Tax Incentives to Conduct Offshore Manufacturing under Current Law

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Manufacturing Location Decisions under Current Law

- U.S. multinational corporations often seek to maximize their tax-deferred foreign earnings by holding high-profit intellectual property in foreign subsidiaries (CFCs).

- To do so, U.S. multinationals must structure their operations so that the CFC's income is not subject to current taxation in the United States, under subpart F or otherwise.

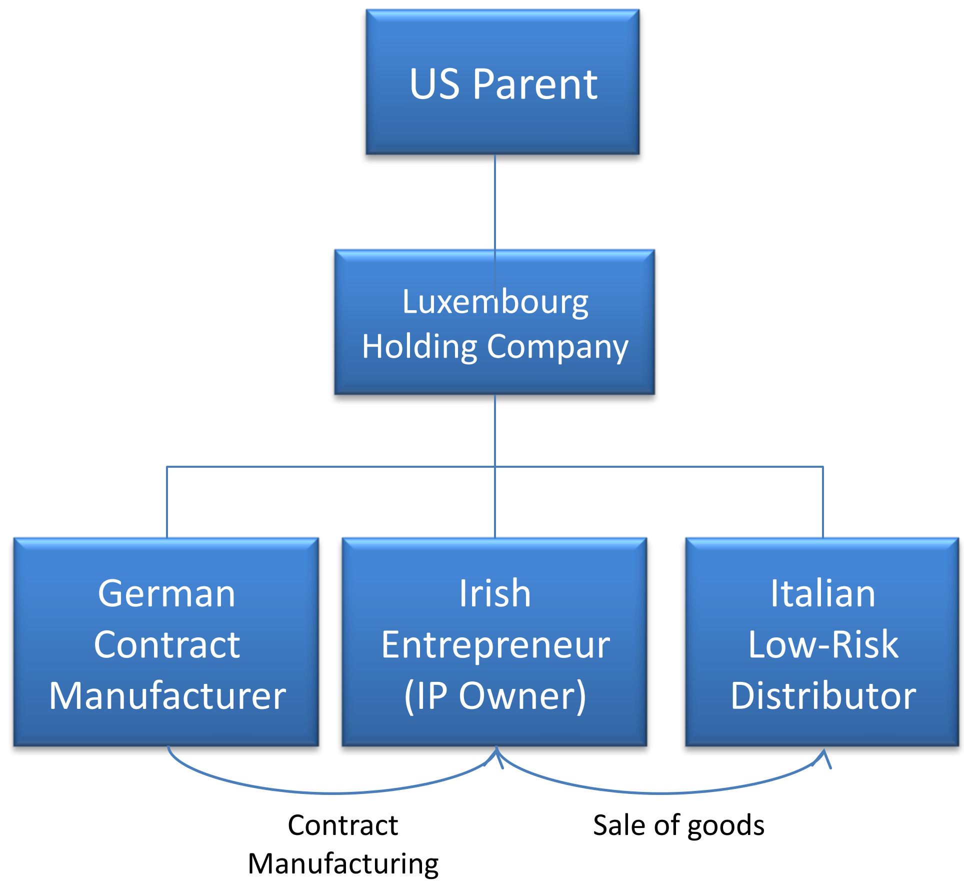
- In most situations, a CFC can most readily earn IP income without being subject to current U.S. taxation if the CFC, either directly or through a contract manufacturer, conducts manufacturing activities *outside the United States*.

- As a result, under the current system of worldwide taxation with deferral as limited by subpart F, U.S. multinationals face significant hurdles in conducting domestic manufacturing to the extent the associated intellectual property is held outside the United States.

Common Foreign IP Holding Structures

Common IP Holding Structures: Principal Structure

- U.S. multinationals will often structure their operations such that their intellectual property, or some portion thereof, is managed and exploited by a central foreign IP holding company (“Foreign Entrepreneur”) that assumes the business risks – and earns the profits – associated with IP ownership and management.
- IP is transferred through a cost-sharing or licensing arrangement.
- The affiliated Foreign Entrepreneur will be responsible for manufacturing directly or hiring and supervising contract manufacturers, and reselling product to low-risk distribution affiliates in the countries of sale.
- The Foreign Entrepreneur will earn the residual profit associated with the purchase and resale of goods.



