Internal Revenue bulletin

Bulletin No. 2008-16
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HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

T.D. 9384, page 792.

Final regulations under section 199 of the Code revise certain rules and examples relating to the definitions of a qualified film produced by the taxpayer under section 199(c)(4)(A)(i)(II) and (c)(6) and an expanded affiliated group under section 199(d)(4).

T.D. 9386, page 788.

Final regulations under section 165 of the Code provide guidance on the availability and character of a deduction for a loss sustained from abandoned stock or other securities.

T.D. 9387, page 789.

Final regulations under section 168 of the Code provide guidance regarding the application of normalization accounting rules to balances of excess deferred income taxes and accumulated deferred investment tax credits of public utilities whose assets cease to be public utility property.

REG–124590–07, page 801.

Proposed regulations under section 954(d) of the Code provide guidance in cases in which personal property sold by a controlled foreign corporation is manufactured, produced, or constructed pursuant to a contract manufacturing arrangement or by one or more branches of the controlled foreign corporation.

Notice 2008–44, page 799.

2007 section 45K inflation adjustment factor. This notice announces the applicable inflation adjustment factor and phase-out amount for the nonconventional source fuel credit for the 2007 calendar year.

EMPLOYEE PLANS

REG–151135–07, page 815.

Proposed regulations under section 432 of the Code provide additional rules for certain multiemployer defined benefit plans that are in effect on July 16, 2006. The regulations affect sponsors and administrators of, and participants in, multiemployer plans that are in either endangered or critical status. The regulations are necessary to implement the new rules set forth in section 432 that are effective for plan years beginning after 2007.

EXEMPT ORGANIZATIONS

Announcement 2008–32, page 826.

The IRS has revoked its determination that Educate the Children Foundation of Long Beach, CA; CFIDS Walk-A-Thon Committee of Hicksville, NY; Open Doors, Inc., of Duluth, GA; Amalgamated Credit Counselors of Lauderhill, FL; Carter Lake Charitable of Urbandale, IA; Christian Credit Counselors, Inc., of Las Vegas, NV; In Time Youth Group of Ontario, OR; Young Lions Foundation of Sausalito, CA; Charity Connections, Ltd., of Pittsford, NY; and North-Tartan Area Girls Basketball Booster Club of Oakdale, MN, qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Code.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

ESTATE TAX

Rev. Rul. 2008–22, page 796.

Substitution power. This ruling provides guidance regarding whether the corpus of an *inter vivos* trust is includible in the grantor's gross estate under section 2036 or 2038 of the Code if the grantor retained the power, exercisable in a nonfiduciary capacity, to acquire property held in the trust by substituting other property of equivalent value. The ruling provides that, for estate tax purposes, the substitution power will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate, provided the trustee has a fiduciary obligation (under local law) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

ADMINISTRATIVE

Announcement 2008–30, page 825.

This document contains corrections to final and temporary regulations (T.D. 9368, 2008–6 I.R.B. 382) regarding the reduction of the number of separate foreign tax credit limitation categories under section 904(d) of the Code. The regulations affect taxpayers claiming foreign tax credits and provide guidance needed to comply with the statutory changes made by the American Jobs Creation Act of 2004 (AJCA).

Announcement 2008–33, page 826.

This document contains a correction to final regulations (T.D. 9273, 2006–2 C.B. 394) addressing the carryover of certain tax attributes, such as earnings and profits and foreign income tax accounts, when two corporations combine in a corporate reorganization or liquidation that is described in both sections 367(b) and 381 of the Code.

Announcement 2008–36, page 827.

This document cancels a public hearing on proposed regulations (REG–114126–07, 2008–6 I.R.B. 410) that provide guidance relating to the reduction of the number of separate foreign tax credit limitation categories under section 904(d) of the Code.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 165.—Losses

26 CFR 1.165–5: Worthless securities.

T.D. 9386

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Abandonment of Stock or Other Securities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning the availability and character of a loss deduction under section 165 of the Internal Revenue Code (Code) for losses sustained from abandoned stock or other securities. The final regulations clarify the tax treatment of losses from abandoned securities, and affect any taxpayer claiming a deduction for a loss from abandoned securities after the date these regulations are published in the **Federal Register**.

DATES: *Effective Date:* These final regulations are effective on March 12, 2008.

Applicability Date: For dates of applicability, see §1.165–5(i)(2).

FOR FURTHER INFORMATION CONTACT: Sean M. Dwyer at (202) 622–5020 or Peter C. Meisel at (202) 622–7750 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1. On July 30, 2007, the IRS published a notice of proposed rulemaking (REG–101001–05, 2007–36 I.R.B. 548) in the **Federal Register** (72 FR 41468). The notice of proposed rulemaking clarified the treatment of abandoned stock or other securities under section 165 of the Code, specifically providing that a loss from an abandoned security is governed by section 165(g), and that the loss is only allowed if all rights in the security are permanently surrendered and relinquished for no consideration. The IRS received no comments in response to the notice of proposed rulemaking. No public hearing was requested or held.

The proposed regulations are adopted as final regulations by this Treasury decision.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking that preceded this final regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these final regulations are Sean M. Dwyer, Office of the Associate Chief Counsel (Income Tax & Accounting), and Peter C. Meisel, Office of the Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.165–5 is amended by:

1. Redesignating paragraph (i) as paragraph (j).

2. Adding a new paragraph (i).

The addition reads as follows:

§1.165–5 Worthless securities.

* * * * *

(i) *Abandonment of securities*—(1) *In general.* For purposes of section 165 and this section, a security that becomes wholly worthless includes a security described in paragraph (a) of this section that is abandoned and otherwise satisfies the requirements for a deductible loss under section 165. If the abandoned security is a capital asset and is not described in section 165(g)(3) and paragraph (d) of this section (concerning worthless securities of certain affiliated corporations), the resulting loss is treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset. See section 165(g)(1) and paragraph (c) of this section. To abandon a security, a taxpayer must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for the security. For purposes of this section, all the facts and circumstances determine whether the transaction is properly characterized as an abandonment or other type of transaction, such as an actual sale or exchange, contribution to capital, dividend, or gift.

(2) *Effective/applicability date. This paragraph (i) applies to any abandonment of* stock or other securities after March 12, 2008.

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Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.

Approved March 3, 2008.

Eric Solomon,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on March 11, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 12, 2008, 73 F.R. 13124)

Section 168.—Accelerated Cost Recovery System

26 CFR 1.168(i)–3: Treatment of excess deferred income tax reserve upon disposition of deregulated public utility property.

T.D. 9387

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Application of Normalization Accounting Rules to Balances of Excess Deferred Income Taxes and Accumulated Deferred Investment Tax Credits of Public Utilities Whose Assets Cease to be Public Utility Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final regulations that provide guidance on the normalization requirements applicable to public utilities that benefit (or have benefited) from accelerated depreciation methods or from the investment tax credit permitted under pre–1991 law. These regulations permit a utility whose assets cease, whether by disposition, deregulation, or otherwise, to be public utility property with respect to the utility (deregulated public utility property) to return to its ratepayers the normalization reserve for excess deferred income taxes (EDFIT) with respect to those assets and, in certain circumstances, also permit the return of part or all of the reserve for accumulated deferred investment tax credits (ADITC) with respect to those assets.

DATES: *Effective Date:* These regulations are effective March 20, 2008.

Applicability Date: For dates of applicability, see §1.46–6(k)(4) and §1.168(i)–3(d) of these regulations.

FOR FURTHER INFORMATION CONTACT: Patrick Kirwan, at (202) 622–3040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

This document amends the Income Tax Regulations (26 CFR Part 1) relating to the normalization requirements of sections 168(f)(2) and 168(i)(9) of the Internal Revenue Code (Code), section 203(e) of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2146), and former section 46(f) of the Code. Proposed regulations relating to the normalization requirements applicable to electric utilities that benefit (or have benefited) from accelerated depreciation methods or from the investment tax credit permitted under pre–1991 law (REG–104385–01, 2003–1 C.B. 634) were published in the **Federal Register** on March 4, 2003 (the 2003 proposed regulations) and again on December 21, 2005 (2006–1 C.B. 389, the 2005 proposed regulations). The preambles of both the 2003 proposed regulations and the 2005 proposed regulations describe the normalization method of accounting and the reserves under the normalization method for excess deferred federal income tax (EDFIT) and accumulated deferred investment tax credits (ADITC).

The 2003 proposed regulations provided that electric utilities whose generation assets become deregulated public utility property could continue to flow through EDFIT reserves associated with those assets without violating the normalization requirements. The rate of flowthrough was limited to the rate that would have been permitted under a normalization method of accounting if the assets had remained public utility property.

The 2003 proposed regulations provided similar rules under which electric utilities could continue to flow through ADITC reserves associated with generation assets that become deregulated public utility property without violating the normalization requirements. The 2003 proposed regulations addressed the treatment of these assets under former section 46(f)(2) (relating to the use of the investment credit to reduce the taxpayer's cost of service) but did not address their treatment under former section 46(f)(1) (relating to the use of the investment credit to reduce the taxpayer's rate base). The 2003 proposed regulations would have applied to public utility generation property deregulated after March 4, 2003. Utilities would have been permitted an election to apply the proposed rules to generation property that was deregulated on or before that date.

In response to the public comments and after further analysis, the 2003 proposed regulations were withdrawn and were replaced by the 2005 proposed regulations. The 2005 proposed regulations generally retain the rule of the 2003 proposed regulations regarding the return of EDFIT reserves and extend the application of the rule to all public utility property.

The 2005 proposed regulations permit flowthrough of the ADITC reserve with respect to deregulated public utility property to continue after its deregulation only to the extent the reduction in cost of service does not exceed, as a percentage of the ADITC with respect to the property at the time of deregulation, the percentage of the total stranded cost that the taxpayer is permitted to recover with respect to the property. In addition, the 2005 proposed regulations provide that the credit may not be flowed through more rapidly than the rate at which the taxpayer is permitted to recover the stranded cost with respect to the property. The 2005 proposed regulations provide similar rules for property to which former section 46(f)(1) (relating to rate base restoration) applies and extend the application of the ADITC flowthrough rules to all public utility property.

The 2005 proposed regulations generally apply to any public utility property that becomes deregulated public utility property after December 21, 2005. They do not include an election to apply the regulations retroactively. For public utility property that became deregulated public utility property on or before December 21, 2005, the preamble of the 2005 proposed regulations states that the IRS will follow the holdings set forth in the private letter rulings prohibiting flowthrough of the EDFIT and ADITC reserves associated with an asset after the asset's disposition. The 2005 proposed regulations provide, however, that flowthrough will be permitted if it is consistent with the 2003 proposed regulations and occurs during the period beginning on March 5, 2003, and ending on the earlier of (1) the last date on which the utility's rates are determined under the rate order in effect on December 21, 2005, or (2) December 21, 2007.

Written comments were received in response to the 2005 proposed regulations, and a public hearing was held on April 5, 2006. Three commentators spoke at the public hearing. After consideration of all the comments, the 2005 proposed regulations are adopted as amended by this Treasury decision. In general, the final regulations follow the approach of the 2005 proposed regulations.

