



The National Foreign Trade Council

Regulatory Working Group – Update

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Regulatory Working Group – Update

- Proposed Contract Manufacturing Regulations
- Proposed Code Section 987 Regulations
- 6/30/09 Business Plan



Proposed Contract Manufacturing Regulations

- Proposed Contract Manufacturing regulations issued on February 27, 2008
- The proposed regulations introduce the "substantial contribution" manufacturing exception to FBCSI.
- Regulations provide non-exclusive list of qualifying activities
 - › Weight given to any activity depends on facts of particular business;
 - › CFC employees must make "substantial contribution" to manufacturing of the property sold.
- Some modifications to branch rules
- Proposed regulations apply to taxable years beginning on or after the date published as final regulations.
- Preamble provides that taxpayers may apply the proposed regulations, if applied in their entirety to all open tax years.

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The Substantial Contribution Test: Qualifying Activities

- Qualifying activities include, but are not limited to the following:
 - › Oversight and direction of physical activities, including "management of risk of loss;"
 - › Performance of physical activities that are considered in, but fail to satisfy, the other tests;
 - › Control of raw materials, work-in-process, and finished goods;
 - › Management of the manufacturing profits;
 - › Materials selection;
 - › Vendor selection;
 - › Control of logistics;
 - › Quality control; and
 - › Direction of development, protection and use of intangibles used to manufacture the product

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Proposed Contract Manufacturing Regulations - Comments Requested

- Activities considered for Substantial Contribution Test.
- Safe harbor(s) for Substantial Contribution Test.
- Expansion of “employees only” rule in manufacturing exception to certain non-employees controlled by CFC.
- Anti-abuse rule for too much US contribution.

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Proposed Contract Manufacturing Regulations – NFTC Comments

- On June 20, 2008, the NFTC submitted comments on the proposed contract manufacturing regulations:
- Major points of submission
 - › Agreed that the non-exclusive list of factors should be driven by facts and circumstances due to differences in industries and businesses.
 - › Recommended that a clarification be added that makes it clear that the factors will be considered on a qualitative rather than quantitative basis and such qualitative analysis will be consistent with principles of Code section 482.
 - In particular, suggested examples which would demonstrate that perhaps only 2 factors are needed (if those are the critical value drivers), as well as illustrating substantial contribution through a few senior decision makers individuals.

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Proposed Contract Manufacturing Regulations – NFTC Comments

With respect to substantial contribution activities, the NFTC suggested:

- › Risk of loss (currently a parenthetical of another factor), be listed as a separate factor and be broadened to include other types of risk and loss in relation to the manufacturing process.
- › Asked for a clarification of “management of the manufacturing profits” and perhaps a description of the types of activities included.
- › That clarification be added with respect to the “management of intellectual property” factor, specifically to change the word “and” to “or” with respect to development and usage of intangibles and that the definition of intangibles be broadened to include trademarks and tradenames.
- › And also confirmation that the definition of “employees” would be broadened to include individuals that may be employed by another entity (related or unrelated), but that are acting under the control and direction of the CFC, such as seconded employees.

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Proposed Contract Manufacturing Regulations – NFTC Comments

With regard to the Branch Rules, the NFTC commented as follows:

- Requested parity between physical manufacturing and substantial contribution with regard to the rate for multiple branches, currently highest for substantial contribution and lowest for physical, as well as the removal of the rebuttable presumption that physical manufacturing takes precedence over substantial contribution.
- Asked for clarification about how a taxpayer can rebut the presumption if it is retained in the regulations
- Agrees that it is appropriate to use a predominance standard to identify a single manufacturing branch for purposes of the branch test. However, as currently drafted, uncertainty has been created, in particular with the current wording of Example #4 as it concludes there is no predominant location.
- Finally, the NFTC requested that branches with insignificant activities should be excluded from the test when determining predominance.

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Proposed Contract Manufacturing Regulations – NFTC Comments

Interplay of branch rules with unrelated transactions

- The proposed regulations seem to conclude that FBCSI may exist even if a company does not have related party transactions. The NFTC suggested that the proposed regulations be amended to eliminate this unintended result.
- Tax Rate Disparity Test
- The NFTC recommended an expansion of the tax rate disparity test to a 10 or 15% tax rate differential, given that the 5% rate differential is overly narrow and doesn't take into account the "normal" differences in tax rates.
- Hypothetical Rate Test
- The NFTC suggested that the hypothetical rate test (of the sales income in the manufacturing branch location) be revised to exclude the provision which prescribes that the tax be determined based on the assumption that the sale of product is sold in the manufacturing branch location (domestic sourced). Instead the rate should be determined assuming the actual characteristics of such sales (i.e., location of customers and place of title passage, etc.), as this assumption can create

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Proposed Contract Manufacturing Regulations – NFTC Comments

Effective Date of the Regulations

- The NFTC requested a transitional rule that would allow taxpayers to elect to apply the regulations to taxable years beginning on or after the first anniversary of the finalization of the regulations.

Examples

- There were suggestions about new examples as well as suggested revisions to a few existing examples.