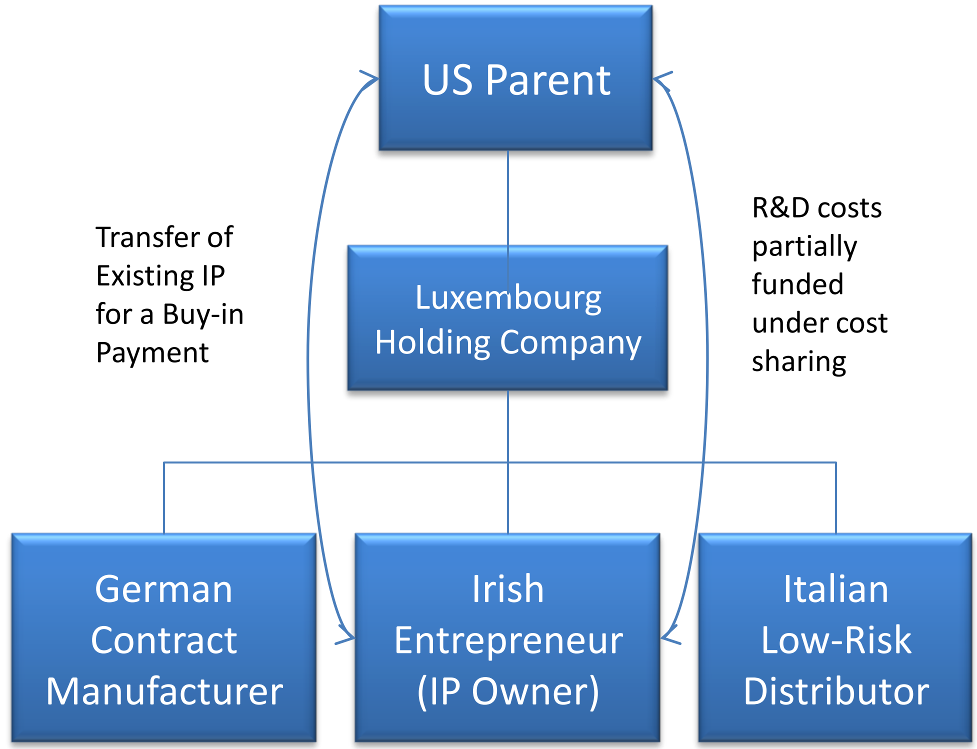
Common IP Holding Structures: Cost Sharing

- In a cost sharing structure, the U.S. Parent will transfer the rights to existing intangibles – generally only in foreign markets – to a foreign affiliate (the Foreign Entrepreneur) in exchange for an initial buy-in payment.
  - The buy-in payment will constitute taxable income of the US Parent.
  - The payment can take the form of a one-time payment or a royalty to be paid over time.

- Thereafter, the Foreign Entrepreneur will be responsible for funding the portion of global R&D costs associated with the ongoing development of IP in its territory.
  - The portion funded by the Foreign Entrepreneur is typically determined by the ratio of foreign sales revenue to global sales revenue of products related to the funded IP.

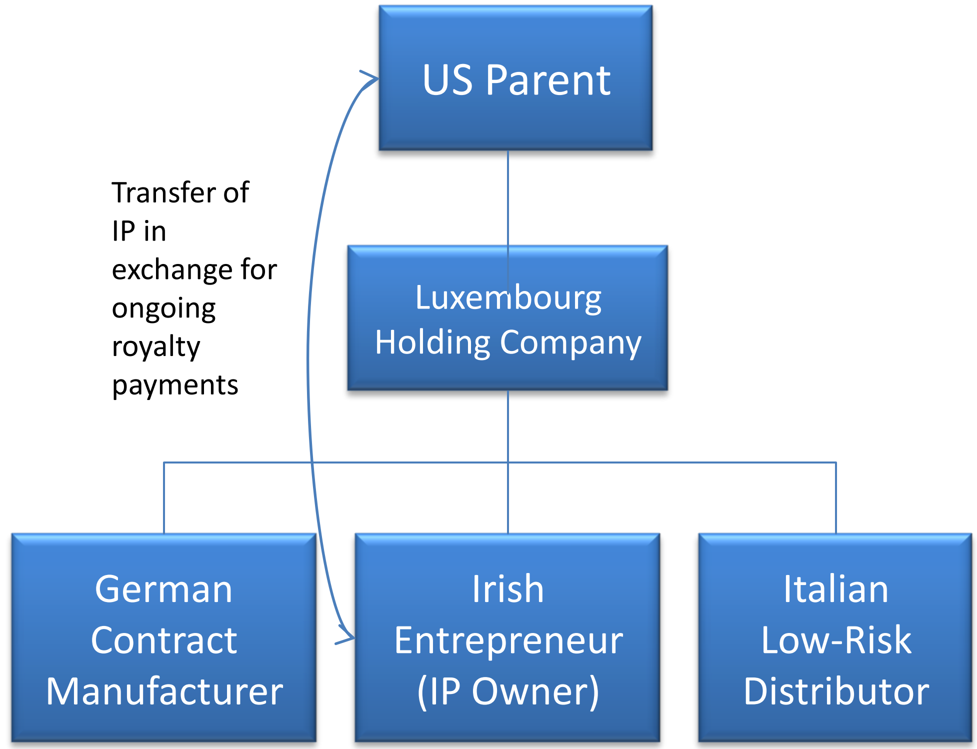
- One or more domestic affiliates will perform the R&D services funded under the cost-sharing agreements.

