DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL
CC:LM:CTM:LA:2

FROM: Valerie Mark Lippe
Senior Technical Reviewer CC:INTL:BR02

SUBJECT: Request for Chief Counsel Advice:

This Chief Counsel Advice responds to your memorandum dated October 1, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

DP =
Corp 1 =
Corp 2 =
Corp 3 =
Corp 4 =
Corp 5 =
Corp 6 =
Corp 7 =
Corp 8 =
Corp 9 =
Corp 10 =
Corp 11 =
Continent 1 =
Continent 2 =
Continent 3 =
Region 1 =
Country A =

Country B =
Country C =
Country D =
Country E =
Country F =
Country G =
Division 1 =
IS 1 =
IS 2 =
IS 3 =
Product x =
Product y =
Product z =
Reporting Unit 1 =
Reporting Unit 2 =
Reporting Unit 3 =
Reporting Unit 4 =
VP 1 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =

ISSUES

Whether Corp 1's sales income is foreign base company sales income can be divided into the following issues:

1. Whether section 954(d)(1) of the Internal Revenue Code applies to purchases of raw materials and sales of finished product.

2. Whether the branch rule of section 954(d)(2) would apply to treat Corp 1's sales income as foreign base company sales income even if Corp 1 were able to satisfy the manufacturing exception.

3. Whether Corp 1 satisfies the manufacturing exception of Treas. Reg. §1.954-3(a)(4).

    A. Whether Corp 1 satisfies the manufacturing exception because Corp 1 through its own activities, can be considered to have manufactured the goods it sold.

B. Whether Corp 1 can satisfy the manufacturing exception by attributing to itself the activities of the consignment manufacturing affiliates or the manufacturing oversight affiliate.

i. Whether the code or regulations provide an independent basis for attributing contract manufacturing activities to a controlled foreign corporation (CFC).

ii. Whether Rev. Rul. 97-48 permits the attribution of the activities of the consignment manufacturing affiliates or the manufacturing oversight affiliate, under the principles of Rev. Rul. 75-7, for the years at issue.

a. Whether, for pre-1997 tax years, Rev. Rul. 97-48 permits the attribution of the activities of a contact manufacturer without the requirement to apply the branch rule.

b. Whether Corp 1 satisfies the factors set forth in Rev. Rul. 75-7, which allow for the activities of the consignment manufacturing affiliates or the manufacturing oversight affiliate to be attributed to Corp 1.

iii. Whether Corp 1 satisfies the manufacturing exception because an agency theory provides support for attributing contract manufacturing activities to a CFC under section 954(d).

iv. Whether Corp 1 satisfies the manufacturing exception because case law provides a basis for attributing contract manufacturing activities to a CFC under section 954(d).

CONCLUSIONS

Corp 1 generated foreign base company sales income through its sales activities.

1. Corp 1, a Country A CFC, sold goods manufactured outside of Country A, to related corporations for use outside of Country A. That Corp 1 purchased raw materials and sold finished product will not prevent Corp 1’s sale income from being treated as foreign base company sales income except to the extent Corp 1 is considered to be the

manufacturer of the goods it sold for purposes of the manufacturing exception of Treas. Reg. §1.954-3(a)(4).

2. From the facts you have provided it appears that, even if Corp 1 satisfies the manufacturing exception, Corp 1 would have foreign base company sales income under the branch rule.

3. Even if the branch rule does not apply to treat Corp 1's sales income as FBCSI, Corp 1's sales income is nevertheless foreign base company sales income because it falls within the definition contained in section 954(d)(1) and the manufacturing exception does not apply.

   A. Corp 1, on its own, cannot be considered the manufacturer of the goods it sold. Corp 1 was engaged in marketing and sales activities. Corp 1 also provided certain administrative services to its parent. Marketing, sales, and administrative activities do not constitute manufacture.

   B. Corp 1 cannot be considered the manufacturer of the goods it sold, based upon any theory of attribution.

      i. The code and regulations do not separately support any theory of attribution.

      ii.a. For the pre-1997 years at issue, Rev. Rul. 97-48 permits Corp 1 to apply Rev. Rul. 75-7 to determine whether attribution of contract manufacturing activities is appropriate, provided Corp 1 treats the attributed manufacturing activities as its branch for purposes of the branch rule of section 954(d)(2).

      ii.b Corp 1 fails to qualify for attribution under Rev. Rul. 75-7 for the years in issue with respect to goods produced by the consignment manufacturing affiliates or by the manufacturing oversight affiliate using unrelated Country F manufacturers. Corp 1 failed to exert control over the manufacturing process, nor did it maintain control over the quality of goods manufactured. Further, Corp 1 had no appreciable risk of loss in connection with the manufacturing operations.

      iii. Corp 1 cannot be considered the manufacturer of the goods produced by the consignment manufacturing affiliates or the manufacturing oversight affiliate under an agency theory.

iv. Case law relating to contract manufacturing, does not apply in the subpart F context. Even if it were to apply, it would not support attribution of the activities of the contract manufacturers to Corp 1.

FACTS

DP is the domestic parent of a number of wholly-owned domestic and foreign subsidiaries, including Corp 1, a Country A corporation and a CFC under section 957(a). Corp 1 was created in Year 4 as DP's Continent 1 Headquarters. The amount of subpart F income attributable to Corp 1 that DP reported on its federal tax returns for Year 1, Year 2, and Year 3 did not include certain sales income of Corp 1. DP takes the position that this sales income is excluded from subpart F income under the manufacturing exception in Treas. Reg. §1.954(a)(4).

DP is in the business of manufacturing, distributing, and selling Product x and other similar products. The majority of DP's design work is done in the United States. Product x is manufactured in Countries C through F for ultimate sale and use throughout the world. Approximately 75% of DP's products are manufactured in company-owned manufacturing facilities located outside of the United States.

The DP products sold by Corp 1 generally are manufactured through one of the following four types of corporations wholly owned, directly or indirectly by DP: 1) the manufacturing affiliates, 2) the consignment manufacturing affiliates, 3) the manufacturing oversight affiliates, or 4) the sourcing affiliates. The manufacturing affiliates and the consignment manufacturing affiliates own and operate manufacturing facilities. Manufacturing affiliates operate under a manufacturing contract. They own the raw materials and finished goods until the goods are sold to affiliates. By contrast, consignment manufacturing affiliates do not own the raw materials or finished goods they produce.[1] Rather, raw materials are consigned to them and they receive a fee for the work they perform. The sole manufacturing oversight affiliate, Corp 2, does not own the factories where the goods are produced. Instead it receives a fee for supervising the manufacturing activities of two unrelated contract manufacturers located in Country F. The sourcing affiliates, outsource the manufacture of finished products to third party vendors. The remainder of the taxpayer's product is manufactured by third-party vendors.

