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Subpart F Manufacturing Exception Applied to Products That Are Grown

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The IRS recently issued a ruling¹ concluding that, under certain circumstances, the “Subpart F”² manufacturing exception can apply to products that are grown (e.g., crops). The IRS further ruled that growing activities that also are production activities are taken into account for purposes of determining whether products sold are manufactured or produced by a controlled foreign corporation (CFC).

Under the facts of the ruling, a U.S. corporation (USP) indirectly wholly owns a CFC formed under the laws of Country X. CFC wholly owns another Country X entity, which is disregarded (DE1). DE1 wholly owns a third Country X entity which is disregarded (DE2), collectively the “CFC Group” or the “CFC.”

CFC Group produces final stage products (the Final Stage Products) in four phases. During the initial phase, CFC makes decisions as to the types of product traits that are needed to meet demand and provide market opportunities. CFC enters into cost-plus arrangements with related and unrelated persons for research and development, as a result of which intellectual property is developed for the risk and account of CFC, and ultimately the Stage A products are developed.

During the second phase, the Stage A Products are planted, and the Stage B Products are harvested from the resulting crop grown from the Stage A Products. During the third phase, the Stage B Products are planted, and the Stage C Products are harvested from the resulting crop grown from the Stage B Products.

CFC Group directly produces some of the Stage B and Stage C Products in Country X or in jurisdictions outside of Country X. CFC Group also contracts with related persons or unrelated persons pursuant to contract manufacturing or toll manufacturing arrangements to produce the Stage B and Stage C Products in jurisdictions outside of Country X. If a contract manufacturing arrangement is used, CFC Group may transfer title of the Stage A or Stage B Products to the contracting party in exchange for a nominal amount. Thus, during the growing and harvesting processes, legal title to the Stage B or Stage C Products is held either by CFC Group or by the contracting party. In cases where title is transferred to the contracting party, title to the Stage B or Stage C Products is subsequently transferred for a nominal amount to CFC Group, and the contracting party is remunerated by CFC Group through a fee.

During the fourth phase, the Stage C Products are organized at processing facilities for final cleaning, quality assessment, and packaging based on relevant marketing requirements. CFC Group either performs these activities directly, or contracts with a related person to perform these activities in a jurisdiction outside of Country X in exchange for a fee. At the conclusion of the fourth phase, the Stage C Products are in their final form. CFC Group sells the Final Stage Products to related persons and unrelated persons for use in jurisdictions inside and outside of Country X.

¹ PLR 201340010.

² §§951–964.

“Subpart F income” generally includes income derived by a CFC from selling to any person products purchased from related persons, or selling products to related persons that were purchased from any person, i.e., foreign base company sales income (FBCSI).³ Nevertheless, income derived by a CFC from the sale of products that it manufactures or produces is excluded from the definition of FBCSI, subject to the branch rule.

More specifically, FBCSI generally does not include income of a CFC derived in connection with personal property “manufactured, produced, or constructed by such corporation.” A CFC will have manufactured or produced such property if it meets either a physical manufacturing or production test, or the CFC substantially contributes to the physical manufacture or production of the property. Only the activities of the CFC’s employees are taken into account for this purpose.⁴

The regulations provide that property is considered as physically manufactured if:

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

Minor assembly and packaging do not qualify as manufacturing.⁵ The Tax Court, however, has broadly interpreted this definition of manufacturing (e.g., assembly of sunglasses qualified as manufacturing).⁶

The regulations further provide that property physically “manufactured, produced or constructed” taking into account activities of a contract manufacturer on behalf of a CFC will be considered as manufactured by the CFC if the facts and circumstances evince that the CFC makes a substantial contribution through the activities of its employees to the manufacture or production of the personal property sold. The regulations list a number of factors that are taken into account for this purpose, including quality control, oversight and direction, vendor selection, physical manufacturing activities, demand planning, management of manufac-

turing costs and capacities, and control of manufacturing-related logistics.

The IRS ruling states that certain income the CFC derives from selling Final Stage Products meets the definition of FBCSI “because the income is derived in connection with the purchase of personal property from a related person, or a sale of personal property to a related person.” Nevertheless, income derived from the sale of Final Stage Products would not be FBCSI to the extent the manufacturing exception applies (subject to the branch rule).⁸

The manufacturing exception would apply if the activities of the employees of CFC and its disregarded entities satisfy the physical manufacturing definition with respect to Final Stage Products that are sold. In addition, the manufacturing exception would apply if the physical manufacturing definition is satisfied taking into account the activities of the contract manufacturers hired by CFC Group and CFC Group substantially contributes to the manufacture or production of the Final Stage Products.

The ruling addressed whether the manufacturing exception is available for products that are grown and, if so, how to determine whether such products are considered as physically “manufactured or produced” by CFC Group or the contract manufacturers.

The issues particularly require analysis because other FBCSI rules expressly refer to products that are grown, while no such reference is contained in the rules providing the manufacturing exception. For example, FBCSI does not include income from the sale of property that “is manufactured, produced, constructed, *grown* or extracted” in the CFC’s country of organization.⁹

In addition, the manufacturing branch rule refers to products that are grown. That rule can apply with respect to “personal property manufactured, produced, constructed, *grown* or extracted by or through a foreign branch.”¹⁰ Thus, a CFC that grows products in a foreign branch can have a “manufacturing branch.”¹¹

The ruling first notes that the regulations do not specifically address whether income derived from the

⁷ Regs. §1.954-3(a)(4)(iv). See Yoder, “Subpart F: Indicia of Manufacturing,” 38 *Tax Mgmt. Int’l J.* 642 (10/9/09).

⁸ The ruling does not address the branch rule. §954(d)(2); Regs. §1.954-3(b).