A number of commentators suggested that the proposed rules should apply on an elective basis to public utility property that was deregulated prior to March 5, 2003, if regulatory proceedings for the deregulated public utility property are pending. The preamble to the 2005 proposed regulations explains that the Secretary's authority under section 7805(b)(7) to provide for retroactive elections should not be exercised in a manner that impairs existing agreements between utilities and their regulators. Many commentators agreed with the objective of not disturbing previously settled and finalized agreements and believed that a retroactive election would likely result in taxpayers being compelled to reopen such agreements. The commentators suggested, however, that applying the regulations to regulatory proceedings that have yet to be finally decided would not impair any existing agreement, and that the final regulations should permit continued flowthrough of the EDFIT and ADITC reserves if no final order or settlement agreement prescribing the treatment of those reserves after deregulation was in effect on December 21, 2005. Other commentators suggested that the section 7805 limitations on retroactivity do not apply to these regulations because the normalization provisions were enacted before the effective date of those limitations. The IRS and Treasury Department agree that there is no statutory impediment that would prohibit the application of the regulations to previously deregulated property. Nevertheless, the IRS and Treasury Department have concluded that there is no compelling argument in this instance for frustrating the expectations of taxpayers who embarked upon deregulation of their public utility property before the publication of the new rules. Accordingly, the final regulations do not depart from the general practice of applying amendments to the regulations without retroactive effect and retain the prospective effective date of the 2005 proposed regulations without a retroactive election. The final regulations retain the proposed transition rule under which flowthrough is permitted if it is consistent with the 2003 proposed regulations and occurs during the period beginning on March 5, 2003, and ending on the earlier of (1) the last date on which the utility's rates are determined under the rate order in effect on December 21, 2005, or (2) December 21, 2007.

One commetator suggested that the regulations should provide guidance concerning when deregulation occurs. Under the regulations, property becomes deregulated public utility property when it ceases to be public utility property with respect to the taxpayer. This depends on the particular facts and circumstances and is more appropriately addressed on a case-by-case basis.

Some commentators suggested that the final regulations should permit flowthrough of ADITC reserves even in cases in which ratepayers do not bear the cost of the asset giving rise to the credit. The comments generally argued that this would be consistent with Congressional intent to share the benefit of the credit between ratepayers and shareholders. The IRS and Treasury Department agree that the Code provides for such sharing in the typical situation in which ratepayers ultimately bear the full cost of an asset through ratemaking depreciation. On the other hand, neither the statutory provision nor the legislative history provides any indication that Congress intended for ratepayers to share in benefits attributable to costs that they do not bear. Accordingly, for the reasons set forth in the preamble of the 2005 proposed regulations, the final regulations retain the proposed rules relating to flowthrough of the ADITC reserve and rate base restoration, including the rule allowing flowthrough consistent with the 2003 proposed regulations during the transition period.

Commentators suggested that the use of terms other than deregulated public utility property in the preamble of the 2005 proposed regulations implies that a distinction exists between property that ceases to be public utility property because of deregulation and property that ceases to be public utility property because of a disposition or other event. To clarify that this is not the case, the term deregulated public utility property is the sole term used in the final regulations to describe property that ceases to be public utility property.

One commentator questioned whether the term deregulated public utility property includes normal retirements. The final regulations clarify that they do not apply to ordinary retirements within the meaning of section 1.167(a)–11(d)(3)(ii).

One commentator suggested that deregulated public utility property should include property that is public utility property in the hands of a transferee. The commentator further suggested that if the transferee of public utility property will continue the flowthrough of the transferor's EDFIT and ADITC reserves, further flowthrough by the transferor should not be required. The IRS and Treasury Department agree with these suggestions. Accordingly, the final regulations provide, on a prospective basis, that they apply to a taxpayer with respect to public utility property that ceases to be public utility property with respect to the taxpayer. Thus, the regulations will apply even if the property remains regulated public utility property in the hands of a transferee. The regulations further provide an exception from the generally applicable rule permitting transferor flowthrough when the transferee will continue flowthrough of the EDFIT reserves. A similar exception was not provided for the ADITC reserve because transferor flowthrough of that reserve does not occur if the transferee, rather than the transferor, is recovering the cost of the property through ratemaking depreciation.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Drafting Information

The principal author of the regulations is Patrick S. Kirwan, Office of Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.46–6 is amended by adding paragraph (k) to read as follows:

§1.46–6 Limitation in case of certain regulated companies.

* * * * *

(k) *Treatment of accumulated deferred investment tax credits upon the deregulation of public utility property*—(1) *Scope*—(i) *In general*. This paragraph (k) provides rules for the application of former sections 46(f)(1) and 46(f)(2) of the Internal Revenue Code to a taxpayer with respect to public utility property that ceases, whether by disposition, deregulation, or otherwise, to be public utility property with respect to the taxpayer and that is not described in paragraph (k)(1)(ii) of this section (deregulated public utility property).

(ii) *Exception*. This paragraph (k) does not apply to property that ceases to be public utility property with respect to the taxpayer on account of an ordinary retirement within the meaning of §1.167(a)–11(d)(3)(ii).

(2) *Ratable amount*—(i) *Restoration of rate base reduction*. A reduction in the taxpayer's rate base on account of the credit with respect to public utility property that becomes deregulated public utility property is restored ratably during the period after the property becomes deregulated public utility property if the amount of the reduction remaining to be restored does not, at any time during the period, exceed the restoration percentage of the recoverable stranded cost of the property at such time.

For this purpose—

(A) The stranded cost of the property is the cost of the property reduced by the amount of such cost that the taxpayer has recovered through regulated depreciation expense during the period before the property becomes deregulated public utility property;

(B) The recoverable stranded cost of the property at any time is the stranded cost of the property that the taxpayer will be permitted to recover through rates after such time; and

(C) The restoration percentage for the property is determined by dividing the reduction in rate base remaining to be restored with respect to the property immediately before the property becomes deregulated public utility property by the stranded cost of the property.

(ii) *Cost of service reduction*. Reductions in the taxpayer's cost of service on account of the credit with respect to public utility property that becomes deregulated public utility property are ratable during the period after the property becomes deregulated public utility property if the cumulative amount of the reduction during such period does not, at any time during the period, exceed the flowthrough percentage of the cumulative stranded cost recovery for the property at such time.

For this purpose—

(A) The stranded cost of the property is the cost of the property reduced by the amount of such cost that the taxpayer has recovered through regulated depreciation expense during the period before the property becomes deregulated public utility property;

(B) The cumulative stranded cost recovery for the property at any time is the stranded cost of the property that the taxpayer has been permitted to recover through rates on or before such time; and

(C) The flowthrough percentage for the property is determined by dividing the amount of credit with respect to the property remaining to be used to reduce cost of service immediately before the property becomes deregulated public utility property by the stranded cost of the property.

(3) *Cross reference*. See §1.168(i)–(3) for rules relating to the treatment of balances of excess deferred income taxes when public utility property becomes deregulated public utility property.

(4) *Effective/applicability dates*—(i) *In general*. Except as provided in paragraph (k)(4)(ii) of this section, this paragraph (k) applies to public utility property that becomes deregulated public utility property with respect to a taxpayer after December 21, 2005.

(ii) *Property that becomes public utility property of the transferee*. This paragraph (k) does not apply to property that becomes deregulated public utility property with respect to a taxpayer on account of a transfer on or before March 20, 2008, if after the transfer the property is public utility property of the transferee.

(iii) *Application of regulation project (REG–104385–01)*. A reduction in the taxpayer's cost of service will be treated as ratable if it is consistent with the proposed rules in regulation project (REG–104385–01) (68 FR 10190) March 4, 2003, and occurs during the period beginning on March 5, 2003, and ending on the earlier of—

(A) The last date on which the utility's rates are determined under the rate order in effect on December 21, 2005; or

(B) December 21, 2007.

Par. 3. Section 1.168(i)–3 is added to read as follows:

§1.168(i)–3 Treatment of excess deferred income tax reserve upon disposition of deregulated public utility property.

(a) *Scope*—(1) *In general*. This section provides rules for the application of section 203(e) of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2146) to a taxpayer with respect to public utility property (within the meaning of section 168(i)(10)) that ceases, whether by disposition, deregulation, or otherwise, to be public utility property with respect to the taxpayer and that is not described in paragraph (a)(2) of this section (deregulated public utility property).

(2) *Exceptions*. This section does not apply to the following property:

(i) Property that ceases to be public utility property with respect to the taxpayer on account of an ordinary retirement within the meaning of §1.167(a)–11(d)(3)(ii).

(ii) Property transferred by the taxpayer if after the transfer the property is public utility property of the transferee and the taxpayer's excess tax reserve with respect to the property (within the meaning of section 203(e) of the Tax Reform Act of 1986) is treated as an excess tax reserve of the transferee with respect to the property.

(b) *Amount of reduction*. If public utility property of a taxpayer becomes deregulated public utility property to which this section applies, the reduction in the taxpayer's excess tax reserve permitted under section 203(e) of the Tax Reform Act of 1986 is equal to the amount by which the reserve could be reduced under that provision if all such property had remained public utility property of the taxpayer and the taxpayer had continued use of its normalization method of accounting with respect to such property.

(c) *Cross reference*. See §1.46–6(k) for rules relating to the treatment of accumulated deferred investment tax credits when utilities dispose of regulated public utility property.

(d) *Effective/applicability dates*—(1) *In general*. Except as provided in paragraph (d)(2) of this section, this section applies to public utility property that becomes deregulated public utility property after December 21, 2005.

(2) *Property that becomes public utility property of the transferee*. This section does not apply to property that becomes deregulated public utility property with respect to a taxpayer on account of a transfer on or before March 20, 2008, if after the transfer the property is public utility property of the transferee.

(3) *Application of regulation project (REG–104385–01)*. A reduction in the taxpayer's excess deferred income tax reserve will be treated as ratable if it is consistent with the proposed rules in regulation project (REG–104385–01) (68 FR 10190) March 4, 2003, and occurs during the period beginning on March 5, 2003, and ending on the earlier of—

(i) The last date on which the utility's rates are determined under the rate order in effect on December 21, 2005; or

(ii) December 21, 2007.

Linda E. Stiff,
Acting Deputy Commissioner for Services and Enforcement.

Approved March 6, 2008.

Eric Solomon,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on March 19, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 20, 2008, 73 F.R. 14934)

Section 199.—Income Attributable to Domestic Production Activities

26 CFR 1.199–3: Domestic production gross receipts.

T.D. 9384

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Qualified Films Under Section 199

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations involving the deduction for income attributable to domestic production activities under section 199. The final regulations revise certain rules and examples relating to the definitions of a qualified film produced by the taxpayer under section 199(c)(4)(A)(i)(II) and (c)(6) and an expanded affiliated group under section 199(d)(4). The final regulations affect taxpayers who produce qualified films and taxpayers who are members of expanded affiliated groups.

DATES: *Effective Date:* These regulations are effective March 7, 2008.

Applicability Date: For dates of applicability, see §1.199–8(i)(8) and (9).

FOR FURTHER INFORMATION CONTACT: Concerning §1.199–3(k), David McDonnell, at (202) 622–3040; concerning §1.199–7, Ken Cohen (202) 622–7790 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document amends §§1.199–3(k) and 1.199–7 of the Income Tax Regulations (26 CFR Part 1). Section 1.199–3(k) relates to the definition of qualified film produced by the taxpayer under section 199(c)(4)(A)(i)(II) and (c)(6) of the Internal Revenue Code (Code) and §1.199–7 involves expanded affiliated groups under section 199(d)(4). Section 199 was added to the Code by section 102 of the American Jobs Creation Act of 2004 (Public Law 108–357, 118 Stat. 1418), and amended by section 403(a) of the Gulf Opportunity Zone Act of 2005 (Public Law 109–135, 119 Stat. 25), section 514 of the Tax Increase Prevention and Reconciliation Act of 2005 (Public Law 109–222, 120 Stat. 345), and section 401 of the Tax Relief and Health Care Act of 2006 (Public Law 109–432, 120 Stat. 2922).

