

Reproduced with permission from Tax Management International Journal, 43 TMIJ 496, 08/08/2014. Copyright © 2014 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

President's Budget Would Apply Subpart F to Toll Manufacturing Arrangements

By Lowell D. Yoder, Esq.
McDermott Will & Emery LLP
Chicago, Illinois

The Obama Administration's FY 2015 budget proposes to expand the definition of "foreign base company sales income" (FBCSI). The new rule would apply to income earned by a controlled foreign corporation (CFC) from selling products that a related person manufactures on its behalf.

The proposal targets the following structure. A CFC operates as a principal. It purchases raw materials and components from unrelated suppliers and consigns them to a related "toll" manufacturer to produce finished products. The CFC then sells the finished products to unrelated persons. The CFC principal pays the related toll manufacturer a fee for its services. The CFC principal may also pay service fees to related persons to assist with other supply chain functions, and typically would own or license the relevant intangible property.

Section 954(d)(1) provides, in relevant part, that income from the purchase and sale of property is FBCSI only if it is derived by a CFC in connection with either: (1) the purchase of personal property from a related person¹ and its sale to any person; or (2) the purchase of personal property from any person and its

¹ A person is related to a CFC if such person is controlled by the CFC or is controlled by the same persons that control the CFC. For this purpose, "control" means, with respect to a corpo-

sale to a related person.² Therefore, FBCSI generally does not include income derived by a CFC from selling products where the CFC does not purchase the products from a related person nor sell the products to a related person.³

In the above example, the CFC principal purchases the raw materials and components from unrelated suppliers and owns the property throughout the manufacturing process, and then sells the finished products to unrelated persons. Therefore, since the CFC neither purchases property from a related person, nor sells the finished products to a related person, its sales income is not FBCSI.⁴

The Tax Court has analyzed the above structure and held in favor of the taxpayer. In *Vetco, Inc. v. Com-*

ration, the direct or indirect ownership of more than 50% (by vote or value) of the stock of such corporation. §954(d)(3).

² Reg. §1.954-3(a)(1)(i). Section 954(d)(1) can also apply to commissions and fee income derived by a CFC from purchasing or selling products on behalf of a related person. The paradigm addressed herein involves a CFC that derives sales income from actually selling products.

³ Under certain circumstances a branch rule can apply to treat a portion of the CFC's income as FBCSI. §954(d)(2); Reg. §1.954-3(b).

⁴ See Reg. §1.954-3(b)(4), Ex. 3 (since "[Corporation] D [is] unrelated to [CFC] E, none of the income would be foreign base company sales income because [CFC] E [is] purchasing from and selling to unrelated persons. . ."). See NPRM, REG-124590-07, 73 Fed. Reg. 10716, 10722 (Feb. 28, 2008) ("NPRM") ("In addition, the result in [Reg.] §1.954-3(b)(4), Example 3 is further revised to add two alternative factual scenarios ([including a] purchase from an unrelated party. . .) to illustrate the point that, in general, a branch will not have FBCSI if a separate CFC would not have FBCSI under like circumstances.").

missioner,⁵ a Swiss CFC sold products manufactured on its behalf by a related U.K. CFC. The Swiss CFC purchased raw materials from unrelated suppliers, consigned them to the U.K. CFC which manufactured finished products, and then the Swiss CFC sold the products to unrelated customers. The Swiss CFC paid the U.K. CFC for procurement and manufacturing services. The Tax Court held that the sales income was not FBCSI.

The IRS asserted that the U.K. CFC should be treated as a manufacturing branch of the Swiss CFC for purposes of the branch rule of §954(d)(2) to create a related person transaction causing the Swiss CFC's income to become FBCSI. The Tax Court rejected the IRS's argument, holding that a separate corporation is not a branch.⁶

In its description of the Administration's proposal, the Treasury acknowledges in the Green Book⁷ that "[i]n order for the foreign base company sales income rules of subpart F to apply, a CFC generally must engage in both a purchase and subsequent sale of personal property where such property is either purchased from, or sold to, a related person." The Treasury further notes that "[u]nder current law, taxpayers take the position that a CFC can avoid foreign base company sales income by structuring the related party transaction by which the CFC obtains the property that the CFC sells to customers as the provision of a manufacturing service to the CFC rather than as a purchase of the property by the CFC."⁸

