

New Contract Manufacturing Regulations Present Planning Opportunities¹

The Internal Revenue Service (the “Service”) has issued final regulations providing much-needed, and generally taxpayer-favorable, guidance on the tax treatment of contract manufacturing arrangements entered into by controlled foreign corporations (“CFCs”). Under the final regulations, a U.S. parent company can obtain tax deferral on a CFC’s income from sales of goods where the CFC, through the activities of its employees, is considered to manufacture such goods in the CFC’s country of incorporation even though the goods are physically manufactured in another country by a related or unrelated contract manufacturer. Specifically, the test is whether the CFC’s employees make a “substantial contribution” to the overall manufacturing process.

With the regulations being effective January 1, 2010, for CFCs with calendar tax years, taxpayers with CFCs should be critically evaluating their existing operations not only to ensure compliance with these regulations but also to take advantage of the opportunities presented by these regulations for structuring their foreign manufacturing operations. There may be opportunities for U.S. tax deferral, enhanced cash flow and other benefits from structuring their foreign manufacturing operations consistent with these regulations. Retroactive tax benefits also may be available.²

Overview of Relevant CFC Rules

A foreign corporation is a CFC if more than 50 percent of its vote or value is owned by U.S. shareholders, defined as U.S. persons who own, directly, indirectly or constructively (by attribution) 10 percent or more of the CFC’s voting power. Only U.S. shareholders who directly or indirectly own 10 percent or more of the CFC’s voting power are subject to the Subpart F income inclusion rules.

In general, U.S. shareholders of a CFC are taxed currently on their pro rata share of the CFC’s “Subpart F” income for the year, regardless of whether the CFC makes any distributions to its

¹ The Service has also issued temporary and proposed regulations addressing branch manufacturing rules, which may lead to results that are less favorable to taxpayers than the rules in effect under the currently effective regulations. These regulations are beyond the scope of this contract manufacturing overview.

² Given that taxpayers can elect to apply the regulations immediately and retroactively to all open taxable years, businesses should review their FIN 48 positions for open years to determine whether financial statement reserves should be released. For additional information, you may read an article on the Lane Powell website, written by Shareholder Neil Kimmelfield. http://www.lanepowell.com/wp-content/uploads/2009/04/kimmelfieldn_005.pdf

U.S. shareholders. Subpart F income includes, among other items, “foreign base company sales income” (“FBSCI”).

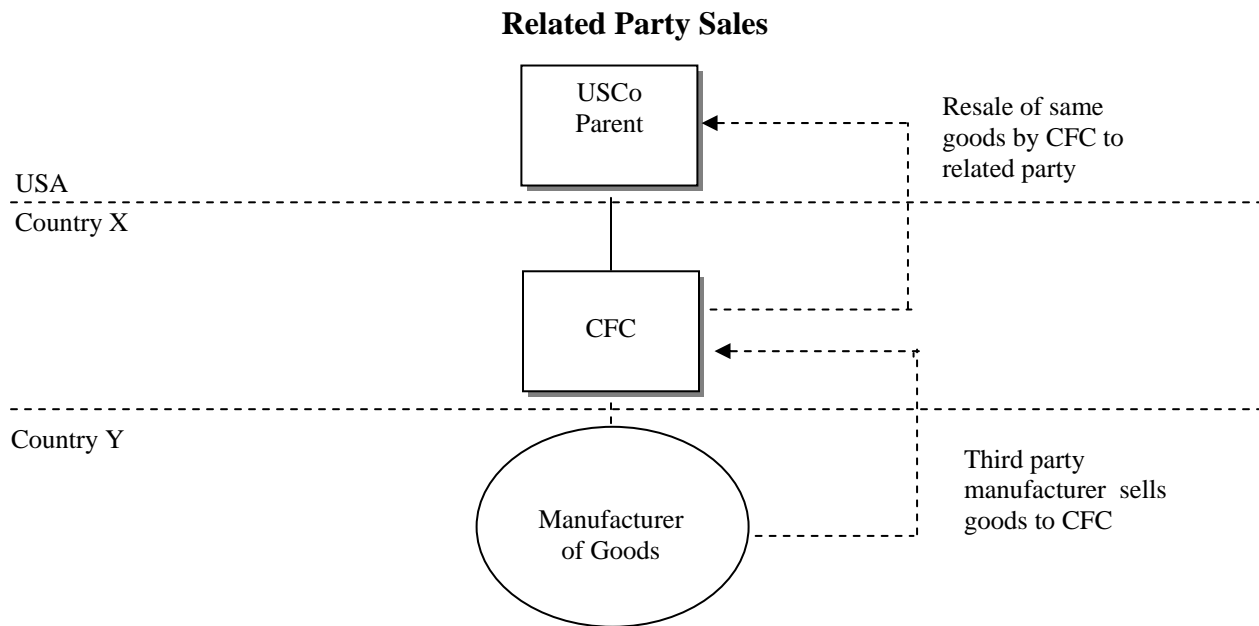
FBSCI is defined as income derived by a CFC from or in connection with four basic types of transactions:

