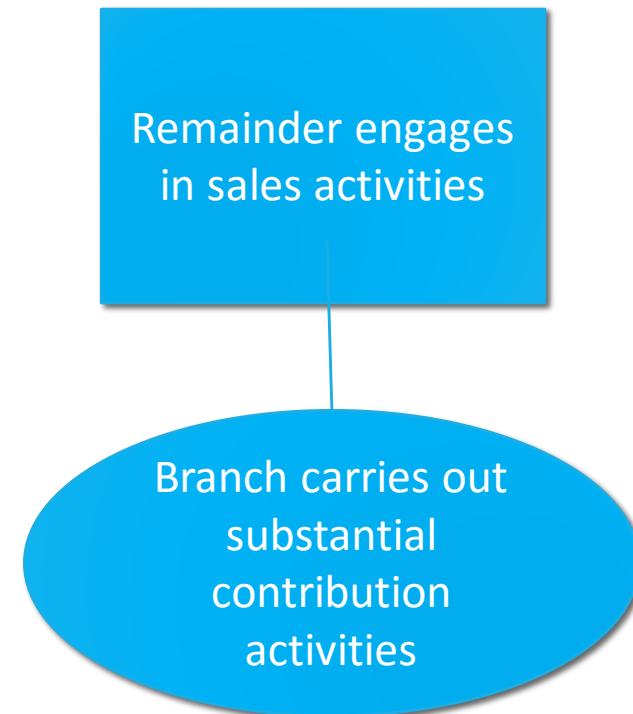
EXPLANATION OF LANGUAGE REQUIRING SUBSTANTIAL ACTIVITIES BEFORE SALE.

The ruling addressed the language in the regulation that the substantial contributor was to make the substantial contribution “prior to selling the product”. The ruling stated that the references in the regulations must be construed consistently with the statute and that the statute referred to “sales income” from selling activities. **The ruling continued that the term “sale” should be interpreted to include the performance of sales activities on behalf of a related person. Therefore an entity that performs sales activities and is compensated with a commission is eligible to carry out substantial contribution activities.**

Substantial Contribution To Manufacturing

Manufacturing Branch Rule

The [manufacturing branch rule] will apply only if 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 [Treas. Reg. §1.954-3 (a)(4)(i)] this section, or carries on growing or extracting activities with respect to such personal property.



Substantial Contribution To Manufacturing

Substantial Contribution to Manufacturing in Commission Situations

Substantial Contribution Activities “Prior to Sale” by [the] CFC.

PLR 201325008

Manufacturing Branch Rule

The ruling does not mention the manufacturing branch rule. That rule does not apply to the facts of the ruling because both the manufacturing and selling activities were in the branch. No income would have been allocated to the remainder.

Tax Rate Disparity Test

Tax Rate Disparity Test

Overview

The manufacturing branch rule and sales branch rule take the same two-step approach to determining whether tax rate disparity exists for purposes of determining whether a branch has the same effect as a wholly owned subsidiary corporation. First, the tax rate disparity special rules are applied to determine whether the remainder of a CFC, that undertakes sales or purchasing activities, does so on behalf of a manufacturing branch. Next, the tax rate disparity test is applied.

Tax Rate Disparity Test

Overview

The tax rate disparity test, in the case of a manufacturing branch, is applied to compare the tax rates in the sales country and the manufacturing country to determine if income is shifted away from the manufacturing country to the country where sales occur so that a substantially lower rate of tax is applied to the sales income in the sales country.

Tax Rate Disparity Test

Overview

The regulations determine whether a tax rate disparity exists by comparing what the ERT would actually be on the sales income in the sales jurisdiction with what the ERT would have been on the sales income (hypothetically) if the sales had occurred in the manufacturing country.

Tax Rate Disparity Test

Computation of Tax Rate Disparity

The use of the branch for manufacturing activities will be considered to have substantially the same tax effect as if it were a wholly owned subsidiary corporation of the CFC “if income allocated to the remainder of the controlled foreign corporation 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 effective rate of tax which would apply to such income under the laws of the country in which the manufacturing branch or similar establishment is located”. Treas. Reg. §1.954-3(b)(1)(ii)(b).