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[1] We note that the ownership of the raw materials is a fact that is in dispute. See infra p.13.

Since both the manufacturing affiliates and the sourcing affiliates sell finished products to Corp 1 and Corp 1 reports this income as subpart F income, none of the issues you have asked us to address apply to Corp 1's income from the sale of these products. Therefore this memorandum will address only the income of Corp 1 derived from the sale of products manufactured by the consignment manufacturing affiliates and the manufacturing oversight affiliate.

Operations of Corp 1 and its Reporting Units

Corp 1 operates under a Headquarters Services Agreement with DP. Pursuant to this agreement, DP engages Corp 1 to provide specified sales support, finance, and administrative services for DP. Since year 1, Corp 1 has had four reporting units: Reporting Units 1 through 4.

Reporting Unit 1

Reporting Unit 1 is located in Country A and sells finished products directly to Continent 1, Continent 3, and Region 1 customers who are located in countries that do not have a DP sales affiliate. To the extent that these sales are of goods purchased from related parties for ultimate use outside of Country A they are reported as foreign base company sales income by Corp 1. Sales of goods purchased from related parties for use in Country A are not reported as Foreign base company sales income.

On Corp 1's year 1 tax return, Corp 1 began to include as its principal business activity, the manufacturing of Product x, in addition to the distribution of Product x.

Reporting Unit 2

Reporting Unit 2, also located in Country A, performs licensing, banking and regional headquarters functions. Corp 1 owns the non-U.S. product rights to various DP trademarks, characters, and other property. Corp 1 licenses the rights directly to unrelated parties for use in connection with sales in Continent 1 and other non-U.S. markets.[2] The banking or treasury function provides cash management services for all DP affiliates outside the United States. Income generated by the banking or treasury function is reported as subpart F income.

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[2] In your request you have indicated that the resulting licensing income is not reported as subpart F income by Corp 1. Further factual development may be necessary to determine whether Corp 1 correctly treated the licensing income as non-subpart F income. We are available to provide you with any needed assistance in developing this issue.

Reporting Unit 2 also includes certain aspects of the Continent 1 marketing function, such as product information systems, product planning, logistics, marketing, finance and accounting. Corp 1 has developed and implemented plans for centralization of key activities including, information systems, product planning and inventory management.

Corp 1 utilizes an extensive information system that begins with market demand and ends with factory raw material orders. Information flows through three information systems. Marketing personnel from Corp 1 input orders into IS 1 which forecasts product sales. The IS 1 system feeds into IS 2 which drives the production schedule. Information in IS 2 feeds into IS 3 which provides information to factories regarding the quantity of raw materials necessary to produce the finished products demanded by the markets. Corp 1's marketing personnel can affect and stop production by lowering the demand for a finished product. Factory personnel in manufacturing affiliates can affect and stop production for quality control reasons or due to mechanical and/or labor problems at the manufacturing plant.

Reporting Unit 3

Reporting Unit 3 is a division of Corp 1, located in Country B. Reporting Unit 3's offices are co-located with two of the manufacturing affiliates. Reporting Unit 3's function includes tooling administration, paying for insurance on inventory, raw material sourcing approval, financial reporting and administration for Corp 1 and product flow and customs compliance for all of DP's overseas operations. In addition to its other employees, Reporting Unit 3's offices are staffed by the vice president and regional controller of Corp 1 as well as 13 clerks who are not employees of Corp 1, but rather of other DP subsidiaries. These clerks perform the paperwork required to carry out Reporting Unit 3's functions, including its accounting functions.

All of DP's overseas sales flow through Reporting Unit 3 except for direct sales to unrelated third parties by the manufacturing affiliates. All of Reporting Unit 3's customers are DP affiliates. Reporting Unit 3 reports subpart F income from sales of finished products purchased from manufacturing affiliates sold for use outside the Country A, but does not report subpart F income from sales of finished goods from the consignment manufacturing affiliates. Sales of finished goods from consignment manufacturing affiliates represent approximately 75% of Corp 1's sales.

Reporting Unit 3 reports certain activities as Corp 1's manufacturing and product development activities in Country B. However, these activities were performed by employees of other affiliates and the costs were charged back to Corp 1.

Reporting Unit 3’s accounting function generates inter-company invoices for all sales, including sales from Reporting Unit 3 to Reporting Unit 4, Division 1 (a division of DP), and emerging market sales affiliates; sales from Reporting Unit 4 to sales affiliates in Country G and Continent 1; and sales from Division 1 to U.S. sales affiliates. The accounting function also generates invoices, purchase orders, and other documents for the purchase of tooling from tooling manufactures; leasing of tooling from Corp 11 to Corp 9; leasing of tooling from Corp 9; charge back of certain expenses incurred by related parties on behalf of Reporting Unit 3, such as costs incurred by Corp 8 and its reporting units, as well as the purchases of raw materials by Corp 2 and the consignment manufacturing affiliates; fees due the consignment manufacturing affiliates; and the fees due to Corp 2. Reporting Unit 3’s accounting function also handles the tooling administration and expatriate support functions. Reporting Unit 3’s accounting activities are carried out by at least one Corp 1 employee and 13 clerks who are not employees of Reporting Unit 3, but rather are employees of related corporations.

As explained in more detail later in this memorandum, in Year 1, Reporting Unit 3 held title to the tooling used by the affiliated manufacturers to manufacture Product x. At the beginning of Year 2, Corp 1 sold its tooling to Corp 9, a Country A subsidiary of DP.

Reporting Unit 3 administers expatriate support in Continent 2 and is in charge of expatriate human resources. For reasons related to pensions, social security and stock options, the payroll for expatriates is located at DP’s U.S. headquarters and is charged back to Reporting Unit 3.

Reporting Unit 3 administers customs compliance. Reporting Unit 3 claims all raw materials and finished products flow through Reporting Unit 3 to centralize product flow into one entity for the purpose of simplifying and facilitating customs compliance.

DP has an umbrella insurance policy that covers all of DP’s inventory. The portion of DP’s umbrella policy which is related to Reporting Unit 3's inventory is charged back to Reporting Unit 3.

Raw material sources must be approved by Reporting Unit 3. To minimize raw material inventory, manufacturing plants generate reports regarding inventory levels that are reviewed by VP 1.

Reporting Unit 3 has 39 personnel who have information systems administration responsibilities for Corp 1. Reporting Unit 3's interactions with marketing personnel in Country A is part of the information systems’ interface. Reporting Unit 3 minimally interfaces with IS 3. Reporting Unit 3 requires extra approval for purchases greater than $200,000. Reporting Unit 3 generates monthly financial reports for itself and Reporting Unit 4 which are sent to Corp 1's headquarters in Country A for consolidation.