On June 7, 2007, the IRS and Treasury Department published proposed regulations under section 199 (REG–103842–07, 2007–28 I.R.B. 79 [72 FR 31478]). The proposed regulations revise certain rules and examples in T.D. 9263, 2006–25 I.R.B. 1063 [71 FR 31268] relating to qualified films produced by the taxpayer under section 199(c)(4)(A)(i)(II) and (c)(6) and expanded affiliated groups under section 199(d)(4). No comments were received responding to the notice of proposed rulemaking and no public hearing was requested or held. Therefore, the proposed regulations are adopted without change by this Treasury decision.

Explanation of Provisions

General Overview

Section 199(a)(1) allows a deduction equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of (A) the qualified production activities income (QPAI) of the taxpayer for the taxable year, or (B) taxable income (determined without regard to section 199) for the taxable year (or, in the case of an individual, adjusted gross income).

Section 199(c)(1) defines QPAI for any taxable year as an amount equal to the excess (if any) of (A) the taxpayer's domestic production gross receipts (DPGR) for such taxable year, over (B) the sum of (i) the cost of goods sold (CGS) that are allocable to such receipts; and (ii) other expenses, losses, or deductions (other than the deduction under section 199) that are properly allocable to such receipts.

Section 199(c)(4)(A)(i) provides that the term DPGR means the taxpayer's gross receipts that are derived from any lease, rental, license, sale, exchange, or other disposition of (I) qualifying production property (QPP) that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States; (II) any qualified film produced by the taxpayer; or (III) electricity, natural gas, or potable water produced by the taxpayer in the United States.

Section 199(c)(6) defines a qualified film to mean any property described in section 168(f)(3) if not less than 50 percent of the total compensation relating to production of the property is compensation for services performed in the United States by actors, production personnel, directors, and producers. The term does not include property with respect to which records are required to be maintained under 18 U.S.C. 2257 (generally, films, videotapes, or other matter that depict actual sexually explicit conduct and are produced in whole or in part with materials that have been mailed or shipped in interstate or foreign commerce, or are shipped or transported or are intended for shipment or transportation in interstate or foreign commerce).

Section 199(d)(4)(A) provides that all members of an expanded affiliated group (EAG) are treated as a single corporation for purposes of section 199. Under section 199(d)(4)(B), an EAG is an affiliated group as defined in section 1504(a), determined by substituting "more than 50 percent" for "at least 80 percent" each place it appears and without regard to section 1504(b)(2) and (4).

Qualified Film Produced by the Taxpayer

Under section 199(c)(4)(A)(i)(II), a taxpayer's gross receipts qualify as DPGR if the receipts are derived from any lease, rental, license, sale, exchange, or other disposition of any qualified film (as defined in section 199(c)(6)) produced by the taxpayer. A film must be both a "qualified film" under section 199(c)(6) and "produced by the taxpayer" under section 199(c)(4)(A)(i)(II) in order for the gross receipts to qualify as DPGR. However, as discussed in the preamble to the proposed regulations published on June 7, 2007 (72 FR 31478), the "by the taxpayer" compensation fraction in §1.199–3(k)(5) in T.D. 9263 (71 FR 31268) may have resulted in a film that was produced entirely within the United States as not qualifying under section 199(c)(6) if less than 50 percent of the total compensation relating to production was paid "by the taxpayer."

This Treasury decision revises the "by the taxpayer" compensation fraction in §1.199–3(k)(5) in T.D. 9263 (71 FR 31268) for determining the not-less-than-50-percent-of-the-total-compensation requirement under §1.199–3(k)(1). Under the revised fraction in §1.199–3(k)(5), the numerator of the revised fraction is the compensation for services performed in the United States and the denominator is the total compensation for services regardless of where the production activities are performed. The revised fraction essentially compares (in the numerator) the sum of the compensation for services paid by the taxpayer for services performed in the United States and the compensation for services paid by others for services performed in the United States to (in the denominator) the sum of the total compensation for services paid by the taxpayer for services and the total compensation for services paid by others for services regardless of location.

Under §1.199–3(k)(6), a film that is a qualified film under §1.199–3(k)(1) will be treated as "produced by the taxpayer" for purposes of section 199(c)(4)(A)(i)(II) if the production activity performed by the taxpayer is substantial in nature within the meaning of §1.199–3(g)(2). Thus, a qualified film will be treated as produced by the taxpayer if the production of the qualified film by the taxpayer is substantial in nature taking into account all of the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer's production activity, the nature of the qualified film, and the nature of the production activity that the taxpayer performs.

The revised fraction in §1.199–3(k)(5) follows the statutory language in section 199(c)(6) by referencing all compensation for services related to the production as opposed to the more limited "by the taxpayer" compensation fraction in T.D. 9263 (71 FR 31268). Because taxpayers may have difficulty obtaining information related to the compensation paid by others, this Treasury decision provides a safe harbor in §1.199–3(k)(7) that treats a film as a qualified film if not less than 50 percent of the total compensation for services paid by the taxpayer is compensation for services performed in the United States. The safe harbor further provides that a qualified film will be treated as produced by the taxpayer if the taxpayer satisfies the safe harbor in §1.199–3(g)(3) with respect to the qualified film, which requires that the direct labor and overhead costs incurred by the taxpayer to produce the qualified film within the United States account for 20 percent or more of the total costs of the film. Thus, a taxpayer will be treated as having produced a qualified film if, in connection with the qualified film, the direct labor and overhead of the taxpayer to produce the qualified film within the United States account for 20 percent or more of the taxpayer's CGS of the qualified film, or in a transaction without CGS (for example, a lease, rental, or license) account for 20 percent or more of the taxpayer's "unadjusted depreciable basis" (as defined in §1.199–3(g)(3)(ii)) in the qualified film.

Expanded Affiliated Groups

As discussed in the preamble to the proposed regulations published on June 7, 2007 (72 FR 31478), §1.199–7(e), *Example 10*, in T.D. 9263 (71 FR 31268) misapplies §1.1502–13 of the consolidated return regulations. Accordingly, §1.199–7(e), *Example 10*, has been revised to correctly apply the consolidated return regulations. In addition, as also discussed in the preamble to the proposed regulations published on June 7, 2007 (72 FR 31478), the section 199 closing of the books method under §1.199–7(f)(1)(ii) in T.D. 9263 (71 FR 31268) could have created a larger section 199 deduction than is warranted. Accordingly, this Treasury decision removes the section 199 closing of the books method and revises the *Ex-*

ample in §1.199–7(g)(3) to apply the *pro rata* allocation method.

Effective/Applicability Dates

Sections 1.199–3(k) and 1.199–7(e), *Example 10*, (f)(1), and (g)(3) are applicable to taxable years beginning on or after March 7, 2008. A taxpayer may apply §§1.199–3(k) and 1.199–7(e), *Example 10*, to taxable years beginning after December 31, 2004, and before March 7, 2008. However, for taxable years beginning before June 1, 2006, a taxpayer may rely on §1.199–3(k) only if the taxpayer does not apply Notice 2005–14, 2005–1 C.B. 498 (see §601.601(d)(2)(ii)(*b*)), or REG–105847–05, 2005–2 C.B. 987 (see §601.601(d)(2)(ii)(*b*)), to the taxable year.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to this regulation, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is David H. McDonnell, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.199–0 is amended by:

1. Revising the entries for §1.199–3(k)(6) and (7).

2. Adding new entries for §§1.199–3(k)(7)(i) and (ii); (8), (9), and (10); and 1.199–8(i)(8) and (9).

3. Removing the entries for §1.199–7(f)(1)(i), (ii), and (iii).

The additions and revisions read as follows:

§1.199–0 Table of contents.

* * * * *

§1.199–3 Domestic production gross receipts.

* * * * *

(k) * * *

(6) Produced by the taxpayer.

(7) Qualified film produced by the taxpayer — safe harbor.

(i) Safe harbor.

(ii) Determination of 50 percent.

(8) Production pursuant to a contract.

(9) Exception.

(10) Examples.

* * * * *

§1.199–8 Other rules.

* * * * *

(i) * * *

(8) Qualified film produced by the taxpayer.

(9) Expanded affiliated groups.

* * * * *

Par. 3. Section 1.199–3 is amended by:

1. Revising paragraphs (k)(1), (k)(4), and (k)(5).

2. Redesignating paragraph (k)(6) as (k)(9).

3. Redesignating paragraph (k)(7) as (k)(10).

4. Adding new paragaphs (k)(6), (k)(7), and (k)(8).

5. Revising *Example 6* of newly redesignated paragraph (k)(10).

The revisions and additions read as follows:

§1.199–3 Domestic production gross receipts.

* * * * *

(k) *Definition of qualified film*—(1) *In general*. The term *qualified film* means any motion picture film or video tape under section 168(f)(3), or live or delayed television programming (film), if not less than 50 percent of the total compensation relating to the production of such film is compensation for services performed in the United States by actors, production personnel, directors, and producers. For purposes of this paragraph (k), the term *actors* includes players, newscasters, or any other persons who are compensated for their performance or appearance in a film. For purposes of this paragraph (k), the term *production personnel* includes writers, choreographers and composers who are compensated for providing services during the production of a film, as well as casting agents, camera operators, set designers, lighting technicians, make-up artists, and other persons who are compensated for providing services that are directly related to the production of the film. Except as provided in paragraph (k)(2) of this section, the definition of a qualified film does not include tangible personal property embodying the qualified film, such as DVDs or videocassettes.

* * * * *

(4) *Compensation for services*. For purposes of this paragraph (k), the term *compensation for services* means all payments for services performed by actors, production personnel, directors, and producers relating to the production of the film, including participations and residuals. Payments for services include all elements of compensation as provided for in §1.263A–1(e)(2)(i)(B) and (3)(ii)(D). Compensation for services is not limited to W–2 wages and includes compensation paid to independent contractors. In the case of a taxpayer that uses the income forecast method of section 167(g) and capitalizes participations and residuals into the adjusted basis of the qualified film, the taxpayer must use the same estimate of participations and residuals in determining compensation for services. In the case of a taxpayer that excludes participations and residuals from the adjusted basis of the qualified film under section 167(g)(7)(D)(i), the taxpayer must use

the amount expected to be paid as participations and residuals based on the total forecasted income used in determining income forecast depreciation in determining compensation for services.

(5) *Determination of 50 percent*. The not-less-than-50-percent-of-the-total-compensation requirement under paragraph (k)(1) of this section is calculated using a fraction. The numerator of the fraction is the compensation for services performed in the United States and the denominator is the total compensation for services regardless of where the production activities are performed. A taxpayer may use any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, including all historic information available, to determine the compensation for services performed in the United States and the total compensation for services regardless of where the production activities are performed. Among the factors to be considered in determining whether a taxpayer's method of allocating compensation is reasonable is whether the taxpayer uses that method consistently from one taxable year to another.

(6) *Produced by the taxpayer*. A qualified film will be treated as produced by the taxpayer for purposes of section 199(c)(4)(A)(i)(II) if the production activity performed by the taxpayer is substantial in nature within the meaning of paragraph (g)(2) of this section. The special rules of paragraph (g)(4) of this section regarding a contract with an unrelated person and aggregation apply in determining whether the taxpayer's production activity is substantial in nature. Paragraphs (g)(2) and (4) of this section are applied by substituting the term *qualified film* for QPP and disregarding the requirement that the production activity must be within the United States. The production activity of the taxpayer must consist of more than the minor or immaterial combination or assembly of two or more components of a film. For purposes of paragraph (g)(2) of this section, the relative value added by affixing trademarks or trade names as defined in §1.197–2(b)(10)(i) will be treated as zero.

(7) *Qualified film produced by the taxpayer — safe harbor*. A film will be treated as a qualified film under paragraph (k)(1) of this section and produced by the taxpayer under paragraph (k)(6) of this section (qualified film produced by the taxpayer) if the taxpayer meets the requirements of paragraphs (k)(7)(i) and (ii) of this section. A taxpayer that chooses to use this safe harbor must apply all the provisions of this paragraph (k)(7).