- The Foreign Entrepreneur will then directly or through affiliates manufacture and distribute the product, and the Foreign Entrepreneur will earn the profit associated with the ownership of the IP in its territory.



Common IP Holding Structures: Licensing

- In a licensing structure, the U.S. parent will transfer the rights to existing intangibles to a foreign affiliate (the Foreign Entrepreneur) in exchange for ongoing royalty payments.
- The royalty payments will constitute taxable income of the US Parent.
- The Foreign Entrepreneur may fund future R&D related to the licensed products.
- The Foreign Entrepreneur will then directly or through other affiliates manufacture and distribute the product, and the Foreign Entrepreneur will earn the profit associated with the IP rights it has licensed.



Obtaining Deferral on Income from Manufacturing for Foreign Markets

Manufacturing in U.S. for Export

- A domestic corporation that manufactures in the U.S. for export is subject to taxation on its income at a 35% statutory rate.

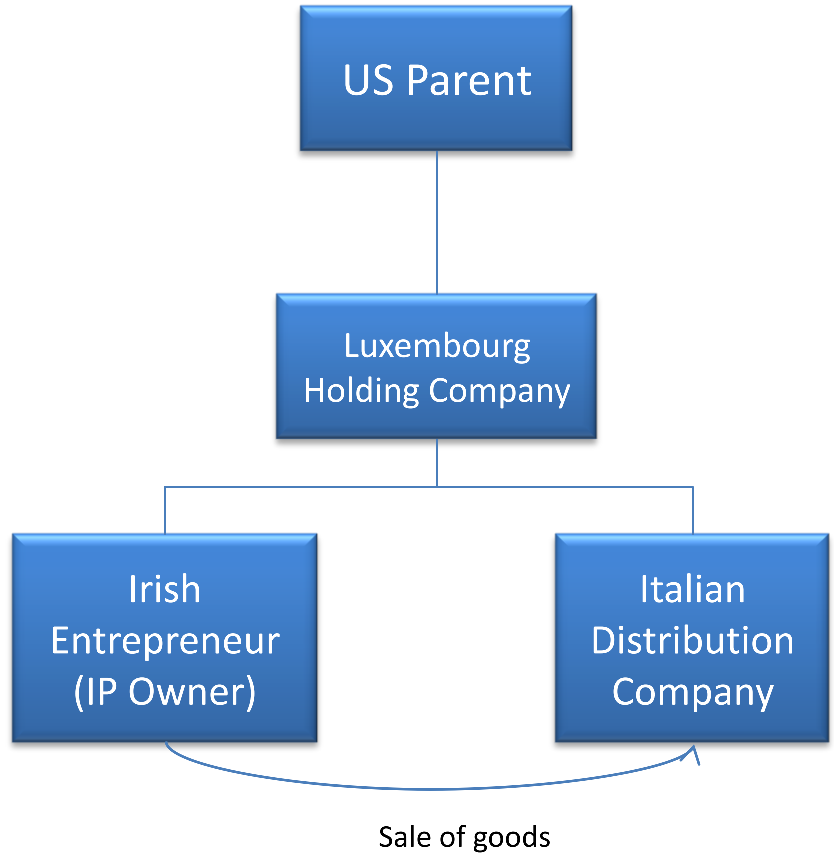
- Various tax incentives that were designed to reduce the tax rate on such export income – e.g., DISC, FSC, and ETI – were rejected under the GATT and WTO rules.

