

IRS Issues Final Subpart F Branch Rule Regulations

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On December 15, 2011, the U.S. Department of the Treasury and the Internal Revenue Service released final regulations addressing the application of the foreign base company sales income rules of subpart F to controlled foreign corporations with branches or similar establishments. These regulations finalize prior temporary regulations, with three clarifying changes. Further guidance in the area is also in the works.

Overview

On December 15, 2011, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) released final regulations addressing the application of the foreign base company sales income (FBCSI) rules of subpart F to controlled foreign corporations (CFCs) with branches or similar establishments (T.D. 9563, published in the Federal Register on December 19, 2011). These regulations finalize 2008 temporary regulations that had been set to expire before the end of 2011. The new regulations make three clarifying changes to the 2008 temporary regulations, and the preamble to the new regulations indicates that more extensive guidance is under consideration.

A detailed summary of the 2008 regulations can be found in [IRS Issues Revised Subpart F Contract Manufacturing Regulations](#).

Background: Branch Rule Implications of "Substantial Contribution" Manufacturing

Income derived by a foreign subsidiary of a U.S. corporation from the sale of products is not generally subject to U.S. taxation on a current basis. However, income of a CFC is currently included in the income of the U.S. parent corporation if (among other things) it falls within the definition of FBCSI. Generally, income of a CFC that neither purchases products from related persons nor sells them to related persons, and that does not purchase or sell the products on behalf of related persons should not constitute FBCSI. In addition, income of a CFC that manufactures the products it sells generally should fall outside the definition of FBCSI. The branch rules mark an exception to the foregoing and,

where applicable, can cause a portion of the CFC's income to be treated as FBCSI.

Final regulations issued at the end of 2008 expanded the definition of "manufacturing" for purposes of the FBCSI manufacturing exception and branch rules. Under these regulations, manufacturing includes not only the physical transformation, assembly or conversion of property (physical manufacturing), but also "substantial contributions" to physical manufacturing.

Seven specific categories of activities are provided, to be weighed (potentially with relevant non-listed activities) based on the facts and circumstances of the particular business: (i) oversight and direction of physical manufacturing; (ii) physical manufacturing activities that do not otherwise satisfy the manufacturing exception; (iii) material selection, vendor selection, or control of raw materials, work-in-process, and finished goods; (iv) management of manufacturing costs or capacities; (v) control of manufacturing-related logistics; (vi) quality control; and (vii) developing, or directing the use or development of, certain intangible property.

Although this expanded definition of manufacturing was a welcome development from the perspective of the FBCSI general rule, it created a host of new issues under the branch rules, because activities not previously considered "manufacturing" could now give rise to manufacturing branches. While the general rules providing for substantial contribution manufacturing were issued as final regulations in 2008, the regulations addressing the resulting branch rule issues were issued in temporary and proposed form due to the complexity of these issues.

Under the branch rules, FBCSI may result where a CFC carries on purchasing, selling or manufacturing activities outside its country of organization through a "branch or similar establishment." The manufacturing branch rule can apply even if the CFC satisfies the manufacturing exception under the general FBCSI rule and even if the manufacturing exception is not the basis for the general rule being inapplicable (e.g., there is no related person, purchase or sale). The branch rules apply, however, only if the use of the branch or similar establishment has substantially the same tax effect as if such branch or similar establishment were a separate corporation, which is determined under regulations using an effective tax rate disparity test. A tax rate disparity exists if the actual tax rate in the sales or purchase location is less than 90 percent of, and at least 5 percentage points lower than, the hypothetical effective tax rate in the manufacturing location. If such a tax rate disparity exists, the sales or purchase branch is treated as a separate CFC that performs selling or purchasing activities on behalf of the manufacturing location. The general FBCSI rules (including the same-country exclusions and the manufacturing exception) are then applied to the deemed separate CFC. The income of each sales or purchase location is tested separately for these purposes.