(i) *Safe harbor*. A film will be treated as a qualified film produced by the taxpayer if not less than 50 percent of the total compensation for services paid by the taxpayer is compensation for services performed in the United States and the taxpayer satisfies the safe harbor in paragraph (g)(3) of this section. The special rules of paragraph (g)(4) of this section regarding a contract with an unrelated person and aggregation apply in determining whether the taxpayer satisfies paragraph (g)(3) of this section. Paragraphs (g)(3) and (4) of this section are applied by substituting the term *qualified film* for QPP but not disregarding the requirement that the direct labor and overhead of the taxpayer to produce the qualified film must be within the United States. Paragraph (g)(3)(ii)(A) of this section includes any election under section 181.

(ii) *Determination of 50 percent*. The not-less-than-50-percent-of-the-total-compensation requirement under paragraph (k)(7)(i) of this section is calculated using a fraction. The numerator of the fraction is the compensation for services paid by the taxpayer for services performed in the United States and the denominator is the total compensation for services paid by the taxpayer regardless of where the production activities are performed. For purposes of this paragraph (k)(7)(ii), the term *paid by the taxpayer* includes amounts that are treated as paid by the taxpayer under paragraph (g)(4) of this section. A taxpayer may use any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, including all historic information available, to determine the compensation for services paid by the taxpayer for services performed in the United States and the total compensation for services paid by the taxpayer regardless of where the production activities are performed. Among the factors to be considered in determining whether a taxpayer's method of allocating compensation is reasonable is whether the taxpayer uses that method consistently from one taxable year to another.

(8) *Production pursuant to a contract*. With the exception of the rules applicable to an expanded affiliated group (EAG) under §1.199–7 and EAG partnerships under §1.199–3(i)(8), only one taxpayer may claim the deduction under §1.199–1(a) with respect to any activity related to the production of a qualified film performed in connection with the same qualified film. If one taxpayer performs a production activity pursuant to a contract with another party, then only the taxpayer that has the benefits and burdens of ownership of the qualified film under Federal income tax principles during the period in which the production activity occurs is treated as engaging in the production activity.

* * * * *

(10) * * *

Example 6. X creates a television program in the United States that includes scenes from films licensed by X from unrelated persons Y and Z. Assume that Y and Z produced the films licensed by X. The not-less-than-50-percent-of-the-total-compensation requirement under paragraph (k)(1) of this section is determined by reference to all compensation for services paid in the production of the television program, including the films licensed by X from Y and Z, and is calculated using a fraction as described in paragraph (k)(5) of this section. The numerator of the fraction is the compensation for services performed in the United States and the denominator is the total compensation for services regardless of where the production activities are performed. However, for purposes of calculating the denominator, in determining the total compensation paid by Y and Z, X need only include the total compensation paid by Y and Z to actors, production personnel, directors, and producers for the production of the scenes used by X in creating its television program.

* * * * *

Par. 4. Section 1.199–7 is amended by:

1. Revising *Example 10* of paragraph (e).

2. Revising paragraphs (f)(1) and (g)(3).

The revisions read as follows:

§1.199–7 Expanded affiliated groups.

* * * * *

(e) * * *

Example 10. (i) *Facts*. Corporation P owns all of the stock of Corporations S and B. P, S, and B file a consolidated Federal income tax return on a calendar year basis. P, S, and B each uses the section 861 method for allocating and apportioning their deductions. In 2010, S MPGE QPP in the United States at a cost of $1,000. On November 30, 2010, S sells the QPP to B for $2,500. On February 28, 2011, P sells 60% of the stock of B to X, an unrelated person. On June 30, 2011, B sells the QPP to U, another unrelated person, for $3,000.

(ii) *Consolidated group's 2010 QPAI*. Because S and B are members of a consolidated group in 2010, pursuant to §1.199–7(d)(1) and §1.1502–13, neither S's $1,500 of gain on the sale of QPP to B nor S's $2,500 gross receipts from the sale are taken into account in 2010. Accordingly, neither S nor B has QPAI in 2010.

(iii) *Consolidated group's 2011 QPAI*. B becomes a nonmember of the consolidated group at the end of the day on February 28, 2011, the date on which P sells 60% of the B stock to X. Under §1.199–7(d)(1) and §1.1502–13(d), S takes the intercompany transaction into account immediately before B becomes a nonmember of the consolidated group. Pursuant to §1.1502–13(d)(1)(ii)(A)(*1*), because the QPP is owned by B, a nonmember of the consolidated group immediately after S's gain is taken into account, B is treated as selling the QPP to a nonmember for $2,500, B's adjusted basis in the property, immediately before B becomes a nonmember of the consolidated group. Accordingly, immediately before B becomes a nonmember of the consolidated group, S takes into account $1,500 of QPAI (S's $2,500 DPGR received from B - S's $1,000 cost of MPGE the QPP).

(iv) *B's 2011 QPAI*. Pursuant to §1.1502–13(d)(2)(i)(B), the attributes of B's corresponding item, that is, its sale of the QPP to U, are determined as if the S division (but not the B division) were transferred by the P, S, and B consolidated group (treated as a single corporation) to an unrelated person. Thus, S's activities in MPGE the QPP before the intercompany sale of the QPP to B continue to affect the attributes of B's sale of the QPP. As such, B is treated as having MPGE the QPP. Accordingly, upon its sale of the QPP, B has $500 of QPAI (B's $3,000 DPGR received from U minus B's $2,500 cost of MPGE the QPP).

* * * * *

(f) *Allocation of income and loss by a corporation that is a member of the expanded affiliated group for only a portion of the year*—(1) *In general*. A corporation that becomes or ceases to be a member of an EAG during its taxable year must allocate its taxable income or loss, QPAI, and W–2 wages between the portion of the taxable year that it is a member of the EAG and the portion of the taxable year that it is not a member of the EAG. This allocation of items is made by using the *pro rata* allocation method described in this paragraph (f)(1). Under the *pro rata* allocation method, an equal portion of a corporation's taxable income or loss, QPAI, and W–2 wages for the taxable year is assigned to each day of the corporation's taxable year. Those items assigned to those days that the corporation was a member of the EAG are then aggregated.

* * * * *

(g) * * *

(3) *Example*. The following example illustrates the application of paragraphs (f) and (g) of this section:

Example. (i) *Facts*. Corporations X and Y, calendar year corporations, are members of the same EAG for the entire 2010 taxable year. Corporation Z, also a calendar year corporation, is a member of the EAG of which X and Y are members for the first half of 2010 and not a member of any EAG for the second half of 2010. During the 2010 taxable year, neither X, Y, nor Z joins in the filing of a consolidated Federal income tax return. Assume that X, Y, and Z each has W–2 wages in excess of the section 199(b) wage limitation for all relevant periods. In 2010, X has taxable income of $2,000 and QPAI of $600, Y has a taxable loss of $400 and QPAI of ($200), and Z has taxable income of $1,400 and QPAI of $2,400.

(ii) *Analysis*. Pursuant to the *pro rata* allocation method, $700 of Z's 2010 taxable income and $1,200 of Z's 2010 QPAI are allocated to the first half of the 2010 taxable year (the period in which Z is a member of the EAG) and $700 of Z's 2010 taxable income and $1,200 of Z's 2010 QPAI are allocated to the second half of the 2010 taxable year (the period in which Z is not a member of any EAG). Accordingly, in 2010, the EAG has taxable income of $2,300 (X's $2,000 + Y's ($400) + Z's $700) and QPAI of $1,600 (X's $600 + Y's ($200) + Z's $1,200). The EAG's section 199 deduction for 2010 is therefore $144 (9% of the lesser of the EAG's $2,300 of taxable income or $1,600 of QPAI). Pursuant to §1.199–7(c)(1), this $144 deduction is allocated to X, Y, and Z in proportion to their respective QPAI. Accordingly, X is allocated $48 of the EAG's section 199 deduction, Y is allocated $0 of the EAG's section 199 deduction, and Z is allocated $96 of the EAG's section 199 deduction. For the second half of 2010, Z has taxable income of $700 and QPAI of $1,200. Therefore, for the second half of 2010, Z has a section 199 deduction of $63 (9% of the lesser of its $700 taxable income or $1,200 QPAI for the second half of 2010). Accordingly, X's 2010 section 199 deduction is $48, Y's 2010 section 199 deduction is $0, and Z's 2010 section 199 deduction is $159, the sum of the $96 section 199 deduction of the EAG allocated to Z for the first half of 2010 and Z's $63 section 199 deduction for the second half of 2010.

* * * * *

Par. 5. Section 1.199–8 is amended by:

1. Adding two sentences at the end of paragraph (a).

2. Adding new paragraphs (i)(8) and (i)(9).

The revisions and additions read as follows:

§1.199–8 Other rules.

(a) *In general*. * * * For purposes of §§1.199–1 through 1.199–9, use of terms such as *payment*, *paid*, *incurred*, or *paid or incurred* is not intended to provide any specific rule based upon the use of one term versus another. In general, the use of the term *payment*, *paid*, *incurred*, or *paid or incurred* is intended to convey the appropriate standard under the taxpayer's method of accounting.

* * * * *

(i) * * *

(8) *Qualified film produced by the taxpayer*. Section 1.199–3(k) is applicable to taxable years beginning on or after March 7, 2008. A taxpayer may apply §1.199–3(k) to taxable years beginning after December 31, 2004, and before March 7, 2008. However, for taxable years beginning before June 1, 2006, a taxpayer may rely on §1.199–3(k) only if the taxpayer does not apply Notice 2005–14, 2005–1 C.B. 498 (see §601.601(d)(2)(ii)(*b*) of this chapter), or REG–105847–05, 2005–2 C.B. 987 (see §601.601(d)(2)(ii)(*b*) of this chapter), to the taxable year.

(9) *Expanded affiliated groups*. Section 1.199–7(e), *Example 10*, (f)(1), and (g)(3) are applicable to taxable years beginning on or after March 7, 2008. A taxpayer may apply §1.199–7(e), *Example 10*, to taxable years beginning after December 31, 2004, and before March 7, 2008.

Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.

Approved March 3, 2008.

Eric Solomon,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on March 6, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 7, 2008, 73 F.R. 12268)

Section 2036.—Transfers With Retained Life Estate

26 CFR 20.2036–1: Transfers with retained life estate.
(Also § 2038; 20.2038–1.)

Substitution power. This ruling provides guidance regarding whether the corpus of an *inter vivos* trust is includible in the grantor's gross estate under section 2036 or 2038 of the Code if the grantor retained the power, exercisable in a nonfiduciary capacity, to acquire property held in the trust by substituting other property of equivalent value. The ruling provides that, for estate tax purposes, the substitution power will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate, provided the trustee has a fiduciary obligation (under local law) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

Rev. Rul. 2008–22

ISSUE

Is the corpus of an *inter vivos* trust includible in the grantor's gross estate under § 2036 or 2038 of the Internal Revenue Code if the grantor retained the power, exercisable in a nonfiduciary capacity, to acquire property held in the trust by substituting other property of equivalent value?

FACTS

In Year 1, *D*, a United States citizen, established and funded Trust. Trust is an irrevocable *inter vivos* trust for the benefit of *D*'s descendants. *T* is the trustee of Trust, and *D* is prohibited from serving as trustee under the terms of Trust. The governing instrument provides that *D* has the power, exercisable at any time, to acquire any property held in Trust by substituting other property of equivalent value. The power is exercisable by *D* in a nonfiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity. To exercise the power of substitution, *D* must certify in writing that the substituted property and the trust property for which it is substituted are of equivalent value. In addition, under local law, *T* has a fiduciary obligation to ensure that the properties being exchanged are of equivalent value. Under local law, if a trust has two or more beneficiaries, the trustee has a duty to act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries. Further, under local law and without restriction in the trust instrument, *T* has the discretionary power to acquire, invest, reinvest, exchange, sell, convey, control, divide, partition, and manage the trust property in accordance with the standards provided by law.

