stated principal amount, and fair market value of $130. Under paragraph (g)(5)(ii) of this section, B's note is treated as satisfied for $130 (determined under the principles of § 1.108–2(f)(1)) immediately after it becomes an intercompany obligation. As a result of the deemed satisfaction of the note, P has no gain or loss and B has $30 of repurchase premium. Under paragraph (g)(6)(iii) of this section, B's $30 of repurchase premium from the deemed satisfaction is amortized by B over the term of the newly issued P note in the same manner as if it were original issue discount and the newly issued P note had been issued directly by B. B is also treated as reissuing a new note to P. The new note is an intercompany obligation, it has a $130 issue price and $100 stated redemption price at maturity, and the treatment of B's $30 of bond issuance premium under the new B note is determined under § 1.163–13.

(iv) *Election to file consolidated returns.* Assume instead that B borrows $100 from S during year 1, but the P group does not file consolidated returns until year 3. Under paragraph (g)(5)(ii) of this section, B's note is treated as satisfied and reissued as a new note immediately after the note becomes an intercompany obligation. The satisfaction and reissuance are deemed to occur on January 1 of year 3, for the fair market value of the obligation (determined under the principles of § 1.108–2(f)(2)) at that time.

Example 11. Notional principal contracts. (i) *Facts.* On April 1 of year 1, M1 enters into a contract with counterparty M2 under which, for a term of five years, M1 is obligated to make a payment to M2 each April 1, beginning in year 2, in an amount equal to the London Interbank Offered Rate (LIBOR), as determined by reference to LIBOR on the day each payment is due, multiplied by a $1,000 notional principal amount. M2 is obligated to make a payment to M1 each April 1, beginning in year 2, in an amount equal to 8 percent multiplied by the same notional principal amount. LIBOR is 7.80 percent on April 1 of year 2, and therefore, M2 owes $2 to M1.

(ii) *Matching rule.* Under § 1.446–3(d), the net income (or net deduction) from a notional principal contract for a taxable year is included in (or deducted from) gross income. Under § 1.446–3(e), the ratable daily portion of M2's obligation to M1 as of December 31 of year 1 is $1.50 ($2 multiplied by 275/365). Under the matching rule, M1's net income for year 1 of $1.50 is taken into account to reflect the difference between M2's net deduction of $1.50 taken into account and the $0 recomputed net deduction. Similarly, the $.50 balance of the $2 of net periodic payments made on April 1 of year 2 is taken into account for year 2 in M1's and M2's net income and net deduction from the contract. In addition, the attributes of M1's intercompany income and M2's corresponding deduction are redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of M2's corresponding deduction control the attributes of M1's intercompany income. (Although M1 is the selling member with respect to the payment on April 1 of year 2, it might be the buying member in a subsequent period if it owes the net payment.)

(iii) *Dealer.* The facts are the same as in paragraph (i) of this *Example 11,* except that M2 is a dealer in securities, and the contract with M1 is not inventory in the hands of M2. Under section 475, M2 must mark its securities to fair market value at year-end. Assume that under section 475, M2's loss from marking to fair market value the contract with M1 is $10. Because M2 realizes an amount of loss from the mark to fair market value of the contract, the transaction is a triggering transaction under paragraph (g)(3)(i)(A)(*1*) of this section. Under paragraph (g)(3)(ii) of this section, M2 is treated as making a $10 payment to M1 to terminate the contract immediately before a new contract is treated as reissued with an up-front payment by M1 to M2 of $10. M1's $10 of income from the termination payment is taken into account under the matching rule to reflect M2's deduction under § 1.446–3(h). The attributes of M1's intercompany income and M2's corresponding deduction are redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of M2's corresponding deduction control the attributes of M1's intercompany income. Accordingly, M1's income is treated as ordinary income. Under § 1.446–3(f), the deemed $10 up-front payment by M1 to M2 in connection with the issuance of a new contract is taken into account over the term of the new contract in a manner reflecting the economic substance of the contract (for example, allocating the payment in accordance with the forward rates of a series of cash-settled forward contracts that reflect the specified index and the $1,000 notional principal amount). (The timing of taking items into account is the same if M1, rather than M2, is the dealer subject to the mark-to-market requirement of section 475 at year-end. However in this case, because the attributes of the corresponding deduction control the attributes of the intercompany income, M1's income from the deemed termination payment from M2 might be ordinary or capital). Under paragraph (g)(3)(ii)(A) of this section, section 475 does not apply to mark the notional principal contract to fair market value after its deemed satisfaction and reissuance.

(8) *Effective/applicability date.* The rules of this paragraph (g) apply to transactions involving intercompany obligations occurring in consolidated return years beginning on or after December 24, 2008.

* * * * *

■ **Par. 3.** Section 1.1502–28 is amended by:

■ 1. Revising paragraph (b)(5)(i).

■ 2. Revising the last sentence of paragraph (b)(5)(ii).

■ 3. Adding a sentence to the end of paragraph (d).

The revisions and addition reads as follows:

§ 1.1502–28 Consolidated section 108.

* * * * *

(b) * * *

(5) *Reduction of basis of intercompany obligations and former intercompany obligations*—(i) *Intercompany obligations that cease to be intercompany obligations.* If excluded COD income is realized in a consolidated return year in which an intercompany obligation becomes an obligation that is not an intercompany obligation because the debtor or creditor becomes a nonmember, or because the assets of the debtor or the creditor are acquired by a nonmember in a transaction to which section 381 applies, then the basis of such intercompany obligation (or new obligation if the intercompany obligation is deemed reissued under § 1.1502–13(g)(3)) is available for reduction in respect of such excluded COD income pursuant to sections 108 and 1017 and this section.

(ii) * * * See § 1.1502–13(g)(3)(i)(A)(*1*) and (g)(4)(i)(A).

* * * * *

(d) * * * Paragraph (b)(5)(i) of this section and the last sentence of paragraph (b)(5)(ii) of this section applies to transactions occurring in consolidated return years beginning on or after December 24, 2008.

Linda E. Stiff,

Deputy Commissioner for Services and Enforcement.

Approved: December 18, 2008.

Eric Solomon,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. E8–30718 Filed 12–24–08; 8:45 am]

BILLING CODE 4810–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9438]

RIN 1545–BI50

Guidance Regarding Foreign Base Company Sales Income

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations that provide guidance relating to foreign base company sales income 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. These regulations modify the foreign base company sales income regulations to address current business structures and practices, particularly the growing importance of contract manufacturing and other manufacturing arrangements. These regulations, in general, will affect controlled foreign corporations and their United States shareholders. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: *Effective Date.* These regulations are effective July 1, 2009.

Applicability Date. For dates of applicability, see § 1.954–3(c) and § 1.954–3T(e). The final regulations shall apply to taxable years of controlled foreign corporations beginning after June 30, 2009, and for taxable years of United States shareholders in which or with which such taxable years of the controlled foreign corporations end. The temporary regulations shall apply to taxable years of controlled foreign corporations beginning after June 30, 2009, and for taxable years of United States shareholders in which or with which such taxable years of the controlled foreign corporations end.

FOR FURTHER INFORMATION CONTACT: Ethan Atticks, (202) 622–3840 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On February 28, 2008, the IRS and the Treasury Department published in the **Federal Register** proposed regulations (REG–124590–07, 2008–16 IRB 801, 73 FR 10716, as corrected at 73 FR 20201), which provided proposed amendments to § 1.954–3, addressing the treatment of contract manufacturing arrangements under the foreign base company sales income (FBCSI) rules. Written comments were received in response to the notice of proposed rulemaking, and a public hearing on the proposed regulations was held on July 29, 2008.

Section 954(d)(1) defines *FBCSI* to mean income derived by a controlled foreign corporation (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 these cases) that the property 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 existing regulations further define FBCSI and the applicable exceptions from FBSCI, including the exceptions to the FBCSI rules for personal property that is: (1) Manufactured, produced, constructed, grown, or extracted within the CFC's country of organization (same country manufacture exception); (2) sold for use, consumption or disposition within the CFC's country of organization; and (3) manufactured, produced, or constructed by the CFC (the manufacturing exception). See § 1.954–3(a)(2)–(4).

The existing regulations set forth certain tests to determine whether a CFC satisfies the manufacturing exception: The ''substantial transformation test'' of § 1.954–3(a)(4)(ii) and the ''substantive test'' and safe harbor of § 1.954–3(a)(4)(iii). For purposes of this preamble, the requirements of § 1.954–3(a)(4)(ii) and 1.954–3(a)(4)(iii) will be referred to collectively as the ''physical manufacturing test'' and the satisfaction of either test will be described as ''physical manufacturing.''

The proposed regulations provide a third test for satisfying the manufacturing exception, which may apply when a CFC is involved in the manufacturing process but does not satisfy the physical manufacturing test. In particular, the proposed regulations provide that a CFC will satisfy the manufacturing exception if the facts and circumstances evince that the CFC makes a substantial contribution through the activities of its employees to the manufacture, production, or construction of personal property (substantial contribution test). The proposed regulations also propose other modifications to the existing regulations to address the treatment of contract manufacturing arrangements under the FBCSI rules.

Written comments were received in response to the notice of proposed rulemaking, and a public hearing was held on July 29, 2008. After consideration of all the comments, the proposed regulations, as revised by this Treasury decision, are adopted as final and temporary regulations.

Summary of Comments and Explanation of Provisions

This Treasury decision contains final and temporary regulations relating to FBCSI. The temporary regulations contained in this Treasury decision also serve as the text of proposed regulations set forth in a notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**. The preamble to this Treasury decision will refer to the proposed regulations published in the **Federal Register** on February 28, 2008, as the proposed regulations. The preamble will refer to the regulations that are published simultaneously as temporary regulations in this Treasury decision and as proposed regulations in this issue of the **Federal Register** as the temporary regulations.

A. Substantial Contribution Test

The proposed regulations provide that a CFC will satisfy the substantial contribution test with respect to personal property only if all the facts and circumstances evince that the CFC makes a substantial contribution through the activities of its employees to the manufacture of the property. Prop. Reg. § 1.954–3(a)(4)(iv)(*b*) includes a non-exclusive list of activities (collectively, ''indicia of manufacturing'') to be considered in determining whether the CFC satisfies the substantial contribution test with respect to the manufacture, production, or construction of the personal property (manufacture of the personal property) under all the facts and circumstances.

1. General Operation of Substantial Contribution Test

In response to the proposed regulations, commentators requested further elaboration of the general operation of the substantial contribution test. For example, commentators requested guidance on the amount of activity performed by a CFC's employees that would be necessary to ''satisfy'' each individual activity listed among the indicia of manufacturing. Several commentators requested clarifications that suggested they believed that a certain threshold of employee activity was required before the activity would be considered in determining whether a CFC satisfied the substantial contribution test. Commentators requested, for example, clarification as to whether the ''vendor selection'' activity is satisfied if the CFC provides a contract manufacturer with an approved list of vendors but allows the contract manufacturer to make the final determination regarding the vendors to be used.

Commentators also requested guidance on how the indicia of manufacturing should be weighed in relation to one another and whether performing a certain minimum number of activities was required in order for

the substantial contribution test to be satisfied. Others asked that the regulations explain whether a CFC must perform any particular activity in all cases to satisfy the substantial contribution test (for example, whether a CFC must always perform oversight and direction of the manufacturing process to satisfy the substantial contribution test). Some commentators requested that the regulations emphasize that the importance of each activity would vary by industry and by taxpayer. Commentators also requested that the regulations make clear that a CFC need not perform all of the indicia of manufacturing to establish a substantial contribution, and that the weight given to activities performed by employees of the CFC will depend on the economic significance of those activities to the business of the taxpayer with respect to the product being manufactured.

Although the proposed regulations provide guidance on many of these issues, the IRS and the Treasury Department believe that additional guidance with respect to the application of the substantial contribution test is warranted in light of the comments received. Consequently, § 1.954–3(a)(4)(iv)(*c*) is added to the final regulations to provide further clarification on the application of the substantial contribution test. First, § 1.954–3(a)(4)(iv)(*c*) clarifies that all CFC employee functions contributing to the manufacture of the personal property will be considered in the aggregate when determining whether a substantial contribution is made to the manufacture of the personal property through the activities of a CFC's employees. Second, § 1.954–3(a)(4)(iv)(*c*) clarifies that there is no single activity that will be accorded more weight than any other activity in every case or that will be required to be performed in all cases. Third, it clarifies that there is no minimum threshold with respect to functions performed by employees of a CFC before their functions with respect to a given activity may be taken into account as part of the substantial contribution test. Therefore, all functions performed by a CFC's employees are considered (and given appropriate weight) under the substantial contribution test, even if the CFC's employees perform only some of the functions in connection with any one activity (for example, some, but not all, of the vendor selection) considered under that test. The weight given to any functions performed by employees of the CFC with respect to any activity will be based on the economic significance of those functions to the manufacture, production, or construction of the relevant personal property. Corresponding amendments and additional examples have been added to the final regulations to illustrate further the application of the substantial contribution test. See § 1.954–3(a)(4)(iv)(*d*).

Other commentators sought clarification as to the extent to which purely contractual assumptions of risk are considered in a substantial contribution analysis. The IRS and the Treasury Department believe that no further clarification in the final regulations is necessary to address this point. Both the proposed and final regulations provide that only activities of the CFC's employees are considered in the substantial contribution analysis and, consequently, purely contractual assumptions of risk are not considered in the substantial contribution analysis.

In addition, commentators requested that the regulations clarify that more than one person can provide a substantial contribution to the manufacturing process with respect to a given product. In response to this comment, the IRS and the Treasury Department amended the regulations to clarify that a CFC will not be precluded from making a substantial contribution to the manufacture of the personal property by the fact that other persons also make a substantial contribution to the manufacture, production, or construction of that property. Further, § 1.954–3(a)(4)(iv)(*d*) *Example 9* is added to the final regulations to illustrate that more than one person can provide a substantial contribution to the manufacture of the same property.