Reporting Unit 4

Reporting Unit 4 was set up to track Corp 1's responsibilities regarding the cost sharing agreement Corp 1 entered into with DP on January 1, Year 1. Under the agreement, DP and Corp 1 share all product development costs. Reporting Unit 4 reports Corp 1's costs and profits resulting from Corp 1's cost sharing agreement with DP. Reporting Unit 4 has no direct employees so it incurs no design and development costs directly. Under the agreement, DP transferred to Corp 1 the non-U.S. intangible property rights to all products developed or marketed by DP after January 1, Year 1. Pursuant to the agreement, Corp 1 has the right to manufacture, distribute, license, modify and create derivative works from or otherwise exercise rights with respect to such products so they may be delivered to Corp 1's customers. To compensate DP for the use of property rights which existed before January 1, Year 1, Corp 1 pays a royalty to DP based on product sales. Reporting Unit 4 generates income, for purposes of intra-company accounting, when it purchases goods from Reporting Unit 3 at cost plus a fixed percentage and then sells those goods to Country G and Continent 1 sales affiliates. Reporting Unit 4 reports foreign base company sales income for profits earned from the sale of products which Corp 1 purchased from manufacturing affiliates and sold for ultimate use outside of Country A.

Consignment Manufacturing Affiliates

All consignment manufacturing affiliates are wholly-owned subsidiaries of DP and have manufacturing plants located in the countries of their incorporation. They include Corp 3 and Corp 4, Country C corporations; Corp 5 and Corp 6, Country D corporations; and Corp 7, a Country E corporation. The consignment manufacturing affiliates operate under a contract manufacturing agreement with Corp 1. The consignment manufacturing affiliates also provide general accounting and bookkeeping services related to the manufacturing operations. The consignment manufacturing affiliates employ the personnel that operate their factories. Certain raw materials are purchased by the consignment manufacturing affiliates and the costs are charged back to Corp 1. All other raw materials are purchased by the consignment manufacturing affiliates acting as either a disclosed or undisclosed agent of Corp 1 or on Corp 1's behalf. If the raw materials are purchased in the name of the consignment manufacturer, it conveys title to Corp 1 once the materials are received so Corp 1 holds title to the products throughout the manufacturing process. Raw material purchases are made only from an approved suppliers list which is updated annually. Purchases in excess of $100,000 require approval by VP 1, a vice president and regional controller of Corp 1 who is a Reporting Unit 3 employee. The consignment manufacturing affiliates charge Corp

1 a processing fee and issue an invoice with each product shipment. Corp 1 guarantees the consignment manufacturing affiliates a 5% profit.

The Manufacturing Oversight Affiliate

Corp 2, a wholly-owned subsidiary of DP incorporated in Country B, is the sole Manufacturing Oversight Affiliate. Corp 2 oversees the manufacture of Product y and Product z. Corp 2 has a Country B business license and files a Country B tax return. Under Corp 2's agreement with Corp 1, Corp 2 primarily engages in manufacturing oversight and administration. Corp 2 does not own a manufacturing plant. The manufacturing takes place in two factories in Country F, overseen by Corp 2 under an agreement between Corp 2 and the local government in Country F. Under this agreement, Corp 2 provides capital equipment for product manufacture, raw materials and component parts, tooling and fixtures, and technical and professional support. The Country F local government partner provides factory buildings, direct labor and operational management. Corp 2 pays the Country F partner a process fee based on labor hours incurred. Corp 2 is not a legal entity in Country F and does not pay tax in Country F.

Corp 2 and Corp 1 also have a services agreement under which Corp 2 agrees to provide overall support for foreign manufacturing operations. Pursuant to the agreement, Corp 2 performs the following functions: human resources and administration, finance, materials procurement planning and scheduling, warehousing, logistics, customs, quality control and assurance, production and manufacturing engineering, overall plant management, coordination of plant activities, monitoring of plant capacities, inventory management and control and textile sourcing. Corp 2 personnel travel to Country F, weekly, to perform manufacturing oversight functions. Corp 2 performs these functions with 265 staff in Country B and 200 staff located in Country F. Corp 2 has the right to interview newcomers to the factory and to fire Country F personnel. However, Corp 2 generally follows the suggestions of the Country F partners in personnel matters.

Although, Corp 2 purchases most of the raw material used in the manufacturing process in Corp 2's own name, Corp 2 maintains that it purchases those raw materials on behalf of Corp 1. Upon receipt of the raw material, title is transferred to Corp 1. Corp 1 holds title to the raw materials and work-in-progress throughout the manufacturing process. In Year 1, Reporting Unit 3 and, in Years 2 through 3, Corp 9 leased tooling to the plants in Country F. The factories' costs from leasing the tooling was reimbursed by Corp 2 as a component of the processing fee.

Under its agreement with Corp 1, Corp 2 receives a manufacturing fee of cost plus 5%. Under this agreement, Corp 2 invoices Corp 1 for raw material costs and other costs. Processing fees are invoiced with each product shipment. Corp 1 claims that it, rather than Corp 2, carries all the risk for the raw materials.

Corp 2 utilizes IS 2 and IS 3. Corp 2 also uses a information subsystem that complements IS 3. Corp 2 ships the finished products to DP's distribution centers. The final products are sold to and charged back to Corp 1. The marketing department of Corp 1 can use IS 1 to stop production by decreasing demand of the product in question. Corp 2 can use the information systems to stop production for quality or labor problems. VP 1, the employee of Corp 1's Reporting Unit 3, is informed about Corp 2's operations from quarterly and monthly financial reviews.

Tooling Leasing And Ownership

Prior to Year 1, Corp 10, a wholly-owned subsidiary of DP, owned tooling used by most of DP's manufacturing affiliates to manufacture Product x. In Year 1, Corp 10 was liquidated into Corp 1 and the tooling became an asset of Reporting Unit 3. In Year 1, Corp 1 did not charge its affiliated manufacturers for use of its tooling because the affiliated manufacturers were manufacturing goods for Corp 1 under agreements pursuant to which Corp 1 guaranteed a profit based on their costs. Pursuant to an agreement effective January 1, Year 2, Corp 1 sold its tooling to Corp 9, a Country A wholly-owned subsidiary of DP, in exchange for a non-interest bearing note repayable at the option of Corp 9. Beginning in Year 2, Corp 9 began charging for the use of the tooling.[3] The effect of the change in ownership of the tooling was an increase in costs of goods sold by Corp 1.

