**Internal Revenue Service**

Department of the Treasury
Washington, DC 20224

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In Re:

LEGEND

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|---|---|---|
| Taxpayer | = | . |
| Subsidiary 1 | = | |
| CFC 1 | = | . |
| CFC 2 | = | |
| CFC 3 | = | |
| DE 1 | = | |
| DE 2 | = | |
| DE 3 | = | . |
| DE 4 | = | |
| DE 5 | = | |
| Country 1 | = | |
| Country 2 | = | |
| Country 3 | = | |
| Country 4 | = | |
| Country 5 | = | |
| Business A | = | |
| | | |
| Year 1 | = | |

Dear :

This letter responds to your May 7, 2009, letter in which you requested rulings under § 954(d)(2) of the Internal Revenue Code of 1986 as amended (the "Code") and Treasury regulations issued thereunder. In particular, you requested rulings under Temp. Treas. Reg. § 1.954-3T(b) and Treas. Reg. § 1.954-3(b) on the application of the manufacturing branch rule to an arrangement involving multiple manufacturing and sales branches. The information submitted in that letter is summarized below.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury

statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

FACTS

Taxpayer is a US corporation and the parent of an affiliated group filing a consolidated federal tax return; it and its foreign subsidiaries are engaged in Business A. Taxpayer and its foreign subsidiaries' tax year ends on July 31. Taxpayer wholly owns the stock of Subsidiary 1, which wholly owns the stock of CFC 1. CFC 1 wholly owns the stock of CFC 2, which wholly owns the stock of CFC 3. CFC 1, CFC 2, and CFC 3 are all controlled foreign corporations ("CFC") as defined in §957(a) of the Code.

CFC 3, incorporated in Country 5, owns five disregarded entities, DE 1, DE 2, DE 3, DE 4, and DE 5. All of these disregarded entities have made valid elections to be disregarded from their owner under Treas. Reg. §301.7701-3(c) of the Code. CFC 3 does not conduct manufacturing activity within the meaning of Treas. Reg. §1.954-3(a)(4)(i) in Country 5. However, CFC 3 does conduct manufacturing activity by or through its branches and similar establishments located outside Country 5.

DE 1 is located in Country 1. DE 1 granted DE 2 a royalty-bearing non-exclusive, worldwide, non-assignable limited license to commercially exploit intangible property. DE 2 is located in Country 2, and it is engaged in sales activities, sales-order processing and management, customer support, marketing, and supervision of sales and distribution functions on a worldwide basis. DE 2 is the principal in a number of contracts with unrelated corporations that are contract manufacturers ("CMs"). These CMs manufacture products for DE 2 within the meaning of Treas. Reg. §§1.954-3(a)(4)(ii) and (iii) using intangible property rights licensed to the CMs by DE 2 for this purpose. DE 2 then sells these products to Taxpayer and unrelated persons. Neither DE 2 nor its employees engage in manufacturing within the meaning of Treas. Reg. §§1.954-3(a)(4)(ii) or (iii); however, DE 2's employees perform certain activities listed under Treas. Reg. §1.954-3(a)(4)(iv) with respect to the products it sells. Additionally, DE 2 has a unilateral advance pricing agreement with the taxing authorities in Country 2 that provides the transfer pricing methodology to be used in Year 1 and beyond to allocate profits to DE 2 with respect to functions performed, risks undertaken, and activities carried out.

DE 3 is located in Country 3, and it engages in activities such as sales-order processing and management, customer support, marketing and sales activities, and general supervision of sales and distribution functions worldwide. DE 3 buys certain products from DE 2 in transactions recognized as sales for Country 3 and Country 2 tax purposes; DE 3 then resells these products to its own customers. Neither DE 3 nor its employees engage in manufacturing within the meaning of Treas. Reg. §§1.954-3(a)(4)(i). Additionally, DE 3 has a unilateral advance pricing agreement with the taxing

authorities in Country 3 that provides the transfer pricing methodology to be used in Year 1 and beyond to allocate profits to DE 3 with respect to its functions performed, risks undertaken, and activities carried out.

