

Challenges Ahead for Contract Manufacturing in China

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Reprinted from *Tax Notes Int'l*, April 7, 2008, p. 73

SPECIAL REPORTS

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Over the past several years, the U.S. economy has witnessed a major outbound shift to the People's Republic of China¹ of manufacturing, processing, and assembly activities. The low-cost manufacturing environment in China has created dynamic foreign direct investment opportunities for U.S.-based operations. After taking into consideration all relevant tax liabilities, the manner in which Chinese manufacturing operations are structured can significantly affect the overall investment return.

One of the favored methods for structuring manufacturing operations in China has been through contract manufacturing arrangements. As described more fully below, a contract manufacturing arrangement (involving either related or unrelated contract manufacturers) historically has provided some tax efficiencies, from a U.S. as well as a Chinese tax perspective.

The U.S. Internal Revenue Service recently issued much-anticipated proposed regulations providing guidance on the U.S. tax implications associated with contract manufacturing in the context of international operations. The regulations parallel China's recent overhaul of its income tax system. The interplay between the new proposed U.S. contract manufacturing regulations and recent changes in Chinese tax law present challenges in structuring manufacturing operations to achieve optimal global tax efficiencies. At the very least, these combined developments in the United States and China demand that U.S.-based businesses carefully review their existing offshore manufacturing

operations to ensure that unanticipated tax consequences have not been created.

The new proposed regulations provide a level of certainty that previously did not exist regarding the ability to achieve manufacturing status for subpart F purposes through the physical manufacturing activities performed by another party. To achieve this certainty, however, the principal company in the contract manufacturing arrangement must satisfy minimum thresholds of involvement in the manufacturing process through the activities of its own employees. These threshold activities may cause the principal to have a branch for U.S. tax purposes in the country in which the manufacturing activities are performed. If a branch status occurs, it is likely that both the manufacturing and distribution income will immediately be subject to U.S. taxation.

At the same time, recent Chinese tax reforms include higher effective income tax rates,² increased return and information reporting, and substantially reduced tax incentives for foreign investors. Thus, competing tensions now exist between the proposed U.S. contract manufacturing regulations and the recently effective Chinese tax reforms. As a result, U.S.-based businesses should minimize the allocation of manufacturing income and eliminate the allocation of distribution income in China. However, the proposed

¹The People's Republic of China is referred to as the P.R.C., the Mainland, or simply as China, and does not include Hong Kong, Macau, or Taiwan.

²While the standard Chinese enterprise income tax rate applicable to domestic enterprises has been reduced from 33 percent to 25 percent, because of the abolishment of various tax incentives the overall effective tax rates for foreign-invested enterprises have increased since the new EIT law became effective on January 1, 2008.

U.S. tax regulations increase the likelihood that contract manufacturing arrangements may give rise to current U.S. taxable income unless a specific level of activities is conducted by the principal located outside of China.

This article reviews the recently proposed U.S. tax regulations dealing with contract manufacturing in the context of the U.S. antiferral rules under subpart F of the Internal Revenue Code. Next, this article reviews common structures for conducting manufacturing operations in China and summarizes significant changes in Chinese tax law that recently came into effect. Finally, this article explores the interplay of the proposed regulations with changes in Chinese tax law within the context of typical contract manufacturing arrangement of U.S.-based businesses.

I. Overview of Proposed Regs

A. Historical Authorities

On February 27, 2008, the IRS issued proposed regulations that provide guidance regarding the implications under section 954(d)³ of property sold by a controlled foreign corporation being manufactured or produced under a contract manufacturing arrangement or by a branch of the CFC (the proposed regulations).⁴

Under the antiferral rules of subpart F, personal property sold by a CFC may give rise to current taxable income for U.S. tax purposes if the personal property was purchased from or sold to a related party (statutorily defined as foreign base company sales income, or FBCSI).⁵ As an exception to the FBCSI rules, Treas. reg. section 1.954-3(a)(4) provides that FBCSI does not include personal property manufactured, produced, or constructed by the CFC. The existing regulations go further, saying that personal property will be considered manufactured, produced, or constructed by the CFC if the property has been “substantially transformed” by the CFC before its sale.⁶ The regulations further provide a substantive test and safe harbor that apply for purposes of determining whether a CFC’s product that incorporates purchased component parts as part of the personal property that is sold has been manufactured or produced.⁷ Under the preamble to the proposed regulations, these historic tests for satisfying the manufacturing exception are collectively referred to as the “physical manufacturing test.”

³Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the code).

⁴REG-124590-07, *Doc 2008-4147*, or *2008 TNT 40-8*. For a definition of CFC, see section 957(a).

⁵Section 954(d)(1).

⁶Treas. reg. section 1.954-3(a)(4)(ii).

⁷Treas. reg. section 1.954-3(a)(4)(iii).

The existing regulations regarding the manufacturing exception do not, however, provide any useful guidance concerning the treatment of manufacturing activities that are conducted by a related or unrelated contract manufacturer on behalf of the CFC. In a contract manufacturing arrangement, all or a portion of the significant activities involved with the actual transformation of personal property into a product may be performed by the contract manufacturer, with varying degrees of participation or activity on the part of the CFC principal company. Thus, when applying the subpart F antiferral rules, the difficulty with a contract manufacturing arrangement lies in assessing whether the principal company has manufactured, produced, or constructed the personal property that it ultimately sells, for purposes of applying the manufacturing exception.

The history of contract manufacturing in the context of FBCSI is controversial, and no attempt will be made here to recite the historical evolution of this issue and the relevant authorities.⁸ Nevertheless, U.S. multinational companies and international tax advisers have relied, for a variety of reasons, on the concept of contract manufacturing for many years to satisfy the manufacturing exception to the FBCSI rules. Among the theories advanced to support the notion that a principal company in a contract manufacturing arrangement is considered to be manufacturing is the concept that the manufacturing activities of the contract manufacturer are attributed to the principal company because of the underlying principal-agency relationship. Also, taxpayers have relied on the “its” defense, which refers to the statutory language under section 954(d)(1) whereby FBCSI arises only from the purchase of personal property from any person and “its” sale to a related person (implying that a sale of that property in any altered form is not the same property that was purchased and therefore cannot create FBCSI).

B. Rejection of ‘Attribution’ and the ‘Its’ Defense

In issuing the proposed regulations, the IRS has exercised its regulatory authority to provide guidance in this area.⁹ The proposed regulations reject the concept

⁸Numerous articles have been written on the subject of contract manufacturing that provide comprehensive analysis of the evolution of issues in this area. *See, e.g.*, Lemein and McDonald, “FSA 20020005: The IRS Attacks Contract Manufacturing,” 80 *TAXES* 5 (July 2002); Levine, Glicklich, and Miller, “Accessing the Manufacturing Exception to Subpart F Through Contract Manufacturing,” 1 *J. of Tax’n of Global Trans.* 37 (Fall 2001); Yoder, “New IRS Ruling Rocks the Contract Manufacturing Boat,” 9 *J. Int’l Tax’n* 6 (1998); and DiFronzo and McClintock, “Contract Manufacturing: Still a Viable Strategy?” *Tax Notes Int’l*, Aug. 24, 1998, p. 589, *Doc 98-26304*, or *98 TNI 163-13*.

⁹This is not the first time that the IRS has issued proposed regulations concerning contract manufacturing. The IRS issued prop. Treas. reg. section 1.954-3(a)(4), which provided that

(Footnote continued on next page.)

of attribution, in order to satisfy the manufacturing exception. Further, the proposed regulations unequivocally express the government's belief that the "its" defense asserted by taxpayers "is contrary to existing law, and results from an incorrect reading of section 954(d)(1) and section 1.954-3(a)(4)(i)." Rather, the proposed regulations conclude that the plain language of the physical manufacturing test clarifies that the manufacturing activities "must be performed by the CFC itself" to satisfy the manufacturing exception. Ironically, it is the plain language of the statute that taxpayers rely on in asserting the "its" argument to claim that the manufacturing exception applies.

