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IRS Clarifies Manufacturing Exception, addresses Contract Manufacturers

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In a recent private letter ruling, PLR 201340010, the Internal Revenue Service (the ?IRS?) provides us with insights into meeting the ?manufacturing exception?[1] for foreign base company sales income (?FBCSI?) under § 954(d) of the Internal Revenue Code (the ?Code?). In ruling that a ?growing activity? itself may be considered and is not a *per se* ?production activity? for purposes of the *manufacturing exception* under the provisions of Subpart F of the Code,[2] the IRS provides us with clarity into what qualifies for this important exception to Subpart F.

PLR 201340010 reaffirms that the *manufacturing exception* is a transformation test. Companies may qualify for it if they demonstrate that (1) the end product has different attributes than the starting product and (2) the difference is the result of some activity. This is especially important for agricultural companies.

In addition, PLR 201340010 endorses the use of contract manufacturers and allows a controlled foreign corporation (the ?CFC?), under proper contractual relationships, to attribute the activity of the contract manufacturers to itself in applying the transformation test to qualify for the *manufacturing exception*.

Consequently, PLR 201340010 emphasizes the need for companies to get their legal and agency relationships right. This places significant importance on correctly structuring the supply chain with related and unrelated parties. PLR 201340010 is examined in further detail below.

Background. Under Code § 951(a)(1)(A)(i), a U.S. shareholder of a Controlled Foreign Corporation (?CFC?) includes in gross income its pro rata share of the CFC's Subpart F income. Subpart F income means, in part, foreign base company income, which includes FBCSI. Code § 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[3]

Treas. Reg. §1.954-3(a)(4)(i) (the ?manufacturing exception?) provides that a FBCSI does not include income of a CFC derived in connection with the sale of personal property ?manufactured, produced or constructed? by the corporation. A CFC will have manufactured, produced or constructed personal property which the corporation sells only if the corporation satisfies the provisions of Treas. Reg. §1.954-3(a)(4)(ii), (iii) or (iv) through the activities of its employees (as defined in Treas. Reg. §31.3121(d)-1(c)) with respect to the property.

Facts. In PLR 201340010, Foreign Corporation (?FC?) is a CFC that produces tangible goods which are referred to as ?Final Stage Products.? FC, through arrangements with related and unrelated parties, develops Stage A products. FC either contracts with related persons or unrelated persons to produce Stage B Products or produces the Stage B Products directly. Specifically, the Stage A Products are planted, and the Stage B Products are harvested from the resulting crop grown from the Stage A Products. If a contract manufacturing arrangement is used, FC may transfer title to the Stage A Products to the contracting party, and then later the Stage B Products are transferred back to FC. A process similar to the Stage B process then occurs for Stage C products?e.g., Stage B products are planted, and then Stage C Products are the result of that planting. The Stage C products are then organized and packaged, either by related or unrelated parties, to create Final Stage Products.

Issue. The PLR addresses whether production activities that also are growing activities, including those done by contract manufacturers, are taken into account for purposes of determining whether FC, in the example, qualifies for the *manufacturing exception* to FBCSI.

Production activities that are also growing activities are taken into account. Under the facts of the PLR, unless the *manufacturing exception* under Treas. Reg. § 1.954-3(a)(4) applies, certain income that FC derives from the sale of the Final Stage Products would meet the definition of FBCSI because the income is derived in connection with the purchase of personal property from a related person, or a sale of personal property to a related person.

The IRS notes in PLR 201340010 that Treas. Reg. § 1.954-3(a)(4)(i) does not specifically address whether income derived from the sale of personal property grown by a CFC is excluded from FBCSI pursuant to the *manufacturing exception*. However, Treas. Reg. § 1.954-3(a)(4)(i) does provide that the *manufacturing exception* applies to income derived in connection with the sale of personal property ?manufactured, produced or constructed? by the CFC. The PLR concludes that the terms ?produced? and ?grown? are not interchangeable, and that the use of the term ?grow? to describe a process or part of a process is not determinative of whether the process constitutes a production activity. Based on facts and circumstances, certain growing activities also may constitute production activities for purposes of Treas. Reg. § 1.954-3(a)(4). The omission of the term ?grown? from Treas. Reg. § 1.954-3(a)(4) does not preclude growing activities that also are production activities from being taken into account in determining whether a CFC satisfies the *manufacturing exception*.

Thus, the IRS concluded that, under these facts, the *manufacturing exception* applied to the extent that income is derived from the sale of property produced by a CFC, even if the relevant production activities include growing activities.

In addition, the IRS went on to hold that, under the facts, the growing activity itself could qualify as a production activity, and the activities of contractors could also be attributed to the owner of the transformed goods. The important language is as follows:

FC Group's activities related to the physical growing of the Stage B Products and Stage C Products that constitute production activities are taken into account in determining whether FC produced the Final Stage Products for purposes of applying the manufacturing exception to the income derived from the sale of the Final Stage Products. In addition, the activities related to the physical growing of Stage B Products and Stage C Products that constitute production activities that are undertaken by ***contract manufacturers*** are taken into account in determining whether FC produced the Final Stage Products for purposes of applying the first sentence of Treas. Reg. §1.954-3(a)(4)(iv)(a).[4]

PLR 201340010 illustrates the importance of structuring the legal and agency relationships properly. The ?tolling structure,? whereby the CFC owns the materials and product throughout the transformation process is validated, but so are supply chains where the ownership is with third parties, such as contract manufacturers. This is an important outcome and, potentially, a much wider application of attribution rules than what we find under the domestic production deduction rules of Code § 199.

