June 20, 2008

CC:PA:LPD:PR (REG-124590-07)

Internal Revenue Service
Courier's Desk
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

RE: Proposed Regulations relating to Foreign Base Company Sales Income Under Section 954 of the Internal Revenue Code (REG-124590-07)

Dear Sir of Madame:

On behalf of the National Foreign Trade Council, I enclose the NFTC's written comments on the above regulations. The NFTC requests permission to testify at the July 29, 2008 hearing on these regulations.

If you have any questions, please do not hesitate to call Catherine Schultz, Vice President for Tax Policy at 202-887-0278, cschultz@nftc.org.

Comments of the National Foreign Trade Council
On the
Proposed Regulations
Relating to Foreign Base Company Sales Income
Under Section 954
Of the Internal Revenue Code
(REG-124590-07)
Submitted to the Internal Revenue Service
June 20, 2008

The National Foreign Trade Council ("NFTC") appreciates the opportunity to provide comments on REG-124590-07 ("proposed contract manufacturing guidance" for foreign base company sales income-FBCSI). The NFTC appreciates the effort of the government to propose modernized rules that provide greater certainty in this very uncertain area to both taxpayers and government.

The NFTC, organized in 1914, is an association of some 300 U.S. business enterprises engages in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial and service activities and the NFTC therefore seeks to foster an environment in which U.S. companies can be dynamic and effective competitors in the

international business arena. The NFTC's emphasis is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities in the treatment of U.S. companies operating abroad. To achieve this goal, American businesses must be able to participate fully in business activities throughout the world, through the export of goods, services, technology, and entertainment and through direct investment in facilities abroad. Foreign trade is fundamental to the economic growth of U.S. companies.

The proposed regulations address important aspects of recent developments in the manufacturing business model, including centralization of the management functions into strategic regional centers that operate and manage their global businesses more efficiently to remain competitive. These regional management centers are the principal entities in the highly specialized management of manufacturing operations around the world. The NFTC's comments seek to promote changes in the proposed regulation which will facilitate a better understanding of the rules, and provide greater clarity for taxpayers with robust global businesses.

This letter comments on both the newly expanded definitions and factors that are referred to as "substantial contribution" and the application of the branch rules. It also comments about the examples in the proposed rules, and it provides new examples that could better illustrate the intent of the proposed regulations.

I. **"Substantial Contribution" Factor Comments**

The "substantial contribution" factors as listed are intended to identify and define the critical "value drivers" that a well-substanced principle entity add to the manufacturing process. Recognizing the importance of these "non-physical" manufacturing characteristics in the context of the manufacturing exception for foreign base company sales income is a welcome development. They focus appropriately on the functions and responsibilities of the participants in the area of contract manufacturing arrangements.

The NFTC agrees that the non-exclusive list of factors that illustrate substantial contribution to manufacturing should be driven by facts and circumstances given the differences in business operations between and among industries as well as companies within any given industry. We would recommend that language and examples be added to include a clarification that the list of factors are really qualitative and not quantitative. This may include better articulating that these factors are to be considered based on value contributed relative to a particular company's business model or industry profile (in relation to its manufacturing process), consistent with principles similar to §482 principles, not just on the number of factors utilized. One way to demonstrate this would be through an example where perhaps only 2 factors were necessary to meet substantial contribution, because those two factors were the critical value drivers of a particular business. Additionally, an example which illustrates that a few senior individuals with decision making authority drive more value and contribution than many lower level employees who are technicians would also be helpful.

We believe that the proposed regulations could also be more clear based on the comments regarding the factors listed below:

- We suggest that risk of loss, which is currently included only as a parenthetical with the oversight and direction factor (factor 1) be listed as a separate factor and be broadened to include other types of risk and loss in relation to the manufacturing

component of a principal entities' entrepreneurial business. The active management of these risks is a crucial part of the strategic planning and management decisions made by senior employees of the principal entity.