Tax Rate Disparity Test

Computation of Tax Rate Disparity

The determination of the tax rate on the remainder's income in the manufacturing branch country is made as if, under the laws of the manufacturing branch country, the entire income of the CFC were considered derived by the branch from sources within such branch country from doing business through a permanent establishment, and the corporation were managed and controlled in such country. Treas. Reg. §1.954-3(b)(1)(ii)(b).

Tax Rate Disparity Test

Computation of Tax Rate Disparity

Income Base to Be Used for Purposes of Tax Rate Disparity Test.

As was noted in the previous slides, the “tax rate disparity test”, requires that the actual, effective, tax rate on income in the branch jurisdiction be compared [-] to the hypothetical tax rate that would be imposed upon the income. One way to do that would be to merely compare the tax rates in the two jurisdictions. (The “direct comparison of rates method”.) This is the approach taken by the examples in the regulations.

To illustrate, the example in Treas. Reg. §1.954-3(b)(ii)(c) involves a manufacturing branch (A) in a country with an ERT of 20% and two sales branches with ERTs of 20% (B) and 18% (C). The example states: “The use of Branch B does not have the same tax effect as if Branch B were a wholly owned subsidiary of FS because the tax rate applicable to the income allocated to Branch B... (20%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax which would apply to such income under the laws of Country A (20%), the country in which Branch A [manufacturing] is located.”

Tax Rate Disparity Test

Computation of Tax Rate Disparity

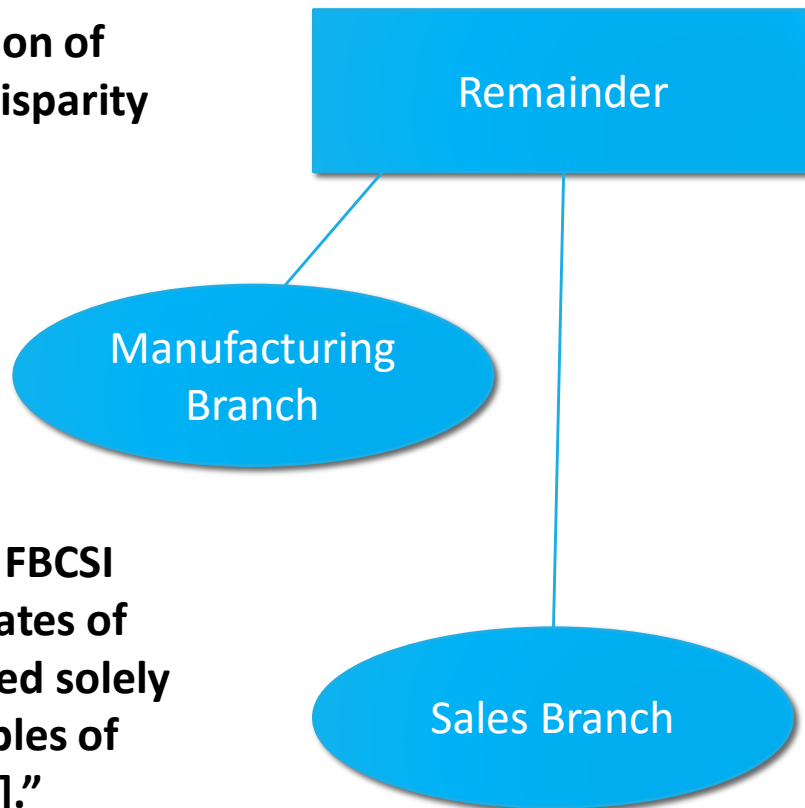
Income Base to Be Used for Purposes of Tax Rate Disparity Test.

