

US Outbound Newsalert*

International Tax Services

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PLR 201002024: IRS applies the prior manufacturing branch rules to a partnership

In its third private ruling issued within three months, the IRS illustrates the application of the tax rate disparity test and other concepts in determining foreign base company sales income ("FBCSI") under the branch rule of section 954(d)(2). Unlike the prior rulings, PLR 201002024 (released on January 15, 2010) involves branches that are owned by an entity that is treated as a partnership for U.S. federal tax purposes, and appears to address transactions that are governed by prior manufacturing branch regulations. Nevertheless, this PLR provides insights into the IRS's interpretation of the manufacturing branch rule under both prior and current regulations (in particular the "aggregation" concept, as discussed below), as well as the application of the manufacturing branch rule to partnerships that have CFC partners.

Key Points

In a situation involving multiple sales and manufacturing locations of a partnership, PLR 201002024 concludes that where the partnership purchases products from its CFC partner's U.S. parent company, performs further manufacturing of the product through "DE5," a branch that is subject to a 0% effective tax rate, and sells the finished products through multiple sales branches, there is no tax rate disparity between any of the sales branches and the manufacturing branch and therefore no FBCSI arises under the branch rule.

The ruling also addresses transactions in which the partnership initially manufactures the products through branches that are subject to effective tax rates of 5-25%, performs further manufacturing of the product through DE5, and sells finished products through the same sales branches mentioned above. In these situations, some of the sales branches were found to be in tax rate disparity to certain manufacturing locations (but not to DE5), and are thus treated as selling products on behalf of a related person under the IRS's application of the manufacturing branch rule. Therefore, a portion of the CFC's distributive share of the partnership's sales income would have been treated as FBCSI; however, in determining whether FBCSI exists, the IRS concludes that each sales branch is aggregated with DE5 and, as a result, each sales branch is deemed to have satisfied the manufacturing exception to having FBCSI. Accordingly, PLR 201002024 rules that the taxpayer has no FBCSI from sales of the product by the partnership's sales locations.

Insight. This ruling, which appears to apply prior manufacturing branch regulations, demonstrates the IRS's position that under prior regulations the sales income of a branch or remainder is tested for tax rate disparity against every manufacturing branch that contributes to the physical manufacturing of products sold by the sales branch or remainder. In contrast, under current manufacturing branch regulations the sales income is tested for tax rate disparity against a *single* manufacturing location, even if multiple branches contribute to the manufacturing of the same item of personal property.

This ruling also shows that the IRS apparently will apply the *branch* rule to a CFC-owned *partnership*; and sets forth the application of the branch rule to a branch or disregarded entity of a partnership. The ruling is helpful in showing that while manufacturing and sales locations are not aggregated for purposes of determining tax rate disparity under either prior or current regulations, they apparently may be aggregated, even under the prior regulations, for purposes of determining whether the manufacturing exception applies.

Facts Underlying the Ruling

Taxpayer, a domestic corporation, owns, indirectly through domestic and foreign subsidiaries, all of the shares of Corp C, a CFC that is incorporated under the laws of Country 2. Corp C is subject to an effective income tax rate of 0% in Country 2.

Corp C holds an unstated percentage of the ownership interest in Partnership 2, a foreign entity treated as a partnership for U.S. federal tax purposes. The remaining ownership interest in Partnership 2 is held by investors unrelated to Taxpayer.

Partnership 2 owns a number of disregarded entities that perform Product X manufacturing and sales activities outside the partnership's country of organization. Partnership 2 owns Country 4 Branch, which in turn owns DE2 through DE7, as discussed below.

- Manufacturing Activities of Partnership 2

The manufacture of Product X occurs in two phases: (1) raw materials are used to produce "fabricated Product X," and (2) fabricated Product X is assembled and tested to produce "finished Product X."