In Years 2 and 3, Corp 9 leased tooling to the consignment manufacturing affiliates and to the factories located in Country F for which Corp 2 performed its oversight function.

Machinery Ownership

The consignment manufacturing affiliates own the machinery used at their plants. Corp 2 owns the machinery used by the plants located in Country F.

Product Flow

For Years 1 through 3, finished goods were held at the manufacturing plants until they were ready for shipment, usually within a day or so. The goods were then shipped to the sales affiliates' warehouses and then on to customers. On the few

[3] A determination should be made as to whether Corp 9's income from renting its tooling is foreign personal holding company income.

occasions when goods were shipped directly from the manufacturing plants to customers, the customer took title to the goods at the plant.

With respect to the transfer of title, the field and the taxpayer disagree on who held title to the raw materials, work-in-progress (WIP), and finished goods manufactured by the consignment manufacturing affiliates and manufacturing oversight affiliate. The taxpayer claims that Corp 1 held title to the raw materials, WIP, and therefore the finished goods. The field is not in agreement with this assertion. The field's view is that the title to the raw materials, WIP, and the finished goods were held by consignment manufacturing affiliates until title of the finished goods was transferred to Corp 1.[4]

LAW AND ANALYSIS

In General

If a foreign corporation is a CFC for an uninterrupted period of at least 30 days during any tax year, every person who is a United States shareholder of the foreign corporation must include in his gross income his pro rata share of the corporation's subpart F income for that year. Section 951(a). Subpart F income includes foreign base company income. Section 952. Foreign base company income includes foreign base company sales income. Section 954(a).

The income of a CFC is not foreign base company sales income (FBCSI) unless each of the following requirements, set forth in Section 954(d)(1), is present: 1) the income is earned from purchasing personal property from or on behalf of, or selling personal property to or on behalf of, a related person; 2) the property that is purchased or sold is manufactured outside the CFC's country of incorporation; and 3) the property is sold or purchased for use outside the CFC's country of incorporation.

Income that otherwise falls within the definition of FBCSI, however, may be excluded from FBCSI, under the manufacturing exception contained in Treas. Reg. §1.954-3(a)(4), if the CFC manufactures the product that it sells.

The manufacturing exception is limited by the branch rule of section 954(d)(2). Under the branch rule, if the CFC carries on manufacturing or sales through a branch located outside its country of incorporation and the carrying out of those activities though the branch has substantially the same tax effect as if the branch were a wholly-owned subsidiary of the CFC, determined based on a tax rate

[4] See infra p. 13.

comparison test, the branch is treated as a subsidiary of the CFC and its income is FBCSI.

Your summary of the facts indicates that the field and the taxpayer are not in agreement about whether Corp 1 took title to the raw materials or only took title to the finished goods. The issues you have asked us to address regarding the application of the manufacturing exception would be relevant only if Corp 1 purchased raw materials and sold finished products because the manufacturing exception does not apply where the CFC sells the same product that it purchases. See Treas. Reg. §1.954-3(a)(4). If the manufacturing exception does not apply, the sales income of Corp 1 that is at issue clearly would be FBCSI. Therefore, we will assume for purposes of this memorandum that Corp 1 owned the raw materials throughout the manufacturing process. We are available, however, to provide you further assistance should this fact change.

Corp 1 purchased raw materials from unrelated parties and sold the finished product, which was manufactured outside of Country A, to related parties for use outside of Country A. Corp 1 takes the position that its income from the sale of the finished product is not FBCSI because the manufacturing exception applies and the branch rule does not apply.

Issue 1. Whether section 954(d)(1) applies to purchases of raw material and sales of finished products.

Section 954(d)(1) provides that "the purchase of personal property from a related person and its sale to any person" generates foreign base company sales income when the property that is purchased is manufactured and sold for use outside the country of incorporation of the CFC. Section 954(d)(1). The statute uses the term "personal property" without distinguishing between raw materials and finished product.

The legislative history of subpart F suggests that income from the purchase of raw materials and the sale of a finished product will fall within the definition of FBCSI except to the extent that the CFC is the entity that transforms the raw materials into a finished product. The Senate Committee on Finance has stated:

> The "foreign base company sales income" referred to here means income from the purchase and sale of property, without any appreciable value being added to the product by the selling corporation. This does not, for example, include cases where any significant amount of manufacturing, major assembling, or construction activity is carried on with respect to the product by the selling corporation.

S. Rep. No. 1881, 87th Cong., 2d Sess. 84 (1962) (emphasis added). The legislative history suggests that purchases of raw materials and sales of finished products will constitute FBCSI when the selling corporation, in this case Corp 1, fails to manufacture the finished product.

The manufacturing exception contained in Treas. Reg. §1.954-3(a)(4), based on this legislative history, carves out sales income derived from purchases of raw materials and sales of finished products from FBCSI only to the extent the CFC qualifies as a manufacturer.

Thus, although the statute and the regulations thereunder as well as the legislative history do not explicitly mention raw materials with respect to the manufacturing process, it appears that the use of the language “personal property” includes raw materials. The legislative history and the regulations envision that, in certain cases, personal property that is purchased by the CFC will undergo a process that transforms it into a finished product. Therefore, it seems clear that section 954(d)(1) applies to the purchase of raw materials and sales of finished products.

<u>Issue 2. Whether Corp 1's sales income is FBCSI after application of the branch rule of section 954(d)(2)</u>.

The activities necessary to manufacture Product x take place outside Country A, Corp 1's country of incorporation. If Corp 1 can satisfy the manufacturing exception, either directly or through attribution, activities conducted, or deemed conducted, by Corp 1 in those countries will be sufficient to treat Corp 1 as carrying on those manufacturing activities through a branch or similar establishment for purposes of the branch rule of section 954(d)(2). Because the branch rule may treat Corp 1's sales income as FBCSI even if the manufacturing exception applies, it is appropriate to first analyze the application of the branch rule.

If the branch rule applied to Corp 1's manufacturing activities carried on through a branch or similar establishment outside its country of incorporation, these manufacturing activities would be treated as subsidiaries of Corp 1 and Corp 1 would be treated as selling on their behalf. Therefore, Corp 1's income from selling products manufactured, either directly or through attribution, outside its country of incorporation would be treated as FBCSI, assuming the other requirements of section 954(d)(1) were satisfied.

The branch rule provides:

> If a controlled foreign corporation carries on manufacturing ... activities by or through a branch or similar establishment located outside the country under the laws of which such corporation is created or

> organized and the use of the branch or similar establishment for such activities with respect to personal property purchased or sold by or through the remainder of the controlled foreign corporation has substantially the same tax effect as if the branch or similar establishment were a wholly-owned subsidiary corporation of such controlled foreign corporation, the branch or similar establishment and the remainder of the controlled foreign corporation will be treated as separate corporations for purposes of determining foreign base company sales income of such corporation.