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Proposed Contract Manufacturing Regulations – Example 4 (Automated Manufacturing)

Facts

- FS, a controlled foreign corporation, purchases raw materials from a related person.
- The raw materials are then manufactured into Product X by CM, an unrelated corporation located outside of FS's country of organization, pursuant to a contract manufacturing arrangement.
- Product X is then sold by FS to related and unrelated persons for use outside of FS's country of organization.
- Under the contract manufacturing arrangement, CM is responsible for the physical transformation of the raw materials into Product X.
- At all times, FS retains ownership of the raw material, work-in-process, and finished goods.
- FS retains the right to oversee and direct the physical conversion of Product X by CM but does not regularly exercise, through its employees, its powers of oversight or direction.
- FS is the owner of sophisticated software and network systems that remotely and automatically (without human involvement) take orders, route them to CM, order raw materials, and perform quality control.

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Proposed Contract Manufacturing Regulations – Example 4 (Automated Manufacturing)

Facts (cont.)

- FS has a small number of computer technicians who monitor the software and network systems to ensure that they are running smoothly and to apply any necessary patches or fixes.
- The software and network systems were developed by employees of DP, the U.S. corporate parent of FS, pursuant to a cost sharing agreement between DP and FS.
- DP employees regularly supervise the computer technicians, evaluate the results of the automated manufacturing business, and make ongoing operational decisions, including with regard to acceptable performance of the manufacturing process, stoppages of that process, and product and process redesign and updates to meet the needs of the business and its customers.
- DP employees develop and provide to FS all of the upgrades to the software and network systems.
- DP also has employees who control the other aspects of the manufacturing process such as product design, vendor and material selection, management and retention of the manufacturing profits, and the selection of CM.

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Proposed Contract Manufacturing Regulations – Example 4 (Automated Manufacturing)

Results

- FS does not satisfy the Substantial Contribution Test because it does not make a substantial contribution through the activities of its employees to the manufacture of Product X.
- Mere contractual ownership of materials and intellectual property together with contractual rights to exercise powers of direction and control and a small number of technical employees are not sufficient.
- FS's primary contribution to the manufacture of Product X is the provision of the software and network systems to CM.
- Substantial operational responsibilities and decision making are exercised by DP employees who direct the activities of the FS employees.
- Therefore, FS is not considered to have manufactured Product X.

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Proposed Contract Manufacturing Regulations – NETC Comments – Example 4A

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.

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Proposed Contract Manufacturing Regulations – NFTC Comments – Example 4A

Results

- FS satisfies the Substantial Contribution Test 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.



Tax Reform Act of 1986 – Subpart J “Foreign Currency Transactions”

- As part of the Tax Reform Act of 1986, Congress enacted a comprehensive set of rules for foreign currency transactions by adding Subpart J to the Code
- Code Section 987 provides rules for taxpayers with branches (“qualified business units” or “QBUs”) that have a “functional currency” other than the US dollar



The 1991 Proposed Regulations

- › On September 25, 1991, the Treasury IRS issued proposed regulations under Section 987 (the “1991 Proposed Regulations”)
- › In general, under the 1991 Proposed Regulations, the net income of a QBU was determined annually based on the profit and loss appearing on the QBU’s books and records, adjusted to conform to US tax principles, and translated into the functional currency of the taxpayer using the weighted average exchange rate for the taxable year
- › The 1991 Proposed Regulations provided for the recognition of exchange gain or loss upon a remittance



The 1991 Proposed Regulations

- Under the 1991 Proposed Regulations, exchange gain or loss was determined with the following equation:

$$\frac{\text{Amount of the remittance}}{\text{The QBU's equity pool}} \times \text{The QBU's basis pool}$$



Notice 2000-20

- In Notice 2000-20, the Treasury and IRS announced their intentions to “review and possibly replace proposed regulations” because they “may not have fully achieved the original goal of facilitating the recognition of true economic foreign currency gain and loss under appropriate circumstances”



The 2006 Proposed Regulations

- On September 6, 2006, the Treasury and IRS withdrew the 1991 Proposed Regulations and issued new proposed Section 987 regulations (the “2006 Proposed Regulations”)
- The 2006 Proposed Regulations adopt the “foreign exchange exposure pool method” to determine foreign exchange gain or loss with respect to branch operations
- The 2006 Proposed Regulations are “designed to prescribe more precisely the foreign exchange gain and loss that is economically realized, while minimizing or eliminating the realization of non-economic currency gain and loss”



The Foreign Exchange Exposure Method

- The foreign exchange exposure pool method uses a balance sheet approach to determine foreign exchange gain or loss
 - › Under this method, foreign exchange gain or loss with respect to "marked items" is identified annually but is pooled and deferred until a "remittance" is made
 - › When a QBU makes a remittance, a portion of the pooled and deferred exchange gain or loss is recognized



Scope of the Proposed Regulations

- › The 2006 Proposed Regulations do not apply to banks, insurance companies and other financial entities (leasing companies, finance coordination centers, regulated investment companies, and real estate investment trusts)
- › Additionally, the 2006 Proposed Regulations do not apply to trusts, estates and S corporations