C. Substantial Contribution Requirement

Even though the proposed regulations reject some arguments relied on by taxpayers in the past to support the manufacturing exception, the proposed regulations nevertheless concede that a CFC should qualify for the manufacturing exception in some cases, even though the physical manufacturing activities are not performed by the CFC.¹⁰ Despite the appearance of generosity in confirming this position, however, the IRS sets standards that may make it difficult to attain manufacturer status under the proposed regulations in many common contract manufacturing arrangements.

The proposed regulations provide that a CFC may qualify for the manufacturing exception if the CFC provides a "substantial contribution" to the manufacture, production, or construction of personal property, even if the physical manufacturing test cannot otherwise be satisfied.¹¹ Whether a CFC has made a substantial contribution to the manufacturing process is determined on a facts-and-circumstances basis, by analyzing a nonexclusive list of determinative factors that include:

- oversight and direction of the activities or process (including management of the risk of loss) under which the property is manufactured under the principles of section 1.954-3(a)(4)(ii) and (iii) (referring to the physical manufacturing test);

- performance of manufacturing activities that are considered in but insufficient to satisfy the tests provided in section 1.954-3(a)(4)(ii) or (iii) (again referring to the physical manufacturing test);
- control of raw materials, work in process, and finished goods;
- management of the manufacturing profits;
- material selection;
- vendor selection;
- control of logistics;
- quality control; and
- 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.¹²

The list of determinative factors might be viewed as daunting, depending on the quantum actually required to satisfy the substantial contribution test under any specific facts and circumstances. Moreover, the IRS made clear that these activities must be performed through the activities of the CFC's own employees.¹³ Accordingly, the otherwise substantial contribution activities of independent or even dependent agents of the CFC will not count.

D. Place of Performance of Substantial Contribution

Also consider that satisfying the manufacturing exception in the context of a contract manufacturing arrangement is generally relevant only when the contract manufacturer is performing activities *outside* of the CFC's country of incorporation. This is because if the manufacturing activities occur in the CFC's jurisdiction, the issue under section 954(d)(1) surrounding the application of the manufacturing exception is moot.¹⁴ As a result, the substantial contribution test effectively contemplates that a significant portion of the activities listed in the proposed regulations in most cases will be performed in a country other than the country in which the physical manufacturing activities occur. As

manufacturing activities of a contract manufacturer could not be attributed to the CFC (adopting the position expressed in Rev. Rul. 97-48, 1997-2 C.B. 89). Due to intense criticism, however, those proposed regulations were withdrawn. See Notice 98-35, 1998-27 I.R.B. 35.

¹⁰Michael DiFronzo, deputy associate chief counsel (international — technical), IRS, explained that a CFC can be considered a manufacturer without doing any physical work on the product (*i.e.*, the CFC need not "turn the screws"). See Lee Sheppard, "Treasury Officials Discuss Reform, Contract Manufacturing," *Tax Notes Int'l*, Mar. 10, 2008, p. 1083, *Doc 2008-4795*, or 2008 WTD 48-9; comments made during the 2008 annual meeting of the USA branch of the International Fiscal Association.

¹¹See prop. Treas. section 1.954-3(a)(4)(i).

¹²Prop. Treas. reg. section 1.954-3(a)(4)(iv)(b).

¹³See prop. Treas. section 1.954-3(a)(4)(iv); see also prop. Treas. reg. section 1.954-3(a)(6) (adopting similar rule in the context of a CFC's distributive share of partnership income). The preamble, however, invites taxpayers to comment on whether employees of the principal may control employees of the contract manufacturer.

¹⁴If the contract manufacturer were conducting the physical manufacturing activities within the same country in which the CFC is organized, there would be no need to rely on the manufacturing exception for the CFC to avoid FBCSI on the sale of the manufactured products (*i.e.*, under section 954(d)(1)(A), FBCSI includes only sales of products that are manufactured outside the country under the laws of which the CFC is created or organized).

will be discussed below, the location where the principal's substantial contribution is deemed to occur is critical. From a practical perspective, what is the likelihood that a CFC would be performing a substantial number of these activities relative to a contract manufacturer that is located and operating in another country? As discussed below, this is a crucial element of structuring a Hong Kong-based CFC with contract manufacturing relationships on the Mainland.