Fabricated Product X is manufactured or purchased by Taxpayer in some cases, and in other cases manufactured by DE2, DE3, or DE4, each located in a different foreign country. The

ruling however does not indicate whether DE2, DE3, or DE4's activities qualify as manufacturing within the meaning of Treas. Reg. § 1.954-3(a)(4)(ii) or (iii). Under agreements with their respective local governments, DE2, DE3 and DE4 are subject to an effective tax rate of 10%, 5%, and 25%, respectively.

Finished Product X is produced by taking fabricated Product X through further testing and assembly by DE5. The ruling stipulates that DE5's activities constitute manufacturing within the meaning of Treas. Reg. § 1.954-3(a)(4)(iii). Under an agreement with its local country authorities, DE5 is subject to an effective tax rate of 0%.

As discussed in more detail below, the fact that DE5 both satisfies the definition of physical manufacturing and is subject to 0% effective tax rate allows Taxpayer to avoid subpart F income from the manufacturing and sale of Product X through the disregarded entities of Partnership 2.

- Purchasing and Selling Activities of Partnership 2

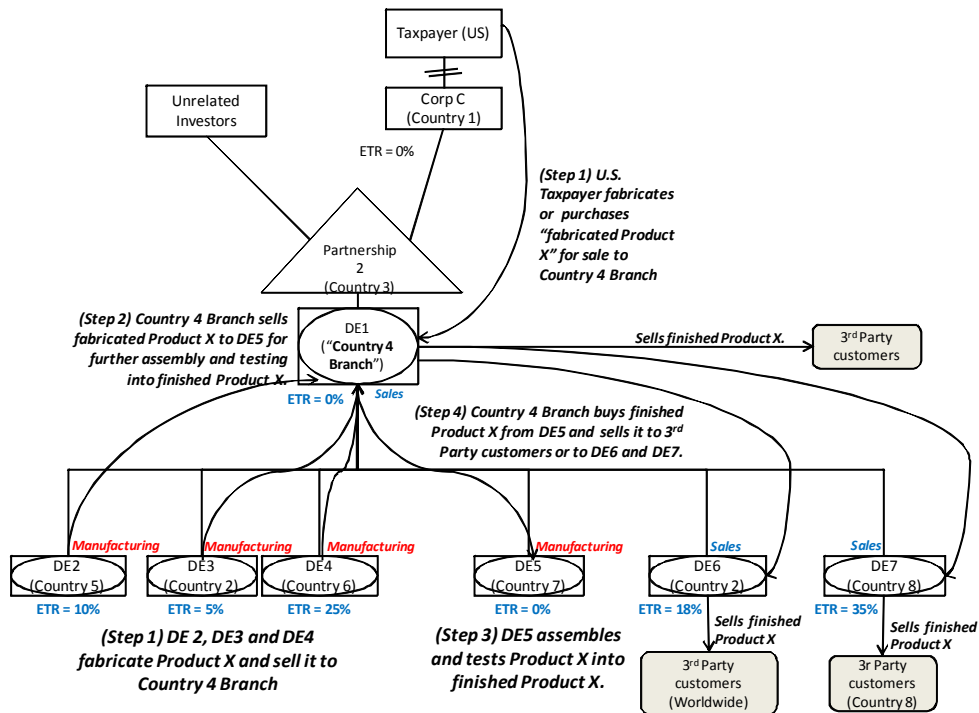
Country 4 Branch purchases fabricated Product X both from Taxpayer (in "Taxpayer-Fabricated Transactions") and from DEs 2, 3, and 4 (in "Branch-Fabricated Transactions"), and resells fabricated Product X to DE 5 for assembly and testing into finished Product X. Upon completion of assembly and testing, Country 4 Branch would purchase finished Product X from DE5 for direct sale to unrelated customers and/or to DE6 and DE7. DE6 and DE7 sell finished Product X to unrelated customers.

Under an agreement with their respective local country governments, Country 4 Branch and DE6 are subject to an effective tax rate of 0% and 18%, respectively. DE7 is subject to an effective tax rate of approximately 35%.