- The term "Management of the manufacturing profits", listed as factor 4, should be clarified. It is possible, although not entirely clear, that this factor may be intended to include all types of financial management decisions with regards to the financial results of the manufacture of product. If so, this factor should be refined to provide greater clarity. It would be helpful to include explanatory language which describes some of these types of activities.
- We also suggest that factor 9, "management of intellectual property" be clarified and expanded as well. This factor, currently stated as "direction of the development, protection and use of trade secrets, technology, product design and design specifications, and other intellectual property used in manufacturing the product….", could be read to conclude that both the direction, protection and use is required to satisfy this component, given the use of the word "and". In many instances, however, a principal entity may not be directly involved in the development and protection of the property if it is a licensee and not owner of the intellectual property. We believe "use" of the intangibles is sufficient as "use" is the most directly related to manufacturing. Therefore, we suggest that the word "or" be substituted for "and". Additionally, the definition of intangible should be broadened to include the license of the trademark or trade names, without which the licensee may not be entitled to manufacture the product at all. Entitlement to the use of trademark/trade names via either ownership or as licensee is an important element for the manufacturer who could be subject to lawsuits, product seizure or destruction if entitlement to the product or name does not exist. Additionally, intangibles are sometimes "bundled" where both the license of the trademarks and names as well as the manufacturing processes and know how are licensed via a single agreement.

Additionally, we do request that the government confirm that the definition of "employees" with regards to determining "substantial contribution", can, in addition to CFC's employees, include individuals that may be employed by another entity (related or unrelated), but are acting under the control and direction of the CFC, such as seconded employees.

II. **Branch Rule Comments**

Physical v. Non-physical Manufacturing

The substantial contribution factors greatly improve the application of the manufacturing exception in the context of modern business enterprise models. The proposed rules recognize the strategic importance of the "non-physical" factors that are critical to the strategic management of the value drivers in manufacturing. However, under the proposed changes to the branch rule, physical manufacturing appears to carry greater weight than "substantial contribution" manufacturing. This is contrary to our understanding of the reason for updating these rules.

The disparity between physical and non physical manufacturing is shown in three ways. First, the rules provide precedence for any physical branch over substantial contribution branches; second, if the physical branch runs afoul of the rate disparity test, there is a rebuttable presumption against a finding of substantial contribution manufacturing in the

same entity which makes it more difficult to establish that the remainder of the entity itself satisfies the manufacturing exception based on its substantial contribution activities. Thirdly, the lowest tax rate location is used for multiple physical manufacturing branches, yet the highest tax rate location is used for determining a single location of "substantial contribution" branches that are not predominant.

We believe these proposed rules should not favor the physical manufacturing branch location, but that both physical and non-physical manufacturing should be treated the same, since we cannot identify a valid policy reason why they should be treated differently.

If the rebuttable presumption is retained in the regulations, it is unclear how a taxpayer can rebut the presumption. What additional proof is needed above demonstrating the "substantial contribution" factors? Further clarification is needed here.

The alternative approach mentioned in the preamble of the regulations, which would deny qualification under the "substantial contribution" rules if physical manufacturing exists in the same CFC, is not a preferred approach as it works against the underlying rationale for modernizing these rules.

Predominance Standard

The NFTC agrees that it is appropriate to use a predominant standard to identify a single manufacturing branch for purposes of the manufacturing branch test. This standard, as currently written, appears to create uncertainty about the tax impacts of transactions for some taxpayers.

There is concern that the predominance standard seems to be the exception rather than the rule. Example #4, in particular, concludes there is no predominant location. Given this outcome, it appears as though the predominant standard is extremely difficult to meet. If this is not the intended result, we suggest that the language and the result of the example be changed to reach the right result, and be consistent with the general meaning of predominant, which is "largest or most common".

Without a determination of a predominant location, using the highest tax rate location is arbitrary and rather punitive, especially in light of using the lowest tax rate location for multiple physical manufacturing branches. We recommend that the government use the lowest rate for "substantial contribution" as well as for physical manufacturing. Alternatively, as suggested in the preamble, using the mean rate could be an improvement over the highest tax rate. However, developing a clear definition of a "mean" rate could prove to be quite difficult. Finally, it is important to apply the rate test for final determination of location only among the truly significant branches. All of the other branches that have only insignificant activity should be excluded from the test. Otherwise very insignificant branch activity could create FBCSI where not intended.

Interplay of branch rules with unrelated transactions

The proposed rules seem to conclude that FBCSI may exist even if a company does not have related party transactions. Section 954 does not apply to purchases of raw materials from an

unrelated supplier and sales to an unrelated customer. The proposed rules should be amended to clearly reflect that transactions between unrelated parties do not create foreign base company sales income, by ensuring that the manufacturing branch rule would only apply in situations where a taxpayer is utilizing the manufacturing exception.

Tax Rate Disparity Test

The current 5% tax rate differential is overly narrow and doesn't take into account the "normal" differences in tax rate jurisdictions given where today's global companies operate. A company should not be penalized with US taxation due to the fact that there are varying tax rates between different regions or jurisdictions.