E. Trading Attribution for Substantial Contribution

The approach adopted by the proposed regulations is not surprising, particularly given the stance taken by the IRS in addressing contract manufacturing arrangements in recent years.¹⁵ Nevertheless, it will be interesting to see where the debate leads following the issuance of the proposed regulations and whether the regulations as currently drafted are ultimately published in final form. Although this article will not attempt to set forth and analyze the potential counterarguments to the reasoning behind the proposed regulations, some historical precedents support the attribution of contract manufacturing activities to the principal in a contract manufacturing relationship.¹⁶

Although the substantial contribution test is purportedly intended to give some clarity to the treatment of contract manufacturing arrangements, the proposed regulations fall far short of giving taxpayers any meaningful direction on how to structure those arrangements so that there is any assurance they will qualify for the manufacturing exemption. For example, despite providing the above-referenced list of activities that might be considered in determining whether the CFC has made a substantial contribution, the proposed regulations effectively render the list ineffective for giving taxpayers meaningful and definitive guidance:

The determination of whether a controlled foreign corporation makes a substantial contribution

¹⁵See, e.g., FSA 200220005 (Feb. 5, 2002) (IRS rejects concept of attribution and examines 13 factors for purposes of determining whether the activities of a contract manufacturer may be attributed to its principal for years that are subject to Rev. Rul. 75-7, 1975-1 C.B. 244 (1975)).

¹⁶See Rev. Rul. 75-7, 1975-1 C.B. 244 (1975), *revoked by* Rev. Rul. 97-48, 1997-2 C.B. 89 (1997) (revoking Rev. Rul. 75-7 for tax years beginning on or after December 8, 1997). Even the U.S. Tax Court has indicated that the activities of a contract manufacturer may be attributed for purposes of the FBCSI rules:

There is *not* an absolute requirement that only the activities actually performed by a corporation's employees or officers are to be taken into account in determining whether the corporation manufactured or produced a product in a possession within the meaning of sections 936(h)(5)(B)(ii) (flush final) and 954(d)(1)(A). [*Electronic Arts, Inc. v. Commissioner*, 118 T.C. 226 (2002) (emphasis added).]

through the activities of its employees to the manufacture, production, or construction of the personal property sold will involve, but will not necessarily be limited to, consideration of the activities set forth in paragraph (a)(4)(iv)(b) of this section. *The weight given to any activity (whether or not set forth) will vary with the facts and circumstances of the particular business. The presence or absence of any activity, or of a particular number of activities, is not determinative.*¹⁷

Based on this language, it would be difficult for most U.S.-based businesses to determine with a meaningful level of comfort whether the activities of a CFC's employees rise to the level of a substantial contribution to the manufacturing process. Hopefully the final version of the proposed regulations will incorporate more objective and meaningful guidelines.

F. The 'Where' Analysis and the Branch Rule

Even if a CFC makes a substantial contribution to the manufacture, processing, or construction of personal property that involves a contract manufacturing arrangement, the next question becomes *where* did the CFC perform those activities that represent the substantial contribution. As mentioned above, a CFC's employees may conduct many of those activities in the country where the contract manufacturer is located (and thus not in the CFC's country of incorporation). In that case, the CFC may be deemed to be manufacturing in the same country where the contract manufacturer is located. If the CFC is manufacturing outside of its country of incorporation, this directly brings into play the branch rule.

The branch rule under section 954(d)(2) provides that when a CFC carries on its activities through a branch or similar establishment located outside of the CFC's country of organization, then that branch may be treated as though it was a separate CFC for purposes of determining FBCSI. The branch rule applies a tax rate disparity test whereby a branch is deemed to have substantially the same effect as if the branch were a wholly owned subsidiary corporation if the income that would be FBCSI is taxed at an effective rate of tax that is less than 90 percent of, and at least 5 percentage points less than, the hypothetical effective rate of tax. Accordingly, assuming the tax rate disparity test is met, the branch is treated as a CFC, which creates the necessary related party for subpart F purposes when one does not already legally exist.¹⁸ The proposed regulations give further guidance regarding the application of

¹⁷Prop. Treas. reg. section 1.954-3(a)(4)(iv) (emphasis added).