The activities of, and local country tax rates imposed on, the disregarded entities of Partnership 2 are summarized below:

Disregarded Entity	Effective Tax Rate	Functions Performed
Country 4 Branch	0%	Purchasing/Selling
DE6	18%	Purchasing/Selling
DE7	35%	Purchasing/Selling
DE2	10%	Manufacturing
DE3	5%	Manufacturing
DE4	25%	Manufacturing
DE5	0%	Manufacturing

The chart below shows the relevant entities and transactions in this ruling:



The taxpayer requested a ruling that Corp C's distributive share of income from Partnership 2 that is attributable to sales of Product X assembled and tested by DE 5 does not constitute FBCSI within the meaning of sections 954(d)(1) and 954(d)(2).

Analysis and Discussion

This PLR first analyzes the application of the branch rule to transactions in which finished Product X is made from fabricated Product X manufactured or purchased by Taxpayer ("Taxpayer-Fabricated Transactions"); separately, the PLR analyzes transactions in which fabricated Product X is produced by one of Partnership 2's branches ("Branch-Fabricated Transactions").

- Taxpayer-Fabricated Transactions

Subpart F income includes FBCSI, which arises when (among other scenarios) a CFC purchases personal property from a related person and sells the property to any person, if the property is both manufactured and sold for use outside the CFC's country of incorporation. Under the "Brown Group regulations," a CFC's distributive share of any item of partnership income is subpart F income to the extent the item of income would have constituted subpart F if received directly by the CFC. See Treas. Reg. § 1.952-1(g)(1).

As discussed above, Corp C is a CFC, and all of its shares are indirectly owned by Taxpayer. Thus, Corp C and Taxpayer are related for purposes of applying the FBCSI rules. Under the Brown Group regulations, Corp C's distributive share of Partnership 2's income would be FBCSI to the extent such income would be FBCSI if received by Corp C directly, unless the manufacturing exception or another exception to FBCSI applies.

In Taxpayer-Fabricated Transactions, Partnership 2 derives income from purchasing fabricated Product X from Taxpayer (through the activities of Country 4 Branch) and selling finished Product X to unrelated customers (through the activities of Country 4 Branch, DE6, and DE7). Because Taxpayer is related to Corp C for FBCSI purposes, Partnership 2's Product X sales income would be FBCSI if it were received by Corp C directly, and Corp C's distributive share of such income would be treated as FBCSI under the Brown Group regulations. However, Corp C's distributive share of such income qualifies for the manufacturing exception to FBCSI because Partnership 2, through the activities of DE5, conducts assembly and testing to convert fabricated Product X into finished Product X in processes that satisfy the

physical manufacturing test of Treas. Reg. § 1.954-3(a)(4)(iii).¹

After concluding that Partnership 2 meets the manufacturing exception to FBCSI, the IRS proceeds to apply the manufacturing branch rule to Partnership 2. The technical basis for applying the manufacturing branch rule in this context is unclear. Under section 954(d)(2), the branch rule applies to a “branch or similar establishment” of a CFC, but Partnership 2 is treated as a partnership, not a branch, of Corp C for U.S. federal tax purposes. Likewise, the relevant manufacturing branch, DE5, is a branch of Partnership 2, not a branch of Corp C. Further, the manufacturing branch rule applies if a CFC satisfies the manufacturing exception and performs manufacturing-related activities through a branch, but the CFC in this instance, Corp C, does not satisfy the manufacturing exception. The exception is met by Partnership 2. Thus, based on the above, good arguments can be made that neither Partnership 2 nor DE5 constitutes a “branch or similar establishment” of Corp C under the branch rule, and the manufacturing branch rule arguably does not apply to the activities of DE5.