2. Indicia of Manufacturing

The IRS and the Treasury Department received numerous comments with respect to the specific activities listed in the proposed regulation that are considered in determining whether a CFC makes a substantial contribution through its employees to the manufacture, production, or construction of personal property.

a. Oversight and Direction of Manufacturing

Commentators requested that the IRS and the Treasury Department clarify certain issues related to the ''oversight and direction of the activities or process'' pursuant to which personal property is manufactured, produced, or constructed. Some commentators asked that the regulations provide that oversight and direction of the activities or process pursuant to which personal property is manufactured, produced, or constructed be a prerequisite for satisfying the substantial contribution test. Other commentators requested that the IRS and the Treasury Department clarify that in certain industries a substantial contribution can be made by a CFC without its employees engaging in significant oversight and direction of the activities or process pursuant to which personal property is manufactured, produced, or constructed. Some commentators focused on the fact that in an example in the proposed regulations the CFC was not treated as making a substantial contribution to the manufacture of personal property when the CFC did not ''regularly exercise'' oversight and direction with respect to the contract manufacturer. See Prop. Reg. § 1.954–3(a)(4)(iv)(*c*) *Example 1.*

The importance of oversight and direction of the activities or process pursuant to which personal property is manufactured, produced, or constructed will vary based on the facts and circumstances associated with the specific manufacture, production, or construction at issue. The IRS and the Treasury Department acknowledge that oversight and direction of the activities or process pursuant to which personal property is manufactured, produced, or constructed is likely to be an important element in many, but not all, substantial contribution analyses. Thus, to address taxpayer comments, the examples in the final regulations are amended to make clear that oversight and direction is not a prerequisite for satisfying the substantial contribution test and that in certain industries a substantial contribution could be made by a CFC without its employees engaging in oversight and direction of the activities or process pursuant to which personal property is manufactured, produced, or constructed. Finally, the examples in the final regulations do not use the potentially confusing reference to ''regularly'' exercising oversight.

b. Material Selection, Vendor Selection, and Control of the Raw Materials, Work-in-process, and Finished Goods

Some commentators asked if other activities listed among the indicia of manufacturing also represented means of exercising control of the raw materials, work-in-process and finished goods. The IRS and the Treasury Department acknowledge that some of the activities in the indicia of manufacturing may overlap with other activities in that list. The final regulations require a substantial contribution to the manufacture of the personal property through the activities of the CFC's employees and not

satisfaction of any specific activity in the indicia of manufacturing. Therefore, the IRS and the Treasury Department determined that it was not necessary to clarify whether any particular function might reasonably be included under more than one heading in the indicia of manufacturing. However, to provide further clarity, the final regulations group material selection, vendor selection, and control of the raw materials, work-in-process, and finished goods as a single activity in the indicia of manufacturing.

Commentators asked whether the control of the raw materials, work-in-process, and finished goods refers to the CFC having the contractual right to take possession of the personal property, to have title to the property, or to have economic risk of loss with respect to the property. These commentators requested clarification regarding whether tax ownership of raw materials, work-in-process and finished goods is required to have control of the raw materials, work-in-process, and finished goods. In connection with this question, commentators also asked whether a CFC can satisfy the substantial contribution test when the contract manufacturing arrangement is buy-sell or ''turnkey'' (that is, when the contract manufacturer purchases the raw materials).

Both the proposed and final regulations provide that only activities of the CFC's employees are considered in the substantial contribution analysis. Thus, mere contractual rights, legal title, tax ownership, or assumption of economic risk are not considered in the substantial contribution analysis. To provide greater clarity, the final regulations revise Prop. Reg. § 1.954–3(a)(4)(iv)(*a*), deleting the phrase ''purchased by a controlled foreign corporation'' in the first sentence of Prop. Reg. § 1.954–3(a)(4)(iv)(*a*) to eliminate any inference that a CFC needs to own the raw materials that are used in the manufacturing process. In addition, examples in the final regulations clarify that buy-sell or turnkey contract manufacturing arrangements may satisfy the substantial contribution test. See § 1.954–3(a)(4)(iv)(*d*) *Examples 3* and *9*.

c. Management of Manufacturing Profits and Management of Risk of Loss

Commentators requested clarification regarding which functions would qualify as ''management of the manufacturing profits'' or ''management of the risk of loss.'' Some commentators expressed concerns regarding the term ''management of the manufacturing profits.'' Other commentators suggested that it would add clarity if ''management of the risk of loss'' were deleted from Prop. Reg. § 1.954–3(a)(4)(iv)(*b*)(*1*) and included with ''management of manufacturing profits'' in a single item in the indicia of manufacturing. Some commentators expressed concern that the term ''management of the risk of loss'' implicitly excluded all other risk management functions. One commentator expressed the view that the indicia of manufacturing should include reference to management of enterprise risk, other than risks pertaining exclusively to sales and marketing functions. Some commentators suggested that management of the manufacturing profits might refer to such activities as the management of risks related to the raw materials and the utilization of plant capacity, but others thought it might encompass the finance function of a company.

The IRS and the Treasury Department agree that further clarification is needed as to the functions that are intended to be included within what was labeled ''management of the manufacturing profits'' and ''management of the risk of loss'' in the proposed regulations. The IRS and the Treasury Department intend that the substantial contribution test recognize contributions made by a CFC's employees to the manufacturing process through functions which help to ensure that a plant is run in an economically efficient manner, such as optimization of plant capacity and reduction of waste (for example, waste of raw materials). On the other hand, not all corporate managerial decisions are intended to be considered in the substantial contribution test, because many such decisions are not directly related to the manufacture of the personal property with respect to which the substantial contribution analysis is being performed. For example, the IRS and the Treasury Department do not intend that corporate finance decisions be considered in the substantial contribution test. Similarly, the IRS and the Treasury Department do not intend that the general management of enterprise risk be considered in the substantial contribution test.

The IRS and the Treasury Department concluded that the term ''management of the manufacturing costs or capacities'' more accurately reflects the type of functions originally contemplated by ''management of the manufacturing profits'' in the proposed regulations and is also related to the types of functions contemplated by the ''management of the risk of loss.'' Accordingly, the activity labeled ''management of the manufacturing profits'' in the proposed regulations is replaced in the final regulations with an activity entitled ''management of manufacturing costs or capacities.'' Further, the final regulations include a parenthetical list of functions (that is, managing the risk of loss, cost reduction or efficiency initiatives associated with the manufacturing process, demand planning, production scheduling, or hedging raw material costs) to elaborate on the meaning of the activity.

d. Control of Logistics

Commentators asked for clarification regarding the scope of logistical functions that will contribute towards a substantial contribution by a CFC. This activity is intended to include, for example, arranging for delivery of raw materials to a contract manufacturer, but to exclude, for example, delivery of finished goods to a customer. The final regulations provide further clarity on this issue by revising the activity to read ''control of manufacturing related logistics.''

e. 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

Commentators noted that the ''and'' in the description of this activity in the proposed regulations could be read to mean that directing the ''development, protection, and use'' of intellectual property are all required for this activity to be considered in the substantial contribution analysis. Commentators requested that these activities be stated in the disjunctive. The IRS and the Treasury Department adopted this comment, replacing ''and'' with ''or'' in the final regulations. This clarification is consistent with providing that all functions performed by a CFC's employees are considered (and given appropriate weight) under the substantial contribution test. Thus, the CFC's employees' activities are considered regardless of whether the CFC's employees perform all or only some of the functions listed in any enumerated item in the indicia of manufacturing.

The term ''protection'' is also deleted from the final regulations. The IRS and the Treasury Department were concerned that absent this clarification the final regulations could be read to provide that legal work performed by a CFC's in-house legal staff was considered under the substantial contribution test, including in cases where, for example, litigation success could be heavily correlated to

profitability or business failure with respect to a product. Further, the IRS and the Treasury Department modified the description of the activity in the final regulations to clarify that developing, or directing the use or development of, trade secrets, technology, or other intellectual property, are considered under the substantial contribution test, but only when activities of this nature are undertaken for the purpose of the manufacture of the personal property.

Commentators asked whether the intellectual property referred to in Prop. Reg. § 1.954–3(a)(4)(iv)(*b*)(*9*) included marketing intangibles. The activity as described in both the proposed and final regulations is with respect to intellectual property used in the manufacture of the personal property. Thus, developing, or directing the use or development of, marketing intangibles is not intended to be considered in the substantial contribution test.

3. Anti-abuse Rule and Safe Harbor

The IRS and the Treasury Department requested comments on whether the substantial contribution test should include an anti-abuse rule and safe harbor. In particular, comments were requested as to whether it would be appropriate to add an anti-abuse rule to prevent a CFC from satisfying the substantial contribution test in cases in which a significant portion of the direct or indirect contributions to the manufacture of personal property provided collectively by the CFC and any related U.S. persons are provided by one or more related U.S. persons. Commentators recommended that in determining whether a CFC makes a substantial contribution it should not be relevant whether other persons (whether U.S. or foreign, related or unrelated) contribute to the manufacturing process. The IRS and the Treasury Department agree with commentators that the substantial contribution test should focus on whether the activities of the CFC itself are substantial without comparing those activities to those of other persons. Thus, the final regulations do not adopt such a rule. Examples in the final regulations also illustrate that the contributions of other persons to the manufacture of a product are not relevant to the analysis of whether a CFC makes a substantial contribution to the manufacturing process. See § 1.954–3(a)(4)(iv)(*d*) *Examples 6, 7,* and *9*.

The IRS and the Treasury Department also requested comments as to whether one or more safe harbors should be added to the substantial contribution test of the proposed regulations. Some commentators suggested that a CFC that contributes at least twenty percent of the costs of manufacturing personal property should be deemed to have substantially contributed to its manufacture. Other commentators suggested that a safe harbor was only appropriate if it were made clear that such a safe harbor would not function as a minimum standard and would be flexible enough to accommodate multiple industries. Many other commentators recommended that the IRS and the Treasury Department not adopt a safe harbor. The IRS and the Treasury Department concluded that no safe harbor could fairly apply across the range of industries potentially subject to § 1.954–3, and therefore no safe harbor is provided in the final regulations.

4. Definition of Employee

The IRS and the Treasury Department requested comments as to whether the requirement in the proposed regulations that the activities of the CFC be performed by its employees should take into account commercial arrangements where individuals performing services for the CFC while not on its payroll are nevertheless controlled by employees of the CFC. Commentators requested that the regulations expand the definition of the term ''employee'' to include various commercial or economic arrangements where individuals who perform services for a CFC under the CFC's direction and control are not necessarily the CFC's employees under local law. In particular, commentators suggested that the term ''employee'' could be defined for purposes of the substantial contribution test using section 3121(d)(2). Other commentators asked that the term ''employee'' be defined more broadly to include anyone in an agency relationship with a CFC.

The IRS and the Treasury Department agree that clarification of the term ''employee'' will promote more effective application of these regulations. The IRS and the Treasury Department also agree that activities performed by certain non-payroll workers should be considered in determining whether the CFC provides a substantial contribution through ''its employees.'' However, the IRS and the Treasury Department concluded that it would be inappropriate to broaden the definition of employee to include anyone in an agency relationship with a CFC, because it could create unintended branch rule issues for taxpayers (for example, as a result of employees of a contract manufacturer being treated as employees of the CFC under such a definition). Thus, the final regulations provide that the term *employee* means any individual who, under § 31.3121(d)–1(c), has the status of an employee for U.S. Federal tax purposes. This definition of the term ''employee'' may encompass certain seconded workers, part-time workers, workers on the payroll of a related employment company whose activities are directed and controlled by CFC employees, and contractors, so long as those individuals are deemed to be employees of the CFC under § 31.3121(d)–1(c). Consistent with commentators' request, this definition of the term employee may result in an individual being treated as an employee of two or more entities simultaneously.

5. Product Grouping

Commentators requested that the determination of whether a CFC provides a substantial contribution to the manufacture of the personal property be made on the basis of a group or line of related products rather than on a product-by-product basis. The IRS and the Treasury Department believe that the substantial contribution test must be met with respect to each product. Whether manufactured goods are separate products or a single product for this purpose is determined by reference to the distinctions or lack thereof made by the CFC in its business operations and in its books and records, rather than by reference to a third party's definition of a product or an industry product classification system, such as the Standard Industrial Classification Code. The IRS and the Treasury Department recognize that some activities taken into account under the substantial contribution test are not performed with respect to each individual unit of a particular product manufactured under a contract manufacturing arrangement. Section 1.954–3(a)(4)(iv)(*d*) *Example 11* has been added to the final regulations to address these comments.

6. Treatment of Partnerships

Commentators requested that the regulations adopt principles to determine when the employees of a partnership should be treated as employees of the CFC for purposes of determining whether the CFC's relative economic interest in the partnership should be relevant in determining whether the CFC satisfies the substantial contribution test. The IRS and the Treasury Department concluded that this issue was beyond the scope of this regulatory project. However, the IRS and the Treasury Department continue to study this issue and welcome comments.

7. Rebuttable Presumption

The proposed regulations provide a rebuttable presumption that the CFC does not satisfy the substantial contribution test when the activities of a branch of the CFC satisfy the physical manufacturing test. The presumption can only be rebutted if the taxpayer can prove to the satisfaction of the Commissioner that the CFC satisfied the substantial contribution test. Commentators suggested that satisfaction of the physical manufacturing test and satisfaction of the substantial contribution test should be treated equally under the regulations. Commentators also expressed the view that the standard required to rebut the presumption was either too subjective, imposed an improperly high standard, or both. They recommended that if a rebuttable presumption was retained, the standard required to rebut the presumption should be clear and convincing evidence.

In response to the comments received, the IRS and the Treasury Department reconsidered the ability to examine a CFC's claim that it substantially contributes to the manufacture of the personal property when the activities of its branch satisfy the physical manufacturing test. Upon further study, the IRS and the Treasury Department concluded that the substantial contribution test can be administered without the benefit of a rebuttable presumption that a CFC does not satisfy the substantial contribution test when the activities of a branch of the CFC satisfy the physical manufacturing test. Thus, these final and temporary regulations do not contain a rebuttable presumption. The IRS and the Treasury Department took into account the request for parity of treatment with respect to satisfaction of the physical manufacturing test and the substantial contribution test in reaching this conclusion, as well as with respect to other aspects of the temporary regulations, as discussed further in Parts C and D of this preamble.

8. Documentation

Some commentators requested guidance on how taxpayers should document their activities for application of the substantial contribution test. Because the necessary documentation will vary by industry and by taxpayer, the IRS and the Treasury Department believe that creating general rules of documentation would prove impracticable and would not allow for enough flexibility in application of the substantial contribution test. Accordingly, the final regulations do not include documentation rules.

9. Automated Manufacturing

Several comments were received concerning Prop. Reg. § 1.954–3(a)(4)(iv)(*c*) *Example 4*. In *Example 4*, a CFC owns software and network systems that remotely and automatically (without human involvement) order raw materials for use by the contract manufacturer, take customer orders and route them to the contract manufacturer, and perform quality control. Although the CFC has a small number of computer technicians monitoring the software and network systems, the software and network systems were developed by employees of DP, the CFC's domestic parent corporation. Those DP employees supervise the CFC's computer technicians, evaluate the results of the automated manufacturing business, make ongoing operational decisions related to the performance of the manufacturing process, redesign and update the products and the manufacturing process, and develop all of the upgrades and patches for the software and network systems owned by the CFC. The example concludes that the CFC does not provide a substantial contribution to the manufacture of Product X.