The use of contract manufacturers in ?qualified production activities? for Code § 199.

Juxtapose the IRS?s position for the *manufacturing exception* under Subpart F against its position under the domestic production deduction.[5] The IRS has been taking a different position in the definition of *qualifying production activity* under Code § 199. Granted, the rules under Code § 199 are intended to meet a special deduction regime, and for this reason may justify different definitions and narrower application of attribution rules. The IRS?s position for Code § 199 has been that there is no attribution of contract manufacturer activity to the principal in qualifying as the manufacturer of a product. They also have denied attribution of activities in a tolling arrangement.

Two Tax Court cases are pending that could be very influential in determining how to apply the Code § 199 rules in contract manufacturing situations. The first case, *Advo Inc. & Subsidiaries v. Commissioner of the Internal Revenue,* [6] illustrates a tolling arrangement. ?Tolling? is a special type of agency relationship in which the principal owns the materials and goods and a third party provides a transformation service. In this case, Advo sold printed advertising products to its customers. Advo subcontracted the printing of certain printed advertising products to third party commercial printers under a cost-reimbursement arrangement. During the printing process, Advo owned the paper on which the product was printed, and the ink was owned by the third-party printer, but the price of ink generally was not a material cost.

Moreover, the contracts between Advo and the printer specified that they were for printing services and not the sale of goods. Advo claimed a Code § 199 deduction for the printed products. The IRS denied

the deduction because in its conclusion, Advo did not establish that the qualified property was manufactured by Advo.

The IRS urged the Tax Court to deny the Code § 199 deduction because it believed that Advo did not possess the benefits and burdens of ownership during the manufacturing process and could not be the owner.[7] The IRS also rejected Advo?s "cradle to grave" argument that it should receive the Code § 199 deduction for activities in the beginning of the process, when Advo?s client places an order, and at the end of the process, when it is delivered. The IRS argued that, because these activities were not manufacturing, Advo was precluded from claiming the Code § 199 deduction. In PLR 201340010, the IRS uses the *cradle to grave* theory when analyzing the activities of contract manufacturers. It was important in their analysis that FC sold and purchased goods to and from contract manufacturers because although FC did not have legal title throughout the manufacturing process, it had economic control over the product during the entire manufacturing process.

The shortcoming in the IRS?s argument in *Advo* is that they are viewing activities in isolation. These are not isolated activities but they are part of an overall design to market business process that allocates risk throughout the supply chain. This process cannot be analyzed simply by asking, ?Who owns the manufacturing equipment?? Design, selling and delivery are critical steps in the overall business process in which Advo manufactures qualified property. From a legal and functional point of view, the printer in *Advo* is merely a service provider that has been contracted by Advo. The fact that the printer owns the equipment and the labor force that does the physical labor is not as relevant a factor since it is at the direction of Advo, who was the owner of the property.

The second Tax Court case with this issue, *Limited Brands Inc. and Subsidiaries et al. v. Commissioner of Internal Revenue*,[8] is pending hearing. Limited Brands manufactures and produces personal care products under several brands including Victoria?s Secret and Bath and Body Works.

A subsidiary of Limited Brands manufactured various products and contracted with numerous vendors and contract manufacturers to produce and assemble these products. Limited Brands controlled and monitored every stage of the production cycle as well as controlled all design and testing of the products. Importantly, Limited Brands was manufacturing branded products and accordingly owned all the intellectual property created during the development of its products and limited the ability of the vendors and contract manufacturers to sell any of the products to third parties under their contracts[9] Limited Brands claimed a Code § 199 deduction for these activities, and again the IRS denied the deduction because it believed that Limited Brands could not establish that it manufactured the QPP.

The broader application of attribution for the *manufacturing exception* seems justifiable in the global supply chain context because it is a more realistic view of how business is done across borders. The IRS should be congratulated for recognizing this reality. It also seems, however, that the same logic can be applied to Code § 199.

[1] Treas. Reg. § 1.954-3(a)(4)(i)

[2] Code §§ 951-965.

[3] Code Sec. 954(d)(1)

[4] Final paragraph of Analysis, just before Ruling.

[5] Code § 199

[6] *Advo Inc. & Subsidiaries v. Commissioner of the Internal Revenue* Docket No. 17247-10.

[7] Note: There is a long line of cases that support *synthetic tolling*, in which ownership is based on benefits and burdens. In the *Advo* case, the IRS is validating this line of cases and their use in tolling arrangements. Yet in the *Limited Branch* case discussed herein they take a different position.

[8] Docket Nos. 17903-10 and 14667-12.

[9] Limited Brands is asserting its ownership using the benefits and burdens factors. They are applying *synthetic tolling*.

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