- The effective tax rate on export income can be reduced by:
  - accelerated depreciation;
  - the section 199 deduction for domestic production activities;
  - the use of third-party debt financing;
  - cross-crediting
    - 50% of export income is characterized as foreign source income, increasing a domestic corporation's foreign tax credit limitation and potentially allowing the corporation to claim additional credits on other high-tax foreign income.
    - Over the past ten years, the value of cross-crediting has substantially diminished as foreign countries have reduced their corporate tax rates.

- For products with high IP values, the value of depreciation and interest deduction in reducing the domestic effective tax rate can be relatively small given how much of the income is attributable to intellectual property. For example, the cost of manufacturing many pharmaceutical products is 5% or less of customer revenues while overall product margins on such products can be 30% of revenues or greater.

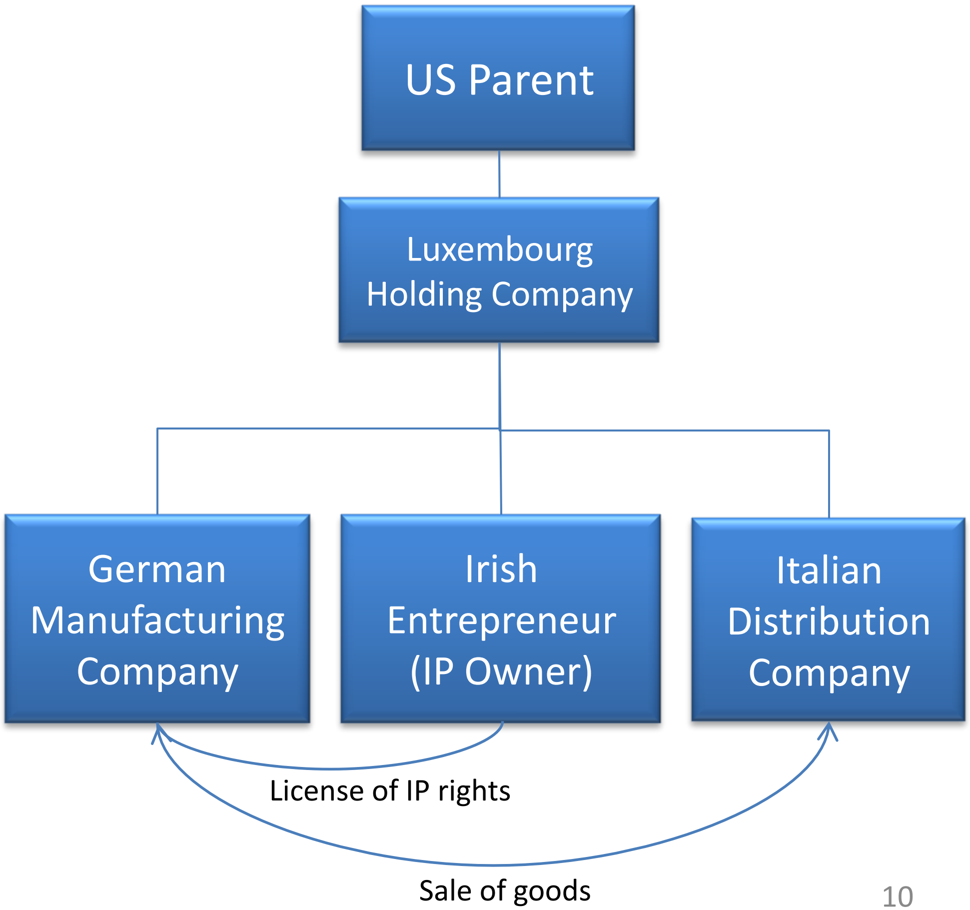
CFC Manufacturing in Low-Tax Foreign Jurisdiction

- As a general matter, CFCs are not subject to taxation in the U.S. unless they have a permanent establishment in the U.S.
- The U.S. Parent can be taxed on the CFC income on a current basis if the income is includible under subpart F.
- Two categories of subpart F income are potentially relevant in this context:
  - foreign personal holding company income
  - foreign base company income
- Where the Irish Entrepreneur manufactures the goods in its own factory and sells them to the Italian distribution company for resale in Italy, the CFCs' income will not be subject to current under subpart F.
- If the Irish Entrepreneur owned manufacturing facilities in the U.S., all IP profit would be subject to direct U.S. tax.