Although a CFC may perform physical or substantial contribution manufacturing activities in multiple locations, the 2008 temporary (now final) regulations treat each CFC as having a single manufacturing location for FBCSI purposes, determined with the assistance of tie-breaker and activity-aggregation rules as needed. When full manufacturing of any kind (physical or substantial contribution) is performed in more than one location, the location of manufacturing will be the lowest-rate jurisdiction of these locations (a taxpayer-favorable tie-breaker rule). If no CFC location independently satisfies any of the manufacturing tests, but the CFC as a whole satisfies the substantial contribution test, then the manufacturing location will be deemed to be the location of sales or purchase (and thus no FBCSI will arise) if the sales or purchase location, together with jurisdictions with no defined effective tax rate disparity relative to the sales or purchase location, provides a "demonstrably greater" (or, under the new final regulations, simply a "greater") contribution to the manufacture of the product compared to the contribution of the other locations.

Otherwise, the location of manufacture will be deemed to be a location that has a tax rate disparity relative to the sales or purchase location (and FBCSI may arise).

The 2008 temporary (now final) regulations also provide that, if separate-corporation treatment applies under the branch rule, the activities of all locations that do not have a defined effective tax rate disparity relative to the sales or purchase location are aggregated for purposes of determining whether the sales or purchase income of a branch is FBCSI when tested on a separate-corporation basis.

Three recent private letter rulings shed further light on the IRS's approach to certain branch rule issues. PLR 200942034 addresses the role of local law in applying the effective tax rate disparity test, PLR 200945036 addresses the application of the tax rate disparity test and the treatment of a sales branch as a separate corporation in situations involving multiple sales and substantial contribution manufacturing locations, and PLR 201002024 addresses several issues, including the aggregation of activities of different branches, the definition of a CFC remainder, and the application of the branch rule in the partnership context. PLR 201002024 left open the question whether, in addition to activities, the income of similar-rate locations might be aggregated when applying the FBCSI rules to a sales or purchase location on a separate-corporation basis. This issue is directly addressed in the new final regulations.

Final Regulations

The new final regulations finalize the 2008 temporary regulations with a few clarifying changes, and with the same effective date as the 2008 temporary regulations – generally taxable years of CFCs beginning after June 30, 2009, and taxable years of U.S. shareholders in which or with which such CFC taxable years end.

The first clarification is to remove the word “demonstrably” from the 2008 temporary regulations’ “demonstrably greater” test for determining the location of manufacturing in situations in which no single CFC location independently satisfies any of the manufacturing definitions. Thus, in these situations, the manufacturing location will be deemed to be the location of sales or purchase (and therefore no FBCSI will arise) if the sales or purchase location, together with jurisdictions with no tax rate disparity relative to the sales or purchase location, provides a “greater” contribution to the manufacture of the product compared to the contribution of the other jurisdictions, as opposed to a “demonstrably greater” contribution. In the preamble to the final regulations, Treasury and the IRS state that this change is intended to eliminate a concern that an elevated standard of proof was intended as an evidentiary matter.

The final regulations also clarify the activity-aggregation rule that applies when the FBCSI rules are applied to a sales or purchase location treated as a separate CFC. This rule is clarified to eliminate any implication that the income of various branches is aggregated, as opposed to just the activities. Therefore, the aggregation rule should not affect the amount of income that is tested with respect to a particular sales or purchase location.

Additionally, the final regulations eliminate a coordination rule between the sales and manufacturing branch rules, because the regulations elsewhere make it clear that only the manufacturing branch rule (rather than the sales or purchase branch rule) can apply in situations involving a combination of manufacturing and sales or purchase branches.

Although the new final regulations make a few helpful clarifications, many difficult and longstanding interpretative issues under the branch rules remain unaddressed (including many issues that pre-date the substantial contribution regulations). In the preamble to the final regulations, Treasury and the IRS state that they continue to study FBCSI issues and that they may issue additional guidance, including guidance regarding when a branch should be treated as a separate corporation under the branch rule. An IRS official has indicated that this guidance may focus in particular on the definition of a branch for these purposes, but that a range of other issues also could be considered.

The preamble further indicates that Treasury and the IRS may issue guidance addressing the scope of, and relationship between, the FBCSI and the foreign base company services income rules.

Treasury and the IRS have invited comments on these issues. Companies that face difficult technical issues under the branch rules, or potential interactions and overlaps between the FBCSI and the foreign base company services income rules, might consider whether now is a good time to make their views known to Treasury and the IRS.

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