Treas. Reg. §1.954-3(b)(1)(ii)(a). The use of a branch or similar establishment will be treated as having substantially the same tax effect as if it were a wholly-owned subsidiary corporation of the CFC if the income allocated to the remainder of the CFC is taxed 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 the income under the laws of the country in which the branch or similar establishment is located if the entire income of the CFC were considered derived from sources within that country through a permanent establishment by a corporation organized in that country. Treas. Reg. §1.954-3(b)(2)(ii)(b).

It must be determined whether Corp 1's deemed branches have substantially the same tax effect as if these branches were wholly-owned subsidiaries of Corp 1. To make this determination, a comparison of Corp 1's effective rate of tax paid on its sales income to the effective rate of tax it would pay if incorporated in each country in which a deemed branch of Corp 1 operates must be made.

In your request, you provided figures for the effective rate of tax imposed on Corp 1's sales income and the corporate tax rate for various other countries in which Corp 1 has relationships with contract manufacturers. Assuming your figures are correct, if the effective rate of tax imposed on this sales income is less than 90% of, or at least 5 percentage points less than, the effective rate of tax that would be imposed on this income if Corp 1 were incorporated in the country where the deemed branch operates, then that deemed branch would be treated as a wholly-owned subsidiary of Corp 1. Based on your figures, an effective rate of tax of 6%, 9%, and 7% for Year 1, Year 2, and Year 3, respectively, was imposed on Corp 1's sales income. You state the <u>corporate tax rate</u>[5] in Country F is 33%, 28% in

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[5] It must be noted that the <u>corporate tax rate</u> and the <u>effective rate of tax</u> are not the same. The effective tax rate (determined as the ratio of the foreign tax paid to net income), takes into account both the tax rate and the tax base. To determine the hypothetical effective tax rate paid in a country, the possibility that a taxpayer may separately be able to negotiate a lower rate of tax with the government of that country is not taken into account. For the purpose of this calculation, we are assuming the

Country C, 30% in Country E, and 35% in Country D. The effective rate of tax imposed on Corp 1's sales income, for the years in question, is more than 5 percentage points less than the lowest tax rate given (Country C). Furthermore, the effective rate of tax imposed on Corp 1's sales income, for the years at issue, is clearly less than 90% the rate of tax for the countries sampled. As a result, the income earned from the sale of the products manufactured by Corp 1's contract manufacturers would be FBCSI under the branch rule.

<u>Issue 3. Whether Corp 1 satisfies the manufacturing exception of Treas. Reg. §1.954-3(a)(4)</u>.

If, after further factual development, it is determined that the branch rule does not apply to treat Corp 1's sales income as FBCSI, it will be necessary to determine whether Corp 1's sales income is excluded from FBCSI under the manufacturing exception.

<u>Issue 3.A. Whether Corp 1 satisfies the manufacturing exception because Corp 1, through its own activities, can be considered to be manufacturing the goods it sold</u>.

The taxpayer contends that the activities of Corp 1, including its four reporting units, constituted the manufacture of goods. However, an examination of Corp 1's activities indicates that, although these activities were integral to DP's overall business operations, Corp 1 was not directly engaged in manufacturing.

Corp 1 directly performed sales and marketing activities and, under its Headquarters Services Agreement with DP, provided sales support, finance and administrative services for DP.

Reporting Unit 1 performed only selling activities for products manufactured by related parties. Reporting Unit 2 performed licensing, banking and regional headquarters functions. Corp 1 owned non-U.S. product rights to various DP trademarks, characters and other property and licensed these rights to unrelated parties for use in connection with sales in Continent 1 and other non-U.S. markets. In addition Reporting Unit 2 developed and implemented plans for centralization of key activities, including information systems, product planning, and inventory management. The information systems allowed Reporting Unit 2's marketing department to track orders and indirectly influence the level of manufacturing production through the number of orders it input into the system. While Corp 1's

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corporate tax rate and the effective rate of tax are equal. Further factual development is needed to verify this assumption.

marketing department drove the production schedule for the goods Corp 1 sold, it did not itself manufacture the products.

Reporting Unit 3 provided tooling administration, expatriate support, information systems administration, raw material sourcing approval, financial reporting and administration for Corp 1, and product flow and customs compliance for all of DP's overseas operations. Nearly all of DP's overseas sales flowed through Reporting Unit 3. Reporting Unit 3 reported certain activities as Corp 1's manufacturing and product development activities in Country B, yet these activities were performed by employees of other affiliates, and the costs were charged back to Corp 1. Reporting Unit 3 owned tooling that was physically located at manufacturing plants for only one of the three years at issue.[6] In the context of section 936, mere ownership of equipment did not constitute the active conduct of a manufacturing business. See MedChem (P.R.), Inc. v. Commissioner, 116 T.C. No. 25, No. 4065-98, No. 4066-98, 2001 U.S. Tax Ct. LEXIS 26, at *96 (U.S. Tax Ct. May 18, 2001).

Reporting Unit 4 was set up to track Corp 1's responsibilities regarding the cost sharing agreement Corp 1 entered into with DP, under which, Corp 1 and DP shared all product development costs. The agreement transferred to Corp 1 the non-U.S. intangible property rights to all products developed or marketed by DP after January 1, Year 1. Under the agreement, Corp 1 had the right to manufacture, distribute, license, modify and create derivative works from or otherwise exercise rights with respect to such products so the goods could be delivered to customers within Corp 1's market area. Reporting Unit 4, however, had no direct employees so it could not, itself, perform manufacturing activities. Further it incurred no design and development costs directly.

Upon reviewing the activities of Corp 1, it is clear that Corp 1's reporting units, viewed separately, or Corp 1, viewed as a whole, failed to manufacture Product x prior to its sale by Corp 1. None of the separate activities performed by Corp 1 or its reporting divisions amounted to the transformation of raw materials into a finished product. Corp 1's activities taken as a whole constitute nothing more than marketing, sales and the provision of administrative services.

Issue 3.B. Whether Corp 1 can satisfy the manufacturing exception by attributing to itself the activities of the consignment manufacturing affiliates or the manufacturing oversight affiliate.

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[6] Reporting Unit 3's ownership of tooling during Year 1 may support the existence of a branch. See discussion of the branch rule supra pp. 14-16.

You have asked whether Corp 1 can satisfy the manufacturing exception of Treas. Reg. §1.954-3(a)(4), by attributing to it the manufacturing functions of third party contract manufacturers.