¹⁸The tax rate disparity test generally will be met as the objective of the U.S.-based business is to place the value drivers (intellectual property and critical sales functions) in a tax-favored jurisdiction.

the branch rule for contract manufacturing arrangements. The proposed regulations provide that if neither the CFC nor any branch of the CFC satisfies the physical manufacturing test but the CFC as a whole is able to establish that it satisfies the substantial contribution test, then the location where manufacturing is deemed to occur will be the location of the CFC or the branch that provides the “predominant amount” of the CFC’s substantial contribution to manufacturing.¹⁹ For this purpose, the CFC or any branch of the CFC will be deemed to have made a predominant amount of the substantial contribution to the manufacture of personal property if it makes a significantly greater contribution to the manufacture, production, or construction of that property than any other branch or the remainder of the CFC.²⁰

Practically speaking, this clarification on the application of the branch rule should cause a CFC to be considered manufacturing in the location where the activities of the CFC’s employees are performed that fulfill the substantial contribution requirement. When these activities are performed in close proximity to the physical manufacturing functions performed by the contract manufacturer, there is an increased likelihood that the CFC’s manufacturing will be considered to occur outside of its country of incorporation, thereby potentially causing the branch rule to apply.

Moreover, if the taxpayer cannot establish whether a predominant amount of the activities that substantially contribute to the manufacturing process has been performed by the CFC or by a branch of the CFC, the manufacturing is deemed to take place in the jurisdiction that has the highest effective tax rate of the jurisdictions in which the CFC or other branches of the CFC are located.²¹ Again, practically speaking, this rule increases the likelihood that a CFC will be subject to the branch rule, by treating the manufacturing activities as occurring in the jurisdiction that most likely satisfies the tax rate disparity test. If the CFC principal in a contract manufacturing arrangement is deemed to be manufacturing outside of its country of incorporation and the branch rule applies, the CFC may generate FBCSI that is currently taxable under subpart F, regardless of whether the CFC is manufacturing the personal property that is sold. As a result of this application of the branch rule, a CFC overseeing contract manufacturing operations in another country should carefully structure the activities of the CFC’s employees to be performed in the CFC’s jurisdiction.

¹⁹Prop. Treas. reg. section 1.954-3(b)(1)(ii)(c)(3)(c) and (d).

²⁰Prop. Treas. reg. section 1.954-3(b)(1)(ii)(c)(3)(c).

²¹Prop. Treas. reg. section 1.954-3(b)(1)(ii)(c)(3)(e).

G. Summary of the Proposed Regs

The proposed regulations confirm that it is possible for a CFC to qualify for the manufacturing exception to FBCSI by virtue of the CFC’s employees’ activities that substantially contribute to the physical manufacturing process separately performed by another party through a contract manufacturing arrangement. Although the proposed regulations identify a number of determinative factors that may be considered in determining whether the CFC has substantially contributed to the manufacturing process, these regulations fail to provide any clear guidance on the number or extent of activities that will satisfy this requirement.

Moreover, even if a CFC is considered to be manufacturing by way of satisfying the substantial contribution test, the proposed regulations enhance the likelihood that the branch rule may apply, first by associating the manufacturing location with the location where the CFC’s employees make a predominant contribution to the manufacturing process, and second, in the absence of a clear indication where the predominant contribution has been made, by causing the manufacturing location to be associated with the jurisdiction that is most likely to satisfy the tax rate disparity test. Thus, on balance, the proposed regulations may provide insufficient comfort to many U.S.-based businesses that rely on contract manufacturing arrangements to avoid FBCSI. Rather, the proposed regulations may have the effect of triggering the application of the branch rule and causing the tax rate disparity text to be satisfied, resulting in FBCSI.²²

II. Investing and Manufacturing in China

A. Traditional Structures in China

Most U.S.-based businesses establishing operations in China structure their investments via one of three routes:

- first, the direct route, whereby a U.S. business directly establishes a Chinese wholly foreign owned enterprise (WFOE) and the U.S. business relies on the applicable provisions of the China-U.S. income tax treaty for appropriate treaty benefits;
- second, the U.S. business structures the operation through a CFC organized under the laws of Hong Kong or another proximate Mainland jurisdiction (such as Singapore or Macau) that provides not only convenient geographical access but also relatively low effective tax rates; and
- third, the U.S. business establishes the investment in China through a country that has a favorable tax treaty with the United States.