D dies in Year 2.

LAW AND ANALYSIS

Section 2036(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a *bona fide* sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which the decedent has retained for life or for any period not ascertainable without reference to the decedent's death or for any period that does not in fact end before the decedent's death, (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income from the property.

Section 2038(a)(1) provides that the value of the gross estate includes the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a *bona fide* sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of the decedent's death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

In *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975), *acq. in result*, 1977–2 C.B. 1, the decedent created an *inter vivos* trust. Under the terms of the trust, the decedent reserved the power to substitute other securities or property for those held in trust, provided the substituted property was equal in value to the property replaced. After the decedent's death, the Service argued that the trust assets were includible in the decedent's gross estate under § 2038 because the decedent's power to substitute assets of equal value could be exercised to alter the beneficial interests in the trust. The court determined, however, that because the decedent was bound by fiduciary standards and was therefore accountable in equity to the succeeding income beneficiary and remaindermen, the decedent could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries. Accordingly, the court held that the substitution power was not a power to alter, amend, or revoke the trust within the meaning of § 2038.

In general, a trustee has a fiduciary duty to the trust and its beneficiaries. As a result, the trustee is held to a high standard of conduct with respect to the administration of the trust. A trustee is under a duty to the beneficiaries of the trust to administer the trust solely in the interest of the beneficiaries. The trustee must act fairly, justly, honestly, in the utmost good faith, and with sound judgment and prudence. 90A C.J.S. Trusts § 323 (2007). The trustee is also subject to a duty of impartiality that requires the trustee to take into account the interests of all the beneficiaries for whom the trustee is acting. Restatement (Third) of Trusts §§ 183 and 232 (2007); 76 Am. Jur. 2d Trusts § 434 (2008). A trustee must administer the trust solely in the interests of the beneficiaries. Generally, a sale, encumbrance, or other transaction involving the investment or management of trust property entered into by the trustee for the trustee's own personal account or which is otherwise affected by a conflict between the trustee's fiduciary and personal interests may be voidable by a beneficiary affected by the transaction. Uniform Trust Code § 802 (2005). If a trust has two or more beneficiaries, the trustee must act impartially in investing, managing, and distributing the trust property, giving due regard to the beneficiaries' respective interests. Uniform Trust Code § 803 (2005). See also, *Sallee v. Fort Knox National Bank, et. al.*, 286 F.3d 878, 891 (6th Cir. 2002) (distinguishing between a duty of good faith and fair dealing, requiring parties to "deal fairly" with one another, and the more onerous fiduciary duty that requires a party to place the interest of the other party before one's own interests).

In situations where the grantor of a trust holds a nonfiduciary power to replace trust assets with assets of equivalent value, the trustee has a duty to ensure that the value of the assets being replaced is equivalent to the value of the assets being substituted. If the trustee knows or has reason to believe that the exercise of the substitution power does not satisfy the terms of the trust instrument because the assets being substituted have a lesser value than the trust assets being replaced, the trustee has a fiduciary duty to prevent the exercise of the power. See Restatement (Third) of Trusts § 75 (2007) and Uniform Trust Code §§ 801 and 802 (2005).

In the instant case, unlike the situation presented in *Estate of Jordahl*, the trust instrument expressly prohibits *D* from serving as trustee and states that *D*'s power to substitute assets of equivalent value is held in a nonfiduciary capacity. Thus, *D* is not subject to the rigorous standards attendant to a power held in a fiduciary capacity. However, under the terms of the trust, the assets *D* transfers into the trust must be equivalent in value to the assets *D* receives in exchange. In addition, *T* has a fiduciary obligation to ensure that the assets exchanged are of equivalent value. Thus, *D* cannot exercise the power to substitute assets in a manner that will reduce the value of the trust corpus or increase *D*'s net worth. Further, in view of *T*'s ability to reinvest the assets and *T*'s duty of impartiality regarding the trust beneficiaries, *T* must prevent any shifting of benefits between or among the beneficiaries that could otherwise result from a substitution of property by *D*. Under these circumstances, *D*'s retained power will not cause the value of the trust corpus to be included in *D*'s gross estate under § 2036 or 2038.

HOLDING

A grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under § 2036 or 2038, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

DRAFTING INFORMATION

The principal author of this revenue ruling is Mayer Samuels of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. Samuels at (202) 622–3090 (not a toll-free call).

Section 2038.—Revocable Transfers

26 CFR 20.2038–1: Revocable transfers.

Is the corpus of an *inter vivos* trust includible in the grantor's gross estate under section 2036 or 2038 of the Internal Revenue Code if the grantor retained the power, exercisable in a nonfiduciary capacity, to acquire property held in the trust by substituting other property of equivalent value. See Rev. Rul. 2008-22, page 796.

Part III. Administrative, Procedural, and Miscellaneous

Nonconventional Source Fuel Credit, Section 45K Inflation Adjustment Factor, and Section 45K Reference Price

Notice 2008–44

SECTION 1. PURPOSE

This notice publishes the nonconventional source fuel credit, inflation adjustment factor, and reference price under § 45K of the Internal Revenue Code for calendar year 2007. These are used to determine the credit allowable under § 45K for fuel produced from a nonconventional source. The calendar year 2007 inflation-adjusted credit applies to the sales of barrel-of-oil equivalent of qualified fuels sold by a taxpayer to an unrelated person during the 2007 calendar year, the domestic production of which is attributable to the taxpayer.

SECTION 2. BACKGROUND

Section 45K(a) provides for a credit for producing fuel from a nonconventional source, measured in barrel-of-oil equivalent of qualified fuels, the production of which is attributable to the taxpayer and is sold by the taxpayer to an unrelated person during the tax year. The credit is equal to the product of $3.00 and the appropriate inflation adjustment factor.

Section 45K(b)(1) and (2) provides for a phase-out of the credit. The credit allowable under § 45K(a) must be reduced by an amount which bears the same ratio to the amount of the credit (determined without regard to § 45K(b)(1)) as the amount by which the reference price for the calendar year in which the sale occurs exceeds $23.50 bears to $6.00. The $3.00 in § 45K(a) and the $23.50 and $6.00 each must be adjusted by multiplying these amounts by the appropriate inflation adjustment factor.

Section 45K(c)(1), in part, defines the term "qualified fuels" to include gas produced from biomass and liquid, gaseous, or solid synthetic fuels produced from coal (including lignite), including such fuels when used as feedstocks.

Section 45K(d)(1) provides that the credit applies only to sales of qualified fuels the production of which is within the United States (within the meaning of § 638(1)) or a possession of the United States (within the meaning of § 638(2)).

Section 45K(d)(2)(A) requires that the Secretary, not later than April 1 of each calendar year, determine and publish in the Federal Register the inflation adjustment factor and the reference price for the preceding calendar year.

Section 45K(d)(2)(B) defines "inflation adjustment factor" for a calendar year as a fraction the numerator of which is the GNP implicit price deflator for the calendar year and the denominator of which is the GNP implicit price deflator for calendar year 1979. The term "GNP implicit price deflator" means the first revision of the implicit price deflator for the gross national product as computed and published by the Department of Commerce.

Section 45K(d)(2)(C) defines "reference price" to mean with respect to a calendar year the Secretary's estimate of the annual average wellhead price per barrel for all domestic crude oil the price of which is not subject to regulation by the United States.

Section 45K(d)(5) provides that the term "barrel-of-oil equivalent" with respect to any fuel generally means that amount of the fuel that has a Btu content of 5.8 million.

Section 45K(g)(1) provides that in the case of a facility for producing coke or coke gas, which was placed in service before January 1, 1993, or after June 30, 1998, and before January 1, 2010, § 45K(g) shall apply with respect to coke and coke gas produced in such facility and sold during the period beginning on the later of January 1, 2006, or the date that such facility is placed in service, and ending on the date which is 4 years after the date such period began.

Section 45K(g)(2)(B) provides that in determining the amount of credit allowable under § 45K solely by reason of § 45K(g), § 45K(d)(2)(B) shall be applied by substituting "2004" for "1979." Accordingly, for purposes of § 45K(g), the inflation adjustment factor for a calendar year is a fraction the numerator of which is the GNP implicit price deflator for the calendar year and the denominator of which is the GNP implicit price deflator for calendar year 2004.

Section 45K(g)(2)(D) provides that the phase-out of the credit under § 45K(b)(1) does not apply in the case of facilities producing coke or coke gas.

SECTION 3. REFERENCE PRICE

The reference price for calendar year 2007 is $66.52.

SECTION 4. INFLATION ADJUSTMENT AND CREDIT AMOUNT

.01 *Gas Produced from Biomass and Liquid, Gaseous, or Solid Synthetic Fuel Produced from Coal.*

In the case of gas produced from biomass and liquid, gaseous, or solid synthetic fuel produced from coal, the inflation adjustment factor for calendar year 2007 is 2.4160. Because the calendar year 2007 reference price exceeds $23.50 multiplied by the inflation adjustment factor, the credit per barrel equivalent of qualified fuel sold in calendar year 2007 is reduced by $4.87, which is the amount that bears the same ratio to the amount of the credit (determined without regard to § 45K(b)(1)) as the amount by which the reference price for the calendar year 2007 exceeds $23.50 (adjusted for inflation) bears to $6.00 (adjusted for inflation).

The phase-out amount is computed as follows:

($3.00 x 2.4160) x [($66.52 - ($23.50 x 2.4160)) / ($6.00 x 2.4160)] = $4.87.

The nonconventional source fuel credit under § 45K(a) is $2.38 per barrel-of-oil equivalent of qualified fuels [($3.00 x 2.4160) - $4.87].

.02 *Facilities for Producing Coke or Coke Gas.* In case of facilities producing coke or coke gas, the inflation adjustment factor for calendar year 2007 is 1.0936. The nonconventional source fuel credit is $3.28 per barrel-of-oil equivalent ($3.00 x 1.0936).

SECTION 5. DRAFTING INFORMATION CONTACT

The principal author of this notice is Jennifer Bernardini of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Ms. Bernardini at (202) 622–3110 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking

Guidance Regarding Foreign Base Company Sales Income

REG–124590–07

AGENCY: Internal Revenue Service (IRS), Treasury Department.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance relating to foreign base company sales income, as defined in section 954(d), in cases in which personal property sold by a controlled foreign corporation (CFC) is manufactured, produced, or constructed pursuant to a contract manufacturing arrangement or by one or more branches of the CFC. These regulations, in general, will affect CFCs and their United States shareholders. Certain portions of these proposed regulations restate changes to §1.954–3(a)(4) that were contained in former proposed regulations.

DATES: Written or electronic comments and requests for a public hearing must be received by May 28, 2008.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–124590–07), Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044 or send electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–124590–07).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Ethan Atticks, (202) 622–3840; concerning submissions of comments, Kelly Banks, (202) 622–0392 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

A. *Foreign Base Company Sales Income*

Under section 951(a)(1)(A)(i), a United States shareholder of a CFC includes in gross income its *pro rata* share of the CFC's subpart F income for the CFC's taxable year which ends with or within the taxable year of the shareholder. Section 952(a)(2) defines the term "subpart F income" to mean, in part, "foreign base company income." Section 954(a)(2) defines "foreign base company income" to include foreign base company sales income (FBCSI) for the taxable year. Section 954(d)(1) defines FBCSI to mean income derived by a CFC in connection with (1) the purchase of personal property from a related person and its sale to any person, (2) the sale of personal property to any person on behalf of a related person, (3) the purchase of personal property from any person and its sale to a related person, or (4) the purchase of personal property from any person on behalf of a related person, provided (in all of these cases) that the property both is manufactured, produced, grown or extracted outside of the CFC's country of organization and is sold for use, consumption or disposition outside of such country.