Nevertheless, the IRS concludes that the manufacturing branch rule does apply, based on the Brown Group regulations. The IRS indicated that, under Treas. Reg. § 1.952-1(g)(1), the determination of whether a CFC’s distributive share of an item of partnership income is FBCSI requires the item to be treated as though it were received by the CFC directly. The ruling points out that DE 5 is a branch engaged in manufacturing outside Partnership 2’s country of organization. If Partnership 2’s income were received by the CFC directly, the manufacturing branch rule would apply to determine whether any portion of that income should be treated as FBCSI. The IRS concludes that, therefore, if a partnership conducts manufacturing activities outside its country of organization, as Partnership 2 does through DE5, then the manufacturing branch rule may apply to treat the branch as a separate corporation, depending on the outcome of the tax rate disparity test. The ruling concludes that, if DE5 were treated as a separate CFC, then the “remainder” of Partnership 2 would be treated as selling finished Product X on behalf of a related person (the deemed CFC) and thus potentially give rise to FBCSI under the branch rule, notwithstanding that the manufacturing exception is met for purposes of the Brown Group regulations, as discussed above.

Insight: In this respect, although the PLR does not expressly define Partnership 2 to be a branch or

similar establishment of Corp C,² the PLR’s application of the Brown Group regulations and the branch rule arguably achieves the same effect. The ruling’s focus on the country of organization of the partnership is also notable. Under regulations that the ruling itself cites, the relevant inquiry would seem to be whether any branch activities are performed outside of the country in which the CFC is organized.³ Accordingly, where the partnership is organized would seem to be irrelevant. In the ruling, however, the IRS took into account where the partnership was organized, and not the CFC.

PLR 201002024 applies the tax rate disparity test by comparing the effective tax rate imposed on the sales income of the “remainder of the partnership” (the sales branches of Partnership 2) with the hypothetical effective tax rate that would apply to such income under the laws of the country in which DE5 is located. The hypothetical effective tax rate is computed by assuming that, under the laws of DE5’s country of operation, the entire income of Partnership 2 were considered derived from sources within (and received in) that country from doing business through a permanent establishment (“PE”) there (and allocable to that PE), and Partnership 2 were created under the laws of, and managed and controlled in DE5’s country (the “requisite assumptions”). The test is applied by treating each of Country 4 Branch, DE6 and DE7 as though it alone were the only “remainder of the partnership.” None of these sales branches were found to be in tax rate disparity with DE5, because the effective tax rate imposed on Country 4 Branch, DE6, and DE7 (0%, 18%, and 35%, respectively), is not less than 90% of, and not at least 5 percentage points lower than, the effective tax rate that would apply to such income (taking into account the requisite assumptions) in DE5’s country of operation (0%).

The sales income of Country 4 Branch, DE6 and DE7 is not tested for tax rate disparity to the other manufacturing branches of Partnership 2 (DE2, DE3, and DE4) because those branches are not

² The Tax Court has rejected prior IRS efforts to define separate manufacturing entities as a branch for this purpose. See *Ashland Oil v. Commissioner*, 95 T.C. 348, 360 (1990) (“[a] separately incorporated manufacturing entity operating pursuant to an arm’s-length agreement, with the CFC having no direct or indirect stock interest in that entity (and vice versa), does not fall within any customary meaning of ‘branch’ of which we are aware.”); see also *Vetco, Inc. v. Commissioner*, 95 T.C. 579, 591-592 (1990), in which the Tax Court held that a separate manufacturing subsidiary of a CFC cannot constitute a branch or similar establishment either.

³ See Treas. Reg. § 1.954-1(g)(1).

¹ See Treas. Reg. § 1.954-3(a)(6).

involved in the manufacturing of Product X in Taxpayer-Fabricated Transactions.

Thus there is no tax rate disparity between Country 4 Branch, DE6 or DE7, with the relevant manufacturing location, DE5, and Corp C's distributive share of Partnership 2 income derived from the Taxpayer-Fabricated Transactions is not FBCSI.

- Branch-Fabricated Transactions

In Branch-Fabricated Transactions, DEs 2, 3, 4, and 5 all engage in manufacturing outside Partnership 2's country of organization. For these transactions, the PLR applies the tax rate disparity test separately to the income derived by the sales branches -- Country 4 Branch, DE6, and DE7, against the hypothetical tax rate which would apply to the tested sales income in *each* country of manufacturing -- the countries in which DE2, DE3, DE4 and DE5 operate.