Commentators expressed concern that Prop. Reg. § 1.954–3(a)(4)(iv)(*c*) *Example 4* did not recognize the importance of automated manufacturing in modern business practices. These commentators noted that manufacturing processes are increasingly automated and explained that in some high technology industries, automated manufacturing processes are the only way to manufacture and test the quality of certain products. In such industries, commentators noted that human involvement in various parts of the manufacturing process could be counterproductive. Some commentators were concerned that Prop. Reg. § 1.954–3(a)(4)(iv)(*c*) *Example 4* penalized such automated manufacturing processes under the substantial contribution test.

The IRS and the Treasury Department agree that a CFC may provide a substantial contribution to a largely automated manufacturing process through its employees. Section 1.954–3(a)(4)(iv)(*d*) *Example 5* contains the same facts as Prop. Reg. § 1.954–3(a)(4)(iv)(*c*) *Example 4*. Under those particular facts, substantial operational responsibilities and decision making by humans are required for the manufacturing process; however, they are not performed by the CFC. To provide additional guidance, the final regulations include an additional example, § 1.954–3(a)(4)(iv)(*d*) *Example 6*, which illustrates that a CFC whose employees perform most of the functions that DP's employees perform in § 1.954–3(a)(4)(iv)(*d*) *Example 5* makes a substantial contribution to the manufacturing process. This result applies even though DP's employees also contribute to the manufacturing process. Section 1.954–3(a)(4)(iv)(*d*) *Example 7* further illustrates that the CFC can make a substantial contribution through the activities of its employees regardless of whether the software and network systems were purchased by the CFC. These examples illustrate that the evaluation of whether a CFC makes a substantial contribution through its employees is determined based on whether industry-sufficient substantial contribution activities are conducted by employees of the CFC.

B. The ''Its'' Argument

The proposed regulations clarify that for purposes of determining FBCSI a CFC qualifies for the manufacturing exception only if the CFC, acting through its employees, manufactured, produced, or constructed the relevant personal property within the meaning of § 1.954–3(a)(4)(i). In response to the proposed regulations, some commentators maintained that a CFC need not satisfy the physical manufacturing test or the substantial contribution test to exclude a sale from FBCSI as long as the personal property sold is not the same as the property originally purchased by the CFC.

The IRS and the Treasury Department believe, as described in the preamble to the proposed regulations, that this position, commonly referred to as the ''its'' argument, is contrary to existing law, and represents an incorrect reading of section 954(d)(1). The final regulations accordingly maintain the rules provided in the proposed regulations regarding when personal property sold by a CFC will be considered to be other than the property purchased by the CFC.

C. Same Country Manufacture Exception

Commentators requested that the regulations incorporate the substantial contribution test in the same country manufacture exception. The IRS and the Treasury Department generally agree with commentators that if the substantial contribution test is sufficient to constitute the manufacture of the personal property where a CFC substantially contributes to the manufacture, production, or construction of that property, then it

should be equally sufficient if those activities are performed by a related person (as defined in section 954(d)(3)) in the CFC's country of organization. However, the IRS and the Treasury Department concluded that the same country manufacture exception would be difficult to administer and enforce in the case of a substantial contribution performed by an unrelated third party. Commentators suggested that these concerns could be ameliorated if taxpayers were required to maintain documentation with respect to a third party's substantial contribution. The IRS and the Treasury Department do not believe a documentation requirement adequately addresses these concerns because the IRS may be unable to audit the third party to verify if those substantial contribution activities in fact took place. Therefore, the final regulations provide that the same country manufacture exception is available to taxpayers in cases when a related person provides a substantial contribution to the manufacture of the personal property in the CFC's country of organization. The final regulations also retain the rule provided in the proposed regulations modifying the application of the principles of § 1.954–3(a)(4)(ii) and (a)(4)(iii) to reflect that the personal property manufactured, produced, or constructed in the country of organization of the selling corporation under the principles of § 1.954–3(a)(4)(ii) and (a)(4)(iii) will qualify for the same country exception regardless of whose employees engage in qualifying manufacturing activities in that country.

D. Branch Rule

In addition to the amendments to § 1.954–3(a), the proposed regulations also proposed amendments to the rules of § 1.954–3(b) dealing with the application of the FBCSI rules to CFCs with branches or similar establishments (the branch rule), particularly the rules dealing with manufacturing branches. For the remainder of this preamble, the word ''branch'' will be used to refer to a ''branch or similar establishment.''

1. Branch Definition

Some commentators requested that the regulations define the term ''branch'' for purposes of the branch rule. These commentators suggested various definitions for the IRS and the Treasury Department to consider. Commentators suggested, for instance, that a branch be defined as a permanent establishment, as a business activity in a jurisdiction outside a CFC's country of organization that has separate books and records, or as a trade or business outside a CFC's country of organization. Commentators pointed to precedents in the section 367 and 987 regulations. Alternatively, some commentators requested that the regulations make clear that a de minimis amount of activity outside of a CFC's country of organization (for example, traveling employees) does not constitute a branch. Other commentators warned that requiring too high a level of activity outside of a CFC's country of organization before a CFC was treated as having a ''branch'' would make it possible for a CFC organized in a lower-tax jurisdiction to contribute substantially to manufacturing activities in a higher-tax jurisdiction without causing the CFC to operate through a branch. Still other commentators suggested that courts have concluded that the IRS and the Treasury Department lack the regulatory authority to determine what constitutes a branch, and they may only address the consequences flowing from the existence of a branch.

The IRS and the Treasury Department determined that defining a branch was beyond the scope of this regulatory project. However, the temporary regulations retain an example similar to Prop. Reg. § 1.954–3(b)(1)(ii)(*c*)(*3*)(*f*) *Example 3*, which illustrates that employees of a CFC that travel to a contract manufacturer's location outside the CFC's country of organization do not necessarily give rise to a branch in that location. See § 1.954–3T(b)(1)(ii)(*c*)(*3*)(*v*) *Example 6*. See also Part D.3.b of this preamble.

2. Determination of Hypothetical Effective Tax Rate

Commentators requested that the regulations clarify that the tax rate disparity tests contained in §§ 1.954–3(b)(1)(i)(*b*) and (b)(1)(ii)(*b*) take into account incentive tax rates and other similar foreign tax relief available to a CFC in calculating the hypothetical effective tax rate of tax.

The IRS and the Treasury Department recognize that the tax rate disparity tests should take into account the actual tax rate paid with respect to the sales income by the selling branch or remainder and the hypothetical effective tax rate that would be paid by the manufacturing branch (or remainder) on that sales income under the laws of the country in which the manufacturing branch is located (or, in the case of a remainder, the country of organization of the CFC) if it were derived from sources within that country. Thus, the IRS and the Treasury Department agree that uniformly available tax incentives are to be considered in determining the hypothetical effective tax rate to be used in applying the tax rate disparity tests. In contrast, if a sales affiliate in the country of manufacturing can theoretically receive certain tax relief by taking certain actions, for example, by applying for special treatment pursuant to a ruling process, but the taxpayer has not affirmatively obtained such tax relief for the manufacturing branch (or remainder), then the hypothetical effective tax rate that would be paid by the manufacturing branch (or remainder) were it to derive the sales income should be the effective tax rate that would be applicable in that jurisdiction without such tax relief. The IRS and the Treasury Department believe that no change to the text of the existing regulations is necessary to address these points. However, § 1.954–3T(b)(4) *Example (8)* is included in the temporary regulations to illustrate that uniformly applicable incentive tax rates are taken into account in determining the hypothetical effective tax rate.

The IRS and the Treasury Department concluded that other questions and requests in this area, including further clarification of the methodology for calculation of hypothetical tax rates, and for changes to the assumptions used in applying the tax rate disparity tests and determining the hypothetical effective tax rate, are beyond the scope of this regulatory project. However, the IRS and the Treasury Department continue to study these questions and welcome comments.

3. Multiple Manufacturing Branch Rules

a. Determination of the Location of Manufacturing

Under Prop. Reg. § 1.954–3(b)(1)(ii)(*c*)(*3*), the relevant tax rate disparity test is applied by giving satisfaction of the physical manufacturing test precedence over satisfaction of the substantial contribution test 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. If more than one branch (or one or more branches and the remainder of the CFC) each independently satisfies 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 is treated as the location of manufacturing, producing, or constructing of the personal property for purposes of applying the tax rate disparity test (lowest-of-all-rates rule). If only one branch (or only the remainder of a CFC) independently satisfies the physical manufacturing test, then that

branch (or remainder) is treated as the location of manufacturing, producing, or constructing of the personal property (location of manufacturing) for purposes of the tax rate disparity test.

If none of the branches or the remainder of the CFC independently satisfies the physical manufacturing test, but the CFC as a whole satisfies the substantial contribution test, then the location of manufacturing under the proposed regulations is the location of the branch or the remainder of the CFC that provides the predominant amount of the CFC's substantial contribution to the manufacture of the personal property (predominant place rule). If a predominant amount of the CFC's contribution to the manufacture of the personal property is not provided by any one location, then the location of manufacturing for purposes of applying the manufacturing branch tax rate disparity test under the proposed regulations is that place (either the remainder of the CFC or one of its branches) where manufacturing activity with respect to that property is performed and which would impose the highest effective rate of tax (highest-of-all-rates rule) when applying either § 1.954–3(b)(1)(i)(*b*) or (b)(1)(ii)(*b*).

The IRS and the Treasury Department received multiple comments comparing and contrasting the highest- and lowest-of-all-rates rules. For example, commentators asked why the lowest-of-all-rates rule should apply when more than one branch (or one or more branches and the remainder of the CFC) independently satisfy the physical manufacturing test, whereas the highest-of-all-rates rule should apply when none of the branches or the remainder of the CFC independently satisfies the physical manufacturing test but the CFC as a whole satisfies the substantial contribution test. Commentators suggested that satisfaction of the physical manufacturing test and the substantial contribution test should be treated equally under the regulations, and therefore suggested having the same rule in both circumstances. These commentators proposed a lowest-of-all-rates rule or the use of a weighted average of the tax rate of each branch or remainder of the CFC in both instances.

The IRS and the Treasury Department generally agreed with these comments. The IRS and the Treasury Department adopted taxpayers' comment that the same rule should apply consistently when a branch (or remainder) independently satisfies § 1.954–3(a)(4)(i), regardless of whether it satisfies the physical manufacturing test or the substantial contribution test. Therefore the rules set forth in the proposed regulations are modified in the temporary regulations to provide that the lowest-of-all-rates rule will apply whenever a branch (or remainder) independently satisfies § 1.954–3(a)(4)(ii), (iii), or (iv). However, providing parity of treatment for satisfaction of the physical manufacturing test and the substantial contribution test in respect of the lowest-of-all-rates rule is not sufficient to determine the location of manufacturing in cases where a CFC satisfies the substantial contribution test, yet no branch (or remainder) independently satisfies § 1.954–3(a)(4)(iv).

Commentators questioned how to treat branches making contributions to the manufacture of the personal property through the activities of employees when no branch independently satisfies § 1.954–3(a)(4)(iv). Some commentators expressed concern that it would be difficult to compare the relative contributions of various locations to determine which branch or remainder of the CFC made a predominant contribution under the predominant place rule. Other commentators requested greater guidance regarding the meaning of predominant contribution. Many commentators suggested that the highest-of-all-rates rule in the proposed regulations could lead to arbitrary results when no predominant contributor could be identified.

The IRS and the Treasury Department generally agreed with these comments. Consequently, the temporary regulations revise the rules for determining the location of manufacture of the personal property when more than one branch (or one or more branches and the remainder) contributes to the manufacture of the personal property but no branch (or remainder) independently satisfies the physical manufacturing test or the substantial contribution test. The revised rules are based on the principle that the branch rule should apply in situations where purchase or sale activities with respect to the personal property are separated from manufacturing activities conducted by the CFC such that a demonstrably greater amount of manufacturing activity with respect to that property occurs in jurisdictions with tax rate disparity relative to the sales or purchase branch (or, in the case of a purchasing or selling remainder, the demonstrably greater amount of manufacturing activity with respect to the personal property occurs in jurisdictions with tax rate disparity relative to the purchasing or selling remainder).

Under the temporary regulations, if a demonstrably greater amount of manufacturing activity with respect to the personal property occurs in jurisdictions without tax rate disparity relative to the sales or purchase branch, the location of the sales or purchase branch will be deemed to be the location of manufacture of the personal property. In that case, the purchase or sales activities with respect to the property purchased or sold by or through the sales or purchase branch of the CFC will not, for purposes of determining FBCSI in connection with the sale of that property, be deemed to have substantially the same tax effect as if a branch were a wholly owned subsidiary corporation of the CFC. Otherwise, the location of manufacture of the personal property will be deemed to be the location of a manufacturing branch (or remainder) that has tax rate disparity relative to the sales or purchase branch. In that case, the purchase or sales activities with respect to the property purchased or sold by or through the sales or purchase branch of the CFC will be deemed to have substantially the same tax effect as if a branch were a wholly owned subsidiary corporation of the CFC, and that branch will be treated as a separate corporation for purposes of applying the regulations.

The temporary regulations apply analogous rules in the case of purchase or sales activity being conducted through the jurisdiction under the laws of which the CFC is organized. In such cases, however, the analysis focuses on whether the demonstrably greater amount of manufacturing activity with respect to the personal property occurs in jurisdictions that do or do not have tax rate disparity relative to the jurisdiction under the laws of which the CFC is organized. The temporary regulations incorporate examples under § 1.954–3T(b)(1)(ii)(*c*)(*3*)(*v*) to illustrate the application of these rules.

b. Location of Activities

The proposed regulations provide that for purposes of the multiple manufacturing branch rules the location of any activity with respect to the manufacture of the personal property is where the CFC's employees engage in such activity. Commentators suggested that in some cases the proposed regulations left it unclear, for purposes of determining the location of manufacturing, which jurisdiction was accorded credit for activities performed by an employee who is traveling temporarily to a foreign jurisdiction. Some commentators suggested that the location of activity rule should be removed or that the regulations should

clarify that, for instance, the activities of employees of a CFC based in the jurisdiction under the laws of which the CFC is organized, even while traveling outside the CFC's country of organization, would generally be credited toward establishing that the jurisdiction under the laws of which the CFC is organized provided a predominant amount of a CFC's substantial contribution. The IRS and the Treasury Department believe the text of § 1.954–3T(b)(1)(ii)(*c*)(*3*)(*iv*) makes clear that when an employee travels to perform activities, those activities are credited to the location in which the activities are conducted if there is a branch or remainder of the CFC in that jurisdiction. Section 1.954–3T(b)(1)(ii)(*c*)(*3*)(*v*) provides examples to further clarify this result.