The Treasury regulations further define FBCSI and the applicable exceptions from FBCSI. These exceptions from FBCSI are contained in §1.954–3(a)(2), which addresses personal property manufactured, produced, constructed, grown, or extracted within the CFC's country of organization (the same country manufacture exception), §1.954–3(a)(3), which addresses personal property sold for use, consumption or disposition within the CFC's country of organization, and §1.954–3(a)(4) which addresses personal property manufactured, produced or constructed by the CFC (the manufacturing exception).

Section 1.954–3(a)(4)(i) provides that FBCSI does not include income of a CFC derived in connection with the sale of personal property manufactured, produced, or constructed by such corporation in whole or in part from personal property which it has purchased. It then states generally that a foreign corporation is considered to have manufactured, produced, or constructed personal property which it sells if the property sold is in effect not the property which it purchased. Specifically, §1.954–3(a)(4)(i) states that personal property sold will be considered as not being the property purchased if the provisions of §1.954–3(a)(4)(ii) or (iii) are satisfied.

Section 1.954–3(a)(4)(ii) and (iii) set forth two separate tests to determine whether a CFC is considered to manufacture, produce, or construct personal property that it sells. First, §1.954–3(a)(4)(ii) sets forth a "substantial transformation" test, pursuant to which if personal property is substantially transformed prior to sale, the property sold will be treated as having been manufactured, produced, or constructed by the selling corporation. Examples of substantial transformation provided in the regulations include the conversion of wood pulp to paper, steel rods to screws and bolts, and tuna fish to canned tuna. Second, §1.954–3(a)(4)(iii) sets forth a general "substantive test" and a safe harbor that apply when purchased property is used by the CFC as a component part of personal property that is sold by the CFC. Under the substantive test, the sale of personal property will be treated as the sale of a product manufactured by the CFC rather than the sale of component parts if the operations conducted by the CFC in connection with the property are substantial in nature and generally considered to constitute the manufacture, production, or construction of the property. The assembly of automobiles from component parts is provided as an example of an activity considered to be substantial in nature and generally considered to constitute the manufacture of a product. Under the safe harbor, without limiting the application of the substantive test, the operations of a selling corporation in connection with the use of purchased property as a component part of the personal property that is sold will be considered to constitute the manufacture of a product if in connection with such property conversion costs (direct labor and factory burden) of such corporation account for 20 percent or more of the total cost of goods sold. Section 1.954–3(a)(4)(iii) makes clear that, in no event, however, will packaging, prepackaging, labeling, or minor assembly operations constitute the manufacture, production, or construction of property for purposes of section 954(d)(1). For purposes of this preamble, satisfaction of the requirements of §1.954–3(a)(4)(ii) or (iii) will be referred to as satisfaction of the "physical manufacturing test."

B. *The Branch Rule*

In addition to the general FBCSI rules of section 954(d)(1), section 954(d)(2) provides a special rule for purposes of determining FBCSI if a CFC carries on activities through a branch or similar establishment outside its country of organization and the carrying on of such activities has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation (the branch rule). Under the branch rule, to the extent prescribed by regulations, the income attributable to the carrying on of such activities is treated as income derived by a wholly owned subsidiary of the CFC and constitutes FBCSI of the CFC. See section 954(d)(2). Section 1.954–3(b)(1)(i) (addressing sales or purchase branches) and (ii) (addressing manufacturing branches) provide rules on the application of the branch rule. The purpose of the branch rule is to prevent a CFC from using a foreign branch to avoid the application of the FBCSI rules. Absent the branch rule, a CFC could engage in purchasing or manufacturing activities with respect to personal property in a high-tax jurisdiction and selling activities with respect to the property in a low-tax jurisdiction without incurring FBCSI. In such a case, the sales income would not be FBCSI to the CFC because the same person would be purchasing or manufacturing the personal property and selling the personal property. The branch rule therefore treats a sales, purchase, or manufacturing branch located outside of the country of organization of the CFC as a separate corporation so as to create a related party transaction between the branch and the remainder of the CFC for purposes of determining FBCSI.

With respect to manufacturing branches, §1.954–3(b)(1)(ii)(*a*) provides that if a CFC carries on manufacturing, producing, constructing, growing, or extracting activities by or through a branch or similar establishment located outside of its country of organization and the use of that branch or similar establishment for such activities with respect to personal property purchased or sold by or through the remainder of the CFC has substantially the same tax effect as if that branch or similar establishment were a wholly owned subsidiary corporation of such CFC, that branch or similar establishment and the remainder of the CFC will be treated as separate corporations for purposes of determining FBCSI of such CFC. Section 1.954–3(b)(1)(ii)(*b*) provides that the use of a manufacturing branch or similar establishment will be considered to have substantially the same tax effect as if it were a wholly owned subsidiary corporation of the CFC if the tax imposed on the income derived by the remainder of the CFC satisfies the test set forth in §1.954–3(b)(1)(ii)(*b*) (the manufacturing branch tax rate disparity test). There is also a separate tax rate disparity test which applies to sales or purchase branches under §1.954–3(b)(1)(i)(*b*) (the sales branch tax rate disparity test).

For purposes of the manufacturing branch tax rate disparity test, the income considered to be derived by the remainder of the CFC is determined first by applying the rules of §1.954–3(b)(2)(i) which treat the CFC and the manufacturing branch as separate corporations, and then by determining the income of the CFC that would be FBCSI under section 954(d)(1) and §1.954–3(a)(1) if the CFC and the branch were separate corporations (but without applying the exceptions contained in §1.954–3(a)(2), (3), and (4)).

Specifically, §1.954–3(b)(2)(i)(*a*) treats the remainder of the CFC and the manufacturing branch as separate corporations. In addition, §1.954–3(b)(2)(i)(*b*) and (*c*) deem purchases or sales to be made "on behalf of" a related person to take into account that the remainder of the CFC and the branch are treated as separate corporations. Section 1.954–3(b)(2)(i)(*b*) addresses sales and purchase branches by treating selling or purchasing activities conducted through a branch or similar establishment with respect to personal property as performed on behalf of the CFC if the CFC manufactures, produces, constructs, grows, extracts, purchases, or sells that same property. Section 1.954–3(b)(2)(i)(*c*) provides a corollary rule addressing manufacturing branches, pursuant to which the purchase or sale of personal property by the remainder of the CFC is treated as performed on behalf of a branch that manufactures, produces, constructs, grows, or extracts that property. The general rule of §1.954–3(a)(1) is then applied to determine the income that would be FBCSI if the branch and the remainder of the CFC were separate corporations subject to the "on behalf of" related party transactions described above.

Section 1.954–3(b)(1)(ii)(*b*) provides that the manufacturing branch tax rate disparity test is satisfied if the income that would be FBCSI after applying these special rules is taxed in the year when earned at an effective rate of tax that is less than 90 percent of, and at least 5 percentage points less than, the hypothetical effective rate of tax. The hypothetical effective rate of tax is the effective rate of tax which would apply to such income under the laws of the country in which the manufacturing branch is located, if, under the laws of such country, the entire income of the CFC were considered derived by such CFC from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the CFC were created or organized under the laws of, and managed and controlled in, such country.

If the manufacturing branch tax rate disparity test is satisfied, §1.954–3(b)(1)(ii)(*a*) then treats the branch and the remainder of the CFC as separate corporations and the special rules of §1.954–3(b)(2)(ii) are applied for purposes of determining FBCSI. Section 1.954–3(b)(2)(ii)(*a*) through (*c*) provide separate CFC and related party rules that mirror §1.954–3(b)(2)(i)(*a*) through (*c*). Section 1.954–3(b)(2)(ii)(*d*) through (*f*) provide special rules to prevent double counting of FBCSI and to align treatment of branches with the treatment of separate CFCs. In particular, §1.954–3(b)(2)(ii)(*e*) provides that income derived by a branch or similar establishment, or by the remainder of the CFC, will not be FBCSI if the income would not be so considered if it were derived by a separate CFC under like circumstances.

C. *Legal Developments*

In Rev. Rul. 75–7, 1975–1 C.B. 244, revoked by Rev. Rul. 97–48, 1997–2 C.B. 89, the IRS considered a case in which a CFC purchased raw material from related persons outside of its country of organization, contracted with an unrelated manufacturer located outside of its country of organization to process the raw material into a finished product, and then sold the finished product to unrelated persons outside of its country of organization. Under the terms of the arrangement, the contract manufacturer was paid a conversion fee. The raw material, work in process, and finished product remained the property of the CFC at all times. The CFC alone had complete control over the time and quantity of production as well as complete quality control over the conversion process. The IRS ruled, under these facts, that the performance of the operations by the contract manufacturer whereby the raw material was processed into a finished good was considered to be a performance by the CFC, and the CFC would therefore be treated as having substantially transformed personal property. The ruling further concluded that, because the CFC conducted the manufacturing activity outside of its country of organization, it was considered to do so through a branch or similar establishment. Because the manufacturing branch tax rate disparity test was not satisfied, however, the activities of the "branch" were not treated as the activities of a separate CFC and the CFC was therefore entitled to the manufacturing exception from FBCSI. See §601.601(d)(2)(ii)(*b*).

In *Ashland Oil, Inc. v. Commissioner*, 95 TC 348 (1990), the Tax Court held that an unrelated manufacturing corporation in a contract manufacturing arrangement with a CFC cannot be treated as a branch or similar establishment of the CFC. In *Vetco, Inc. v. Commissioner*, 95 TC 579 (1990), the Tax Court held that a wholly owned subsidiary of a CFC in a contract manufacturing arrangement with the CFC also cannot be treated as a branch or similar establishment of the CFC.

In Rev. Rul. 97–48 the IRS revoked Rev. Rul. 75–7. Rev. Rul. 97–48 states that the IRS will follow *Ashland Oil, Inc. v. Commissioner* and *Vetco, Inc. v. Commissioner*, and therefore confirms that the IRS will not treat a separate contract manufacturer as a branch for purposes of section 954(d)(2). In addition, Rev. Rul. 97–48 rules that the activities of a contract manufacturer cannot be attributed to a CFC for purposes of either section 954(d)(1) or section 954(d)(2) to determine whether the income of a CFC is FBCSI. However, the ruling does not address the circumstances under which the activities of the CFC itself may qualify as manufacturing when a contract manufacturing or similar arrangement is in place. See §601.601(d)(2)(ii)(*b*).

D. *Business Developments*

Final regulations addressing FBCSI were first published in 1964 (T.D. 6734, 1964–1 C.B. 237 [29 FR 6392]). Since then, global economic expansion and globalization have led to significant changes in manufacturing. Many multinational groups have extensive manufacturing networks that straddle geographic borders. These cross-border manufacturing networks are created primarily to leverage expertise and cost efficiencies. In addition, the use of contract manufacturing arrangements has become a common way of manufacturing products because of the flexibility and efficiencies it affords. Accordingly, updated rules in this area are important to the continued competitiveness of U.S. businesses operating abroad.

Explanation of Provisions

In response to the growing importance of contract manufacturing and other manufacturing arrangements, the Treasury Department and the IRS propose to modernize the FBCSI regulations in light of current business structures and practices that are inadequately addressed by the current regulations. Specifically, the proposed regulations address: (1) the application of the manufacturing exception where the physical manufacturing test is not satisfied by the CFC but where the CFC, and/or a branch of the CFC, is otherwise involved in the manufacturing process; (2) the application of the branch rule to business structures involving the use of one or more branches engaged in manufacturing, producing, constructing, growing, or extracting activities; and (3) other miscellaneous branch rule issues. Certain portions of these proposed regulations restate changes that were previously proposed in REG–104537–97, 1998–1 C.B. 892 [63 FR 14669] and withdrawn in REG–113909–98, 1999–2 C.B. 125 [64 FR 37727].