For example, a CFC principle and manufacturer located in the UK, who also distributes within Europe, and has a Hong Kong branch that distributes in Asia, could have FBCSI given the rate differentials between the UK and Hong Kong, neither of which are considered low tax jurisdictions.

The government should consider amending the tax rate disparity test to apply to branches which have greater than 10 or 15% tax rate differential versus the current narrowly defined 5% rate disparity.

Hypothetical Rate Test

The purpose underlying the manufacturing branch rule, is to prevent the separation of manufacturing and sales functions, and therefore the profit from each function, in order to reduce foreign tax on sales income. Currently, the tax rate disparity test compares the actual rate of tax applicable to the CFC remainder's sales income (the "actual effective rate") against the rate of tax that would apply to the sales income if it were derived by the manufacturing branch in the country in which the branch is located (the "hypothetical effective rate"). In determining this "hypothetical rate" the Current Regulations require taxpayers to assume that the branch is a corporation created and organized, and managed and controlled, in the country in which the branch is created, and that the branch (which is deemed to be a corporation) derives the remainder's sales income "from sources within such country" through a permanent establishment. The effect is that the tax rate is determined assuming the sales income is domestic source income in the country in which the manufacturing branch is located, instead of computing the actual tax rate that would apply to the sales income, given the taxpayer's facts and circumstances with respect to such sales, if the sales activities and income were in the branch itself.

Given the different sourcing rule that is required to be applied in the hypothetical determination, the hypothetical effective tax rate may be greater than the tax rate that would actually apply if all of the sales activities actually engaged in by the CFC, and the income therefrom, were in the branch, rather than in the CFC or remainder. This often results in the application of the manufacturing branch rule even where the sales income has not been placed in a lower-tax jurisdiction, which does not adhere to the objective of the policy underlying the manufacturing branch rule.

The issue described above can be illustrated with the following example. Assume that CFC, a corporation organized in Country A, derives foreign source income from selling products from Country A to customers located exclusively in Country C. Further assume that the products are manufactured by a related party in Country B, but that CFC's branch in Country B performs activities with respect to the manufacturing process that rise to the level of a substantial contribution. CFC's sales income is subject to tax in Country A at a 20 percent rate. Country B similarly imposes tax on the income derived by Branch B at a 20 percent rate. Moreover, the 20 percent rate would apply even if Branch B were a corporation organized in Country B that derived income from sales to customers located in Country C through a permanent establishment in Country B. However, under Country B's tax laws, income derived from sales to Country B customers would be treated as domestic source income and would therefore be subject to tax at a 30 percent rate.

In the above example, the policy underlying the manufacturing branch rule is not implicated because CFC's sales income is subject to tax at a rate that is equal to the rate of tax that would apply if the sales income were derived by Branch B (20 percent in Country A vs. 20 percent in Country B). However, the manufacturing branch rule potentially applies because, in determining the hypothetical rate, the Current Regulations ignore the actual facts and provide that the sales income must be treated as domestic source income of Branch B, which in this example would be subject to a higher rate of tax than the rate of tax that would apply if Branch B conducted the export sales that actually occurred. Thus, although there is no shifting of the sales income to a lower-tax jurisdiction, CFC's sales income may be foreign base company sales income solely by virtue of section 954(d)(2).

We request that the Treasury and Service remove the in-country sales requirement from the list of assumptions that apply in determining the hypothetical effective rate of a manufacturing branch. Specifically, we request that the Treasury and Service clarify that the hypothetical effective rate should be determined by asking what rate of tax would apply if all of the remainder's sales activities and sales income were effectively performed and earned by the manufacturing branch, taking into account the actual characteristics of such sales (i.e., location of customers, place of title passage).

The hypothetical rate test not only is inequitable due to the application of the manufacturing branch rule when the sales income has not actually been placed in a lower tax jurisdiction, but the calculation is more complicated. Making a determination of what hypothetical rate might apply can be very complicated and time consuming because the taxpayer must assume different facts and circumstances and potential tax implications. Changing the rate test requirement to actual facts would be a simplification.

This goal could be accomplished by removing the requirement in Treas. Reg. §1.954-3(b)(1)(ii)(b) that the sales income must be treated as derived from sources within the country in which the branch is located. Treas. Reg. §1.954-3(b)(1)(ii)(b) could further be amended to provide (or an example could be added illustrating) that sourcing determinations, if relevant for local country tax purposes, should be made based on the actual facts relating to the sales (i.e., location of the customers, place of title passage). Thus, Treas. Reg. §1.954-3(b)(1)(ii)(b) would still provide that the sales income must be treated as derived by the manufacturing branch from a permanent establishment, but the actual facts underlying the sales activities and income would otherwise be taken into account and only the entity conducting those activities would be changed for purposes of the hypothetical determination. This would serve as a more accurate test of whether the purpose underlying the manufacturing branch rule is implicated.