- (1) the purchase of personal property from a related party and its sale to any person;
- (2) the purchase of personal property from any person and its sale to a related party;
- (3) the purchase of personal property from any person on behalf of a related party (*i.e.*, acting as a purchasing agent for the related party); or
- (4) the sale of personal property to any person on behalf of a related party (*i.e.*, acting as a sales agent for the related party).

However, there can only be FBSCI if the property is both: (i) manufactured (or produced, grown or extracted) outside the CFC’s country of incorporation; and (ii) sold for use, consumption or disposition outside that foreign country.

In other words, FBSCI is income derived by the CFC in connection with the purchase or sale of property manufactured and sold for use outside of the CFC’s country of incorporation where a related party is involved on the purchase or sale side of the transaction.

Common Foreign Base Company Sales Income Transaction

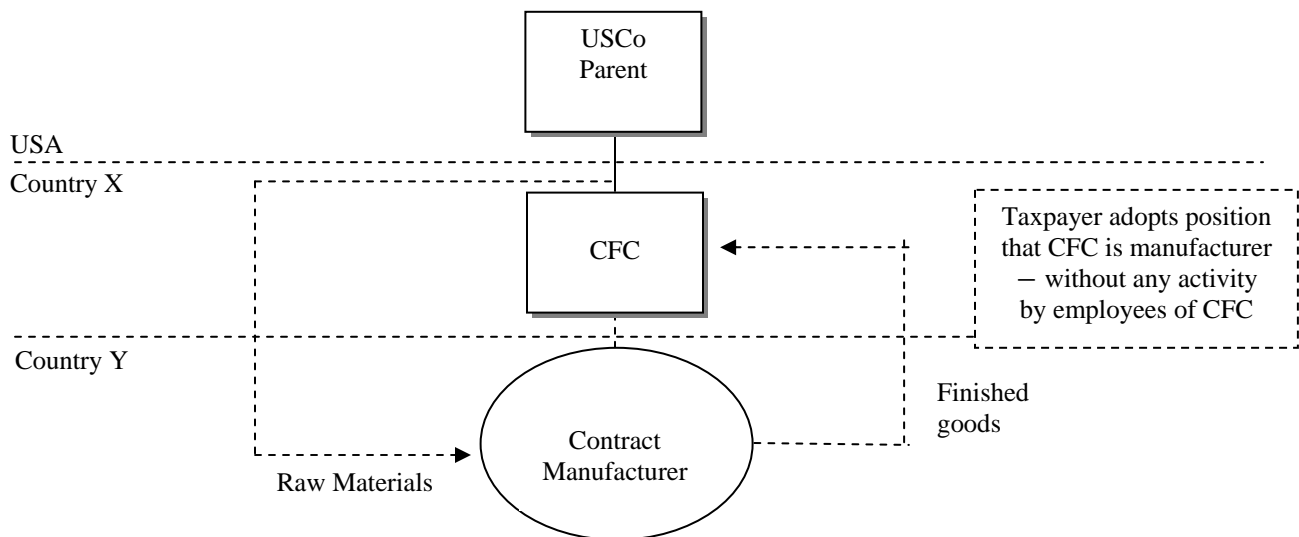


Manufacturing Exception and Contract Manufacturing Under the Final Regulations

Under a special “manufacturing exception” to the FBCSI rules, a CFC does not have FBCSI if it is considered to manufacture the property that it sells, or if the goods sold are manufactured in the CFC’s country of incorporation, regardless of who manufactures the property.