DE 4 and DE 5 are located in Country 4, and their employees perform certain activities listed under Treas. Reg. §1.954-3(a)(4)(iv) with respect to products sold by DE 2 and DE 3. DE 4 and DE 5 are, under the laws of Country 4, subject to an income tax on their earnings, and they are also subject to a business tax and a value added tax imposed under the laws of Country 4.

The facts and circumstances evince that CFC 3 makes a substantial contribution as defined under Treas. Reg. § 1.954-3(a)(4)(iv) through the activities of its employees; however, it is not yet clear whether DE 2, DE 4, or DE 5 make a predominant contribution as defined in Temp. Treas. Reg. § 1.954-3T(b)(1)(ii)(c)(3) to the manufacture of products to which they each make a contribution under Treas. Reg. § 1.954-3(a)(4)(iv).

RULING REQUESTED

Taxpayer requests a ruling under §954(d)(2) and the Treasury regulations issued thereunder; specifically, Taxpayer requests a ruling on the application of the manufacturing branch rule to an arrangement involving multiple manufacturing and sales branches under Temp. Treas. Reg. §1.954-3T(b) and Treas. Reg. §1.954-3(b). In particular, Taxpayer asks for clarification on the proper method for computing tax disparity between the effective rate of tax and the hypothetical rate of tax under the “tax rate disparity test” contained in Treas. Reg. §1.954-3(b)(1)(ii), and on the treatment of the sales branch as a separate corporation if tax rate disparity exists .

LAW

Subsection 954(d) of the Code and the Treasury regulations issued thereunder, in part, define foreign base company sales income (“FBCSI”) of a CFC as income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with the purchase of personal property from a related person and its sale to any person or the sale of personal property to any person on behalf of a related person where (A) the property that is purchased (or in the case of property sold on behalf of a related person, the property that is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the CFC is created or organized (i.e., outside the CFC’s “home country”), and (B) the property is sold for use, consumption, or disposition outside such foreign country.

Treas. Reg. § 1.954-3(a)(4)(i) provides, in relevant part, 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. A CFC will have

manufactured, produced, or constructed personal property that the corporation sells only if such corporation satisfies the provisions of Treas. Reg. §§ 1.954-3(a)(4)(ii), -3(a)(4)(iii), or -3(a)(4)(iv) through the activities of its employees (defined in Treas. Reg. § 31.3121(d)-1(c)) with respect to such property. Treas. Reg. §1.954-3(a)(4)(ii) provides that if personal property is substantially transformed prior to sale then that property will be treated as having been manufactured. Treas. Reg. §1.954-3(a)(4)(iii) provides that if the personal property is a component of property that is sold and the selling corporation's involvement is substantial and generally considered to constitute manufacturing then the personal property sold will be considered to have been manufactured. Additionally, Treas. Reg. §1.954-3(a)(4)(iii) provides a safe harbor that allows the purchased property to be considered to have been manufactured so long as the selling corporation's conversion costs with respect to such property account for 20 percent or more of the total cost of goods sold.

Treas. Reg. § 1.954-3(a)(4)(iv) provides that an item of personal property is considered to be manufactured by a CFC if its employees make a substantial contribution to the manufacture of the item, and the item would be considered manufactured, produced, or constructed (under the principles of Treas. Reg. §§ 1.954-3(a)(4)(ii) or -3(a)(4)(iii)) prior to sale by the CFC had all of the manufacturing, producing, and constructing activities undertaken with respect to that property been undertaken by the CFC through its employees.

Temp. Treas. Reg. § 1.954-3T(b)(1)(ii)(*a*) provides in general that if (1) a CFC carries on manufacturing, producing, constructing, growing, or extracting activities by or through a branch or similar establishment located outside the country under the laws of which such corporation is created or organized and (2) the use of the branch or similar establishment for such activities with respect to personal property purchased or sold by or through the remainder of the CFC has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of such CFC, then the branch or similar establishment and the remainder of the CFC will be treated as separate corporations for purposes of determining FBCSI of such corporation. Further, the provisions of Temp. Treas. Reg. § 1.954-3T(b)(1)(ii) and Treas. Reg. § 1.954-3(b)(1)(ii)(*b*) apply only if the CFC (including any of its branches or similar establishments) manufactures, produces, or constructs such personal property within the meaning of Treas. Reg. § 1.954-3(a)(4)(i).