Alternatively, or in addition, a policy-based safe harbor could be added under which the tax rate disparity test would not be triggered if the U.S. shareholders can prove that the sales income of a CFC would not be subject to tax at a materially higher rate if the CFC's sales income were derived by the branch and all of the sales activities were performed by employees of the branch from a permanent establishment in the country in which the branch is located.

III. **Other Comments**

We would ask the government to consider a transitional rule to allow taxpayers to elect either the adoption of these new rules as prescribed in the current proposed regulations, or the following fiscal year to allow time for analysis, business restructuring and systems reconfigurations, if needed to conform to the new rules**.**

IV. **Examples**

In general, examples can be helpful in assisting with the interpretation and understanding of rules for both taxpayers and the Service. In addition to the comments above on suggestions for examples, we would also encourage the government to add more examples which would include both positive and negative outcomes to better illustrate the differences. Also, writing separate examples and demonstrating "substantial contribution" apart from illustrating the branch rules and the rate disparity test, may make the examples more clear.

Below are a few examples that we request for consideration. Example 1A is intended to be in addition to Example 1. Example 4A is intended to be a substitution of the existing Example 4. The last example below is intended to be an additional example.

Example 1A. Substantial contribution to manufacturing related manufacturer. (i) Facts. Assume the same facts as in Example 1, except for the following. FS and CM are related corporations. Employees of FS include the managers of a regional manufacturing function. The employees of CM who are engaged in the manufacturing activity, including on-site control of logistics, material selection, quality control, and control of raw materials, work-in-process and finished goods ultimately report to and are managed by employees of FS. The managers employed FS do not manage and direct the employees of FS on a daily basis, rather, exercise managerial control through weekly or monthly meetings that forecast, plan, monitor, and review the manufacturing activity and performance of the manufacturing plant operated by CM.

(ii) Result. FS does not satisfy paragraph (a) (4)(ii) or (a)(4)(iii) of this section with respect to Product X because FS does not, through the activities of its employees, substantially transform, convert or assemble personal property into Product X. However, Product X was manufactured (by CM), and therefore this paragraph (a)(4)(iv) applies. FS satisfies the test under this paragraph (a)(4)(iv) because through the regular exercise of its rights to oversee and direct activities of CM through the management of the regional manufacturing function, it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore FS is considered to have manufactured Product X.

Example 4A. Automated manufacturing. (i) Facts. The facts are the same as in Example 4 except that FS employees (rather than DP employees) regularly supervise the computer technicians, evaluate the results of the automated manufacturing business, and make ongoing operational decisions, including, (i) whether the manufacturing process is performing at an acceptable level and (ii) when stoppages of the manufacturing process are required. In addition, FS employees (rather than DP employees) control other aspects of the manufacturing process such as vendor and material selection, management and retention of the manufacturing profits, and the selection of the CM. Upgrades to the software and network systems are made available to FS by virtue of being a participant to the cost sharing arrangement with DP (as in Example 4, DP employees develop the upgrades to the software and network systems). Also as in Example 4, DP employees are responsible for product and process redesigns and updates to meet the needs of the business and customers.

(ii) Result. FS does not satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X because FS does not, through activities of its employees, substantially transform, convert or assemble personal property into Product X. If the manufacturing activities undertaken with respect to Product X between the time the raw were purchased and the time Product X was sold were undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. FS employees regularly supervise the computer technicians, evaluate the results of the automated manufacturing business, and make ongoing operational decisions, including, (i) whether the manufacturing process is performing at an acceptable level and (ii) when stoppages of the manufacturing process are required. In addition, FS employees control other aspects of the manufacturing process such as vendor and material selection, management and retention of the manufacturing profits, and the selection of the CM. Therefore, FS is considered to have manufactured Product X.

Manufacturing Branch Rule Example:

(i) Facts.