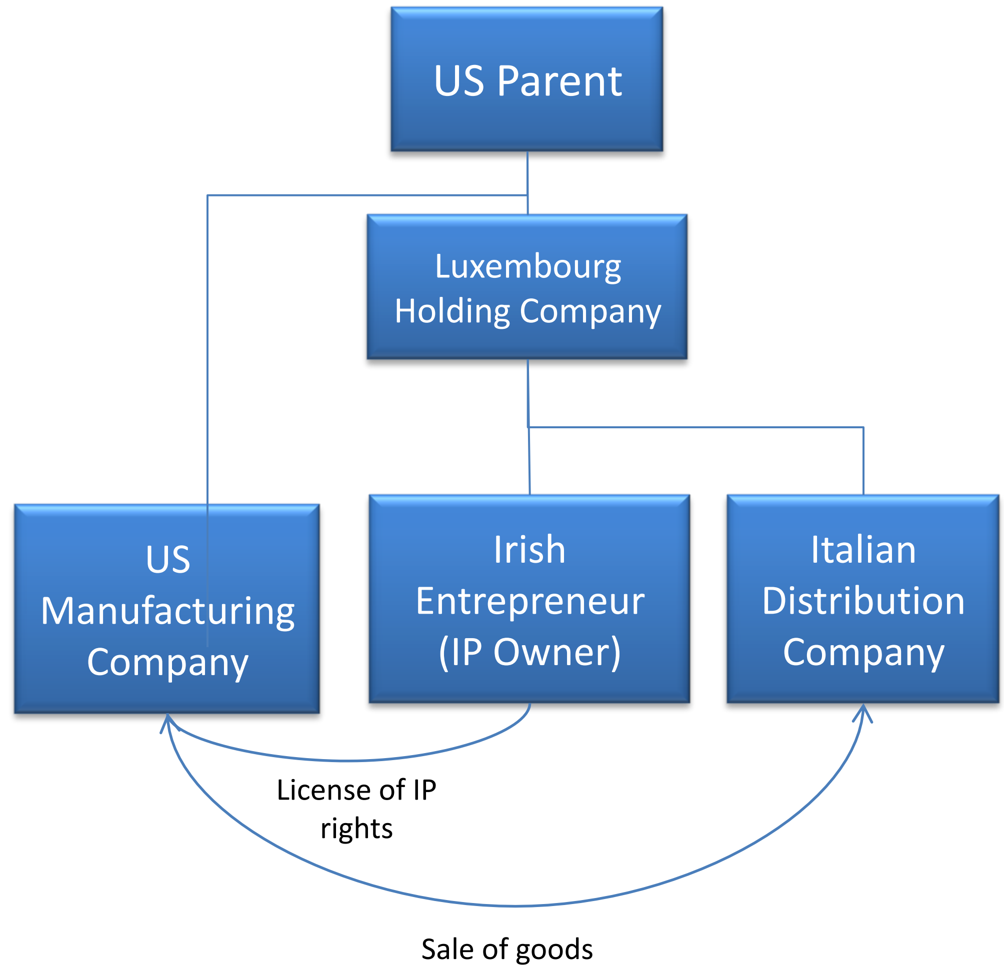
CFC Manufacturing in High-Tax Foreign Jurisdiction – Royalty Model:
Avoiding Subpart F Foreign Personal Holding Company Income

- In this scenarios, the Irish Entrepreneur earns royalty income from the German manufacturer.
- Royalty income is generally subject to inclusion as foreign personal holding company income under section 954(c)(1)(A).
- However, under section 954(c)(6), the royalty income paid by the German company to the Irish company will not be includible under subpart F.
- Section 954(c)(6) is currently set to expire at the end of 2013.
- In the absence of section 954(c)(6), the U.S. Parent could check-the-box to treat the German company and the Irish Entrepreneur as disregarded entities, thereby eliminating the intercompany royalty for U.S. federal income tax purposes.



Comparison to Irish Entrepreneur Using a U.S. Manufacturing Company

- In this scenarios, the Irish principal company will earn royalty income from the US manufacturer.
- Section 954(c)(6) does not apply to the royalty paid to the Irish Entrepreneur by a U.S. company, and check-the-box planning would result in direct U.S. taxation of the IP income.
- As a result, the use of a U.S. manufacturer would result in little if any deferral benefit for the Irish Entrepreneur.