Other commentators asked which location was accorded credit, if any, for activities performed by traveling employees of the CFC while located in a country in which there is no branch or remainder of the CFC. The temporary regulations provide that the location of any manufacturing activity is where the employees of the CFC perform that activity. Thus, the activities of employees while traveling to a country where the CFC does not maintain a branch or remainder are not credited to the branch or remainder where the traveling employees are regularly employed for purposes of determining the location of manufacture of the personal property under the branch rule. Such activities, however, can be taken into account for purposes of satisfying the manufacturing exception and the substantial contribution test. See § 1.954–3T(b)(1)(ii)(*c*)(*3*)(*v*) *Example 6*.

c. Clarifying Application of the Rule for Determining the Remainder of the CFC When Activities Are Performed in Multiple Locations

Prop Reg. § 1.954–3(b)(2)(ii)(*a*) provides that when treating the location of sales or purchase income as a separate corporation for purposes of determining whether FBCSI is realized, that separate corporation will exclude any branch or the remainder of the CFC that would be treated as a separate corporation, if the hypothetical tax 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. Commentators suggested that the application of this rule for determining the remainder of the CFC when activities are preformed in multiple locations is unclear. To clarify, the language from the proposed regulations is revised in the temporary regulations to describe what is included in the remainder, rather than what is excluded from the remainder, for purposes of determining whether there is FBCSI, after it is determined that a manufacturing branch should receive treatment as a separate corporation for purposes of applying the regulations. See § 1.954–3T(b)(2)(ii)(*a*).

As with the rule provided in the proposed regulations, this rule is intended to provide that the activities of all branch locations (or, in the case of a remainder, the activities in the jurisdiction under the laws of which the CFC is organized) that do not have tax rate disparity relative to the sales or purchase branch location (or, in the case of a purchasing or selling remainder, the jurisdiction under the laws of which the CFC is organized) may be taken into account together with the activities of the sales or purchase branch (or, in the case of a purchasing or selling remainder, activities of the remainder of the CFC in the jurisdiction under the laws of which the CFC is organized) for purposes of applying the separate corporation analysis required under the regulations and determining whether the sales income of the sales or purchase branch (or remainder) is FBCSI. Such determination will depend on whether the substantial contribution test is satisfied by the combined activities of the sales or purchase branch (or remainder) and the other locations aggregated with the sales or purchase branch (or remainder).

4. Coordination of Sales and Manufacturing Branch Rules

Commentators requested guidance on how the sales or purchase branch rules interact with the manufacturing branch rules. The current manufacturing branch rules contemplate the existence of a sales or purchase branch and a manufacturing branch. The rules provide that in such an instance the sales or purchase branch is treated as the remainder of the CFC for purposes of applying the tax rate disparity test. However, the sales or purchase branch rules of § 1.954–3(b)(1)(i) of the existing regulations do not indicate that those rules do not apply in cases where the manufacturing branch rules are applied. Commentators were concerned that the manufacturing branch rules would be applied in addition to, rather than in lieu of, the sales or purchase branch rules.

The IRS and the Treasury Department agree that if one or more sales or purchase branches are used in addition to a manufacturing branch and § 1.954–3T(b)(1)(ii)(*c*)(*1*) (use of one or more sales or purchases branches in addition to a manufacturing branch) is applied with respect to income from the sale of an item of personal property, then the sales or purchasing branch rules do not also apply to determine whether that income is FBCSI. Therefore, the temporary regulations clarify this point. See § 1.954–3(b)(1)(i)(*c*).

5. Unrelated to Unrelated Transactions

Commentators suggested that there was uncertainty as to whether a substantial contribution to the manufacture, production, or construction of personal property by a CFC could cause the CFC to earn FBCSI in cases where, in the absence of the substantial contribution test, some taxpayers had taken the position that they were outside the scope of the FBCSI rules. Some commentators expressed concern that transactions that are not currently subject to the existing regulations may become subject to the regulations as a result of the interaction of the substantial contribution test and the manufacturing branch rule. Other commentators suggested more generally that it was unclear if the substantial contribution test might create a branch through which a CFC carries on activities in a contract manufacturer's jurisdiction. Commentators suggested that taxpayers should be exempted from the branch consequences of the regulations by providing that the manufacturing branch rule only apply if the CFC was relying on the manufacturing exception for purposes of section 954(d)(1), or alternatively that the substantial contribution test should be elective. In this context, commentators noted that placing a CFC's substantial contribution activities, which are performed outside the country where the sales activities are performed, in a separately incorporated entity could prevent the CFC from having a branch that is subject to the manufacturing branch rule as a result of such activities.

The IRS and the Treasury Department agree that taxpayers may be subject to the FBCSI rules as a result of CFC employees performing indicia of manufacturing activities through a branch outside the country of organization of a CFC. The IRS and the Treasury Department believe this result is clear in the proposed regulations, and therefore no modifications are made to the text of the temporary regulations to clarify further this result. The IRS and the Treasury Department note that many commentators criticized the proposed regulations for drawing inappropriate distinctions between satisfaction of the

physical manufacturing test and satisfaction of the substantial contribution test, and argued that updating the manufacturing exception in the context of modern business enterprise models required treating with equal importance and weight physical manufacturing and activities satisfying the substantial contribution test. The IRS and the Treasury Department adopted this comment in both the final regulations and the temporary regulations and, accordingly, did not incorporate in the temporary regulations an exception regarding activities performed through a branch located outside the country of organization of a CFC for cases in which, in the absence of the substantial contribution test, some taxpayers had taken the position that they were outside the scope of the FBCSI rules.

One commentator noted that while there are strong policy reasons for the substantial contribution test and the branch rules to apply in the case of ''unrelated to unrelated'' transactions, the IRS and the Treasury Department should consider a special delayed effective date to allow taxpayers in this position time to restructure their operations in light of the regulations. The commentator argued that such taxpayers had been outside the scope of the FBCSI rules prior to these regulations and should be provided reasonable time to restructure. For a discussion of the effective date of the final and temporary regulations, see Part F of this preamble.

6. Branch Rule Examples

Commentators expressed concern that the facts of Prop. Reg. § 1.954–3(b)(1)(ii)(*c*)(*3*)(*f*) *Example 4* ascribed most substantial contribution activities to the remainder, but determined that the remainder had not met the substantial contribution test. In the example, the remainder performs seven activities listed in the indicia of manufacturing of the proposed regulations, whereas Branch A performs only one activity (design) and Branch B performs only two activities. The example was intended to show that in a CFC's particular industry, the weight accorded to the activities performed by each branch can be comparable, even though a different number of activities occur in different locations, because the economic significance of the activities conducted in each location is comparable. However, the IRS and the Treasury Department recognize that the example may have caused confusion for taxpayers. Therefore, the allocation of activities in *Example 4* of Prop. Reg. § 1.954–3(b)(1)(ii)(*c*)(*3*)(*f*) has been revised in § 1.954–3T(b)(1)(ii)(*c*)(*3*)(*v*) *Example 3*. Moreover, *Examples 4, 5*, and *6* of Prop. Reg. § 1.954–3(b)(1)(ii)(*c*)(*3*)(*f*) have been restructured in the temporary regulations to be consistent with the revisions to the branch rules.

Commentators also noted that *Example 4* and *Example 5* of Prop. Reg. § 1.954–3(b)(1)(ii)(*c*)(*3*)(*f*) suggest that income other than sales or purchasing income may be FBCSI. These examples are amended in the temporary regulations to be consistent with section 954(d)(2), which provides that income attributable to the carrying on of purchase or sales activities by a branch may be FBCSI.

Commentators requested that the IRS and the Treasury Department add an example to the regulations to illustrate how the substantial contribution test and the branch rules operate in cases involving multiple manufacturing branches and multiple sales branches. The temporary regulations include such an example. See § 1.954–3T(b)(1)(ii)(*c*)(*3*)(*v*) *Example 5*.

The temporary regulations also include an example illustrating the operation of the location of manufacture rules under § 1.954–3T(b)(1)(ii)(*c*)(*3*) and the application of the substantial contribution test when a tested manufacturing location has been determined to have tax rate disparity with a tested sales location. See § 1.954–3T(b)(4) *Example (9). Example (9)* illustrates that a tested sales location can satisfy the substantial contribution test for purposes of determining FBCSI once it has been determined that a tested manufacturing location should be treated as a separate corporation for purposes of determining FBCSI. Although a branch that has tax rate disparity with the tested sales location is the tested manufacturing location, *Example (9)* concludes that the CFC does not have FBCSI from the sale of the personal property because, after applying the aggregation rules of § 1.954–3T(b)(2)(ii)(*a*), the tested sales location satisfies § 1.954–3(a)(4)(iv).

E. Conforming Amendments

Sections 1.954–3(a)(1)(i) and (c) of the existing regulations contain cross-references to foreign base company shipping income under § 1.954–6. Section 954 was amended by Public Law 108–357 in 2004, and foreign base company shipping income was removed as a separate category of foreign base company income. The final regulations are amended by deleting both references to foreign base company shipping income to reflect the 2004 amendment to section 954.

Section 1.954–3(a)(1)(i) of the existing regulations defines ''related person'' and ''unrelated person'' by an obsolete cross reference to § 1.954–1(e). The final regulations are amended to define ''related person'' and ''unrelated person'' with reference to § 1.954–1(f).

F. Effective Date

Several commentators requested that the new regulations provide for a delayed effective date to allow taxpayers to implement supply chain and structural changes that may be required to satisfy the substantial contribution test and the branch rules. The IRS and the Treasury Department agree that a delayed effective date is appropriate for taxpayers whose structures require modification to accommodate the new regulations. Accordingly, these final and temporary regulations will apply to taxable years of CFCs beginning after June 30, 2009, and for taxable years of United States shareholders in which or with which such taxable years of the CFCs end. Thus, the final and temporary regulations will become applicable January 1, 2010, for CFCs whose taxable year is the calendar year. The temporary regulations will expire on or before December 23, 2011. In addition, a taxpayer may choose to apply these final and temporary regulations retroactively with respect to its open taxable years. The taxpayer may so choose if and only if the taxpayer and all members of the taxpayer's affiliated group apply both the final and temporary regulations, in their entirety, to the earliest taxable year of each controlled foreign corporation that ends with or within an open taxable year of the taxpayer and to all subsequent taxable years. A taxpayer that chose, prior to December 24, 2008, to apply Prop. Reg. § 1.954–3 (73 FR 10716 as corrected at 73 FR 20201) in its entirety to all of the taxpayer's open taxable years in which or with which a taxable year of a controlled foreign corporation of the taxpayer ended, may continue to apply Prop. Reg. § 1.954–3 (73 FR 10716 as corrected at 73 FR 20201) in its entirety with respect to all of the taxpayer's open taxable years that begin prior to July 1, 2009.

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 has also 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. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking that preceded these final and temporary regulations 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 Ethan Atticks of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income Taxes, Reporting and recordkeeping requirements.

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 26 CFR part 1 continues to read in part as follows:

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

■ **Par. 2.** Section 1.954–3 is amended by:

■ 1. Revising paragraphs (a)(1)(i), (a)(1)(iii) *Examples 1* and *2*, (a)(2), (a)(4)(i), (a)(4)(ii), (a)(4)(iii), (a)(6)(i), and (c).

■ 2. Adding paragraphs (a)(4)(iv) and (d).

■ 3. Removing and reserving paragraphs (b)(1)(i)(*c*), (b)(1)(ii)(*a*), (b)(1)(ii)(*c*), (b)(2)(i)(*b*), (b)(2)(i)(*d*), (b)(2)(ii)(*a*), (b)(2)(ii)(*b*), (b)(2)(ii)(*e*) and (b)(4) *Example (3)*.

The additions and revisions read as follows:

§ 1.954–3 Foreign base company sales income.

(a) * * *

(1) *In general*—(i) *General rules.* Foreign base company sales income of a controlled foreign corporation shall, except as provided in paragraphs (a)(2), (a)(3) and (a)(4) of this section, consist of gross 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, the sale of personal property to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person on behalf of a related person. See section 954(d)(1). For purposes of the preceding sentence, except as provided in paragraphs (a)(2) and (a)(4) of this section, personal property sold by a controlled foreign corporation will be considered to be the same property that was purchased by the controlled foreign corporation regardless of whether the personal property 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. This section shall apply to the purchase and/or sale of personal property, whether or not such property was purchased and/or sold in the ordinary course of trade or business, except that income derived in connection with the sale of tangible personal property will not be considered to be foreign base company sales income if such property is sold to a person that is not a related person, as defined in § 1.954–1(f), after substantial use has been made of the property by the controlled foreign corporation in its trade or business. This section shall not apply to the excess of gains over losses from sales or exchanges of securities or from futures transactions, to the extent such excess gains are includible in foreign personal holding company income of the controlled foreign corporation under § 1.954–2; nor shall it apply to the sale of the controlled foreign corporation's property (other than its stock in trade or other property of a kind which would properly be included in its inventory if on hand at the close of the taxable year, or property held primarily for sale to customers in the ordinary course of its business) if substantially all the property of such corporation is sold pursuant to the discontinuation of the trade or business previously carried on by such corporation. The term ''any person'' as used in this paragraph (a)(1)(i) includes a related person as defined in § 1.954–1(f).

* * * * *

(iii) * * *

Example 1. Controlled foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A purchases from M Corporation, a related person, articles manufactured in the United States and sells the articles to P, an unrelated person, for delivery and use in foreign country Y. Gross income of A Corporation derived from the purchase and sale of the personal property is foreign base company sales income.

Example 2. Corporation A in *Example 1* also purchases from P, an unrelated person, articles manufactured in country Y and sells the articles to foreign corporation B, a related person, for use in foreign country Z. Gross income of A Corporation derived from the purchase and sale of the personal property is foreign base company sales income.

* * * * *

(2) *Property manufactured, produced, constructed, grown, or extracted within the country in which the controlled foreign corporation is created or organized.* Foreign base company sales income does not include income derived in connection with the purchase and sale of personal property (or purchase or sale of personal property on behalf of a related person) in a transaction described in paragraph (a)(1) of this section if the property is manufactured, produced, constructed, grown, or extracted in the country under the laws of which the controlled foreign corporation which purchases and sells the property (or acts on behalf of a related person) is created or organized. See section 954(d)(1)(A). The principles set forth in paragraphs (a)(4)(ii) and (a)(4)(iii) of this section apply under this paragraph (a)(2) in determining what constitutes the manufacture, production, or construction of personal property, excluding the requirement set forth in paragraph (a)(4)(i) of this section that the provisions of paragraphs (a)(4)(ii) and (a)(4)(iii) of this section may only be satisfied through the activities of employees of the corporation manufacturing, producing, or constructing the personal property. The principles of paragraph (a)(4)(iv) of this section apply under this paragraph (a)(2) in determining what constitutes the manufacture, production, or construction of personal property but only when the personal property is manufactured, produced, or constructed by a person related to the controlled foreign corporation within the meaning of § 1.954–1(f). The application of this paragraph (a)(2) may be illustrated by the following examples:

* * * * *

(4) *Property manufactured, produced, or constructed by the controlled foreign corporation*—(i) *In general.* Foreign base company sales income does not include income of a controlled foreign corporation derived in connection with the sale of personal property manufactured, produced, or constructed by such corporation. A controlled foreign corporation will have manufactured, produced, or constructed personal property which the corporation sells only if such corporation satisfies the provisions of paragraph (a)(4)(ii), (a)(4)(iii), or (a)(4)(iv) of this section through the activities of its employees (as defined in § 31.3121(d)–1(c) of this chapter) with respect to such property.