A. *Application of the manufacturing exception where the physical manufacturing test is not satisfied by the CFC but the CFC is involved in the manufacturing process — Substantial contribution to manufacturing*

Section 954(d)(1) includes, as FBCSI, income derived in connection with the purchase of personal property from a related person and "its" sale to any person, and income derived in connection with the purchase of personal property from any person and "its" sale to a related person. Some taxpayers argue that use of the word "its" implies that the property sold must be the same property that is purchased for the sales income to be FBCSI. Accordingly, these taxpayers assert that where the personal property purchased by the CFC is manufactured such that the property purchased is not the same as the property sold by the CFC, the property sold by the CFC is not the property purchased and therefore the sale of such property does not generate FBCSI, even if the CFC itself performs little or no part of the manufacture of that property. They further argue that the manufacturing exception under §1.954–3(a)(4)(i) provides a safe harbor but does not define the universe of cases in which personal property sold by a CFC is considered to be different from the property purchased by the CFC for purposes of determining FBCSI. In addition, they argue that §1.954–3(a)(4)(i) supports their view because it states, in part, that "[a] foreign corporation will be considered, for purposes of this subparagraph, to have manufactured, produced, or constructed personal property which it sells if the property sold is in effect not the property which it purchased."

The Treasury Department and the IRS believe that the position taken by these taxpayers is contrary to existing law, and results from an incorrect reading of section 954(d)(1) and §1.954–3(a)(4)(i). Section 954(d)(1) requires only a purchase of personal property and the sale of that personal property by the CFC with no indication as to form. Moreover, section 954(d)(1)(A) limits FBCSI to income derived in connection with the purchase (or sale) of personal property that is manufactured, produced, grown, or extracted outside of the CFC's country of organization, thereby indicating that section 954(d)(1) is concerned with the segregation of purchasing or selling and manufacturing into different jurisdictions, not merely with whether the property was manufactured.

Section 1.954–3(a)(4) provides the only set of rules under which a change in form of personal property is considered relevant for purposes of determining FBCSI. The first sentence of Treas. Reg. §1.954–3(a)(4) sets forth the general rule that "foreign base company sales income does not include income of a CFC derived in connection with the sale of personal property manufactured, produced, or constructed by such corporation in whole or in part from personal property which it has purchased." The third sentence of that paragraph explains that "the property sold will be considered, for purposes of this subparagraph, as not being the property which is purchased if the provisions of subdivision (ii) or (iii) of this subparagraph are satisfied." The plain language of the regulation, as well as the examples, clarify that in order to satisfy §1.954–3(a)(4)(ii) or (iii) the relevant manufacturing activities must be performed by the CFC itself. See, for example, *Electronic Arts, Inc. v. Commissioner*, 118 TC 226, 265 (2002) (stating that "petitioner's focus on certain language in section 1.954–3(a)(4), Income Tax Regs., overlooks the regulation's requirement that various actions have been done 'by' the corporation being evaluated"). See also, *Medchem v. Commissioner*, 116 TC 308 (2001).

Further, this regulation was issued shortly after the statute became effective, and is consistent with the legislative history, which contemplates that property sold will be considered different from the property purchased only when the CFC itself manufactures that property. See S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), 1962–3 C.B. 841, 949 (stating that "[i]n a case in which a controlled foreign corporation purchases parts or materials which it then transforms or incorporates into a final product, income from the sale of the final product would not be foreign base company sales income if the corporation substantially transforms the parts or materials, so that, in effect, the final product is not the property purchased.")

The proposed regulations clarify that for purposes of determining FBCSI personal property sold by a CFC will be considered to be the property purchased by the CFC regardless of whether it is sold in the same form in which it was purchased, in a different form than the form in which it was purchased, or as a component part of a manufactured product, except as specifically provided by the same country manufacture exception contained in §1.954–3(a)(2) and the manufacturing exception contained in §1.954–3(a)(4). Therefore, the only time that the manufacture of a product will affect whether income is FBCSI is when the manufacture of the product is performed by the CFC or performed in the country of organization of the CFC. With respect to the manufacturing exception contained in §1.954–3(a)(4), the proposed regulations clarify that a CFC qualifies for the manufacturing exception only if the CFC, acting through its employees, manufactured the relevant product within the meaning of §1.954–3(a)(4)(i). The proposed regulations also further provide rules to determine whether the activities of a branch or similar establishment outside the country in which the CFC is incorporated have substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation, and thus whether under section 954(d)(2) the income attributable to the branch or similar establishment constitutes FBCSI of the CFC.

The Treasury Department and the IRS recognize, however, that due to business considerations in the global marketplace, personal property may be manufactured pursuant to a contract manufacturing arrangement under which the CFC engages in activities related to the manufacture of the property (for example, oversight, direction and control over the contract manufacturer) but does not satisfy the physical manufacturing test. In certain of these cases, the Treasury Department and the IRS believe that the CFC should qualify for the manufacturing exception to FBCSI. Accordingly, the proposed regulations modify §1.954–3(a)(4) to provide that a CFC that provides a "substantial contribution" with respect to the manufacture, production, or construction of personal property, but that could not satisfy the physical manufacturing test, may have manufactured such property for purposes of the manufacturing exception. Specifically, proposed §1.954–3(a)(4)(i) provides that, in addition to proposed §1.954–3(a)(4)(ii) and (iii), a taxpayer may qualify for the manufacturing exception by satisfying the "substantial contribution test" in proposed §1.954–3(a)(4)(iv). Pursuant to proposed §1.954–3(a)(4)(iv)(*a*), a CFC will satisfy the substantial contribution test with respect to personal property only if the facts and circumstances evidence that the controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture of that property.

Factors to be considered in determining whether a CFC makes a substantial contribution to the manufacture of personal property include but are not limited to: (1) oversight and direction of the activities or process (including management of the risk of loss) pursuant to which the property is manufactured under the principles of §1.954–3(a)(4)(ii) or (iii); (2) performance of activities that are considered in, but insufficient to satisfy the tests provided in §1.954–3(a)(4)(ii) and (iii); (3) control of the raw materials, work-in-process and finished goods; (4) management of the manufacturing profits; (5) material selection; (6) vendor selection; (7) control of logistics; (8) quality control; and (9) 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.

In light of the addition of the new test contained in proposed §1.954–3(a)(4)(iv), the interaction between several existing regulation sections and the new test is clarified. First, the existing manufacturing exceptions under §1.954–3(a)(4)(ii) and (iii) are modified to clarify that the applicability of the tests under §1.954–3(a)(4)(ii) and (iii) are restricted to cases in which physical transformation or physical assembly or conversion of component parts is conducted by the selling corporation.

Second, the definition of manufacturing for purposes of the same country manufacture exception contained in §1.954–3(a)(2) is modified to exclude manufacturing as defined under the substantial contribution test, and to ensure that the modifications to the existing manufacturing exceptions under §1.954–3(a)(4)(ii) and (iii) do not narrow the same country manufacture exception. The Treasury Department and the IRS did not intend these regulations to change the scope of the same country manufacture exception. Section 1.954–3(a)(2) excludes manufacturing as defined under the substantial contribution test because a rule that expanded the definition of manufacturing to include §1.954–3(a)(4)(iv) activities for purposes of the same country manufacture exception could prove difficult to administer. Such a rule could require an assessment of activities other than physical manufacturing conducted by an unrelated person. Modifying §1.954–3(a)(2) ensures that the modifications to the existing manufacturing exceptions under §1.954–3(a)(4)(ii) and (iii) do not narrow the same country manufacture exception by clarifying that property manufactured in the country of organization of the selling corporation will qualify for the same country manufacture exception regardless of whose employees engage in manufacturing activities that satisfy the principles of §1.954–3(a)(4)(ii) or (iii).

Third, the proposed regulations modify §1.954–3(a)(6), which addresses the application of the manufacturing exception to a CFC's distributive share of partnership income where the partnership manufactures and sells personal property. The reference to "the separate activities or property of the controlled foreign corporation or any other person," in §1.954–3(a)(6) was intended to clarify that the activities of another person could not be attributed to the partnership for purposes of applying the manufacturing exception. Because these proposed regulations clarify that no attribution is allowed for purposes of applying the manufacturing exception that language is now unnecessary and is therefore removed. Section 1.954–3(a)(6) is also modified consistent with the modifications to §1.954–3(a)(4) providing that a CFC may only qualify for the manufacturing exception through the activities of its employees.

B. *Application of the branch rule to business structures involving the use of more than one branch engaged in manufacturing*

Proposed §1.954–3(b)(2)(ii)(*c*)(*2*) creates a rebuttable presumption with respect to the application of the substantial contribution test where a CFC claims to satisfy the substantial contribution test with respect to the activities of a branch of that CFC that satisfies §1.954–3(a)(4)(ii) or (iii). Under this rebuttable presumption, if a branch of a CFC satisfies the physical manufacturing test with respect to personal property sold by the remainder of the CFC, the remainder of the CFC will be presumed not to make a substantial contribution to the manufacture of that personal property unless the CFC can rebut that presumption to the satisfaction of the Commissioner.

The Treasury Department and the IRS believe that these rules are necessary as a backstop to the branch rule. In the absence of the rebuttable presumption, a rule permitting a CFC to qualify for the manufacturing exception based upon its contribution to the manufacturing activities of a branch would prove difficult to administer. Such a rule could encourage a CFC to elect classification of its subsidiaries that engage in manufacturing activities as disregarded entities, obfuscating the division of manufacturing labor and income between the CFC and its branches. Of course, the presumption may be rebutted and any adverse consequences alleviated by incorporating the branch that satisfies the physical manufacturing test.

Although §1.954–3(b)(1)(i)(*c*) provides a rule addressing the use of multiple sales or purchase branches, §1.954–3(b)(1)(ii) does not provide a corollary rule for the use of multiple manufacturing branches. The Treasury Department and the IRS believe that the lack of a specific rule addressing the use of more than one manufacturing branch does not currently limit the general manufacturing branch rule of §1.954–3(b)(1)(ii)(*a*) from applying to each manufacturing branch of a CFC in a case where a CFC performs manufacturing activities through more than one branch or similar establishment. Rather, such an application is consistent with the rules regarding multiple sales or purchase branches. Nonetheless, for clarity, the proposed regulations set forth rules addressing the use of multiple manufacturing branches.

The proposed regulations set forth two rules addressing the application of the manufacturing branch tax rate disparity test to multiple manufacturing branches.

Proposed §1.954–3(b)(1)(ii)(*c*)(*2*) addresses situations in which multiple branches each perform manufacturing activities with respect to separate items of personal property that are then sold by the CFC. Consistent with the rule for multiple sales branches, the proposed regulations require the separate application of the manufacturing branch tax rate disparity test to each branch that is manufacturing a separate item of personal property.

Proposed §1.954–3(b)(1)(ii)(*c*)(*3*) addresses situations in which multiple branches, or one or more branches and the remainder of the CFC, perform manufacturing activities with respect to the same item of personal property that is then sold by the CFC. When multiple branches, or one or more branches and the remainder of the CFC, perform manufacturing activities with respect to the same item of personal property, the manufacturing branch tax rate disparity test is applied by giving satisfaction of the physical manufacturing test precedence over other contributions to manufacturing. Therefore, if only one branch, or only the remainder of the CFC, satisfies the physical manufacturing test of §1.954–3(a)(4)(ii) or (iii), then the location of that branch or the remainder of the CFC will be the location of manufacturing of the personal property for purposes of applying the manufacturing branch tax rate disparity test. If more than one branch, or one or more branches and the remainder of the CFC, each satisfy the physical manufacturing test, then the branch or the remainder of the CFC located or organized in the jurisdiction that would impose the lowest effective rate of tax will be the location of manufacturing of the personal property for purposes of applying the manufacturing branch tax rate disparity test.