However, situations arise in which the amount of taxable income in the selling and manufacturing jurisdictions differ because of differences in the tax laws of the two countries. In those instances, the question arises of whether a different approach is required to the tax rate disparity analysis so that more is done than a comparison of tax rates in the relevant jurisdictions. The IRS has issued conflicting guidance as to how the relevant tax rates is to be determined in those situations.

The next two slides illustrate the “local law” approach that is taken in recent private letter rulings. The third slide illustrates the Services new “same income base” approach.

Tax Rate Disparity Test

Computation of Tax Rate Disparity



PLR 200945036-
“Determination of FBCSI
and the effective rates of
tax... are determined solely
under... law principles of
[the two countries].”

Manufacturing Branch obtains APA under which its income is \$50. Manufacturing branch country **tax imposed at rate of 20%. Tax imposed on branch is \$10.** Tax rate is determined by the fraction $10/50=20\%$.

Sales branch obtains APA under which its income is \$60. Sales **Branch tax rate is imposed at rate of 20%. Branch income tax is \$12.** Tax rate is determined by the fraction $20/100=20\%$.

Implicit Conclusion: no tax rate disparity because tax rates are both 20%.

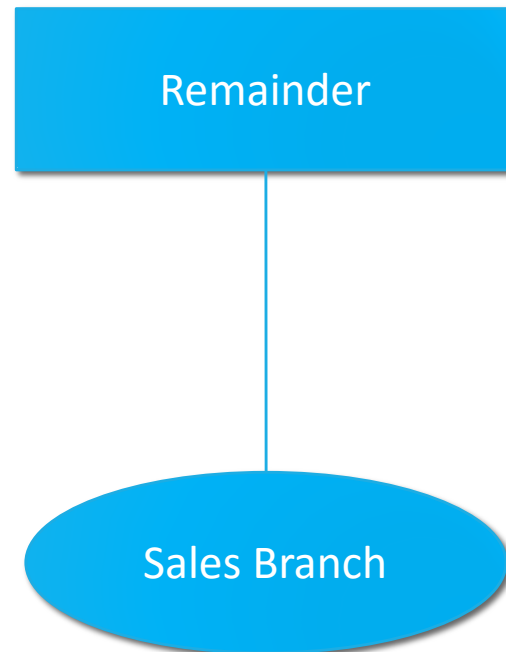
Tax Rate Disparity Test

Computation of Tax Rate Disparity

Remainder is obligor on interest bearing note.

Sales Branch incurs interest expense on Remainder's note.

PLR 200942034.



The issue in the ruling was whether interest expense with respect to note incurred by Sales Branch, which was allowed as deduction under Sale's Branch country tax law should be taken into account for purposes of tax rate disparity comparison.

The PLR concluded that the interest deduction should be taken into account according to laws of Country 2. "For [-] purposes of determining the effective rate of tax to which the sale income derived...is subject...the effective rate of tax is determined **by applying local law**. The effective rate of tax ... is calculated by ...taking the ...income taxes paid by [Sales Branch] attributable to its FBCSI, which may require adjustments to allocate or apportion expenses in accordance with [Sales Branch Country Laws]."

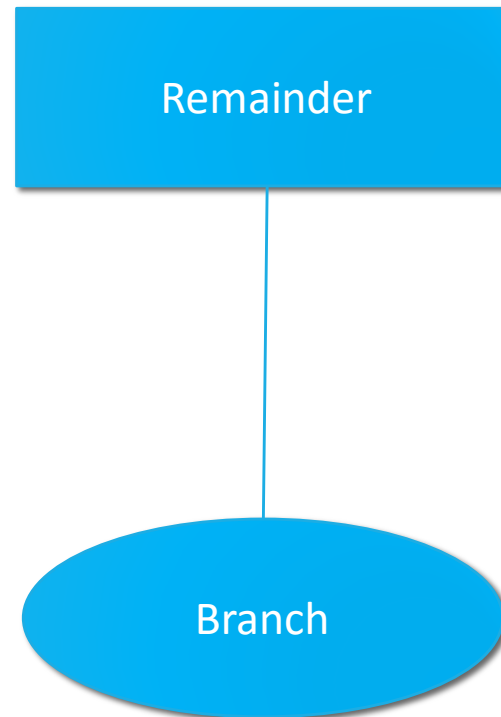
Tax Rate Disparity Test

Computation of Tax Rate Disparity

Chief Counsel Advice 2015-002. “An appropriate common tax base must be used....[T]he most appropriate method of computing the actual ERT and the hypothetical ERT is to use the hypothetical sales income tax base of the manufacturing jurisdiction.”