A controlled foreign corporation will not be treated as having manufactured, produced, or constructed personal property which the corporation sells merely because the property is sold in a different form than the form in which it was purchased. For rules of apportionment in determining foreign base company sales income derived from the sale of personal property purchased and used as a component part of property which is not manufactured, produced, or constructed, see paragraph (a)(5) of this section.

(ii) *Substantial transformation of property.* If personal property purchased by a foreign corporation is substantially transformed by such foreign corporation prior to sale, the property sold by the selling corporation is manufactured, produced, or constructed by such selling corporation. The application of this paragraph (a)(4)(ii) may be illustrated by the following examples:

* * * * *

(iii) *Manufacture of a product when purchased components constitute part of the property sold.* If purchased property is used as a component part of personal property which is sold, the sale of the property will be treated as the sale of a manufactured product, rather than the sale of component parts, if the assembly or conversion of the component parts into the final product by the selling corporation involves activities that are substantial in nature and generally considered to constitute the manufacture, production, or construction of property. Without limiting this substantive test, which is dependent on the facts and circumstances of each case, the operations of the selling corporation in connection with the use of the purchased property as a component part of the personal property which 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. In no event, however, will packaging, repackaging, labeling, or minor assembly operations constitute the manufacture, production, or construction of property for purposes of section 954(d)(1). The application of this paragraph (a)(4)(iii) may be illustrated by the following examples:

* * * * *

(iv) *Substantial contribution to manufacturing of personal property*—(*a*) *In general.* If an item of personal property would be considered manufactured, produced, or constructed (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) prior to sale by the controlled foreign corporation had all of the manufacturing, producing, and constructing activities undertaken with respect to that property prior to sale been undertaken by the controlled foreign corporation through the activities of its employees, then this paragraph (a)(4)(iv) applies. If this paragraph (a)(4)(iv) applies and if the facts and circumstances evince that the controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture, production, or construction of the personal property sold, then the personal property sold by the controlled foreign corporation is manufactured, produced, or constructed by such controlled foreign corporation.

(*b*) *Activities.* The determination of whether a controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture, production, or construction of the personal property sold involves, but will not necessarily be limited to, consideration of the following activities:

(*1*) Oversight and direction of the activities or process pursuant to which the property is manufactured, produced, or constructed (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section).

(*2*) Activities that are considered in, but that are insufficient to satisfy, the tests provided in paragraphs (a)(4)(ii) and (a)(4)(iii) of this section.

(*3*) Material selection, vendor selection, or control of the raw materials, work-in-process or finished goods.

(*4*) Management of manufacturing costs or capacities (for example, managing the risk of loss, cost reduction or efficiency initiatives associated with the manufacturing process, demand planning, production scheduling, or hedging raw material costs).

(*5*) Control of manufacturing related logistics.

(*6*) Quality control (for example, sample testing or establishment of quality control standards).

(*7*) Developing, or directing the use or development of, product design and design specifications, as well as trade secrets, technology, or other intellectual property for the purpose of manufacturing, producing, or constructing the personal property.

(*c*) *Application of substantial contribution test.* When considering whether a controlled foreign corporation makes a substantial contribution to the manufacture, production, or construction of the personal property, the performance of any activity in paragraph (a)(4)(iv)(*b*) of this section will be taken into account. The performance or lack of performance of any particular activity in paragraph (a)(4)(iv)(*b*) of this section, or of a particular number of activities in (a)(4)(iv)(*b*) of this section, is not determinative. The weight accorded to the performance of any quantum of any activity (whether or not specified in paragraph (a)(4)(iv)(*b*) of this section) will vary with the facts and circumstances of the particular business. See paragraph (a)(4)(iv)(*d*) *Examples 8, 10* and *11* of this section. In determining whether the activities of the controlled foreign corporation constitute a substantial contribution, there is no minimum performance threshold before an activity can be considered. The fact that other persons make a substantial contribution to the manufacture, production, or construction of the personal property prior to sale does not preclude the controlled foreign corporation from making a substantial contribution to the manufacture, construction, or production of that property through the activities of its employees. See paragraph (a)(4)(iv)(*d*) *Example 9* of this section.

(*d*) *Examples.* The rules of this paragraph (a)(4)(iv) are illustrated by the following examples:

Example 1. No substantial contribution to manufacturing. (i) *Facts.* FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion outside of FS's country of organization. Product X is sold by FS for use outside of FS's country of organization. Under the terms of the contract, FS retains the right to control the raw materials, work-in-process, and finished goods, and the right to oversee and direct the activities or process pursuant to which Product X is manufactured by CM. FS owns the intellectual property used in the manufacturing process. However, FS does not exercise, through its employees, its powers to control the raw materials, work-in-process, or finished goods, and FS does not exercise its powers of oversight and direction. Likewise, FS does not, through its employees, develop or direct the use or development of the intellectual property for the purpose of manufacturing Product X.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale were undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii)

of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. FS does not satisfy the test under this paragraph (a)(4)(iv) because it does not make a substantial contribution through the activities of its employees to the manufacture of Product X. Mere contractual rights to control materials, contractual rights to oversee and direct the manufacturing activities or process pursuant to which the property is manufactured, and ownership of intellectual property are not sufficient to satisfy this paragraph (a)(4)(iv). Therefore, under the facts and circumstances of the business, FS is not considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 2. Substantial contribution to manufacturing. (i) *Facts.* Assume the same facts as in *Example 1*, except for the following. FS, through its employees, engages in product design and quality control and controls manufacturing related logistics. Employees of FS exercise the right to oversee and direct the activities of CM in the manufacture of Product X.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale were undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section. The analysis and conclusion would be the same if CM were related to FS because the relationship between CM and FS is irrelevant for purposes of applying paragraph (a)(4) of this section.

Example 3. Raw materials procured by contract manufacturer. (i) *Facts.* FS, a controlled foreign corporation, enters into a contract with CM to manufacture (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) Product X. CM physically performs the substantial transformation, assembly, or conversion required to manufacture Product X outside of FS's country of organization. Product X is sold by FS for use outside of FS's country of organization. Employees of FS select the materials that will be used to manufacture Product X. FS does not own the materials or work-in-process during the manufacturing process. FS, through its employees, exercises oversight and direction of the manufacturing process and provides quality control. FS manages the manufacturing costs and capacities with respect to Product X by managing the risk of loss and engaging in demand planning and production scheduling.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale were undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 4. Physical conversion by employees of a person other than the contract manufacturer. (i) *Facts.* FS, a controlled foreign corporation organized in Country M, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion required to manufacture Product X outside of FS's country of organization. Product X is sold by FS for use outside of FS's country of organization. CM contracts with another corporation for its employees in order to operate CM's manufacturing plant and transform, assemble, or convert the raw materials into Product X. Apart from the physical performance of the substantial transformation, assembly, or conversion of the raw materials into Product X, employees of FS perform all of the other manufacturing activities required in connection with the manufacture of Product X (for example, oversight and direction of the manufacturing process; vendor selection; control of raw materials, work-in-process, and finished goods; control of manufacturing related logistics; and quality control).

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale were undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 5. Automated manufacturing supervised by another person. (i) *Facts.* FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation selected by FS, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion outside of FS's country of organization. Product X is sold by FS to related and unrelated persons for use outside of FS's country of organization. At all times, FS retains ownership of the raw materials, work-in-process, and finished goods. FS retains the right to oversee and direct the activities or process pursuant to which Product X is manufactured by CM, but does not exercise, through its employees, its powers of oversight and direction. FS is the owner of sophisticated software and network systems that remotely and automatically (without human involvement) take orders, route them to CM, order raw materials, and perform quality control. FS has a small number of computer technicians who monitor the software and network systems to ensure that they are running smoothly and apply any necessary patches or fixes. The software and network systems were developed by employees of DP, the U.S. corporate parent of FS. DP's employees supervise the computer technicians, evaluate the results of the automated manufacturing business, and make ongoing operational decisions, including decisions related to acceptable performance of the manufacturing process, stoppages of that process, and decisions related to product and manufacturing process design. DP's employees develop and provide to FS all of the upgrades to the software and network systems. DP also has employees who direct and control other aspects of the manufacturing process such as vendor and material selection, management of the manufacturing costs and capacities, and the selection of CM. The need for DP's employees to direct the activities of the FS employees and otherwise contribute to the manufacturing process evinces that substantial operational responsibilities and decision making are required to be exercised by parties other than CM in order to manufacture Product X.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale were undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstance of the business, FS does not satisfy the test under this paragraph (a)(4)(iv) because it does not make a substantial contribution through the activities of its employees to the manufacture of Product X. Mere ownership of materials and intellectual property along with contractual rights to exercise powers of direction and control are not sufficient to satisfy this paragraph (a)(4)(iv). The employees of FS do not perform the amount of activity necessary to constitute a substantial contribution. FS is not considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 6. Automated manufacturing supervised by FS. (i) *Facts.* Assume the same facts as in *Example 5*, except for the following. FS, through its employees, engages in the activities undertaken by DP's employees in *Example 5.* DP's employees also contribute to product and manufacturing process design, and provide support and oversight to FS in connection with functions performed by FS through its employees.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale were undertaken by FS through the activities of its employees, FS would have

satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. This determination does not require a comparison between the activities of FS and the activities of DP. Selection of the contract manufacturer, even though not specifically identified in paragraph (a)(4)(iv)(*b*) of this section, is considered under paragraph (a)(4)(iv)(*c*) of this section in determining whether FS makes a substantial contribution to the manufacture of Product X through its employees. FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 7. Automated manufacturing supervised by FS with purchased intellectual property. (i) *Facts.* Assume the same facts as in *Example 6,* except for the following. The software and network systems, and the upgrades to those systems, were purchased by FS rather than developed by employees of FS.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale were undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. The lack of performance of software and network system development activities is not determinative under the facts and circumstances of the business. Therefore, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. This determination does not require a comparison between the activities of FS and the activities of DP. FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 8. Manufacture without intellectual property. (i) *Facts.* FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion outside of FS's country of organization. Product X is sold by FS for use outside of FS's country of organization. At all times, FS controls the raw materials, work-in-process, and finished goods. FS controls the manufacturing related logistics, manages the manufacturing costs and capacities, and provides quality control with respect to CM's manufacturing process and product. No intellectual property of significant value is required to manufacture Product X. FS does not own any intellectual property underlying Product X, or hold an exclusive or non-exclusive right to manufacture Product X.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale were undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Because use of intellectual property plays little or no role in the manufacture of Product X, it is irrelevant to the substantial contribution analysis under paragraph (a)(4)(iv) of this section. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 9. Substantial contribution by more than one CFC. (i) *Facts.* FS1 and FS2, unrelated controlled foreign corporations, contract with CM, an unrelated corporation, to manufacture (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) Product X. CM physically performs the substantial transformation, assembly, or conversion required to manufacture Product X outside of FS1's and FS2's respective countries of organization. Neither FS1 nor FS2 owns the materials or work-in-process during the manufacturing process. Product X is sold by FS1 and FS2 to persons related to FS1 and FS2, respectively, for disposition outside of FS1's and FS2's respective countries of organization. FS1, through its employees, designs Product X. FS1 directs the use of the product design and design specifications, and other intellectual property, for the purpose of manufacturing Product X. Employees of FS1 also select the materials that will be used to manufacture Product X, and the vendors that provide those materials. FS2, through its employees, designs the process for manufacturing Product X. FS2, through its employees, manages the manufacturing costs and capacities with respect to Product X. FS1 and FS2 each provide quality control and oversight and direction of CM's manufacturing activities with respect to different aspects of the manufacture of Product X.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale were undertaken by FS1 or FS2 through the activities of their employees, FS1 or FS2 would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. The fact that other persons make a substantial contribution to the manufacture of personal property does not preclude a controlled foreign corporation from making a substantial contribution to the manufacture of personal property through the activities of its employees. In the analysis of whether FS1 or FS2 make a substantial contribution to the manufacture of Product X, each company takes into account its individual activities, including those of providing quality control and oversight and direction of the manufacture of Product X. In addition, no threshold level of activity is required, including with respect to providing quality control or oversight and direction of the activities or process pursuant to which Product X is manufactured, before FS1 and FS2 can take into account their respective activities. Under the facts and circumstances of the business, both FS1 and FS2 satisfy the test under this paragraph (a)(4)(iv) because each independently makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS1 and FS2 are each considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 10. Manufacture of products designed by CFC. (i) *Facts.* FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion outside of FS's country of organization. Product X is sold by FS for use outside of FS's country of organization. Products in the X industry are distinguished (and vary widely in value) based on the raw materials used to make the product and the product design. FS designs the product and selects the materials that CM will use to manufacture Product X. FS also manages the manufacturing costs and capacities. Product X can be manufactured from the raw materials to FS's design specifications without significant oversight and direction, quality control, or control of manufacturing related logistics. The activities most relevant to the substantial contribution analysis under these facts are material selection, product design and management of the manufacturing costs and capacities.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale were undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS makes a substantial contribution through the activities of its employees to the manufacture of Product X. FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

Example 11. Direction and oversight of manufacturing and quality control through periodic visits. (i) *Facts.* FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion outside of FS's country of organization. Product X is sold by FS for use outside of FS's country of organization. FS controls the raw material, work-in-process, and finished goods, manages the manufacturing costs and

capacities, and provides oversight and direction of the manufacture of Product X. Employees of FS visit CM's manufacturing facility for one week each quarter and perform quality control tests on a random sample of the units of Product X produced during the week. In the X industry, quarterly visits to a manufacturing facility by qualified persons are sufficient to control the quality of manufacturing.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale were undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) with respect to Product X because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

* * * * *

(6) *Special rule applicable to distributive share of partnership income*—(i) *In general.* To determine the extent to which a controlled foreign corporation's distributive share of any item of gross income of a partnership would have been foreign base company sales income if received by it directly, under § 1.952–1(g), the property sold will be considered to be manufactured, produced, or constructed by the controlled foreign corporation, within the meaning of paragraph (a)(4)(i) of this section, only if the manufacturing exception of paragraph (a)(4)(i) of this section would have applied to exclude the income from foreign base company sales income if the controlled foreign corporation had earned the income directly, determined by taking into account only the activities of the employees of, and property owned by, the partnership.