The Administration expresses concern with a related manufacturer being based in the United States. The Green Book observes that "[i]n some cases, taxpayers take this position with respect to property produced in the United States on behalf of a related CFC." The Treasury states that the "policy concerns that underlie the foreign base company sales income rules" include "U.S. base erosion," and that such concerns "apply with respect to income earned by a CFC from the sale of property produced by a related party, regardless of whether the CFC is characterized as ob-

taining the property through a purchase transaction or through a manufacturing service."⁹

The Administration's proposal would expand the category of FBCSI to include income of a CFC from the sale of property manufactured on behalf of the CFC by a related person. Apparently, the CFC would be treated as purchasing the products it sells from a related person, i.e., the toll manufacturer. Under this construct, the transaction would effectively be recast from a services arrangement with the related manufacturer to a buy-sell arrangement.¹⁰

The exceptions to FBCSI would continue to apply. Accordingly, income otherwise subject to the new rule would not be FBCSI if the products are manufactured in a CFC's country of organization, or sold for use in a CFC's country of organization.¹¹ In addition, if a CFC manufactures the property it sells, then the proposal would not cause its income to be FBCSI.¹² For example, if a CFC principal substantially contributes to the manufacture of the property by a related toll manufacturer, then the CFC's income from selling the finished products would not be FBCSI.¹³

The proposal would not apply to other structures where the CFC does not purchase property from, nor sell property to, a related person. For example, it would not apply where a CFC purchases products from an unrelated contract manufacturer, and then sells the products to unrelated customers.¹⁴ Such sales income would not be FBCSI under the proposal even if the CFC paid service fees to a related person to assist with supply chain functions (provided those functions did not rise to the level of "substantial contribution" manufacturing).¹⁵

The Administration's proposal to apply Subpart F to "toll" manufacturing structures is short-sighted. Causing income derived by foreign subsidiaries from the manufacture and sale of products to be subject to taxation in the United States — which has the highest tax rate of any industrialized country — puts U.S.-based companies at a competitive disadvantage. Simi-

⁹ *Id.*

¹⁰ The new rule would apply prospectively to years beginning after Dec. 31, 2014.

¹¹ Reg. §1.954-3(a)(2) and Reg. §1.954-3(a)(3). See Yoder, "Same-Country-of-Manufacturing Exception Applied to Subpart F Sales Income," 38 *Tax Mgmt. Int'l J.* 240 (Apr. 10, 2009).

¹² Reg. §1.954-3(a)(4).

¹³ See Yoder, "Subpart F: Indicia of Manufacturing," 38 *Tax Mgmt. Int'l J.* 642 (Oct. 9, 2009); Yoder, "Supply Chain Distribution Structures Outside the Scope of Subpart F," 42 *Tax Mgmt. Int'l J.* 367 (June 14, 2013).

¹⁴ See *Ashland*, above, n. 6.

¹⁵ See Yoder, "The Application of Subpart F to a Distributor Principal," 40 *Tax Mgmt. Int'l J.* 241 (Apr. 18, 2011); Yoder, "No Subpart F Income if no Related Party Purchase or Sale of Products," 40 *Int'l Tax J.* 3 (July–August 2014).

⁵ 95 T.C. 579 (1990).

⁶ See also *Ashland Oil Inc. v. Commissioner*, 95 T.C. 348 (1990) (Tax Court rejected IRS's argument that an unrelated contract manufacturer is a branch of a CFC that purchases products from the manufacturer). The IRS will follow *Ashland Oil* and *Vetco*. Rev. Rul. 97-48, 1997-2 C.B. 89. See also NPRM, 73 Fed. Reg. at 10718 (noting that Rev. Rul. 97-48 states that the IRS will follow *Ashland Oil* and *Vetco* and "therefore confirms that the IRS will not treat a separate contract manufacturer as a branch for purposes of section 954(d)(2)").

⁷ Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals* (2014).

⁸ Green Book, at p. 60.

lar operations of non-U.S.-based companies generally are not subject to home country taxation. In addition, targeting U.S. manufacturing is counterproductive, as the high U.S. tax costs may incentivize U.S.-based

multinationals to look for manufacturing opportunities outside the United States. The better answer is to repeal the FBCSI rules to level the playing field.