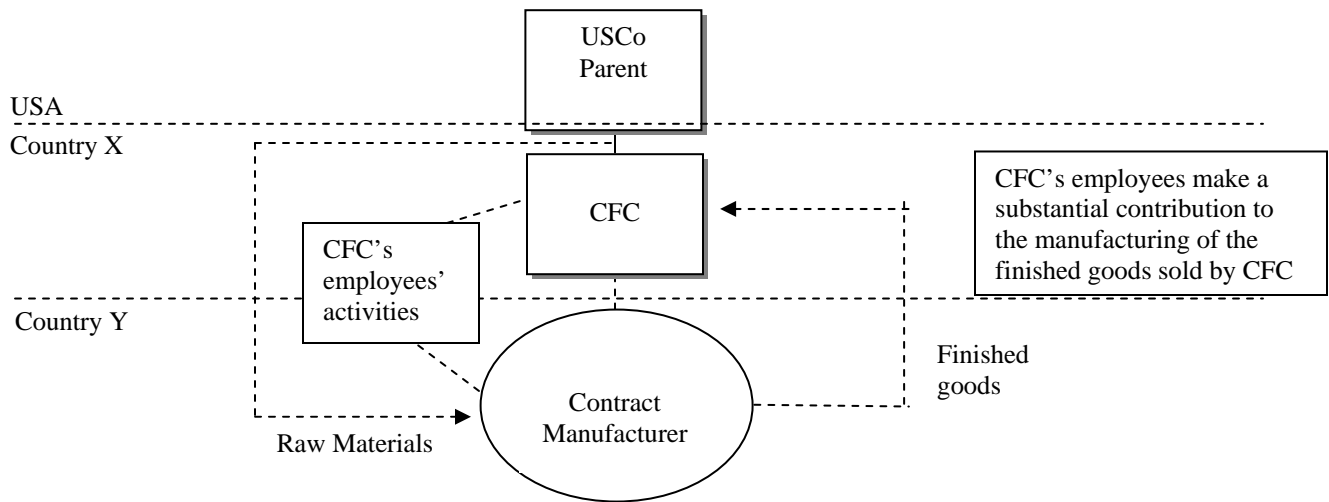
For years, taxpayers and the Service have clashed over whether a CFC could avoid FBCSI under the manufacturing exception based on attributing the manufacturing activities of a contract manufacturer to the CFC. The Service opposed the position adopted by many taxpayers that a CFC should be treated as having manufactured goods in its country of incorporation where the goods were actually manufactured by the CFC’s contract manufacturer in another country.

Manufacturing Exception - Attribution of Contract Manufacturing



The final regulations resolve this issue by adopting the Service’s position that the activities of a contract manufacturer cannot be attributed to a CFC for purposes of qualifying for the manufacturing exception. In closing one door, however, the Service opened another by adding a new “substantial contribution” test in the regulations, which applies in contract manufacturing situations. Under the final regulations, a CFC can now qualify for the manufacturing exception if the CFC’s employees make a “substantial contribution” to the manufacture of the goods sold by the CFC.

Manufacturing Exception
- Attribution Based on Substantial Contribution of CFC Employees



Only the activities of the CFC's employees are considered in determining whether the CFC satisfies the substantial contribution test. In general, the activities of regular employees are counted as well as the activities of part-time or seasonal workers. The activities of seconded workers, workers on the payroll of a related employment company and even contractors, may be considered if the CFC exercises sufficient control over their activities.

Previously, taxpayers and the Service often focused on whether a CFC was required to have possession of, hold legal title to or bear the economic risk of loss with respect to the raw materials, work-in-process or finished goods in a contract manufacturing arrangement. Under the new regulations, contractual rights, legal title, tax ownership or assumption of risk of loss are not considered in determining whether the CFC has substantially contributed to the manufacture of a product. Only the activities of the CFC's employees are considered, and, as a result, no minimum level of contractual control or ownership is required. In particular, the regulations provide that there can be substantial contribution in a buy-sell or turnkey arrangement, as well as in a consignment manufacturing arrangement.

The final regulations make it clear that a "facts and circumstances" analysis is required and that there is no safe harbor or objective standard for determining when a CFC's activities will rise to the level of "substantial." Instead, the regulations set forth a non-exclusive list of seven broadly-grouped activities, referred to as "indicia of manufacturing," to be considered in determining whether a CFC's activities rise to the level of substantial contribution.

Indicia of Manufacturing

A CFC does not need to perform all or any particular number of the indicia of manufacturing in order to establish a substantial contribution. The performance or lack of performance of any particular activity, whether or not among the indicia of manufacturing, is not determinative. Further, the CFC's employees do not need to meet a minimum threshold of performance with

respect to a particular activity before such activity can be taken into account. All employee activity will be considered in the aggregate.