Treas. Reg. § 1.954-3(b)(1)(ii)(*b*) provides a "tax rate disparity test" to determine whether a manufacturing branch or a similar establishment should be treated as a separate corporation:

> The determination as to whether such use of the branch or similar establishment has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of the [CFC] shall be made by allocating to the remainder of such [CFC] only that income derived by the remainder

> of such corporation, which, when the special rules of subparagraph (2)(i) of this paragraph are applied, is described in paragraph (a) of this section (but determined without applying subparagraphs (2), (3), and (4) of such paragraph). The use of the branch or similar establishment for such activities will be considered to have substantially the same tax effect as if it were a wholly owned subsidiary corporation of the [CFC] if income allocated to the remainder of the [CFC] under the immediately preceding sentence is, by statute, treaty obligation, or otherwise, 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 effective rate of tax which would apply to such income under the laws of the country in which the branch or similar establishment is located, if, under the laws of such country, the entire income of the [CFC] were considered derived by such corporation 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 corporation were created or organized under the laws of, and managed and controlled in, such country.

Therefore, in a case which a CFC conducts manufacturing activities through a branch or a similar establishment located outside the CFC's country of incorporation and conducts selling activities through the remainder of the CFC, the "tax rate disparity test" compares the effective tax rate that applies to the FBCSI against the effective tax rate that would hypothetically apply to such FBCSI under the laws of the country in which the manufacturing branch or similar establishment is located. For purposes of the "tax rate disparity test", the effective tax rate is compared to the hypothetical effective tax rate by comparing the actual amount of tax that would be paid on the FBCSI in each jurisdiction. Therefore, it is necessary to determine the amount of taxable FBCSI under the principles of local law in each jurisdiction in order to compare the tax rates on that income.

Temp. Treas. Reg. § 1.954-3T(b)(1)(ii)(*c*)(*1*) provides that if, with respect to personal property manufactured by or through a branch outside a CFC's home country, selling activities are carried on by or through one or more branches located outside such country, then Treas. Reg. § 1.954-3(b)(1)(ii)(*b*) shall be applied separately to the FBCSI derived by each such selling branch "(by treating each such . . . selling branch or similar establishment as through it alone were the remainder of the [CFC]) . . . ." Temp. Treas. Reg. § 1.954-3T(b)(1)(ii)(*c*)(*3*) gives detailed rules for determining the location of manufacture for purposes of applying the tax rate disparity test in Treas. Reg. § 1.954-3(b)(1)(ii)(*b*) if more than one branch of a CFC, or one or more branches and the remainder of the CFC, each engage in manufacturing, producing, or constructing activities with respect to the same item of personal property that is then sold by the CFC. Temp. Treas. Reg. §§ 1.954-3T(b)(1)(ii)(*c*)(*3*)(*ii*) and (*iii*) give rules for

determining the location of manufacture if either (a) more than one branch, or one or more branches and the remainder of the CFC, each independently satisfies Treas. Reg. § 1.954-3(a)(4)(i) with respect to an item of personal property; or (b) none of the branches or the remainder of the CFC independently satisfies Treas. Reg. § 1.954-3(a)(4)(i) with respect to an item of personal property but the CFC as a whole makes a substantial contribution to the manufacture of that property within the meaning of Treas. Reg. § 1.954-3(a)(4)(iv), respectively. Because the "tax rate disparity test" is a comparison between an actual rate and a single hypothetical rate, each of these rules determines a single location of manufacture for purposes of computing the hypothetical rate.