Remainder is engaged in sales activities.

Branch engages in manufacturing activities.



Sales income is \$50. Home country tax imposed at rate of 20%. Tax is \$10. **Tax rate used for the tax rate disparity test per the CCA is determined by the fraction $10/100=10\%$**

Branch income is \$100. Branch tax rate is imposed at rate of 20%. Branch income tax is \$20. Tax rate is determined by the fraction $20/100=20\%$

Conclusion: there is tax rate disparity because home country tax (on 100 of income) is 10 and branch tax is 20.

Tax Rate Disparity Test

Computation of Tax Rate Disparity

Rationale of Chief Counsel Advice 2015-02.

The approach taken in the CCA is that the same income base must be used for both the sales branch and the manufacturing branch in making the tax rate disparity comparison. The CCA is not so much based on the language of the regulation as it is based on what the CCA perceives to be the purpose of the branch rule. The CCA states:

1. For the comparison of tax rates to be appropriate a common income base must be used.
2. Using dissimilar tax bases would be contrary to the legislative purpose of §954(d).
3. The use of different tax bases would incentivize the shifting of income from the manufacturing jurisdiction to the sales jurisdiction (that grants exclusions and deductions).

Tax Rate Disparity Test

Computation of Tax Rate Disparity

Criticisms of Chief Counsel Advice 2015-02.

1. The regulations do not explicitly adopt the same income base approach.

The determination as to [tax rate disparity]...shall be made by allocating to the remainder of such controlled foreign corporation **only that income** derived by the remainder of such corporation [as is allocated under the special rules]....

The use of the branch ... for such activities will be considered to have substantially the same tax effect as if it were a wholly owned subsidiary corporation of the controlled foreign corporation **if income allocated to the remainder of the controlled foreign corporation** under the immediately preceding sentence 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 effective rate of tax which would apply **to such income** under the laws of the country in which the branch or similar establishment is located, 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....

Tax Rate Disparity Test

Computation of Tax Rate Disparity

Criticisms of Chief Counsel Advice 2015-02 - Continued

2. The examples contained in the branch rule regulations do not use the same income base approach.
3. The regulations have previously been interpreted by the Service not to use the same income base approach. PLR 200942034 (October 16, 2009) and PLR 200945036 (November 6, 2009).

Foreign Personal Holding Company Income Regulations

Temporary FPHCI regs—active conduct of a trade or business exception

Subparagraph 954(c)(1)(A) provides that FPHCI generally includes rents and royalties gross income; but there's an exception for certain rents and royalties a CFC gets from an unrelated person:

(c) FOREIGN PERSONAL HOLDING COMPANY INCOME.—

(1) IN GENERAL.—For purposes of [§ 954(a)(1)], the term [FPHCI] means the portion of gross income which consists of:

(A) DIVIDENDS, ETC. Dividends, interest, royalties, rents, and annuities.

* * *

(2) EXCEPTION FOR CERTAIN AMOUNTS.—

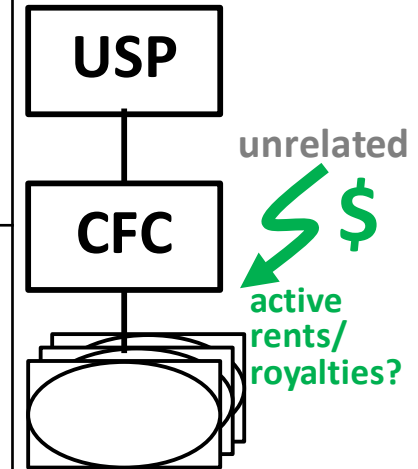
(A) RENTS AND ROYALTIES DERIVED IN ACTIVE BUSINESS. [FPHCI] shall not include rents and royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person