In considering whether a CFC makes a substantial contribution, the weight accorded the performance of various activities/indicia will depend on the economic significance or value of those activities relative to the manufacture of the product, considering the particular business and industry. No particular indicia or other activity is mandatory or accorded more weight than other indicia. In other words, the regulations reject any “super factor” approach.

The fact that other related or unrelated persons make a substantial contribution to the manufacture of a product does not, in and of itself, preclude a CFC from also making a substantial contribution to the manufacture of the same product. More than one party can substantially contribute to the manufacture of a product. Thus, multiple CFCs owned by different U.S. shareholders can each substantially contribute to the physical manufacture of the same product.

The Regulations list seven indicia of manufacturing:

1. Oversight and direction of the activities and process pursuant to which the property is physically manufactured. Although the regulations acknowledge this may be an important factor, the regulations do not deviate from the “no super factor” approach and make it quite clear that there is no requirement for a CFC to perform oversight and direction activities with any minimum regularity.
2. Material selection, vendor selection or control of the raw materials, work-in-process or finished goods. Contractual control or ownership of raw materials, work-in-process or finished goods is not required.
3. Management of manufacturing costs or capacities. This indicia encompasses managing the risk of loss, cost reduction or efficiency initiatives associated with the manufacturing process (such as optimizing plant capacity and reducing waste), demand planning, production scheduling and hedging raw material costs, but not activities such as corporate finance decision making and general management of enterprise risk.
4. Control of manufacturing-related logistics. The relevant logistical activity is limited in scope to that directly relating to the manufacturing process, thus including activities such as arranging delivery of raw materials to the contract manufacturer, but excluding post-manufacturing logistical activities such as arranging the shipment of finished goods to customers.
5. Quality control. This indicia encompasses sample testing or establishment of quality control standards.
6. Developing or directing the use or development of product design and design specifications, as well as trade secrets, technology or other intellectual property

for the purpose of physically manufacturing the property. Only activities with respect to intangible property used in the manufacturing process are taken into account. Developing or directing the use or development of marketing intangibles is not taken into account. Protection of intangible property also is not taken into account.

7. Activities that are considered in but that are insufficient to qualify as physical manufacturing.

The regulations provide no guidance concerning the manner in which a taxpayer should document the activities of its CFC. The regulations merely state that the required documentation will likely vary by industry and providing such standards would inappropriately limit flexibility in the application of the substantial contribution test. This leaves taxpayers to their own devices; however, maintaining detailed, contemporaneous documentation should go a long way toward establishing compliance with the new rules.

Examples from the Regulations

The final regulations include several examples that identify the types of activities that, if performed by a CFC's employees, could qualify the CFC for the manufacturing exception. These examples of substantial contribution to the manufacturing activity carried out by the CFC's contract manufacturer ("CM") include the following types of activities:

- CFC's employees design the product and select the materials that CM will use to manufacture the product.
- CFC's employees manage the manufacturing costs and capacities.
- CFC's employees provide oversight and direction of the manufacture of the product.
- CFC's employees visit CM's manufacturing facility for one week each quarter and perform quality control tests on a random sample of the units of the products.
- CFC's employees manage the overall risk of loss and engage in demand planning and production scheduling.
- CFC owns the supply chain software, which is utilized by CFC's employees.
- CFC's employees supervise the computer technicians, evaluate the results of the automated manufacturing business, and make ongoing operational decisions related to acceptable performance of the manufacturing process, stoppages of that process and decisions related to product and manufacturing process design.
- CFC's employees develop and provide all upgrades to the software and network systems.
- CFC's employees direct and control other aspects of the manufacturing process, such as vendor and material selection, management of manufacturing costs and capacities and the selection of CM.
- U.S. parent corporation contributes to product manufacturing process design and provides support and oversight to CFC in connection with functions performed by CFC's employees.

Conclusion

The regulations embrace a highly factual approach to determining whether a CFC, through its employees, has substantially contributed to the manufacture of the product it sells. Without a bright-line or other objective test, businesses must carefully evaluate their existing operations and adopt the necessary changes to ensure compliance with the new rules. At the same time, businesses should consider restructuring existing operations to take advantage of the tax planning opportunities presented by these regulations. Businesses may achieve U.S. tax deferral, enhanced cash flow and other benefits from structuring their foreign manufacturing operations consistent with these regulations. Retroactive tax benefits also may be available.

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