* * * * *

(b) * * *

(1) * * *

(i) * * *

(*c*) [Reserved]. For further guidance, see § 1.954–3T(b)(1)(i)(*c*).

(ii) * * *

(*a*) [Reserved]. For further guidance, see § 1.954–3T(b)(1)(ii)(*a*).

* * * * *

(*c*) [Reserved]. For further guidance, see § 1.954–3T(b)(1)(ii)(*c*).

(2) * * *

(i) * * *

(*b*) [Reserved]. For further guidance, see § 1.954–3T(b)(2)(i)(*b*).

* * * * *

(*d*) [Reserved]. For further guidance, see § 1.954–3T(b)(2)(i)(*d*).

* * * * *

(ii) * * *

(*a*) [Reserved]. For further guidance, see § 1.954–3T(b)(2)(ii)(*a*).

(*b*) [Reserved]. For further guidance, see § 1.954–3T(b)(2)(ii)(*b*).

* * * * *

(*e*) [Reserved]. For further guidance, see § 1.954–3T(b)(2)(ii)(*e*).

* * * * *

(4) * * *

Example (3). [Reserved]. For further guidance, see § 1.954–3T(b)(4) *Example (3).*

* * * * *

(c) *Effective/applicability date.* Paragraphs (a)(1)(i), (a)(1)(iii) *Example 1,* (a)(1)(iii) *Example 2,* (a)(2), (a)(4)(i), (a)(4)(ii), (a)(4)(iii), (a)(4)(iv) and (a)(6)(i) shall apply to taxable years of controlled foreign corporations beginning after June 30, 2009, and for taxable years of United States shareholders in which or with which such taxable years of the controlled foreign corporations end.

(d) *Application of regulations to earlier taxable years.* A taxpayer may choose to apply these regulations and the regulations under § 1.954–3T retroactively with respect to its open taxable years. The taxpayer may so choose if and only if the taxpayer and all members of the taxpayer's affiliated group (within the meaning of § 1504(a)) apply both these regulations and the regulations under § 1.954–3T, in their entirety, to the earliest taxable year of each controlled foreign corporation that ends with or within an open taxable year of the taxpayer and to all subsequent taxable years of the taxpayer.

■ **Par. 3.** Section 1.954–3T is added to read as follows:

§ 1.954–3T Foreign base company sales income (temporary).

(a) Through (b)(1)(i)(*b*) [Reserved]. For further guidance, see § 1.954–3(a) through (b)(1)(i)(*b*).

(*c*) *Use of more than one branch.* If a controlled foreign corporation carries on purchasing or selling activities by or through more than one branch or similar establishment located outside the country under the laws of which such corporation is created or organized, then § 1.954–3(b)(1)(i)(*b*) shall be applied separately to the income derived by each such branch or similar establishment (by treating such purchasing or selling branch or similar establishment as if it were the only branch or similar establishment of the controlled foreign corporation and as if any such other branches or similar establishments were separate corporations) in determining whether the use of such branch or similar establishment has substantially the same tax effect as if such branch or similar establishment were a wholly owned subsidiary corporation of the controlled foreign corporation. See paragraph (b)(1)(ii)(*c*)(*1*) of this section for rules applicable to a controlled foreign corporation that carries on purchase or sales activities by or through one or more branches or similar establishments in addition to carrying on manufacturing activities by or through one or more branches or similar establishments.

(ii) *Manufacturing branch*—(*a*) *In general.* If a controlled foreign corporation 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 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 controlled foreign corporation has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of such controlled foreign corporation, the branch or similar establishment and the remainder of the controlled foreign corporation will be treated as separate corporations for purposes of determining foreign base company sales income of such corporation. See section 954(d)(2). The provisions of this paragraph (b)(1)(ii) and § 1.954–3(b)(1)(ii)(*b*) will apply only if the controlled foreign corporation (including any branches or similar establishments of such controlled foreign corporation) manufactures, produces, or constructs such personal property within the meaning of § 1.954–3(a)(4)(i), or carries on growing or extracting activities with respect to such personal property.

(*b*) [Reserved]. For further guidance, see § 1.954–3(b)(1)(ii)(*b*).

(*c*) *Use of more than one branch—(1) Use of one or more sales or purchase branches in addition to a manufacturing branch.* If, with respect to personal property manufactured, produced, constructed, grown, or extracted by or through a branch or similar establishment located outside the country under the laws of which the controlled foreign corporation is created or organized, purchasing or selling activities are carried on by or through more than one branch or similar establishment, or by or through one or more branches or similar establishments located outside such country, of such corporation, then § 1.954–3(b)(1)(ii)(*b*)

shall be applied separately to the income derived by each such purchasing or selling branch or similar establishment (by treating such purchasing or selling branch or similar establishment as though it alone were the remainder of the controlled foreign corporation) for purposes of determining whether the use of such manufacturing, producing, constructing, growing, or extracting branch or similar establishment has substantially the same tax effect as if such branch or similar establishment were a wholly owned subsidiary corporation of the controlled foreign corporation. If this rule applies, the sales or purchase branch rules contained in paragraph (b)(1)(i)(*c*) of this section and § 1.954–3(b)(1)(i) do not apply. The application of this paragraph (b)(1)(ii)(*c*)(*1*) is illustrated by the following example:

Example. All activities of controlled foreign corporation conducted through sales branches and manufacturing branch. (i) *Facts.* FS, a controlled foreign corporation organized under the laws of country M, operates three branches. Branch A, located in country A, manufactures Product X under the principles of § 1.954–3(a)(4)(i). Branch B, located in Country B, sells Product X manufactured by Branch A to customers for use outside of Country B. Branch C, located in Country C sells Product X manufactured by Branch A to customers for use outside of Country C. FS does not conduct any manufacturing or selling activities apart from the activities of Branches A, B and C. Country M imposes an effective rate of tax on sales income of 0%. Country A imposes an effective rate of tax on sales income of 20%. Country B imposes an effective rate of tax on sales income of 20%. Country C imposes an effective rate of tax on sales income of 18%.

(ii) *Result.* Pursuant to this paragraph (b)(1)(ii)(*c*)(*1*), § 1.954–3(b)(1)(ii)(*b*) is applied to the sales income derived by Branch B by treating Branch B as though it alone were the remainder of the controlled foreign corporation. The use of Branch B does not have the same tax effect as if Branch B were a wholly owned subsidiary of FS because the tax rate applicable to the income allocated to Branch B under § 1.954–3(b)(1)(ii)(*b*) (20%) is not 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 Country A (20%), the country in which Branch A is located. Section 1.954–3(b)(1)(ii)(*b*) is applied separately to the sales income derived by Branch C by treating Branch C as though it alone were the remainder of the controlled foreign corporation. The use of Branch C does not have the same tax effect as if Branch C were a wholly owned subsidiary of FS because the tax rate applicable to the income allocated to Branch C under § 1.954–3(b)(1)(ii)(*b*) (18%) is not 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 Country A (20%), the country in which Branch A is located. Pursuant to this paragraph (b)(1)(ii)(*c*)(*1*), the rules under paragraph (b)(1)(i)(*c*) of this section and § 1.954–3(b)(1)(i) for determining whether a sales or purchase branch is treated as a separate corporation from the remainder of the controlled foreign corporation do not apply.

(*2*) *Use of more than one branch to manufacture, produce, construct, grow, or extract separate items of personal property.* If a controlled foreign corporation carries on manufacturing, producing, constructing, growing, or extracting activities with respect to separate items of personal property by or through more than one branch or similar establishment located outside the country under the laws of which such corporation is created or organized, then paragraph (b)(1)(ii)(*c*) of this section and § 1.954–3(b)(1)(ii)(*b*) will be applied separately to each such branch or similar establishment (by treating such manufacturing branch or similar establishment as if it were the only such branch or similar establishment of the controlled foreign corporation and as if any other such branches or similar establishments were separate corporations) for purposes of determining whether the use of such branch or similar establishment has substantially the same tax effect as if such branch or similar establishment were a wholly owned subsidiary corporation of the controlled foreign corporation. The application of this paragraph (b)(1)(ii)(*c*)(*2*) is illustrated by the following example:

Example. Multiple branches that satisfy § 1.954–3(a)(4)(i). (i) *Facts.* FS is a controlled foreign corporation organized in Country M. FS operates two branches, Branch A and Branch B located in Country A and Country B, respectively. Branch A and Branch B each manufacture separate items of personal property (Product X and Product Y, respectively) within the meaning of § 1.954–3(a)(4)(ii) or (iii). Raw materials used in the manufacture of Product X and Product Y are purchased by FS from an unrelated person. FS engages in activities in Country M to sell Product X and Product Y to a related person for use, disposition or consumption outside of Country M. Employees of FS located in Country M perform only sales functions. The effective rate imposed in Country M on the income from the sales of Product X and Product Y is 10%. Country A imposes an effective rate of tax on sales income of 20%. Country B imposes an effective rate of tax on sales income of 12%.

(ii) *Result.* Pursuant to this paragraph (b)(1)(ii)(*c*)(*2*), § 1.954–3(b)(1)(ii)(*b*) is applied separately to Branch A and Branch B with respect to the sales income of FS attributable to Product X (manufactured by Branch A) and Product Y (manufactured by Branch B). Because the effective rate of tax on FS's sales income from the sale of Product X in Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in which Branch A is located (20%), the use of Branch A to manufacture Product X has substantially the same tax effect as if Branch A were a wholly owned subsidiary corporation of FS. Because the effective rate of tax on FS's sales income from the sale of Product Y in Country M (10%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in which Branch B is located (12%), the use of Branch B to manufacture Product Y does not have substantially the same tax effect as if Branch B were a wholly owned subsidiary corporation of FS. Consequently, only Branch A is treated as a separate corporation apart from the remainder of FS for purposes of determining foreign base company sales income from the sales of Product X.

(*3*) *Use of more than one manufacturing branch, or one or more manufacturing branches and the remainder of the controlled foreign corporation, to manufacture, produce, or construct the same item of personal property*—(*i*) *In general.* This paragraph (b)(1)(ii)(*c*)(*3*) applies to determine the location of manufacture, production, or construction of personal property for purposes of applying § 1.954–3(b)(1)(i)(*b*) or (b)(1)(ii)(*b*) where more than one branch (or similar establishment) of a controlled foreign corporation, or one or more branches (or similar establishments) of a controlled foreign corporation and the remainder of the controlled foreign corporation, each engage in manufacturing, producing, or constructing activities with respect to the same item of personal property which is then sold by the controlled foreign corporation. The location of manufacture, production, or construction is determined under paragraph (b)(1)(ii)(*c*)(*3*)(*ii*) of this section if one or more branches (or similar establishments), or the remainder of the controlled foreign corporation, independently satisfies § 1.954–3(a)(4)(i) with respect to an item of personal property. The location of manufacture, production, or construction is determined under paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section if none of the branches (or similar establishments), or the remainder of the controlled foreign corporation, independently satisfies § 1.954–3(a)(4)(i) with respect to an item of personal property, but the controlled foreign corporation as a whole makes a substantial contribution to the manufacture, production or construction of that property within the meaning of § 1.954–3(a)(4)(iv). For purposes of this paragraph (b)(1)(ii)(*c*)(*3*), the location of any activity with respect to the manufacture, production, or construction of an item

of personal property is determined under paragraph (b)(1)(ii)(*c*)(*3*)(*iv*) of this section. For purposes of this paragraph (b)(1)(ii)(*c*)(*3*), if multiple branches (or similar establishments) are located in a single jurisdiction, then the activities of those branches will be aggregated for purposes of determining whether a branch or remainder of the controlled foreign corporation satisfies § 1.954–3(a)(4)(i).

(*ii*) *Manufacture, production, or construction in one or more locations.* If only one branch (or similar establishment), or only the remainder of a controlled foreign corporation, independently satisfies § 1.954–3(a)(4)(i) with respect to an item of personal property, then that branch (or similar establishment) or the remainder of the controlled foreign corporation will be the location of manufacture, production, or construction of that property for purposes of applying § 1.954–3(b)(1)(i)(*b*) or (b)(1)(ii)(*b*) to the income from the sale of that property. See paragraph (b)(1)(ii)(*c*)(*3*)(*v*) *Example 1* of this section. If more than one branch (or similar establishment), or one or more branches (or similar establishments) and the remainder of the controlled foreign corporation, each independently satisfy § 1.954–3(a)(4)(i) with respect to an item of personal property, then the location of manufacture, production, or construction of that property for purposes of applying § 1.954–3(b)(1)(i)(*b*) or (b)(1)(ii)(*b*) will be the location of that branch (or similar establishment) or the jurisdiction under the laws of which the remainder of the controlled foreign corporation is organized that satisfies § 1.954–3(a)(4)(i) and that would, after applying § 1.954–3(b)(1)(ii)(*b*) to such branch (or similar establishment) or § 1.954–3(b)(1)(i)(*b*) to the remainder of the controlled foreign corporation, impose the lowest effective rate of tax on the income allocated to such branch or the remainder of the controlled foreign corporation under such section (that is, either § 1.954–3(b)(1)(i)(*b*) or (b)(1)(ii)(*b*)). See paragraph (b)(1)(ii)(*c*)(*3*)(*v*) *Example 2* of this section.

(*iii*) *No location independently satisfies manufacturing test.* If none of the branches (or similar establishments) or the remainder of the controlled foreign corporation independently satisfies § 1.954–3(a)(4)(i) with respect to an item of personal property but the controlled foreign corporation as a whole makes a substantial contribution to the manufacture, production, or construction of that property within the meaning of § 1.954–3(a)(4)(iv), then for purposes of applying § 1.954–3(b)(1)(i)(*b*) or (b)(1)(ii)(*b*), the location of manufacture, production, or construction with respect to that property will be the ''tested manufacturing location'' unless the ''tested sales location'' provides a demonstrably greater contribution to the manufacture, production, or construction of the property. The tested manufacturing location is the location of any branch (or similar establishment) or remainder of the controlled foreign corporation that contributes to the manufacture, production, or construction of the personal property, if any, and that would, after applying § 1.954–3(b)(1)(ii)(*b*) to such branch (or similar establishment) or § 1.954–3(b)(1)(i)(*b*) to the remainder of the controlled foreign corporation, be treated as a separate corporation and would impose the lowest effective rate of tax on the income allocated to such branch (or similar establishment) or to the remainder of the controlled foreign corporation under such section (that is, either § 1.954–3(b)(1)(ii)(*b*) or (b)(1)(i)(*b*)). The tested sales location is the location where the branch (or similar establishment) or the remainder of the controlled foreign corporation purchases or sells the personal property. For purposes of this paragraph (b)(1)(ii)(*c*)(*3*)(*iii*), the contribution to the manufacture, production, or construction of the personal property by the tested sales location will be deemed to include the activities of any branch (or similar establishment) or remainder of the controlled foreign corporation that would not be treated as a corporation separate from the tested sales location after the application of § 1.954–3(b)(1)(ii)(*b*) or (b)(1)(i)(*b*). For purposes of this paragraph (b)(1)(ii)(*c*)(*3*)(*iii*), the contribution of the tested manufacturing location to the manufacture, production, or construction of the personal property will be deemed to include any activities of any branch (or similar establishment) or remainder of the controlled foreign corporation that would be treated as a corporation separate from the tested sales location after the application of § 1.954–3(b)(1)(ii)(*b*) or (b)(1)(i)(*b*). Whether the tested sales location provides a demonstrably greater contribution to the manufacture, production, or construction of the personal property is determined by weighing the relative contributions to the manufacture, production, or construction of that property by the tested sales location and the tested manufacturing location under the facts and circumstances test provided in § 1.954–3(a)(4)(iv). See paragraph (b)(1)(ii)(*c*)(*3*)(*v*) *Examples 4, 5,* and *6* of this section. If the tested sales location provides a demonstrably greater contribution to the manufacture, production, or construction of the personal property than the tested manufacturing location or if there is no tested manufacturing location, then the tested sales location is the location of manufacture, production, or construction of that property and the rules of paragraph (b)(1)(ii)(*a*) of this section and § 1.954–3(b)(1)(i)(*a*) will not apply with respect to the sales income related to that property and the use of the purchasing or selling branch (or similar establishment) or the purchasing or selling remainder will not result in a branch being treated as a separate corporation for purposes of paragraph (b)(2)(ii) of this section or § 1.954–3(b)(2)(ii).