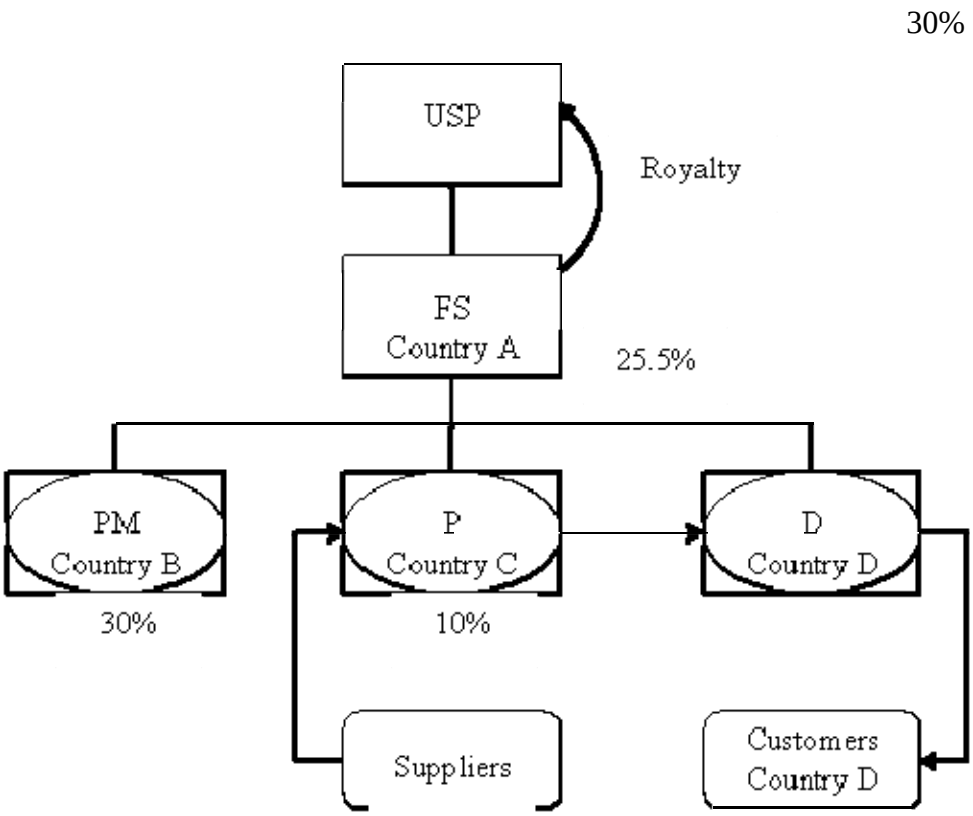
- USP owns 100% of FS (CFC)
- FS is in the business of manufacturing industrial products where the key factors are procurement, supply/demand balancing, capacity management, inventory management
- FS licenses the rights to product and process related technologies from its US Parent paying an arm's length royalty rate
- FS manufactures and distributes its products through branches including Branch P (employees that substantially contribute to the physical manufacturing activity), Branch PM (physical manufacturing branch and Branch D (sells and distributes the finished products).

FS Employees (through branch P) substantially contribute to the physical manufacturing branches as follows:

- Retain control of the raw material, work-in-process, and finished goods, as well as the intangibles used in the conversion process
- Retain the right to oversee and direct the physical conversion by PM and regularly exercise powers of oversight or direction through its employees
- Select vendors and materials, negotiate and conclude contracts with vendors

- Direct which plant will produce what product
- Plans PM's production on a 12 month rolling forecast basis
- Manages the manufacturing profits through obtaining low cost feed-stocks and the planning process to maximize plant utilization and optimize inventory levels
- Sets the standards for quality and regularly provides technical engineering services to assist PM and customers
- FS employees direct the overall manufacturing activities through weekly and/or monthly meetings that forecast, plan, monitor, and review the manufacturing activity and performance of the manufacturing plant operated by PM.

(ii) Branch Structure. FS branch structure and related tax rates are as follows:



(iii) Result. FS must rebut the negative presumption that it is not making a substantial contribution given the physical manufacturing branches. FS successfully rebuts the negative presumption by making substantial contribution through its employees located in branch P. Therefore FS is considered to have manufactured Product X for purposes of determining Foreign Base Company Sales Income.

P does not fail the rate disparity test under the Manufacturing Branch Rule because the effective rate of tax in branch D is not less than 95% of and 5% less than the hypothetical rate that would apply if D were taxed in Country C, the location of the manufacturing branch, under a permanent establishment.

D does not fail the rate disparity test under the Sales Branch Rule because the effective rate of tax in sales branch D is not less than 95% and 5% less than the rate that would hypothetically apply if D were taxable in Country A. D would not have Foreign Base Company Sales Income even if it did fail the rate disparity test so long as D only sells in Country D.