CFC Manufacturing in High-Tax Foreign Jurisdictions – Contract Manufacturing Model:

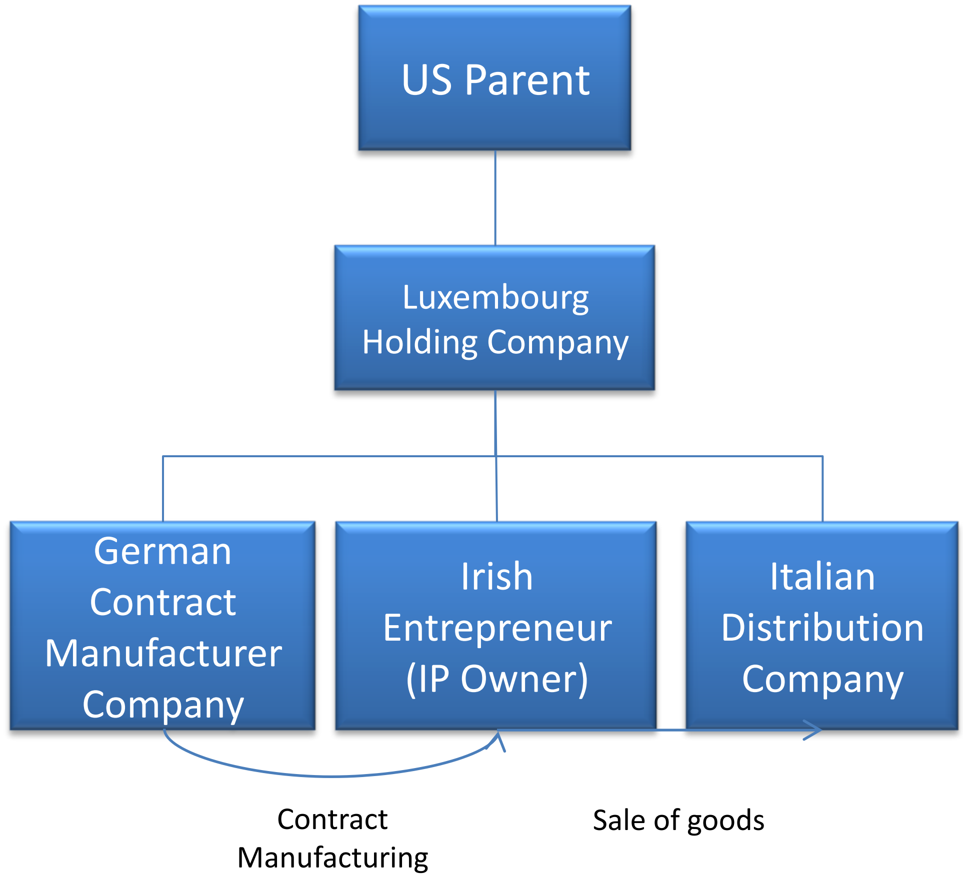
Avoiding Subpart F Foreign Base Company Sales Income

- Under section 954(d), the Irish company's income from its buy-sell operation will be foreign base company sales income unless the Irish company is considered the "manufacturer" of those goods.

- A CFC is considered the manufacturer of goods if it "substantially contributes" to the manufacture of the goods through its oversight of a contract manufacturer. Treas. Reg. § 1.954-3(a)(4)(iv).

- The "substantial contribution" regulations were promulgated in 2008; prior to that time the law in this area was unclear.

- The CFC's "substantial contribution" must be done using its own employees.



Contract Manufacturing: Substantial Contribution

- Treasury Regulation § 1.954-3(a)(4)(iv)(b) sets forth the following non-exclusive list of activities involved in determining whether a CFC satisfies the substantial contribution test:
  - Oversight and direction of the manufacturing process
  - Material selection, vendor selection, or control of raw materials, work-in-process, or finished goods
  - Management of manufacturing costs and capacities (e.g., management of risk of loss or cost efficiency initiatives)
  - Control of manufacturing related logistics
  - Quality control
  - Developing or directing the use or development of product design, trade secrets, or other IP for use in manufacturing.

- The Irish Entrepreneur must satisfy this test without being deemed to have a permanent establishment in Germany.

- The Irish Entrepreneur must satisfy the German tax authority that the German contract manufacturer is adequately compensated.