²²For further discussion and analysis of the proposed regulations, see also Granwell, “Contract Manufacturing and Subpart F,” *Doc 2008-5309* or *2008 WTD 54-8*.

From a manufacturing perspective, many U.S.-based businesses will have no reason to create a taxable presence in China, especially for turnkey contract manufacturing. To the contrary, because goods manufactured in China are often destined for the U.S. market and other non-Chinese markets, a U.S.-based business would prefer to avoid becoming subject to tax in China (in this case only the in-country contract manufacturer's profits would be subject to potential Chinese income taxation). This is particularly true now, taking into consideration changes in Chinese tax law (as discussed below). Moreover, because of the vast number of independent contract manufacturers in China, it is possible for a U.S.-based business to access the attractive low-cost Chinese manufacturing environment without generally establishing a separate legal entity or taxable presence in China.

At the same time, China historically has offered significant tax holiday incentives for foreign investment in China (also discussed below). Thus, it has often been possible to establish Chinese operations at a very low effective tax cost. Nevertheless, even in situations when a U.S.-based business does not object to establishing a legal entity or presence in China, a contract manufacturing arrangement may often be used to take advantage of an established workforce and operation without significant capital commitment.

As discussed below, changes to the Chinese taxation landscape may increase the attractiveness of contract manufacturing arrangements on a prospective basis, especially for turnkey arrangements. In particular, higher effective Chinese tax rates and increased reporting obligations may heighten the motivation to avoid being taxed in China. Moreover, the replacement of historic tax holiday incentive programs with industry-focused incentives may cause many U.S.-based businesses to become active Chinese taxpayers when they previously enjoyed significant tax holidays and reduced tax rates. Finally, a shift in the scope of entities that are subject to tax in China and the corresponding definition of residency will broaden the scope of entities that are subject to income tax in China. Those provisions will likely contribute to an environment in which traditional contract manufacturing arrangements are more attractive to outside investors who want to avoid paying tax in China.

B. The New 'Unified' EIT Law

On March 16, 2007, the P.R.C.'s 10th National People's Congress overwhelmingly approved a sweeping Chinese income tax reform with 2,826 voting in favor of the reform package, and only 37 dissenting votes and 22 abstentions. The new law, known as the Enterprise Income Tax Law, became effective January 1, 2008.

In principle, the EIT law provides for a unified enterprise income tax rate that requires both foreign and domestic invested enterprises to pay tax at a 25 percent

income tax rate (phased in over a five-year period if the enterprise is enjoying a lower tax rate under the old law) as opposed to different tax rates for domestic vs. foreign firms.²³ Based on the historical tax incentive system applicable only to qualified foreign direct investment (FDI) transactions, foreign-invested enterprises typically were subject to a maximum income tax rate of about 15 percent at the company level, whereas their domestic counterparts paid a significantly higher tax rate.

In view of the contentious and complex legislative, public, and private debates that preceded enactment of the EIT law, with the elimination of the dual system for tax rates and tax holiday incentives, the Chinese government has made a legislative and policy decision to limit the granting of incentives to specific geographical regions or specific limited targeted businesses, such as technology, as well as some small enterprises. This represents a significant shift from granting tax holidays and other incentives to the export-oriented and special economic zone operations that have dominated the Chinese tax landscape since the early 1980s.