Temporary FPHCI regs—active conduct of a trade or business exception [cont'd]

T.D. 9733, September 2, 2015—policy considerations ⇒

- ◇ CFC must perform activities relevant to “active development” tests through its own officers or employees to qualify for active rents and royalties exception; and
- ◇ CFC can perform relevant activities in more than one foreign country.

income \ test	rents	royalties
active development tests	Property that the lessor, <u>through its own officers or staff of employees</u> , has manufactured or produced, or property that the lessor has acquired and, <u>through its own officers or staff of employees</u> , added substantial value to, but only if the lessor, <u>through its officers or staff of employees</u> , is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind;	Property that the licensor, <u>through its own officers or staff of employees</u> , has developed, created, or produced, or property that the licensor has acquired and, <u>through its own officers or staff of employees</u> , added substantial value to, but only so long as the licensor, <u>through its officers or staff of employees</u> , is regularly engaged in the development, creation, or production of, or in the acquisition and addition of substantial value to, property of such kind;
active marketing test	Property that is leased as a result of the performance of marketing functions by such lessor <u>through its own officers or staff of employees located in a foreign country or countries</u> , if the lessor, through its officers or staff of employees, maintains and operates an <u>organization either</u> in such country <u>or in such countries (collectively), as applicable</u> , that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property <u>and that is substantial in relation to the amount of rents</u> derived from the leasing of such property.	Property that is licensed as a result of the performance of marketing functions by such licensor <u>through its own officers or staff of employees located in a foreign country or countries</u> , if the licensor, through its officers or staff of employees, maintains and operates an <u>organization either</u> in such foreign country <u>or in such foreign countries (collectively), as applicable</u> , that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property <u>and that is substantial in relation to the amount of royalties</u> derived from the licensing of such property.



Temporary FPHCI regs—active conduct of a trade or business exception [cont'd]

§ 1.482-7(j)(3) →

- ◇ CST payments generally will be considered the payor's costs of developing intangibles at the location where such development is conducted.
- ◇ PCT Payments will be considered either as consideration for a transfer of an interest in intangible property or for services.

income \ test	rents	royalties
active expenses	<p>The term active leasing expenses means the deductions incurred by an organization of the lessor in a foreign country that are properly allocable to rental income and that would be allowable under section 162 to the lessor if it were a domestic corporation, other than— * * *</p> <p><u>(E) Deductions for CST Payments or PCT Payments (as defined in § 1.482-7(b)).</u></p>	<p>The term active licensing expenses means the deductions incurred by an organization of the licensor in a foreign country that are properly allocable to royalty income and that would be allowable under section 162 to the licensor if it were a domestic corporation, other than— * * *</p> <p><u>(E) Deductions for CST Payments or PCT Payments (as defined in § 1.482-7(b)).</u></p>
CSAs	<p><u>(vii) Cost sharing arrangements (CSAs). For purposes of [§§ 1.954-2T(C)(1)(i) & (iv)] CST Payments or PCT Payments . . . made by the lessor to another controlled participant . . . pursuant to a CSA . . . do not cause the activities undertaken by that other controlled participant to be considered to be undertaken by the lessor's own officers or staff of employees.</u></p>	<p><u>(vii) Cost sharing arrangements (CSAs). For purposes of [§§ 1.954-2T(C)(1)(i) & (iv)] CST Payments or PCT Payments . . . made by the licensor to another controlled participant . . . pursuant to a CSA . . . do not cause the activities undertaken by that other controlled participant to be considered to be undertaken by the licensor's own officers or staff of employees.</u></p>

Substantiality of foreign operations—safe harbor:

active leasing/licensing expenses
 $\geq 25\% \times \text{active leasing/licensing profit}$