Issue 3.B.i. Whether the Code or regulations provide an independent basis for attributing contract manufacturing activities to a CFC.

There is no specific authority under the Code or regulations for attributing the activities of a contract manufacturer to the CFC that hires it. As noted previously, the legislative history of subpart F lends support to the proposition that the CFC, itself, must engage in manufacture to come within the manufacturing exception. The regulations under section 954 conform to this legislative history. The regulations state:

> Foreign base company sales income does not include income of a controlled foreign corporation derived in connection with the sale of personal property manufactured by such corporation in whole or in part from personal property which it has purchased. A foreign corporation will be considered ... to have manufactured ... personal property which it sells if the property sold is in effect not the property which it purchased.

Treas. reg. §1.954-3(a)(4) (emphasis added). The first sentence makes clear that it is the CFC who must perform the manufacturing activities but that some or all of the components it uses may be purchased. The second sentence describes the level of transformation that must take place before the property will be considered to be manufactured. The language "by such corporation" and the references to the property the CFC purchased limit the manufacturing exception to a CFC that performs the manufacturing activities.

Issue 3.B.ii.a. Whether Rev. Rul. 97-48 permits the attribution of the activities of the consignment manufacturing affiliates or the manufacturing oversight affiliate without the requirement to apply the branch rule.

The only formal guidance issued by the service that specifically allowed attribution of contract manufacturing activities to a CFC was Rev. Rul. 75-7, 1975-1 C.B. 244, which was revoked by Rev. Rul. 97-48, 1997-2 C.B. 89. Rev. Rul. 97-48 announced that the Service would not allow the activities of a contract manufacturer to be attributed to a CFC for purposes of either section 954(d)(1) or section 954(d)(2) because of the decisions in Ashland Oil Co. v. Commissioner, 95 T.C. 348 (1990) and Vetco, Inc. v. Commissioner, 95 T.C. 579 (1990).

Nonetheless, Rev. Rul. 97-48 allowed Rev. Rul. 75-7 to be applied retroactively to pre-1997 tax years if the taxpayer agreed to treat the contract manufacturing activities as being preformed through a branch or similar establishment of the CFC for purposes of the branch rule of section 954(d)(2). The application of the branch rule in this situation is warranted to prevent taxpayers from escaping the application of the branch rule simply by entering into a contract manufacturing arrangement. Therefore, any attribution of the activities of a contract manufacturer to a CFC must be linked to the application of the branch rule.

The tax years at issue are pre-1997 tax years. Accordingly, under Rev. Rul. 97-48, Corp 1 will be permitted to rely on the provisions of Rev. Rul. 75-7, including both the attribution principles and the application of the branch rule of section 954(d)(2). Therefore, you should determine whether the branch rule would treat Corp 1's sales income as FBCSI. See the discussion of the branch rule supra pp. 14-16.

Issue 3.B.ii.b Whether Corp 1 satisfies the factors set forth in Rev. Rul. 75-7, which allow for the activities of the consignment manufacturing affiliates or the manufacturing oversight affiliate to be attributed to Corp 1.

The facts of Rev. Rul. 75-7 are as follows: X, a CFC, incorporated in Country M, purchased metal ore concentrate in the United States and Canada from related persons. Conversion of the ore concentrate into a ferroalloy was accomplished pursuant to an arm's length contract by Y, an unrelated foreign corporation incorporated in country O. X paid Y a conversion fee. The ore concentrate, before and during processing, and the finished product remained the sole property of X at all times. X purchased all raw materials necessary for the processing operation and bore the risk of loss. X maintained complete control of the quality and quantity of the product. X was responsible for the negotiation and consummation of the finished product. Y's only interest in the entire transaction was the fee paid by X for the conversion of the ore. The effective tax rate in country M was 46% while the effective tax rate in country O was 38.5%.

The factors favoring attribution in Rev. Rul. 75-7 were that: 1) the CFC entered into an arm's length contract with the unrelated contract manufacturer; 2) the manufacturing process was intricate and involved highly skilled labor, working in accordance with scientific controls; 3) the contract manufacturer's plant was one of the few in the world equipped to accomplish the task; 4) the contract manufacturer had no present or future plans to have an affiliation with the CFC other than through the contractual obligation arising under the arm's length contract; 5) the contract manufacturer received a conversion fee rather than a share of the profits; 6) the raw materials remained the sole property of the CFC at all times; 7) the CFC alone purchased the raw materials needed to manufacture the product; 8) the CFC bore the risk of loss at all times in connection with the operation; 9) the CFC controlled the time and quantity of production; 10) the CFC controlled the quality of the product by requiring the contract manufacturer to use such processes as were directed by the CFC; 11) the CFC could, when necessary, send engineers or technicians to the contract manufacturer's plant to inspect, correct or advise with respect to the processing operation; 12) negotiation and consummation of the sale of the finished product were solely the responsibility of the CFC; and 13) the finished product was sold to unrelated parties.

Based on these facts, Rev. Rul. 75-7 held that the activities of Y, the contract manufacturer, could be attributed to X for purposes of the manufacturing exception. Further, the ruling held that, although the contract manufacturing activities would be treated as performed through a branch of X, for purposes of the branch rule, the branch rule, in this case, did not apply based on the application of the effective tax rate test contained in Treas. Reg. §1.954-(3)(b).

Application of Rev. Rul. 75-7 test to the consignment manufacturing affiliates.

When applying Rev. Rul.75-7 to the facts of this case, Corp 1 satisfies only two of the thirteen factors favoring attribution discussed above. Of the remaining factors, ten clearly do not support attribution of the activities of the consignment manufacturing affiliates to Corp 1 and one requires further factual development.

As in Rev. Rul. 75-7, Corp 1 controlled the time and quantity of production and the interest of the consignment manufacturing affiliates appears to be limited to a conversion or processing fee. However, due to the brother-sister relationship between Corp 1 and its consignment manufacturing affiliates, an inquiry should be made as to whether the consignment manufacturing affiliates received some other indirect fees or otherwise participated in the profits of this enterprise.

The issue of whether Corp 1 retained ownership of the raw materials, WIP, and the finished product at all times requires further factual development. Corp 1's chain of ownership of raw materials, WIP, and the finished product is complicated and varies depending on the specific relationship with the third-party contract manufacturer. As noted earlier, it is assumed, for purposes of this memorandum, that Corp 1 owned the raw materials, WIP and finished products manufactured by Corp 1's consignment manufacturing affiliates. We understand, however that this fact is in dispute.[7]

The remainder of the factors discussed in Rev. Rul. 75-7 do not support a finding of attribution. Some of the factors favoring attribution in Rev. Rul. 75-7

[7] See supra p. 13.

resulted from the CFC's use of an unrelated contract manufacturer. Unlike Rev. Rul. 75-7, this case involves contract manufacturers that are related to the CFC. Because related entities can be used in this context to separate sales and manufacturing activity to artificially lower the tax rate on the sales income, contrary to the purposes of the FBCSI provisions, these transactions involving related contract manufacturers should receive greater scrutiny.