⁹ Regs. §1.954-3(a)(2) (emphasis added). This phrase is also in §954(d)(1)(A).

¹⁰ Regs. §1.954-3(b)(1)(ii)(a) (emphasis added); see also Regs. §1.954-3(b)(1)(ii)(c). The Code does not contain this language because it does not provide a manufacturing branch rule.

¹¹ See also Regs. §1.954-3(a)(1)(ii) (special rule for agricultural commodities). Other rules of the Code that have provided an export or domestic manufacturing incentive referring to manufacturing and production also have included a reference to products that are grown. See §993(c) (Domestic International Sales Corporation (DISC) rules); §927(a)(1)(C) (Foreign Sales Corporation rules);

³ §954(d); Regs. §1.954-3(a)(1).

⁴ Regs. §1.954-3(a)(4)(i).

⁵ Regs. §1.954-3(a)(4)(ii) and (iii).

⁶ *Bausch & Lomb, Inc. v. Commissioner*, 71 T.C.M. 2031 (1996); see also *Dave Fischbein Mfg. Co. v. Commissioner*, 59 T.C. 338 (1972) (assembly of bag-closing machine in six-hour, 58-step process met definition of manufacturing).

sale of products grown by a CFC is excluded from FBCSI pursuant to the manufacturing exception. Nevertheless, the ruling states that property that is grown may also be considered as manufactured or produced and thus income from the sale of such property can qualify for the manufacturing exception.

The ruling points out, however, that the terms “produced” and “grown” are not interchangeable. The mere fact that property is “grown” does not mean that it will be considered as “produced” for purpose of the manufacturing exception.

The ruling further states that the terms “grow” and “produce” are not mutually exclusive. The use of the term “grow” to describe a process or part of a process is not determinative of whether the process constitutes a production activity. Rather, growing activities that also are producing activities are taken into account for purposes of applying the manufacturing exception.

In sum, for products that are grown, in applying the manufacturing exception the determination is whether the products are also considered as manufactured or produced within the meaning of the manufacturing exception. This is a facts and circumstances test. If a particular activity is a producing activity, it is taken into account, even if such activity may also be considered as a growing activity.

The ruling specifically states that activities — of CFC Group and contract manufacturers — related to the physical growing of the Stage B and Stage C Products that constitute production activities are taken into account in determining whether CFC produced the Final Stage Products for purposes of the manufacturing exception. Thus, taking into account such activities performed by the CFC itself may cause the CFC to satisfy the physical manufacturing or producing definition. In addition, taking into account such activities performed by the contract manufacturers may cause the Final Stage Products to be considered as physically manufactured or produced for purposes of qualifying for the substantial contribution definition of manufacturing.

The taxpayer represented that CFC Group’s activities with respect to the Final Stage Products constituted production if activities that are both growing and production activities are taken into account in determining whether a CFC has “produced” property for purposes of the manufacturing exception.

Based on the information submitted and the representations made, the ruling concluded that income derived by CFC Group from the sale of Final Stage Products produced by CFC Group that otherwise is

§941(a)(1)(A) (Extraterritorial Income rules); §199(c)(4)(A) (deduction for domestic production activities).

FBCSI is excluded from FBCSI pursuant to the manufacturing and producing exception.

The ruling did not address the types of growing activities that also are considered as producing activities. It would seem that production activities in this context should be broadly defined. This would be consistent with the same-country-of-manufacturing exception as well as the manufacturing branch rule, which both treat growing itself as equivalent to manufacturing or producing.¹² An inclusive definition of “production activities” would also be consistent with case law, which has broadly defined physical manufacturing and production for purposes of the Subpart F manufacturing exception.¹³ Thus, it would seem appropriate that where a CFC engages in substantial activities (directly or through contract manufacturers) related to growing and preparing products for sale, that the CFC should be considered as producing the property sold.¹⁴

The ruling appears to analyze the application of the manufacturing exception to the sale of the Final Stage Products by aggregating activities undertaken at all four phases. Thus, all production activities performed by CFC Group and by all contract manufacturers, and all substantial contribution activities performed by CFC Group during all four phases of producing the Final Stage Products, should be taken into account for purposes of determining whether the Final Stage Products were manufactured or produced. This is the case whether or not different stage products are sold and repurchased from contract manufacturers for nominal amounts, and whether the products undergo transformation during a particular phase of production. All phases are considered as the process of producing the Final Stage Products for purposes of the manufacturing exception.

In sum, income from the sale of products that are grown can qualify for the manufacturing exception. For purposes of satisfying the physical manufacturing and producing definition, all production activities are

¹² Indeed, it would seem odd if a CFC is considered as having a manufacturing branch based on growing products in a branch, but then for that branch not to qualify for the manufacturing exception with respect to its own income from the sale of the products.

¹³ See Yoder, “Subpart F: LMSB Provides Guidance Concerning the Definition of Manufacturing,” 35 *Tax Mgmt. Int’l J.* 360 (7/14/06); Yoder, “The Subpart F Physical Manufacturing Exception,” 34 *Int’l Tax J.* 3 (Nov.–Dec. 2008); Yoder, “Bausch & Lomb: The ‘Manufacturing’ Exception to Foreign Base Company Sales Income,” 25 *Tax Mgmt. Int’l J.* 427 (4/29/96).

¹⁴ For application of a similar manufacturing or producing test under the DISC rules to products that are grown, see *Webb Export Corp. v. Commissioner*, 91 T.C. 131 (1988); *Garnac Grain Co. v. Commissioner*, 95 T.C. 7 (1990); Rev. Rul. 75-394, 1975-2 C.B. 311.

taken into account, even if such activities might also be considered as growing activities.