If none of the branches nor the remainder of the CFC satisfies the physical manufacturing test, but the CFC as a whole satisfies the substantial contribution test contained in proposed §1.954–3(a)(4)(iv), then the location of manufacturing of the personal property will be the location of the branch or the remainder of the CFC that provides the predominant amount of the CFC's substantial contribution to manufacturing. Whether any branch or the remainder of the CFC provides a predominant amount of the CFC's contribution to manufacturing is determined by applying the facts and circumstances test provided in §1.954–3(a)(4)(iv) to weigh the contribution to manufacturing of each branch or the remainder of the CFC. If a predominant amount of the CFC's contribution to manufacturing is not provided by any one location, the location of manufacturing of the personal property for purposes of applying the manufacturing branch tax rate disparity test will be that place (either the remainder of the CFC or one of its branches) where manufacturing activity is performed and which would impose the highest effective rate of tax when applying either §1.954–3(b)(1)(i)(*b*) or (ii)(*b*).

Because the proposed regulations address cases in which two or more branches, or one or more branches and the remainder of the CFC, perform manufacturing activities related to the manufacture of the same item of property, §1.954–3(b)(2)(ii)(*a*) is modified to clarify the application of the branch rule where manufacturing activities are performed in more than one location. In such cases, proposed §1.954–3(b)(2)(ii)(*a*) provides that, for purposes of treating the location of sales or purchase income as a separate corporation for purposes of determining whether FBCSI is incurred, that separate corporation will exclude any branch or the remainder of the CFC that would be treated as a separate corporation, if the hypothetical rate imposed by the jurisdiction of each such branch or the remainder of the CFC were separately tested against the effective rate of tax imposed on the sales or purchase income under the relevant tax rate disparity test.

C. *Miscellaneous Branch Rule Issues*

The Treasury Department and the IRS also propose to amend certain other aspects of §1.954–3(b) as follows:

1. *Definition of a manufacturing branch*

While §1.954–3(b)(1)(ii)(*a*) defines a manufacturing branch as a branch or similar establishment through which a CFC carries on manufacturing activities, it does not explicitly require that §1.954–3(a)(4)(i) be satisfied by the CFC as a whole in order for the manufacturing branch rule to apply. The Treasury Department and the IRS believe that a manufacturing branch only exists with respect to personal property sold by a CFC if the CFC (including any branch of that CFC) has manufactured that property. Accordingly, proposed §1.954–3(b)(1)(ii)(*a*) clarifies this point by providing that the manufacturing branch rule applies only where a CFC (including any branch of the CFC) satisfies the manufacturing requirement under proposed §1.954–3(a)(4).

2. *Modification of §1.954–3(b)(2)(ii)(e)*

Section 1.954–3(b)(2)(ii)(*e*) provides that income derived by a branch or similar establishment, or by the remainder of the CFC, will not be FBCSI if the income would not be so considered if it were derived by a separate CFC under like circumstances. For example, if a branch of a CFC purchases personal property from an unrelated person and sells the property to an unrelated person without any involvement by the remainder of the CFC, the branch rule will not apply to create a related party transaction between the branch and the remainder of the CFC. Therefore the purchase and sale of that personal property by the branch will not generate FBCSI.

The proposed regulations provide that the substantial contribution test generally applies to a CFC that sells personal property where another person (for example, a second CFC) satisfies the physical manufacturing test with respect to that property. However, a negative presumption applies where a CFC claims to satisfy the substantial contribution test with respect to income from the sale of personal property where the physical manufacturing test is satisfied by a branch of that CFC. The effect of these rules is that, where a CFC seeks to rely on the substantial contribution test with respect to the income from the sale of personal property manufactured (within the meaning of §1.954–3(a)(4)(ii) or (iii)) by one or more of its branches, but cannot rebut the negative presumption to the satisfaction of the Commissioner, a branch or the remainder of a CFC may have FBCSI where a separate CFC would not. Therefore, to integrate the rules regarding the substantial contribution test and its application under the branch rule, proposed §1.954–3(b)(2)(ii)(*e*) excepts from its general rule cases in which a branch satisfies the physical manufacturing test with respect to personal property and the remainder of the controlled foreign corporation fails to rebut the presumption that it does not satisfy the substantial contribution test with respect to the activities of that manufacturing branch.

In addition, consistent with §1.954–3(b)(2)(ii)(*f*), §1.954–3(b)(2)(ii)(*e*) is modified to clarify that it applies only for purposes of paragraph (b) of §1.954–3 (that is, the branch rule). This clarifies that in no event will the branch rule cause income not to be FBCSI if that income would otherwise be FBCSI under section 954(d)(1). For example, assume a CFC incorporated in Country Y purchases personal property from a related party and has that property manufactured by a contract manufacturer in Country Z. If the CFC does not perform any other activity with respect to the manufacture of the property, and if the CFC sells the manufactured property through a branch located in Country Z for use, consumption, or disposition outside of Country Y, the income from the sale of that property is FBCSI under section 954(d)(1). If the branch located in Country Z were a separate CFC the income would not be FBCSI because it would be selling personal property manufactured in its country of organization, Country Z. However, because the income would be FBCSI to the CFC under section 954(d)(1), proposed §1.954–3(b)(2)(ii)(*e*) does not apply to create a different result.

3. *Modification of §1.954–3(b)(2)(i)(b), (b)(2)(ii)(b) and (b)(4), Example 3*

Commentators have noted that §1.954–3(b)(2)(i)(*b*) and (ii)(*b*) can be read to cause a branch that purchases from unrelated persons and sells to unrelated persons to have FBCSI even where the remainder of the CFC has no connection with the personal property that is sold. Although §1.954–3(b)(2)(ii)(*e*) should prevent such a result, commentators note that a contrary reading is possible because the sales branch rules of §1.954–3(b)(2)(i)(*b*) and (ii)(*b*) apply, in part, with respect to personal property manufactured, produced, constructed, grown, or extracted by, or personal property purchased or sold by the "controlled foreign corporation" (as opposed to by the "remainder" of the controlled foreign corporation). For example, in a case in which a branch both manufactures and sells personal property, the branch could be considered to sell on behalf of the remainder of the CFC because the branch's manufacturing activities would be considered to be manufacturing activities of the CFC, thereby triggering the application of §1.954–3(b)(2)(ii)(*b*). Further, commentators note that §1.954–3(b)(4), *Example 3* appears to support this reading because in that example a branch of a corporation purchases from a related person and sells to an unrelated person, and the branch is treated as selling that property on behalf of the remainder of the CFC, even though the remainder of the corporation does not manufacture, purchase, or sell the personal property.

Section 1.954–3(b)(2)(i)(*b*) and (ii)(*b*) are intended to apply only to purchasing or selling by a branch with respect to personal property manufactured, purchased, or sold by "the remainder of" the CFC (including any branch treated as the remainder of the CFC). For example, the branch rule could apply in a case where personal property is manufactured by the CFC in the country of organization of the CFC and then sold by a branch of the CFC located outside of the country of organization of the CFC. However, the branch rule does not apply where, for example, a branch of the CFC purchases personal property from an unrelated party and sells it to an unrelated party without any involvement by the remainder of the CFC. Accordingly, the proposed regulations amend §1.954–3(b)(2)(i)(*b*) and (ii)(*b*) by adding the words "remainder of" before each place where the words "controlled foreign corporation" appear in those paragraphs and by adding the words "(or by any branch treated as the remainder of the CFC)" after each place where the words "controlled foreign corporation" appear in those paragraphs. Consistent with this change, the proposed regulations revise the rationale for the result in §1.954–3(b)(4), *Example 3* as described below.

In §1.954–3(b)(4), *Example 3*, a branch of a second-tier CFC purchases finished goods from the first-tier CFC and sells 90 percent of the product for use, consumption, or disposition outside of the country in which the branch is located and the country of organization of the second-tier CFC. The remainder of the second-tier CFC does not engage in any manufacturing or selling activities. The sales branch tax rate disparity test is met in comparison to the effective tax rate of the second-tier CFC (the first-tier CFC and second-tier CFC are organized in the same country). The example concludes that since the sales branch tax disparity test is met, the branch is treated as a separate CFC and is treated as selling personal property on behalf of the second-tier CFC and therefore the 90 percent of sales made for use, consumption, or disposition outside of the branch's country result in FBCSI.

The rationale of the example is incorrect because the branch is not selling on behalf of the second-tier CFC because the remainder of the second-tier CFC (not including the branch) does not manufacture, purchase, or sell the personal property. Therefore, §1.954–3(b)(2)(i)(*b*) and (ii)(*b*) do not apply. However, the result is correct because the branch, treated as a separate corporation, is purchasing from a related person, the first-tier CFC, organized outside of the branch's country and selling to persons outside the branch's country and the branch is located in a jurisdiction that satisfies the sales branch tax rate disparity test with respect to the income from the sale of the personal property. Accordingly, the proposed regulations revise §1.954–3(b)(4), *Example 3* to provide the correct rationale for the result. In addition, the result in §1.954–3(b)(4), *Example 3* is further revised to add two alternative factual scenarios (purchase from an unrelated party, and manufacture within the meaning of proposed §1.954–3(a)(4)(iv) by the selling branch) to illustrate the point that, in general, a branch will not have FBCSI if a separate CFC would not have FBCSI under like circumstances.

Proposed Effective/Applicability Date

These regulations will apply to taxable years of CFCs beginning on or after the date they are published as final regulations in the **Federal Register**, and for taxable years of United States shareholders in which or with which such taxable years of the CFCs end.

Reliance on Proposed Regulations

Until these regulations are finalized, taxpayers may choose to apply these regulations in their entirety to all open tax years as if they were final regulations.

Request for Comments

The Treasury Department and the IRS request comments on all aspects of these proposed regulations, including comments regarding the substantial contribution test, and the activities listed in §1.954–3(a)(4)(iv)(*b*). In particular, comments are requested on whether one or more safe harbors should be added to the substantial contribution test. In drafting the proposed regulations, the Treasury Department and the IRS considered a number of approaches to a safe harbor but ultimately chose to request comments in this regard because of difficulties in fashioning a safe harbor that would be flexible enough to apply across various industries and across a range of different types of manufacturing arrangements. Among the safe harbors considered in drafting the proposed regulations were: (1) a list of mandatory activities; (2) a cost based test; (3) a compensation based test; (4) a value based test; (5) a tax rate disparity based test; and (6) a percentage based test comparing the compensation paid to employees of the CFC for performing activities related to the manufacturing process vs. the total cost for all activities related to the manufacturing process (that is, including costs paid to a contract manufacturer but excluding the cost of raw materials and marketing intangibles). In addition, the Treasury Department and the IRS request comments as to whether the requirement, under the manufacturing exception from foreign base company sales income, that the activities of the CFC be performed by its employees, should permit commercial arrangements where individuals performing services for the CFC, while not on its payroll, are nevertheless controlled by employees of the CFC.

Comments are also requested on whether it would be appropriate to add an anti-abuse rule similar to the foreign base company services substantial assistance test announced in Notice 2007–13 to prevent a CFC from qualifying for the manufacturing exception based on the application of the substantial contribution test in cases in which substantially all of the direct or indirect contributions to the manufacture of personal property provided collectively by the CFC and any related United States person is provided by one or more related United States persons. Such a rule might provide, for example, that where (1) the United States parent of a CFC provides 45 percent of the manufacturing contribution, (2) the CFC provides 5