Treas. Reg. § 1.954-3(b)(2)(i) provides special rules for purposes of determining whether the use of a branch that is treated as a separate corporation has substantially the same tax effect as if the branch were a wholly owned subsidiary corporation of a CFC. In particular, Treas. Reg. § 1.954-3(b)(2)(i)(*e*) provides that tax determinations shall be made by taking into account only the income, war profits, excess profits, or similar tax laws (or absence of such laws) of the countries involved.

Treas. Reg. § 1.954-3(b)(2)(ii) and Temp. Treas. Reg. § 1.954-3T(b)(2)(ii) provide rules for determining whether a branch or the remainder of a CFC has FBCSI once it has been determined under Treas. Reg. § 1.954-3(b)(1) or Temp. Treas. Reg. § 1.954-3T(b)(1) that a branch and the remainder of the CFC are to be treated as separate corporations. Temp. Treas. Reg. § 1.954-3T(b)(2)(ii)(*a*) provides that the branch or similar establishment will be treated as a wholly owned subsidiary corporation of the CFC, and such branch or similar establishment will be deemed to be incorporated in the country in which it is located.

Treas. Reg. §1.954-3(b)(2)(ii)(b) provides that purchasing or selling activities performed by or through the branch or similar establishment with respect to personal property shall be treated as performed on behalf of the CFC.

Treas. Reg. § 1.954-3(b)(3) provides that a branch or similar establishment of a CFC and the remainder of such corporation shall be treated as separate corporations under this paragraph solely for purposes of determining the FBCSI of each such corporation.

Temp. Treas. Reg. § 1.954-3T(b)(1)(ii)(c)(3) provides that for the purposes of applying paragraph (b)(1)(i)(b) or (ii)(b) of this section, the branch or remainder of the CFC that makes the predominant amount of the CFC's substantial contribution with respect to its manufacture of property will be the location of manufacturing with respect to that property.

ANALYSIS

Under Temp. Treas. Reg. §1.954-3T(b)(1)(ii)(*a*), the provisions of the manufacturing branch rule in Temp. Treas. Reg. §1.954-3T(b)(1)(ii) apply because CFC 3 manufactures, produces, or constructs the products it sells, and it carries on manufacturing or producing activities by or through one or more branches or similar establishments located outside Country 5.

CFC 3 sells products by or through DE 2 and DE 3, which are branches of CFC 3. With respect to these selling activities, the location of manufacture must be determined under the rules of Temp. Treas. Reg. §§1.954-3T(b)(1)(ii)(*c*)(*3*)(ii) and -3T(b)(1)(ii)(*c*)(*3*)(iii). This determination involves applying the tax rate disparity test between the location where each item of personal property is manufactured and the location of the branch selling the personal property. Once the location of manufacture is determined for sales of products by a sales branch, the tax rate disparity test in Treas. Reg. §1.954-3(b)(1)(ii)(*b*) must be applied to determine whether or not the use of the manufacturing branch (i.e., the location of manufacture) has substantially the same tax effect as if the manufacturing branch and sales branch were wholly owned subsidiary corporations of CFC 3.

The tax rate disparity test in Treas. Reg. §1.954-3(b)(1)(ii)(*b*) involves determining an effective tax rate for the sales branch (DE 2 or DE 3), and a hypothetical effective tax rate for the location of manufacture. This requires determining the amount of FBCSI and then the tax rate applied to such FBCSI. Treas. Reg. §1.954-3(b)(2)(i)(*e*) provides that tax determinations shall be made by taking into account only the income, war profits, excess profits, or similar tax laws (or the absence of such laws) of the countries involved (Country 2 or Country 3, respectively, for sales branches DE 2 or DE 3; Country 2 for DE 2 if it is the location of manufacture of products sold through DE 3; Country 4 for DE 4 or DE 5 if either is the location of manufacture of products sold through DE 2 or DE 3). Neither the business tax nor any value added tax imposed under the laws of Country 4 are imposed under the income, war profits, excess profits, or similar tax laws of Country 4. Accordingly, business tax and value added tax imposed under the laws of Country 4 are irrelevant and not taken into consideration for purposes of determining the hypothetical effective tax rate in the tax rate disparity test.