Risk of loss, another factor described in Rev. Rul. 75-7, in this case can be divided into two components: 1) risk that property will not meet specifications and 2) risk that manufactured products will not be sold (economic risk). Upon review of the materials submitted with your request, Corp 1 bore little of the risk.

Corp 1 did not bear the risk that the products would not meet its specifications. According to the contract manufacturing agreements, Corp 1 had the right to return products to its contract manufacturers if the products did not conform to Corp 1's contract specifications. Further, according to the agreement, the consignment manufacturing affiliate was liable for any expenses incurred by Corp 1 when returning defective products. Lastly, under the agreement Corp 1 was not liable for costs or expenses incurred by the consignment manufacturing affiliate that were due to the fault of the consignment manufacturing affiliate, such as when the contract manufacturer supplied non-conforming goods. Thus, Corp 1 did not bear the risk of receiving non-conforming goods.

Corp 1 did not bear any appreciable economic risk that products would not be sold. Under Corp 1's integrated information and ordering systems, products were ordered to be manufactured only when there was a customer for that product. Corp 1 controlled the quantity of products to be ordered through the use of its computer systems. If Corp 1 detected a drop in demand for a given product, it could immediately stop production merely by reducing its sales forecasts created by Corp 1's IS 1 and IS 2 computer systems. As a result of Corp 1's integrated ordering and sales system, which affected production schedules, Corp 1 would rarely have products on hand that could not be sold.

Corp 1 does not appear to have controlled the quality of the products produced by the consignment manufacturing affiliates. Although Corp 1 was contractually granted the right to control quality of the finished product, it appears to have failed to exercise this control. The information you have submitted provides no evidence that Corp 1 specified the processes to be used by the consignment manufacturing affiliates, that Corp 1 personnel ever visited factories to inspect, advise or perform other quality control activities or that Corp 1 even employed personnel qualified to perform such quality control activities. However, more information should be developed with respect to what, if any, quality control Corp 1 actually performed, and whether any of its employees were qualified to perform such quality control.

Attribution of the activities of the consignment manufacturing affiliates to Corp 1 under Rev. Rul. 75-7 is not appropriate under these facts because Corp 1 did not satisfy most of the significant factors set forth in that revenue ruling. Corp 1 did not retain the risk of loss. It did not control the quality of production by directing the consignment manufacturing affiliates about the processes to be used. Nor did it control the manufacturing process by sending personnel to inspect or advise. Further, because Corp 1 and the consignment manufacturing affiliates were related entities, their affiliation extended beyond the scope of the contract manufacturing agreements.

Application of Rev. Rul. 75-7 test to the manufacturing oversight affiliates.

The relationship between Corp 1 and Corp 2, the manufacturing oversight affiliate, is different than Corp 1's relationship with its other contract manufacturers. Corp 2 agreed to provide management oversight as well as to manufacture Product x for Corp 1. Corp 2 did not own any manufacturing plants or factories, but had agreements with unrelated contract manufacturers in Country F to manufacture Product x.

It appears that under the factors in Rev. Rul 75-7, Corp 2 could be treated as the manufacturer of Product x. Corp 2 oversees the manufacture of Product x in the factories located in Country F by sending personnel to those factories to conduct oversight and technical support. Corp 2 has control over the workforce of those factories, and has the right to stop production for quality or labor problems. All of these factors tend to show that Corp 2 is doing more than merely acting as a middleman in arranging the sale of Product x to Corp 1.

Rev. Rul. 75-7, however, does not provide support for attributing the manufacturing and oversight activities of Corp 2 to Corp 1. Corp 1 continues to act in a sales and marketing capacity with respect to goods produced in Country F in factories overseen by Corp 2. There is no evidence that Corp 1 sends its personnel to oversee production, or perform quality control. There is no evidence that Corp 1 bears the risk of loss from the manufacture of Product x from those factories. Upon review of the factors required for attribution under Rev. Rul. 75-7, there is no difference in the result when Corp 1 contracts with its consignment manufacturing affiliates directly and when Corp 1 contracts with Corp 2 to provide management oversight with respect to unrelated contract manufacturers. In both situations, Corp 1 is not participating in the manufacturing process, but merely engaging in sales and marketing activities.

Issue 3.B.iii. Whether the activities of the consignment manufacturing affiliates or the manufacturing oversight affiliate can be attributed to Corp 1 under an agency theory.

You have raised the issue of whether the activities of the consignment manufacturing affiliates or the manufacturing and oversight activities of Corp 2 may be attributed to Corp 1 under an agency theory.

“Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.” Restatement (Second) of Agency § 1 (1958). One main principle of agency is that the “principal has the right to control the conduct of the agent with respect to the matters entrusted to him.” Id. § 14. For purposes of your request we will assume an agency relationship exists between Corp 1 and its various contract manufacturers. However, more facts are needed to determine whether an agency relationship existed and, if so, the scope of the agency relationship.

The principal in an agency relationship need have no active involvement in the activities conducted by its agent. Thus, attribution of manufacturing activities based solely on agency would create a result contrary to the purposes of subpart F. Subpart F is aimed at “income of a selling subsidiary (whether acting as principal or agent) which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income.” S. Rep. No. 1881, 87th Cong., 2d Sess. 84 (1962). If a CFC could satisfy the manufacturing exception by merely hiring an agent to perform manufacturing or manufacturing oversight activities on its behalf without any active involvement on its own, such a CFC could easily use an agent to separate sales from manufacturing activity to obtain a lower rate of tax on the sales income. Therefore, an agency theory, alone, is not a sufficient basis for attribution of manufacturing activities.

If an agency theory were determined to be a sufficient basis for attribution, however, such a theory would also support treating the activities of the agent as a “branch or similar establishment” of the CFC for purposes of the branch rule of section 954(d)(2). See Taisei Fire and Marine Ins. Co. v. Commissioner, 104 T.C. 535 (1995) (U.S. permanent establishment exists where agent is subject to comprehensive control and does not bear entrepreneurial risk); Handfield v. Commissioner, 23 T.C. 633 (1955) (newsstand to which taxpayer’s cards were consigned was deemed to be an agent and therefore permanent establishment of taxpayer for purposes of U.S.-Canadian tax treaty). The branch rule is discussed supra at pp. 14-16.