Contract Manufacturing Model: Same Country Exception

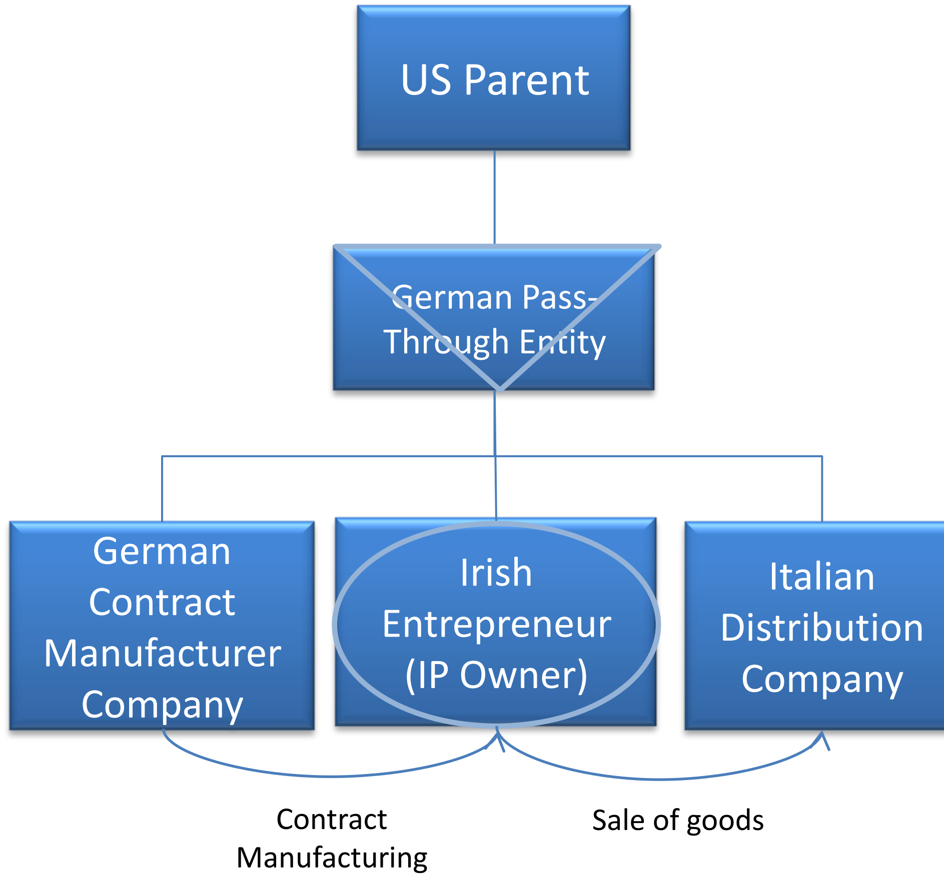
Avoiding the Substantial Contribution Requirements

- Under section 954(d)(1)(A), a CFC's income from the sale of goods to a related party will not be foreign base company sales income if the good is manufactured by the CFC or another party in the CFC's home country.

- The German Pass-Through Entity is treated as a pass-through for German tax purposes, but US Parent elects to treat it as a corporation for U.S. tax purposes. The German Contract Manufacturer and Irish Entrepreneur are treated as disregarded entities.

- The income of the German Contract Manufacturer and the Irish Entrepreneur is treated as income of the German Pass-Through Entity for U.S. tax purposes, and is not foreign company sales income because the good sold to the related party distributor is manufactured in the German CFC's home country.

- From a foreign perspective, the IP income is earned by an Irish entity and is not subject to taxation in Germany.