As discussed above, the effective tax rate imposed on the income of Country 4 Branch (0%), DE6 (18%), and DE7 (35%), in each case is not in tax rate disparity to the hypothetical tax rate which would apply in DE5's country of operation (0%), taking into account the requisite assumptions, and thus DE5 is not treated as a separate corporation with respect to any of these sales branches.

DE7, taxed at 35%, also does not have a tax rate disparity to any other manufacturing locations, *i.e.*, DE2, DE3, and DE4, which are taxed at 10%, 5%, and 25%, respectively. Thus, DE7 is not treated as a separate corporation selling on behalf of any related person in Branch-Fabricated Transactions, and Partnership 2's income from selling finished Product X through DE7 is not FBCSI.

In contrast, Country 4 Branch, a sales branch taxed at 0%, would be in tax rate disparity to each of DE2, DE3, and DE4, taxed at 10%, 5%, and 25%, respectively. The remaining sales branch, DE6, taxed at 18%, would be in tax rate disparity with DE4, taxed at 25%, but not in tax rate disparity with either DE2 or DE3, taxed at 10% and 5%, respectively.

The PLR indicates that because DE2, DE3, and DE4 would each be related to Corp C if they were separate corporations, Partnership 2 (through its sales branches) is treated as deriving income from selling personal property to customers on behalf of persons related to Corp C. Specifically, Country 4 Branch is deemed to be selling Product X on behalf of DE2, DE3, and DE4 (but not on behalf of DE5). Further, DE6 is deemed to be selling Product X on behalf of DE4 (but not on behalf of

DE2, DE3, or DE5). Thus, Partnership 2, through the activities of Country 4 Branch and DE6, is deemed to be selling Product X on behalf of related persons. If Corp C derived income from such sales directly, it would be FBCSI under section 954(d)(1); thus, Corp C's distributive share of such income qualifies as FBCSI under the Brown Group regulations. Treas. Reg. §1.952-1(g)(1). Following this analysis, Partnership 2's income from the sale of finished Product X through the Country 4 Branch and DE6 would give rise to FBCSI unless an exception to FBCSI applies. As discussed below, however, the ruling ultimately concludes that Country 4 Branch and DE6 do not have FBCSI by reason of their "aggregation" with DE5.

This PLR appears to have applied the tax rate disparity test of the prior regulations, which do not expressly require the determination of a *single* manufacturing location when multiple branches manufacture the same item of personal property. Under the current regulations,⁴ DE5 would have been treated as the single location of manufacturing (and the income of the sales branches tested for tax rate disparity only with respect to DE5 and not to any other branch) because DE5's activities satisfy the manufacturing exception, and DE5 is subject to the lowest effective tax rate among all the branches that are involved in the manufacturing of Product X.⁵ Under the current regulations, neither Country 4 Branch, DE6, nor DE7 would be in tax rate disparity to the single manufacturing location of DE5, and thus no FBCSI would arise under the branch rule from Branch-Fabricated Transactions. In contrast, in this PLR, the income of each sales branch is tested for tax rate disparity not only against DE5, but also against DE2, DE3, and DE4, even though the ruling does not specifically indicate that DE2, DE3, or DE4's activities satisfy the manufacturing exception. Thus, this PLR appears to signal the IRS's position that, under prior regulations, the sales income of each sales branch or "remainder" of the CFC must be tested for tax rate disparity against every branch that contributes to the (physical) manufacturing of the product sold by the sales branch or remainder,⁶ and potentially without regard to whether the manufacturing branch independently satisfies the manufacturing exception.

⁴ See generally Temp. Treas. § 1.954-3T(b)(1)(ii)(c)(3).

⁵ See Temp. Treas. Reg. § 1.954-3T(b)(1)(ii)(c)(3)(ii).

⁶ Alternatively, the ruling may be read to suggest that the single location of manufacturing approach under the current regulations does not apply to branches of a partnership.