The 2006 Proposed Regulations - Definitions

- The two terms that are central to the foreign exchange exposure pool method are “marked item” and “historic item”
- These two key terms distinguish items that generate Section 987 gain or loss from those that do not
 - › A “marked item” is defined as an asset or liability reflected on the books and records of a QBU that (i) would generate Section 988 gain or loss if held or entered into directly by the owner of the QBU and (ii) is not a Section 988 transaction to the QBU
 - › An “historic item” is an asset or liability reflected on the books and records of a QBU that is not a marked items



Partnerships

- With respect to partnerships, the 2006 Proposed Regulations apply an aggregate (versus an entity) approach to determine a partner's the amount of Section 987 gain or loss
 - › In other words, under the 2006 Proposed Regulations, the foreign exchange exposure pool method is applied at the partner level, rather than the partnership level
 - › Therefore, each partner is required to make its own foreign exchange exposure pool calculations by reference to the partner's functional currency



Termination of a QBU

- The termination of a QBU is treated as a remittance of all the gross assets of the QBU to its owner
- As a result, any unrecognized Section 987 gain or loss is recognized in full
- A QBU will be deemed to terminate in four situations:
 - › when its activities cease;
 - › when substantially all of the QBU's assets are transferred from the QBU to its owner;
 - › when a foreign corporation that is a CFC ceases to be a CFC; or
 - › the owner of the QBU goes out of existence (including in connection with a transaction described in Code Section 381(a))

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Record Keeping

- Given the detailed nature of the calculations (and the fact that they require the basis of historic items to be translated at historic exchange rates), the 2006 Proposed Regulation impose a significant record keeping burden on taxpayers
- Under the proposed regulations, a taxpayer that is an owner of a QBU is required to maintain reasonable records that are sufficient to establish the QBU's taxable income or loss and Section 987 gain or loss

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Effective Date

- Except as otherwise provided, the 2006 Proposed Regulations become effective for taxable years beginning one year after the first day of the first taxable year following the date the regulations are finalized
- Nevertheless, a taxpayer may elect to apply the regulations to taxable years beginning after the date the regulations are finalized
 - › If finalized in 2008, effective for calendar year taxpayers will be on 1/1/10, unless adopted early on 1/1/09

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NFTC Comments/Meetings with IRS

- On April 23, 2007, the NFTC submitted its first set of talking points to the IRS regarding the proposed Code Section 987 regulations
- On May 1, 2007, the NFTC met with the IRS with respect to those talking points.
- On or around October 7, 2007, the NFTC submitted revised talking points.
- On October 18, 2007, the NFTC met with the IRS with respect to those revised talking points.
- On April 25, 2008, the NFTC submitted revised talking points.
- On April 29, 2008, the NFTC met again with the IRS with respect to the revised talking points.

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NFTC Comments/Meetings with IRS

- The NFTC has suggested the inclusion of an angel list of short-lived/low-value assets that would be excepted from the definition of "historic asset," *e.g.*, inventory, pre-paid expenses, office furniture, fixtures and equipment, computers and peripheral equipment, typewriters, calculators, copiers and other duplicating equipment, automobiles, light general purpose trucks, etc.
- That the term "weighted average exchange rate" shall have the definition given to that term by Treas. Reg. Sec. 1.989(b)-1.
- With a view of simplifying the Code Section 987 calculations, the NFTC has suggested that a rule be adopted that would allow taxpayers to treat Code Section 987 QBUs of owners that are members of a U.S. consolidated return group as a single Code Section 987 QBU.

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NFTC Comments/Meetings with IRS

- The Preamble states that the proposed regulations provide that a termination occurs when the owner of a Code section 987 QBU transfers the QBU to another corporation in exchange for stock in a transaction qualifying under Code Section 351. The termination occurs because the owner no longer has a section 987 QBU. While Prop. Treas. Reg. Sec. 1.987-8(e) Example 2 supports that result, the explicit rule seems to be absent in the proposed regulations.
- For the sake of clarity, the NFTC suggested a modification to modify Prop. Treas. Reg. Sec. 1.987-8(b) by adding new paragraph (2) relating to Code Section 351 terminations.

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NFTC Comments/Meetings with IRS

- The NFTC has urged the IRS to adopt a rule that would provide that transfers qualifying under Code Section 351 between members of a U.S. consolidated return group will not trigger a remittance or a termination.
- Finally, the NFTC has urged the IRS to adopt some sort of *de minimis* rule with respect to Code Section 987 accounting for interests in partnerships.

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IRS Business Plan – F/Y/E 6/30/09

- Guidance on Code Section 959;
- Guidance with respect to Notice 2007-13;
- Guidance on inbound investments;
- Guidance on conduit financing arrangements;
- GRA guidance;
- International restructurings;

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IRS Business Plan – F/Y/E 6/30/09

- Withholding taxes on dividends and interest;
- Rules on FTC's;
- Cost sharing;
- Global dealing; and
- Compensation for services.