(*iv*) *Location of activity.* For purposes of paragraph (b)(1)(ii)(*c*)(*3*) of this section, the location of any activity with respect to the manufacture, production, or construction of an item of personal property is the location where the employees of the controlled foreign corporation perform such activity. For example, the location of any activity concerning intellectual property is determined based on where employees of the controlled foreign corporation develop, or direct the use or development of, the intellectual property, not on the formal assignment of that intellectual property.

(*v*) *Examples.* The following examples illustrate the application of this paragraph (b)(1)(ii)(*c*)(*3*):

Example 1. Multiple branches contribute to the manufacture of a single product, only one branch satisfies § 1.954–3(a)(4)(i). (i) *Facts.* FS is a controlled foreign corporation organized in Country M. FS operates three branches, Branch A, Branch B, and Branch C, located respectively in Country A, Country B, and Country C. Branch A, Branch B, and Branch C each performs different manufacturing activities with respect to the manufacture of Product X. Branch A, through the activities of employees of FS located in Country A, designs Product X. Branch B, through the activities of employees of FS located in Country B, provides quality control and oversight and direction. Branch C, through the activities of employees of FS located in Country C, manufactures Product X (within the meaning of § 1.954–3(a)(4)(ii) or (a)(4)(iii)) using the designs developed by Branch A and under the oversight of the quality control personnel of Branch B. The activities of Branch A and Branch B do not independently satisfy § 1.954–3(a)(4)(i). Employees of FS located in Country M purchase the raw materials used in the manufacture of Product X from a related person and control the work-in-process and finished goods throughout the manufacturing process. Employees of FS located in Country M also manage the manufacturing costs and

capacities related to Product X. Further, employees of FS located in Country M oversee the coordination between the branches. Employees of FS located in Country M sell Product X to unrelated persons for use outside of Country M. The sales income from the sale of Product X is taxed in Country M at an effective rate of tax of 10%. Country C imposes an effective rate of tax of 20% on sales income.

(ii) *Result.* Country C is the location of manufacture for purposes of applying § 1.954–3(b)(1)(ii)(*b*) because only the activities of Branch C independently satisfy § 1.954–3(a)(4)(i). The use of Branch C has substantially the same tax effect as if Branch C were a wholly owned subsidiary corporation of FS because the effective rate of tax on the sales income (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in which Branch C is located (20%). Therefore, sales of Product X by the remainder of FS are treated as sales on behalf of Branch C. In determining whether the remainder of FS will qualify for the manufacturing exception under § 1.954–3(a)(4)(iv), the activities of FS will include the activities of Branch A or Branch B, respectively, if each of those branches would not be treated as a separate corporation under § 1.954–3(b)(1)(ii)(*b*), if that paragraph were applied independently to each of Branch A and Branch B. See paragraph (b)(2)(ii)(*a*) of this section.

Example 2. Multiple branches satisfy § 1.954–3(a)(4)(i) with respect to the same product sold by the controlled foreign corporation. (i) *Facts.* Assume the same facts as in *Example 1*, except for the following. In addition to the design of Product X, Branch A also performs in Country A other manufacturing activities, including those ascribed to FS in *Example 1,* that are sufficient to qualify as manufacturing under § 1.954–3(a)(4)(iv) with respect to Product X. Country A imposes an effective rate of tax of 12% on sales income.

(ii) *Result.* Branch A and Branch C through their activities each independently satisfy the requirements of § 1.954–3(a)(4)(i). Therefore, § 1.954–3(b)(1)(ii)(*b*) is applied by comparing the effective rate of tax imposed on the income from the sales of Product X against the lowest effective rate of tax that would apply to the sales income in either Country A or Country C if § 1.954–3(b)(1)(ii)(*b*) were applied separately to Branch A and Branch C. Country A imposes the lower effective rate of tax, and therefore, Branch A is treated as the location of manufacture for purposes of applying § 1.954–3(b)(1)(ii)(*b*). The effective rate of tax in Country B is not considered because Branch B does not satisfy § 1.954–3(a)(4)(i). Neither Branch A nor Branch C is treated as a separate corporation because the effective rate of tax on the sales income of FS from the sale of Product X (10%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in which Branch A is located (12%). Sales of Product X by the remainder of the controlled foreign corporation are not treated as made on behalf of any branch.

Example 3. Determining the location of manufacture when manufacturing activities performed by multiple branches and no branch independently satisfies § 1.954–3(a)(4)(i). (i) *Facts.* FS, a controlled foreign corporation organized in Country M, purchases raw materials from a related person. The raw materials are manufactured (under the principles of § 1.954–3(a)(4)(ii) or (a)(4)(iii)) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion of the raw materials in Country C. FS has two branches, Branch A and Branch B, located in Country A and Country B respectively. Branch A, through the activities of employees of FS located in Country A, designs Product X. Branch B, through the activities of employees of FS located in Country B, controls manufacturing related logistics, provides oversight and direction during the manufacturing process, and controls the raw materials and work-in-process. FS manages the manufacturing costs and capacities related to the manufacture of Product X through employees located in Country M. Further, employees of FS located in Country M oversee the coordination between the branches. Employees of FS located in Country M also sell Product X to unrelated persons for use outside of Country M. Country M imposes an effective rate of tax on sales income of 10%. Country A imposes an effective rate of tax on sales income of 20%, and Country B imposes an effective rate of tax on sales income of 24%. Neither the remainder of FS, nor any branch of FS independently satisfies § 1.954–3(a)(4)(i). However, under the facts and circumstances of the business, FS as a whole provides a substantial contribution to the manufacture of Product X within the meaning of § 1.954–3(a)(4)(iv).

(ii) *Result.* Based on the facts, neither the remainder of FS (through the activities of its employees in Country M) nor any branch of FS independently satisfies § 1.954–3(a)(4)(i) with respect to Product X, but FS, as a whole, provides a substantial contribution through the activities of its employees to the manufacture of Product X. The remainder of FS, Branch A, and Branch B each provides a contribution through the activities of employees to the manufacture of Product X. Therefore, FS must determine the location of manufacture under paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section The tested sales location is Country M because the remainder of FS performs the selling activities with respect to Product X. The location of Branch A is the tested manufacturing location because the effective rate of tax imposed on FS's sales income by Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country A (20%), and Country A has the lowest effective rate of tax among the manufacturing branches that would, after applying § 1.954–3(b)(1)(ii)(*b*), be treated as a separate corporation. The activities of Branch B will be included in the contribution of Branch A for purposes of determining the location of manufacture of Product X because the effective rate of tax imposed on the sales income by Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country B (24%). Under the facts and circumstances of the business, the activities of the remainder of FS would not provide a demonstrably greater contribution to the manufacture of Product X than the activities of Branch A and Branch B, considered together. Therefore, the location of manufacture is Country A, the location of Branch A.

Example 4. Manufacturing activities performed by multiple branches, no branch independently satisfies § 1.954–3(a)(4)(i), selling activities performed by remainder of the controlled foreign corporation, remainder contribution includes branch manufacturing activities. (i) *Facts.* The facts are the same as *Example 3,* except that the effective rate of tax on sales income in Country B is 12%. In addition, under the facts of the particular business, the activities of employees of FS located in Country B and Country M, if considered together, would provide a demonstrably greater contribution to the manufacture of Product X than the activities of employees of FS located in Country A.

(ii) *Result.* Based on the facts, neither the remainder of FS (through activities of its employees in Country M) nor any branch of FS independently satisfies § 1.954–3(a)(4)(i) with respect to Product X, but FS, as a whole, provides a substantial contribution through the activities of its employees to the manufacture of Product X. The remainder of FS, Branch A, and Branch B each provide a contribution through the activities of their employees to the manufacture of Product X. Therefore, FS must determine the location of manufacture under paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section. The tested sales location is Country M because the remainder of FS performs the selling activities with respect to Product X. The location of Branch A is the tested manufacturing location because the effective rate of tax imposed on FS's sales income by Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country A (20%), and Branch A is the only branch that would, after applying § 1.954–3(b)(1)(ii)(*b*), be treated as a separate corporation. The activities of Branch B will be included in the contribution of the remainder of FS for purposes of determining the location of manufacture of Product X because the effective rate of tax imposed on the sales income by Country M (10%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country B (12%). Under a facts and circumstances analysis, considered together, the activities of Branch B and the remainder of FS would provide a demonstrably greater contribution to the manufacture of Product X than the activities of Branch A. Therefore, the rules of paragraph (b)(1)(ii)(a) of this section will not apply and neither Branch A nor Branch B will be treated as a separate corporation for purposes of paragraph (b)(2)(ii) of this section and § 1.954–3(b)(2)(ii).

Example 5. Manufacturing activities performed by multiple branches, no branch independently satisfies § 1.954–3(a)(4)(i), selling activities performed by remainder of

the controlled foreign corporation and a sales branch. (i) *Facts.* The facts are the same as *Example 3*, except that selling activities are also performed by Branch D in Country D, and Country D imposes a 16% effective rate of tax on sales income. In addition, under the facts and circumstances of the business, the activities of employees of FS located in Country A and Country M, considered together, would provide a demonstrably greater contribution to the manufacture of Product X than the activities of employees of FS located in Country B.

(ii) *Result.* Based on the facts, neither the remainder of FS nor any branch of FS independently satisfies § 1.954–3(a)(4)(i) with respect to Product X, but FS, as a whole, provides a substantial contribution through the activities of its employees to the manufacture of Product X. The remainder of FS, Branch A, and Branch B each provide a contribution through the activities of their employees to the manufacture of Product X. Therefore, FS must determine the location of manufacture under paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section. Further, pursuant to paragraph (b)(1)(ii)(*c*)(*1*) of this section, paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section must be applied separately to the sales income derived by the remainder of FS and Branch D respectively. The results with respect to the remainder of FS in this *Example 6* are the same as in *Example 3*. However, paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section must also be applied with respect to Branch D because Branch D performs selling activities with respect to Product X. Thus, for purposes of that sales income, the location of Branch D is the tested sales location. The location of Branch B is the tested manufacturing location because the effective rate of tax imposed on the Branch D's sales income by Country D (16%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country B (24%), and Branch B is the only branch that would, after applying § 1.954–3(b)(1)(ii)(*b*), be treated as a separate corporation. The manufacturing activities performed in Country M by the remainder of FS and the manufacturing activities performed in Country A by Branch A will be included in Branch D's contribution to the manufacture of Product X for purposes of determining the location of manufacture of Product X with respect to Branch D's sales income because the effective rate of tax imposed on the sales income by Country D (16%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country M (10%) and Country A (20%). Under the facts and circumstances of the business, the activities of Branch D, Branch A, and the remainder of FS, considered together, would provide a demonstrably greater contribution to the manufacture of Product X than the activities of Branch B. Therefore, the rules of paragraph (b)(1)(ii)(*a*) of this section will not apply to Branch D and neither Branch A nor Branch D will be treated as a separate corporation for purposes of paragraph (b)(2)(ii) of this section and § 1.954–3(b)(2)(ii).

Example 6. Determining the location of manufacture when employees of remainder of controlled foreign corporation travel to location of unrelated contract manufacturer to perform manufacturing activities. (i) *Facts.* FS, a controlled foreign corporation organized in Country M, purchases raw materials from a related person. The raw materials are manufactured (under the principles of § 1.954–3(a)(4)(ii) or (a)(4)(iii)) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion of the raw materials in Country C. Employees of FS located in Country M sell Product X to unrelated persons for use outside of Country M. Employees of FS located in Country M engage in product design, manage the manufacturing costs and capacities with respect to Product X, and direct the use of intellectual property for the purpose of manufacturing Product X. Quality control and oversight and direction of the manufacturing process are conducted in Country C by employees of FS who are employed in Country M but who regularly travel to Country C. Branch A, located in Country A, is the only branch of FS. Product design with respect to Product X conducted by employees of FS located in Country A is supplemental to the bulk of the design work, which is done by employees of FS located in Country M. At all times, employees of Branch A control the raw materials, work-in-process and finished goods. Employees of FS located in Country A also control manufacturing related logistics with respect to Product X. Country M imposes an effective rate of tax on sales income of 10%. Country A imposes an effective rate of tax on sales income of 20%. Neither the remainder of FS nor Branch A independently satisfies § 1.954–3(a)(4)(i). However, under the facts and circumstance of the business, FS as a whole (including Branch A) provides a substantial contribution to the manufacture of Product X within the meaning of § 1.954–3(a)(4)(iv).

(ii) *Result.* Based on the facts, neither the remainder of FS nor Branch A independently satisfies § 1.954–3(a)(4)(i) with respect to Product X, but FS, as a whole, provides a substantial contribution through the activities of its employees to the manufacture of Product X. The remainder of FS and Branch A each provide a contribution through the activities of employees to the manufacture of Product X. Therefore, FS must determine the location of manufacture under paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section. The tested sales location is Country M because the remainder of FS performs the selling activities with respect to Product X. The tested manufacturing location is the location of Branch A because the effective rate of tax imposed on the remainder of FS's sales income by Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country A (20%), and Branch A is the only branch that would, after applying § 1.954–3(b)(1)(ii)(*b*), be treated as a separate corporation. Although the activities of traveling employees are considered in determining whether FS, as a whole, makes a substantial contribution to the manufacture of Product X under § 1.954–3(a)(4)(iv), the activities of the employees of FS that are performed in Country C are not taken into consideration in determining whether Country M, the jurisdiction under the laws of which FS is organized, is the location of manufacture under paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section. Activities of employees performed outside the jurisdiction in which the controlled foreign corporation is organized and outside a location in which the controlled foreign corporation maintains a branch or similar establishment, are not considered in determining the location of manufacture. Under the facts and circumstances of the business, the activities of employees of FS performed in Country M do not provide a demonstrably greater contribution to the manufacture of Product X than the activities of employees of FS performed in Country A. Therefore, the location of manufacture is Country A, the location of Branch A.

