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Corporate Tax Alert

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LB&I Instructs Field Agents on How to Audit the Subpart F Manufacturing Exception

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In the midst of all the hubbub surrounding the new tax reform law, the IRS Large Business & International division last week quietly posted to its website a new "Practice Unit" to educate its examiners on how to audit a taxpayer's reliance on the subpart F substantial contribution test under the manufacturing exception.

Practice Units are not considered official IRS guidance and taxpayers cannot rely upon them, but this Practice Unit offers insight into how the IRS will approach the subpart F substantial contribution exception on audit – and it could signal the IRS's intention to bump up exam activity in this area.

Taxpayers relying on the exception would be well advised to review the document and discuss with their tax advisors its potential impact on their audit strategy.

<u>Background - Substantial Contribution Test</u>

Under subpart F, a U.S. shareholder of a controlled foreign corporation (a "CFC") will be subject to tax in the U.S. on its share of the CFC's subpart F income. One type of subpart F income is foreign base company sales income, which is income earned by a CFC in connection with personal-property sales involving a related party when the goods at issue are manufactured and sold for use outside the CFC's home country.

An exception to this inclusion rule applies to CFC income "derived in connection with the sale of personal property manufactured, produced, or constructed by such corporation."[1] A U.S. shareholder can claim this manufacturing exception if it can satisfy one of three tests. Two of the tests focus largely on physical manufacturing. The substantial contribution test, which is the subject of the new IRS document, applies where the CFC cannot satisfy the other tests.

To meet the substantial contribution test, a taxpayer must be able to demonstrate that the CFC's employees make a substantial contribution to the manufacture of the property at issue. The regulations, which were finalized in 2008 (T.D. 9438), list seven key indicia of manufacturing – activities such as oversight and direction of the manufacturing process, involvement in quality control, and control of manufacturing-related logistics, to name a few – and outline principles for applying them to particular facts.

[1] Treas. Reg. §1.954-3(a)(4)(i).

Long Road Ahead

The new Practice Unit serves as a guide for field agents who are auditing a taxpayer's substantial contribution position. Notably, it instructs the examiner to perform a full-blown functional analysis "to identify what activities are performed in manufacturing the property and who performs these activities." It further explains,

> The functional analysis will give the examiner a clear picture of the entire manufacturing process and the relative significance of the activities performed by the CFC's employees with respect to that process. Note, however, that the functional analysis … should focus on whether the activities of the CFC itself are substantial without comparing those activities to the activities of other persons. By understanding the importance of the contribution of the CFC's employees' activities relative to the entire manufacturing process (not relative to other persons), the examiner can properly determine whether the CFC makes a substantial contribution to the manufacture of a particular product, when considering the key elements of the manufacturing process for that particular product.

The instruction for LB&I examiners to perform a functional analysis could signal a long road ahead for an affected taxpayer. The guide urges examiners to begin the process early in the exam, because "[p]erforming a functional analysis can be a time-consuming process." It also encourages – more than once – examiners to consult with IRS engineers as part of the process, a step that may add additional delay, given constraints in IRS resources. As a result, if a substantial contribution issue shows up on a taxpayer's audit plan, it is possible the plan may be accompanied by a request to keep open the statute of limitations for longer than usual.

Key Themes

A couple of key themes emerge from the guide's discussion of the seven "key" factors and the eleven examples in the regulations. First, the document repeatedly emphasizes the point, made clear in the regulations, that bare contractual rights – to control materials, or to oversee and direct manufacturing, or the ownership of IP, for example – are not considered in the substantial contribution test. CFC employees must be actually engaged in the performance of related activities; merely having the right to do so is not enough. While this is not new ground for the IRS, it re-emphasizes that field agents should not be impressed by "paper tigers" – i.e., entities that possess significant contractual rights, but don't actually perform any activities.

Second, the Practice Unit repeatedly notes that the application of particular factors will be different from industry to industry, item to item. For example, the quarterly, weeklong quality control visits described in Example 11 of the regulations may be sufficient to ensure the manufacturing quality of commoditized goods, but a heavier hand in quality control may be required in the case of "high-precision, specialized" goods. Twice the document uses the phrase, not found in the regulations, "industry-sufficient substantial contribution activities."

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Next Steps

Although a Practice Unit comes loaded with disclaimers about how it cannot be relied upon as guidance, it may signal a potential uptick in audit activity in the particular area under discussion. In light of this new Practice Unit, taxpayers who have relied on meeting the substantial contribution test should consider performing a detailed self-evaluation of their facts and drafting a functional analysis that aligns with the approach described in the guide.

With sufficient forethought and preparation, it may be possible to foreclose an IRS inquiry in this area before it becomes an intractable part of an examiner's audit plan.

The new document is available, as of this date, on LB&I's Practice Unit page, https://www.irs.gov/businesses/corporations/practice-units.

Please contact the author of this alert at hklumpp@ipbtax.com or 202.662.3462 if you would like to discuss this topic further.