Accordingly, the following is held for Year 1 and subsequent taxable years to the extent the underlying facts, representations, and law do not materially change. With regard to DE 2, first, for purposes of applying the tax rate disparity test in Treas. Reg. §1.954-3(b)(1)(ii)(*b*) to DE 2 with respect to DE 2's sales of products, the determination of FBCSI and the effective rates of tax applied thereto are determined solely under Country 2 tax law principles as and to the extent modified by the Country 2 advance pricing agreement. Second, pursuant to Treas. Reg. §1.954-3(b)(2)(i)(*e*), only Country 2 income taxes paid by DE 2 are taken into account. Any Country 2 taxes that are not imposed under the income, war profits, excess profits, or similar tax laws of Country 2 are not taken into account. Third, if there is tax disparity between DE 2 and a manufacturing branch whose products DE 2 sells, then, solely for purposes of determining FBCSI, the manufacturing branch will be treated as a separate corporation

organized in the jurisdiction where it is located and DE 2 will be treated as a separate corporation, organized in the jurisdiction where it is located (Country 2). Temp. Treas. Reg. §§ 1.954-3T(b)(1)(ii)(c), 1.954-3T(b)(2)(ii)(a), and Treas. Reg. §1.954-3(b)(3). Further, for purposes of determining FBCSI, DE2 will be treated as the remainder of the corporation and will be treated as selling on behalf of the manufacturing branch that is treated as a separate corporation. Temp. Treas. Reg. §§ 1.954-3T(b)(1)(ii)(c) and 1.954-3T(b)(2)(ii)(c).

With regard to DE 3, first, for purposes of applying the tax rate disparity test in Treas. Reg. §1.954-3(b)(1)(ii)(*b*) to DE 3 with respect to DE 3's sales of products, the determination of FBCSI and the effective rates of tax applied thereto are determined solely under Country 3 tax law principles as and to the extent modified by the Country 3 advance pricing agreement. Second, pursuant to Treas. Reg. §1.954-3(b)(2)(i)(*e*), only Country 3 income taxes paid by DE 3 are taken into account. Any Country 3 taxes that are not imposed under the income, war profits, excess profits, or similar tax laws of Country 3 are not taken into account. Third, if there is tax disparity between DE 3 and a manufacturing branch whose products DE 3 sells, then, solely for purposes of determining FBCSI, the manufacturing branch will be treated as a separate corporation organized in the jurisdiction where it is located and DE 3 will be treated as a separate corporation, organized in the jurisdiction where it is located (Country 3). Temp. Treas. Reg. §§ 1.954-3T(b)(1)(ii)(c), 1.954-3T(b)(2)(ii)(a), and Treas. Reg. § 1.954-3(b)(3). Further, for purposes of determining FBCSI, DE 3 will be treated as the remainder of the corporation and will be treated as selling on behalf of the manufacturing branch that is treated as a separate corporation. Temp. Treas. Reg. §§ 1.954-3T(b)(1)(ii)(c) and 1.954-3T(b)(2)(ii)(c).

Regarding DE 2, DE 4 and DE 5, for purposes of applying the tax rate disparity test in Treas. Reg. §1.954-3(b)(1)(ii)(*b*), in the event DE 2 or DE 4 or DE 5 is held to be the location of manufacture with respect to products sold by or through branches of CFC 3, the hypothetical effective tax rate is determined solely under the tax law principles of the country in which that branch is located (i.e., Country 2 if Branch 2 is the location of manufacture or Country 4 if DE 4 or DE 5 is the location of manufacture). Second, pursuant to Treas. Reg. §1.954-3(b)(2)(i)(*e*), only Country 4 income taxes are taken into account. Any Country 4 taxes that are not imposed under the income, war profits, excess profits, or similar tax laws of Country 4 are not taken into account.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

This ruling is directed only to the Taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. Pursuant to a power of attorney on file with this office, a copy of this letter is being provided to your authorized representative.

Sincerely,

Ethan A. Atticks
Senior Technical Reviewer
(International)