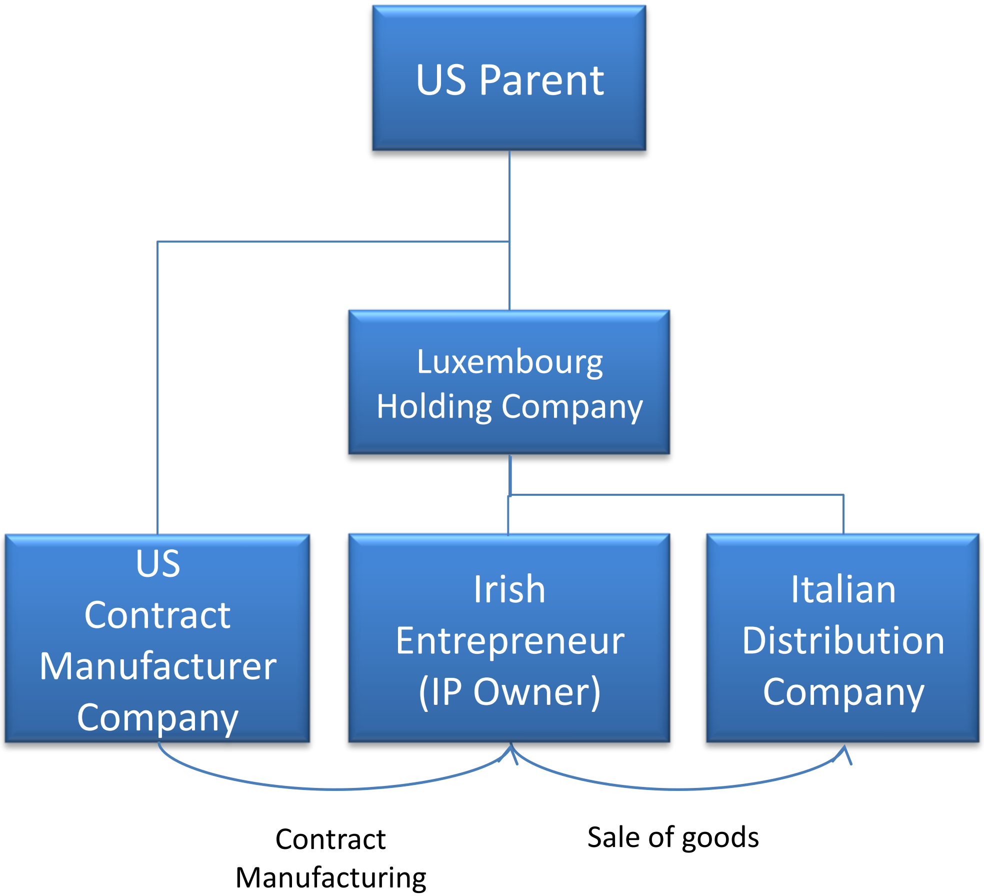


Comparison to Irish Entrepreneur Using a U.S. Contract Manufacturer

- Subpart F Risk
  - The Irish principal company must meet the "substantial contribution" test to avoid current taxation under subpart F.
  - Practical limitations of having the Irish Entrepreneur supervising the U.S. manufacturing affiliate of a U.S. parent company.

- PE Risk
  - The "substantial contribution" activities of the Irish company might constitute a U.S. permanent establishment.
  - Practical limitations of having the Irish Entrepreneur supervise the U.S. manufacturer from outside the United States.

- Transfer Pricing Risk
  - Given that the U.S. is performing R&D for U.S. sales, conducts manufacturing for U.S. sales, and indirectly distributes for U.S. sales, it may be difficult to argue that the residual profit is allocated to the Irish Entrepreneur. For export sales, the argument is stronger but still difficult.



Summary of Current Law Impediments to Domestic Manufacturing

- **Subpart F – foreign personal holding company income (section 954(c)) and foreign base company sales income (Section 954(d))**
- **US PE Risk**
- **US transfer pricing risk**

Options for Reform

- Expand Subpart F
  - Repeal section 954(c)(6) and the check-the-box rules.
  - Expand foreign base company sales income by prohibiting contract manufacturing (i.e., not treating the supervisor of a contract manufacturer as satisfying the manufacturing exception), and eliminating the same country exception.
  - These would have the effect of substantially curtailing the availability of deferral on foreign earnings, where the manufacturing operations are conducted outside the low-tax country.
  - Low-taxed CFCs that own their own manufacturing facilities would continue to be able to obtain deferral on their IP income.

- Narrow Subpart F & Clarify Transfer Pricing Rules
  - Subpart F could be narrowed, particularly in the context of broader international tax reform, to end the bias against U.S. manufacturing for export with minimal risk of raising a WTO challenge.
  - Eliminate the foreign base company sales income rules so that a CFC could use either a U.S. or foreign contract manufacturer without its buy-sell income being subject to current U.S. taxation.
  - Exclude from foreign personal holding company income any royalties paid by a domestic manufacturer to a CFC, so that a CFC could license its IP to either a foreign manufacturer or a domestic manufacturer without the royalty income being subject to current taxation.
    - To protect the U.S. tax base, U.S. tax might be imposed on income from the sale of goods by low-taxed CFCs into the U.S. market.
  - Make clear, by regulation or otherwise, that the appropriate compensation to be earned by a domestic contract manufacturer is the same as the compensation that would be earned by a third-party contract manufacturer under the same circumstances.