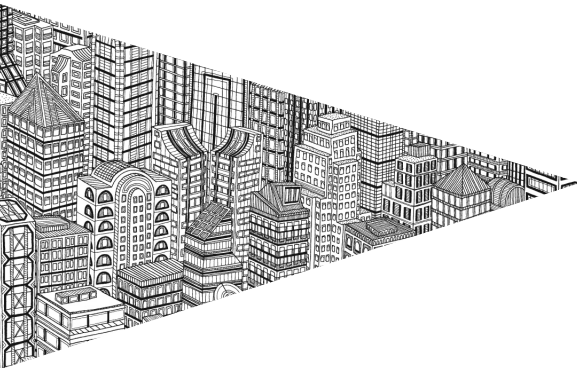


International Tax Alert



Treasury releases final regulations on foreign base company sales income branch rules

Executive summary

On 16 December 2011, the Internal Revenue Service (IRS) released final regulations on the rules that apply to foreign base company sales income (FBCSI) when personal property sold by a controlled foreign corporation (CFC) is purchased, sold, manufactured, produced, constructed, grown or extracted by one or more of its branches. Specifically, these final regulations address the application of the “branch rules” in situations where a CFC has multiple branches. With the issuance of these final regulations, the IRS and Treasury have also removed the temporary regulations that were released on 29 December 2008. (For more information, see International Tax Alerts: *Treasury issues final, temporary and proposed contract manufacturing regulations*, dated 5 January 2009 and *Treasury issues technical corrections to final, temporary and proposed contract manufacturing regulations*, dated 26 March 2009).

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These final regulations adopt the provisions contained in the temporary regulations with the following minor modifications:

- ▶ The final regulations have eliminated the adverb “demonstrably” from Treas. Reg. Section 1.954-3(b)(1)(ii)(c)(3)(iii) where the regulations require a comparison of the “tested manufacturing location” against the “tested sales location,” to prevent the use of such word from being misconstrued as a standard of proof.
- ▶ The final regulations have eliminated the confusion that seemed to exist with respect to the rule regarding grouping of branches under Treas. Reg. Section 1.954-3T(b)(2)(ii)(a). The phrase “the activities of” has

been added to the grouping rule, confirming that the purpose of the rule providing for the grouping of certain branches is only to determine whether the sales income of the sale or purchase branch (or remainder) is FBCSI (and does not change the quantum of income that is FBCSI).

- ▶ The final regulations have deleted Treas. Reg. Section 1.954-3(b)(2)(ii)(d), which provided that the manufacturing branch rules did not apply when FBCSI results from the application of the sale and purchase branch rules, as unnecessary given the rule under Treas. Reg. Section 1.954-3(b)(1)(ii)(c)(1) that provides that the manufacturing branch rules trump the sales branch rules when one or more sales branches are used in addition to a manufacturing branch.

The final regulations apply generally to taxable years of a CFC beginning on or after 30 June 2009, and for taxable years of US shareholders in which or with which such taxable years of the CFC end. In addition, a taxpayer may choose to apply the final regulations to earlier open taxable years that began prior to 1 July 2009, but only if the taxpayer and all members of the affiliated group apply the regulations in their entirety.

Detailed discussion

Code Sec. 954(d)(1) defines FBCSI as 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 is manufactured, produced, grown or extracted outside of the CFC's country of organization and is sold for use, consumption or disposition outside of that country.

Code Section 954(d)(2) establishes a special set of rules that apply if a CFC conducts its manufacturing or sales activities outside its country of incorporation through a branch, if conducting such operations through a branch has substantially the same effect as if such operations were conducted through a wholly-owned subsidiary of the CFC. Temporary regulations issued in 2008 focused in particular on the application of the branch rules in the case of a CFC with multiple branches.

The final regulations generally adopt the provisions contained in the 2008 temporary regulations, with the minor modifications described below.

Demonstrably greater contribution

Treas. Reg. Section 1.954-3T(b)(1)(ii)(c)(3) provided rules on determining the location of manufacture where more than one branch of a CFC and the remainder of the CFC engage in manufacturing activities with respect to the same item of property that is then sold by the CFC. If none of the branches

or remainder of CFC independently satisfy any manufacturing exception with respect to an item of personal property, but the CFC as a whole makes a substantial contribution to the manufacture, then under the temporary regulations the location of manufacture was the "tested manufacturing location," unless the "tested sales location" provides a demonstrably greater contribution to the manufacture of the item of personal property potentially giving rise to FBCSI. (Treas. Reg. Section 1.954-3T(b)(1)(ii)(c)(3)(iii)).

Based on comments received requesting clarification of the meaning of "demonstrably," the IRS and Treasury, in the final regulations, retained the general structure and operation of the regulation but eliminated the term "demonstrably." According to the preamble, the removal of this term clarifies that the government did not intend to require a specific or elevated standard of proof with respect to the determination of the location of manufacture. (Treas. Reg. Section 1.954-3(b)(1)(ii)(c)(3)(iii)).

Grouping of branches by activity

Under the temporary regulations, if a branch is treated as a separate corporation from the CFC (because it fails the rate disparity test with respect to a selling or purchasing branch or the remainder), it is considered to be incorporated in the jurisdiction where the branch is located. However, there would not be a subpart F inclusion if the taxpayer can show that the income of the branch would not have been subpart

F income if it had been actually earned by a separate corporation; this is the so-called “comparison with ordinary treatment” test. One way to demonstrate this would be to show that the branches activities themselves rise to the level of manufacturing or of substantial contribution. For this purpose, under Treas. Reg. Section 1.954-3T(b)(2)(ii)(a), grouping is allowed for activities of all branches that do not fail the rate disparity test with respect to a sales or purchasing branch (or remainder selling or purchasing on behalf of a branch). Some practitioners suggested that this grouping rule could be interpreted also to group the income of the branches.

According to the preamble, the IRS and Treasury have always intended that the grouping rule only aggregate the activities of the branches. To eliminate doubt, the phrase “the activities of” has been added in the final Treas. Reg. Section 1.954-3(b)(2)(ii)(a).

Manufacturing branch rules

The final regulations delete Treas. Reg. Section 1.954-3(b)(2)(ii)(d). This rule provided that once income is determined to be FBCSI under the sale or purchase branch rules, then there is no need to analyze such income under the manufacturing branch rules (Treas. Reg. Section 1.954-3(b)(1)(ii)). In explaining the deletion in the preamble, the IRS and Treasury refer to the inclusion in the regulations of the rule under Treas. Reg. Section 1.954-3(b)(1)(ii)(c)(1), which provides that only the manufacturing branch rules apply in situations where there is one or more sales or purchasing branches used in addition to a manufacturing branch.

Implications

The final regulations do not change the rules contained in the 2008 temporary regulations in any substantial way.

In the preamble to the final regulations, the IRS and Treasury acknowledge the need for continuing work in the FBCSI arena and state that they are considering whether to issue additional guidance. The issues specifically noted in the preamble as potential areas for future guidance are when a branch should be treated as a separate corporation and, interestingly, the scope and relationship between FBCSI and foreign base company services income. In addition to these two issues that were identified in the preamble, there are many other areas for which additional guidance could be helpful, including for example how a branch should be defined, how income should be allocated to perform the rate disparity test, and how losses and NOLs should be allocated for purposes of determining income to name a few.

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