The PLR then concludes that, even though Country 4 Branch and DE6 is each treated as the remainder of the partnership selling on behalf of DE2, DE3, and/or DE4, the remainder will in each case “include” DE5 for purposes of determining whether Country 4 Branch and DE6 have earned FBCSI. The inclusion of DE5 with Country 4 Branch and DE6 is similar to an “aggregation rule” contained in the current regulations, under which a tested sales branch or remainder essentially is credited with the manufacturing-related activities of other branches not in tax rate disparity with the sales branch or remainder. The aggregation rule applies both for purposes of determining the location of manufacturing,⁷ as well as for purposes of determining whether the sales branch or remainder has FBCSI.⁸ The preamble to the current regulations explains that the purpose of the aggregation rule is to determine whether the sales branch or remainder has FBCSI after being treated as a separate corporation, and that “[s]uch determination will depend on whether the substantial contribution test is satisfied by the *combined activities* of the sales or purchase branch (or remainder) and the other locations aggregated with the sales or purchase branch (or remainder).”⁹ (Emphasis added).

Although the prior regulations do not expressly contain the same aggregation rule, this PLR applies a similar concept to determine that the remainder of Partnership 2 will include the sales branches Country 4 Branch and DE6, plus “any other portions of the partnership” that is neither a sales branch nor a manufacturing branch that is in tax rate disparity to the tested sales branch. Thus, the remainder of Partnership 2 would include DE5, a manufacturing branch that is not in tax rate disparity to Country 4 Branch and DE6. Because DE5 itself satisfies the physical manufacturing test, its inclusion into the remainder qualifies both Country 4 Branch and DE6 for the manufacturing exception. Although the ruling does not expressly cite this point, under the “comparison with ordinary treatment” exception of Reg. § 1.954-3(b)(2)(ii)(e) of the prior regulations, the income of a branch or remainder is not FBCSI under the branch rule if the income would not constitute FBCSI if derived by a separate CFC under like circumstances.¹⁰ If Country 4 Branch and DE6 were separate CFCs, then the income that they derive from selling finished Product X, although treated as sold on

behalf of related persons (DE2, DE3, and/or DE4), would not be treated as FBCSI because the deemed CFC would satisfy the FBCSI manufacturing exception by reason of DE5’s activities.

Based on the inclusion or “aggregation” of DE5’s activities into the remainder of Partnership 2, the ruling concludes that no portion of Corp C’s distributive share of Partnership 2 income derived from the Branch-Fabricated Transactions constitutes FBCSI.

Conclusion

PLR 201002024 provides insights into the application of the manufacturing branch rule in the context of multiple sales and manufacturing locations. This ruling, which appears to apply prior manufacturing branch regulations, demonstrates that the IRS apparently will test, under the prior regulations, the sales income of a branch or remainder for tax rate disparity against every branch that contributes to the manufacturing of products sold by the sales branch or remainder. In contrast, under the current regulations, the sales income is tested for tax rate disparity against a single manufacturing location even if multiple branches participate in the manufacture of the same item of property. Further, while the ruling confirms that each sales branch is analyzed on a standalone basis for determining tax rate disparity, the ruling also suggests that a sales branch apparently may be aggregated with a manufacturing branch, even under the prior regulations, for purposes of determining whether the sales branch meets the manufacturing exception. However, companies should be advised that the IRS, as demonstrated by this PLR, likely will apply the branch rule to a branch or disregarded entities of a partnership, even though an entity that is treated as a partnership for U.S. federal tax purposes (including its branches) arguably is not a “branch or similar establishment” for purposes of the branch rule.

⁷ See Temp. Treas. Reg. § 1.954-3T(b)(1)(ii)(c)(3)(iii).

⁸ See Temp. Treas. Reg. § 1.954-3T(b)(2)(ii)(a).

⁹ See preamble to T.D. 9438, 73 Fed. Reg. 79,342 (Dec. 29, 2008).

¹⁰ This exception currently is found in Temp. Treas. Reg. § 1.954-3T(b)(2)(ii)(e).

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