(*4*) *Use of more than one branch to manufacture, produce, construct, grow, or extract separate items of personal property.* For purposes of paragraphs (b)(1)(ii)(*c*)(*2*) and (b)(1)(ii)(*c*)(*3*) of this section, an *item* of personal property refers to an individual unit of personal property rather than a type or class of personal property.

(2) [Reserved]. For further guidance, see § 1.954–3(b)(2).

(i) [Reserved]. For further guidance, see § 1.954–3(b)(2)(i).

(*a*) Treatment as separate corporations. [Reserved]. For further guidance, see § 1.954–3(b)(2)(i)(*a*).

(*b*) *Activities treated as performed on behalf of the remainder of corporation.* With respect to purchasing or selling activities performed by or through the branch or similar establishment, such purchasing or selling activities will—

(*1*) With respect to personal property manufactured, produced, or constructed by the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation); or

(*2*) With respect to personal property (other than property described in paragraph (b)(2)(i)(*b*)(*1*) of this section) purchased or sold, or purchased and sold, by the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation), be treated on behalf of the remainder of the controlled foreign corporation.

(*c*) [Reserved]. For further guidance, see § 1.954–3(b)(2)(i)(*c*).

(*d*) *Determination of hypothetical tax.* To the extent applicable, the principles of § 1.954–1(d)(2) shall be used in determining, under paragraph (b)(1)(i) of this section and § 1.954–3(b)(1)(i), the effective rate of tax which would apply to the income of the branch or similar establishment under the laws of the

country in which the controlled foreign corporation is created or organized, or in determining, under paragraph (b)(1)(ii) of this section and § 1.954–3(b)(1)(ii), the effective rate of tax which would apply to the income of the branch or similar establishment under the laws of the country in which the manufacturing, producing, constructing, growing, or extracting branch or similar establishment is located.

(*e*) [Reserved]. For further guidance, see § 1.954–3(b)(2)(i)(*e*).

(ii) [Reserved]. For further guidance, see § 1.954–3(b)(2)(ii).

(*a*) *Treatment as separate corporations.* The branch or similar establishment will be treated as a wholly owned subsidiary corporation of the controlled foreign corporation, and such branch or similar establishment will be deemed to be incorporated in the country in which it is located. For purposes of applying the rules of this paragraph (b)(2)(ii) and § 1.954–3(b)(2)(ii), a branch or similar establishment of a controlled foreign corporation treated as a separate corporation purchasing or selling on behalf of the remainder of the controlled foreign corporation under paragraph (b)(2)(ii)(*b*) of this section, or the remainder of the controlled foreign corporation treated as a separate corporation purchasing or selling on behalf of a branch or similar establishment of the controlled foreign corporation under § 1.954–3(b)(2)(ii)(*c*), will include any other branch or similar establishment or remainder of the controlled foreign corporation that would not be treated as a separate corporation (apart from the branch or similar establishment of a controlled foreign corporation that is treated as performing purchasing or selling activities on behalf of the remainder of the controlled foreign corporation under paragraph (b)(2)(ii)(*b*) of this section or the remainder of the controlled foreign corporation that is treated as performing purchasing or selling activities on behalf of the branch or similar establishment under § 1.954–3(b)(2)(ii)(*c*)) if the effective rate of tax imposed on the income of the purchasing or selling branch or similar establishment, or purchasing or selling remainder of the controlled foreign corporation, were tested under the principles of § 1.954–3(b)(1)(i)(*b*) or (b)(1)(ii)(*b*) against the effective rate of tax that would apply to such income if it were considered derived by such other branch or similar establishment or the remainder of the controlled foreign corporation.

(*b*) *Activities treated as performed on behalf of the remainder of corporation.* With respect to purchasing or selling activities performed by or through the branch or similar establishment, such purchasing or selling activities will—

(*1*) With respect to personal property manufactured, produced, or constructed by the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation); or

(*2*) With respect to personal property (other than property described in paragraph (b)(2)(ii)(*b*)(*1*) of this section) purchased or sold, or purchased and sold, by the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation), be treated as performed on behalf of the remainder of the controlled foreign corporation.

(*c*) and (*d*) [Reserved]. For further guidance, see § 1.954–3(b)(2)(ii)(*c*) and (*d*).

(*e*) *Comparison with ordinary treatment.* Income derived by a branch or similar establishment, or by the remainder of the controlled foreign corporation, shall not be determined to be foreign base company sales income under paragraph (b) of this section or § 1.954–3(b) if the income would not be so considered if it were derived by a separate controlled foreign corporation under like circumstances.

(*f*) [Reserved]. For further guidance, see § 1.954–3(b)(2)(ii)(*f*).

(3) [Reserved]. For further guidance, see § 1.954–3(b)(3).

(4) *Illustrations.* The application of this paragraph (b)(4) may be illustrated by the following examples:

Examples (1) and *(2).* [Reserved]. For further guidance, see § 1.954–3(b)(4) *Examples (1)* and *(2).*

Example (3). (i) *Facts.* Corporation E, a controlled foreign corporation incorporated under the laws of foreign Country X, is a wholly owned subsidiary of Corporation D, also a controlled foreign corporation incorporated under the laws of Country X. Corporation E maintains Branch B in foreign Country Y. Both corporations use the calendar year as the taxable year. In 1964, Corporation E's sole activity, carried on through Branch B, consists of the purchase of articles manufactured in Country X by Corporation D, a related person, and the sale of the articles through Branch B to unrelated persons. One hundred percent of the articles sold through Branch B are sold for use outside Country X and 90 percent are also sold for use outside of Country Y. The income of Corporation E derived by Branch B from such transactions is taxed to Corporation E by Country X only at the time Corporation E distributes such income to Corporation D and is taxed on the basis of what the tax (a 40 percent effective rate) would have been if the income had been derived in 1964 by Corporation E from sources within Country X from doing business through a permanent establishment therein. Country Y levies an income tax at an effective rate of 50 percent on income derived from sources within such country, but the income of Branch B for 1964 is effectively taxed by Country Y at a 5 percent rate since under the laws of such country, only 10 percent of Branch B's income is derived from sources within such country. Corporation E makes no distributions to Corporation D in 1964.

(ii) *Result.* In determining foreign base company sales income of Corporation E for 1964, Branch B is treated as a separate wholly owned subsidiary corporation of Corporation E, the 5 percent rate of tax being less than 90 percent of, and at least 5 percentage points less than the 40 percent rate. Income derived by Branch B, treated as a separate corporation, from the purchase from a related person (Corporation D), of personal property manufactured outside of Country Y and sold for use, disposition, or consumption outside of Country Y constitutes foreign base company sales income. If, instead, Corporation D were unrelated to Corporation E, none of the income would be foreign base company sales income because Corporation E would be purchasing from and selling to unrelated persons and if Branch B were treated as a separate corporation it would likewise be purchasing from and selling to unrelated persons. Alternatively, if Corporation D were related to Corporation E, but Branch B manufactured the articles prior to sale under the principles of § 1.954–3(a)(4)(iv), the income would not be foreign base company sales income because Branch B, treated as a separate corporation, would qualify for the manufacturing exception under § 1.954–3(a)(4).

Examples (4) through *(7)* [Reserved]. For further guidance, see § 1.954–3(b)(4) *Examples (4)* through *(7).*

Example (8). Uniformly applicable incentive tax rate in one country. (i) *Facts.* FS is a controlled foreign corporation organized in Country M. FS operates one branch, Branch A, located in Country A. Branch A manufactures Product X within the meaning of § 1.954–3(a)(4)(ii) or (a)(4)(iii). Raw materials used in the manufacture of Product X are purchased by FS from an unrelated person. FS engages in activities in Country M to sell Product X to a related person for use outside of Country M. Employees of FS located in Country M perform only sales functions. The effective rate imposed in Country M on the income from the sale of Product X is 10%. Country A generally imposes an effective rate of tax on income of 20%, but imposes a uniformly applicable incentive rate of tax of 10% on manufacturing income and related sales income.

(ii) *Result.* The use of Branch A to manufacture Product X does not have substantially the same tax effect as if Branch A were a wholly owned subsidiary corporation of FS because the effective rate of tax on FS's sales income from the sale of Product X in Country M (10%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in

which Branch A is located (10%). Consequently, pursuant to § 1.954–3(b)(1)(ii)(*b*), Branch A is not treated as a separate corporation apart from the remainder of FS for purposes of determining foreign base company sales income.

Example (9). Manufacturing activities performed by multiple branches, no branch independently satisfies § 1.954–3(a)(4)(i), selling activities performed by remainder of the controlled foreign corporation, branch manufacturing activities included in remainder contribution. (i) *Facts.* FS, a controlled foreign corporation organized in Country M, has two branches, Branch A and Branch B, located in Country A and Country B respectively. FS purchases raw materials from a related person. The raw materials are manufactured (under the principles of § 1.954–3(a)(4)(ii) or (a)(4)(iii)) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion required to manufacture Product X outside of FS's country of organization. FS manages the manufacturing costs and capacities with respect to the manufacture of Product X through employees located in Country M. Further, employees of FS located in Country M oversee the coordination between the branches. Branch A, through the activities of employees of FS located in Country A, designs Product X, controls manufacturing related logistics, and controls the raw materials and work-in-process during the manufacturing process. Branch B, through the activities of employees of FS located in Country B, provides quality control and oversight and direction during the manufacturing process. Employees of FS located in Country M sell Product X to unrelated persons for use outside of Country M. Country M imposes an effective rate of tax on sales income of 10%. Country A imposes an effective rate of tax on sales income of 12%, and Country B imposes an effective rate of tax on sales income of 24%. None of the remainder of FS, Branch A, or Branch B independently satisfies § 1.954–3(a)(4)(i). However, under the facts and circumstances of the business, FS, as a whole, provides a substantial contribution to the manufacture of Product X within the meaning of § 1.954–3(a)(4)(iv). Under the facts and circumstances of the business, the activities of the remainder of FS and Branch A, if considered together, would not provide a demonstrably greater contribution to the manufacture of Product X than the activities of Branch B. Under the facts and circumstances of the business, however, the activities of the employees of the remainder of FS and Branch A, if considered together, would constitute a substantial contribution to the manufacture of Product X.

(ii) *Result.* Based on the facts, neither the remainder of FS (through activities of its employees in Country M) nor any branch of FS independently satisfies § 1.954–3(a)(4)(i) with respect to Product X, but FS, as a whole, provides a substantial contribution through the activities of its employees to the manufacture of Product X. The remainder of FS, Branch A, and Branch B each provide a contribution through the activities of employees to the manufacture of Product X. Therefore, FS must determine the location of manufacture under paragraph (b)(1)(ii)(*c*)(*3*)(*iii*) of this section. The tested sales location is Country M because the remainder of FS performs the selling activities with respect to Product X. The location of Branch B is the tested manufacturing location because the effective rate of tax imposed on FS's sales income by Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country B (24%); and Branch B is the only manufacturing branch that would, after applying § 1.954–3(b)(1)(ii)(*b*), be treated as a separate corporation. The manufacturing activities performed in Country A will be included in the contribution of the remainder of FS for purposes of determining the location of manufacture of Product X because the effective rate of tax imposed on the sales income by Country M (10%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country A (12%). Under the facts and circumstances of the business, the manufacturing activities of the remainder of FS and Branch A, considered together, would not provide a demonstrably greater contribution to the manufacture of Product X than the activities of Branch B. Therefore, the location of manufacture is Country B, the location of Branch B. In determining that Country B is the location of manufacture, it was determined that after applying § 1.954–3(b)(1)(ii)(*b*) Branch B would be treated as a separate corporation under paragraph (b)(1)(ii)(*a*) of this section for purposes of determining foreign base company sales income. To determine whether income from the sale of Product X is foreign base company sales income, the remainder of FS takes into account the activities of Branch A because, under paragraph (b)(2)(ii)(*a*) of this section, Branch A would not be treated as a separate corporation apart from FS. The remainder of FS is considered to have manufactured Product X under § 1.954–3(a)(4)(i) because the manufacturing activities of the remainder of FS and Branch A, considered together, would make a substantial contribution to the manufacture of Product X within the meaning of § 1.954–3(a)(4)(iv). Therefore, income derived from the sale of Product X by the remainder of FS does not constitute foreign base company sales income.

(c) [Reserved]. For further guidance, see § 1.954–3(c).

(d) [Reserved]. For further guidance, see § 1.954–3(d).

(e) *Effective/applicability date of temporary regulations.* Paragraphs (b)(1)(i)(*c*), (b)(1)(ii)(*a*), (b)(1)(ii)(*c*), (b)(2)(i)(*b*), (b)(2)(ii)(*a*), (b)(2)(ii)(*b*), (b)(2)(ii)(*e*), and (b)(4) *Example (3)*, *Example (8)*, and *Example (9)* of this section shall apply to taxable years of controlled foreign corporations beginning after June 30, 2009, and for taxable years of United States shareholders in which or with which such taxable years of the controlled foreign corporations end.

(f) *Application of temporary regulations to earlier taxable years.* For the application of these temporary regulations retroactively with respect to taxable years of controlled foreign corporations and to open taxable years of United States shareholders in which or with which such taxable years of the controlled foreign corporations end, see § 1.954–3(d).

(g) *Expiration date.* The applicability of this section expires on or before December 23, 2011.

Linda E. Stiff,

Deputy Commissioner for Services and Enforcement.

Approved: December 18, 2008.

Eric Solomon,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. E8–30727 Filed 12–24–08; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 31

[TD 9440]

RIN 1545–BI39

Employer's Annual Federal Tax Return and Modifications to the Deposit Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations relating to the annual filing of Federal employment tax returns and requirements for employment tax deposits. These temporary regulations relate to sections 6011 and 6302 of the Internal Revenue Code (Code) concerning reporting and paying income taxes withheld from wages and reporting and paying taxes under the Federal Insurance Contributions Act (FICA) (collectively, ''employment taxes''). These temporary regulations generally allow certain employers to file a Form 944, ''Employer's ANNUAL Federal Tax Return,'' rather than Form 941, ''Employer's QUARTERLY Federal Tax Return.'' In addition to rules related to Form 944, the temporary regulations provide an additional method for employers who file Form 941 to determine whether the amount of accumulated employment taxes is considered de minimis. The portions of this document that are final regulations