Issue 3.B.iv. Whether Corp 1 can be considered the manufacturer of the goods it sold under case law.

In certain cases, courts have determined that a taxpayer manufactured a product when such a determination furthered the legislative purpose behind the statutory provision at issue. Those cases involved code sections outside of subpart

F. Because the purposes of subpart F differ from those of the statutes analyzed in those cases, those cases do not provide support in the subpart F context.

The recent decision of MedChem (P.R.) Inc. v. Commissioner, 116 T.C. No. 25; No. 4065-98, No. 4066-98, 2001 U.S. Tax Ct. LEXIS 26 (T.C. May 18, 2001), addressed contract manufacturing in the section 936 context. In MedChem, the taxpayer argued that it satisfied the active conduct of a trade or business requirement of the section 936(a) because it manufactured a blood clotting agent in Puerto Rico. In this case, the taxpayer purchased from the seller the equipment and technology used to manufacture the product. The taxpayer then entered into a contract with the seller under which the seller agreed to manufacture the blood clotting agent using its own labor and facilities and the taxpayer's equipment, technology and raw materials for a fee equal to the seller's manufacturing costs plus 10 percent. Throughout most of the relevant period, the taxpayer had no employees. Taxpayer claimed it was involved in the active conduct of a trade or business in Puerto Rico because the clotting agent was manufactured in Puerto Rico, and it was entitled to attribute the seller's manufacturing activities to itself.

The court found that the taxpayer did not actively conduct a trade or business in Puerto Rico in that it did not participate regularly, continually, extensively and actively in the management and operation of a profit motivated activity in that possession. MedChem, 2001 U.S. Tax Ct. LEXIS 26, at *96-97. The court stated that "the services underlying a manufacturing contract may be imputed to a taxpayer only to the extent that the performance of those services is adequately supervised by the taxpayer's own employees." Id. at *94.

Corp 1 would fail to satisfy this adequate supervision standard because it did not perform any management oversight. In any case, the position of the MedChem court that attribution may be appropriate under certain circumstances to determine whether a taxpayer is engaged in an active trade or business in a U.S. possession, for purposes of section 936(a), is not determinative of whether attribution is appropriate under subpart F. The MedChem court reached its conclusion by examining the legislative purposes of section 936. 2001 U.S. Tax Ct. LEXIS 26, at *85-94. To effectuate the purposes of subpart F, however, attribution can be permitted only under circumstances that prevent a CFC from being used to separate sales activities from the manufacturing activities of a related corporation to obtain a lower rate of tax for the sales income. Rev. Rul. 75-7 addressed this issue by allowing attribution but applying the branch rule to the attributed activities. The MedChem opinion provides no analysis that safeguards the purposes of subpart F.

Suzy's Zoo® v. Commissioner, 114 T.C. 1 (2001), affirmed 273 F.3d 875 (9th Cir.), addressed contract manufacturing in the section 263A context. In Suzy's Zoo® the taxpayer sold paper products on which were printed cartoon images designed by the taxpayer's employees. The issue in this case was whether the taxpayer was subject to the uniform capitalization (UNICAP) rules of section 263A. Section 263A contains a contract manufacturing provision that specifically provides that property produced under contract is considered produced by the party for whom the property is produced, in this case Suzy's Zoo. Subpart F contains no similar provision. This contract manufacturing rule of section 263A is essentially an anti-avoidance rule that treats taxpayers that have inventory goods produced for them the same as taxpayers that produce inventory for themselves for purposes of rules regarding the capitalization of indirect costs. Nonetheless, the court determined that the contract manufacturing rule of section 263A did not apply because of the nature of the taxpayer's extensive involvement in the production of the product.

In Suzy's Zoo®, the taxpayer argued it was a small reseller, and thus not subject to the UNICAP rules, because it did not engage in manufacturing or production with respect to its paper products but merely resold those products after buying them from third party independent printing companies. Id. The Tax Court disagreed, concluding that Suzy's Zoo® was the only owner of the paper products up until the time the goods were sold to customers and thus the petitioner was the only producer of the paper goods. Id. at 8. The Tax Court found that the printers' act of reproducing the artist's drawing onto greeting cards was only one small part of the manufacturing process that was "mechanical in nature in that it involves little independence on the printers' part and is subject to petitioner's control, close scrutiny, and approval." Id.

On appeal the Ninth Circuit affirmed the Tax Court's decision. Suzy's Zoo® v. Commissioner, 273 F.3d 875 (9th Cir. 2001). The Ninth Circuit noted that, to effectuate the legislative purpose behind the UNICAP rules, a broad construction of the word "produce" is necessary. Id. at 879. Consistent with this broad definition of "produce," the Court held that the "only requirement for being a producer under section 263A is that the taxpayer be considered an owner of the property produced under federal income tax principles." Id. at 880.

Suzy's Zoo® does not provide support for attribution in this case. First, in Suzy's Zoo®, the Ninth Circuit determined that the art work performed by the taxpayer was the most important part of the production process. Id. at 879. Further, the taxpayer remained involved throughout the manufacturing process, giving detailed specifications to the contractors about how the product was to be manufactured. Id. In this case, Corp 1 does not perform any of the steps necessary to manufacture Product x, nor was it actively involved in the manufacturing processes carried on by the contract manufacturers. Second, the broad definition of term "produce" does not effectuate the purposes of subpart F, as noted above.

Similarly, other tax cases that attribute contract manufacturing activities to the taxpayer are not applicable for purposes of subpart F due to the different legislative purposes of the statutes. For example, in Carbon Steel Co. v. Lewellyn, 251 U.S. 501 (1920), the issue before the Court was whether the taxpayer was the manufacturer of artillery shells for purposes of an excise tax on manufacturers when it utilized contract manufacturers to aid in the manufacture of the shells. Id. The taxpayer in Carbon Steel Co. retained control of the manufacturing process and retained ownership of the materials, work-in-progress, and final product up until delivery to the customer. Id. The Court held that the taxpayer was properly taxed for having manufactured the shells because the word "manufacture" as used in the statute contemplated both a corporation manufacturing on its own, as well as, the use of third parties in the manufacturing process. The Court determined that a narrower interpretation of a manufacturer would have allowed the statute to be easily avoided. Id. at 504. See also Polaroid Corp. v. United States, 235 F.2d 276 (1st Cir. 1956) (holding that a an excise tax on the manufacturer or producer of cameras could be levied on a corporation that retained a third-party contract manufacturer that completely controlled the manufacturing process). In the case of subpart F, however, avoidance of the statute is made easier by a broad interpretation of manufacturing. Thus, the interpretation of manufacturing for excise tax purposes should not control for purposes of subpart F.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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