The Chinese government recently issued new implementing regulations for the new EIT law.²⁴ The implementing regulations are based on China's principles-based format for tax legislation, and the EIT law is compartmentalized in 60 separate articles spanning eight chapters.²⁵

Before the EIT law, the Foreign Enterprise Income Tax Law contained the "two + three" tax holiday system (which was generally available for qualifying manufacturing operations), and a 10 percent tax rate was available to export-oriented enterprises, both of which were a significant magnet for attracting FDI.²⁶ These rules are being grandfathered for enterprises that were established before the EIT law's March 16, 2007, enactment date. For enterprises established after that date, the two + three tax holiday benefits are no longer

²³Chinese domestic enterprises were historically subject to Chinese income tax at a 33 percent rate, whereas the maximum Chinese income tax rate for foreign-invested enterprises was 15 percent. The likely phase-in of the EIT law's 25 percent tax rate is as follows: 18 percent in 2008, 20 percent in 2009, 22 percent in 2010, 24 percent in 2011, and 25 percent in 2012. Note that once fully phased in, the overall effective Chinese tax cost for a domestic enterprise in view of the new 10 percent withholding tax rate (see *infra* note 45) will be 32.5 percent.

²⁴See R. Chang and J. Kadet, "China Issues Implementation Rules on Tax Unification," *Tax Notes Int'l*, Dec. 17, 2007, p. 1099, *Doc 2007-27104*, or *2007 WTD 239-1*; and A. Granwell and Q. Xu, "China's New Enterprise Income Tax Law: Planning Opportunities and Traps for the Unwary," available at http://www.dlapiper.com/chinese_enterprise_income_tax_law.

²⁵Overall, the eight chapters of the new EIT law consume less than two dozen pages of text.

²⁶Under the pre-tax-reform system, FDI tax incentives included more favorable tax rates, special tax holidays, special tax

(Footnote continued on next page.)

available unless otherwise qualifying for comparable tax holidays in limited cases.²⁷ Accordingly, practitioners should carefully analyze whether a proposed foreign investment transaction in China would qualify for one of the EIT law's newly adapted narrow tax holiday rules.

The implementing regulations clarify that approval for purposes of qualifying for the now-repealed tax holiday system means that a foreign-invested enterprise must have had its business license issued by the Chinese government before March 16, 2007. For example, if the application process had been submitted before this date, but the actual business license was not issued before March 16, 2007, then the foreign enterprise would not qualify for tax holiday benefits.

Foreign-invested enterprises that are eligible for the two + three tax holiday program before March 16, 2007, will continue to benefit from those holidays. In contrast to the old rules in which the two + three time frame did not begin to run until the first year of profitability of the foreign-invested enterprise, under the EIT law's transition rules this five-year term will begin to run on January 1, 2008, even though the enterprise does not report a profit.

The EIT law and the implementing regulations also include provisions to determine circumstances under which an enterprise incorporated under laws *other than* China's may be subject to China's worldwide income tax system in the event the foreign enterprise's place of effective management is in China (and thus the enterprise is deemed resident in China). The new rules also address limited Chinese income taxation treatment of nonresident companies that have an "establishment or site" in China or, when no such establishment or site exists, if the nonresident foreign enterprise has Chinese-source income. For a non-Chinese organized entity with substantial Mainland links, those rules need to be carefully reviewed with Chinese tax counsel.²⁸

III. Review of Common Structures

A. Overview

Contract manufacturing has become a frequently used vehicle to develop global manufacturing and assembly operations by U.S. multinationals and U.S. pri-

vately held concerns. Contract manufacturing and its cousin, consignment manufacturing, enable U.S. companies to more effectively compete with their foreign counterparts by reducing product costs. The types of products manufactured under contract and consignment manufacturing vary from low-end garments to high-end technology components.

From a contractual perspective, contract manufacturing typically involves the appointment by a principal of a related or unrelated manufacturing, processing, or assembly operation, known as the contract manufacturer, to manufacture the principal's products. It is important for the contractual documentation between the principal and the contract manufacturer to delineate all relevant terms and conditions, including provisions to substantiate that the principal is actually the substantive manufacturer based on its assumption and retention of the economic risk of loss even though the contract manufacturer in a buy-sell arrangement takes title to some raw materials (or even the finished goods) during the manufacturing process. The classic contract manufacturing agreement delineates the contract manufacturer's responsibilities, specifies which party bears the risk of loss regarding raw materials, work in process, and finished goods inventory, and also describes the manner in which the principal pays the contract manufacturing fee to the manufacturer.

Although not used as frequently in China because of legal restrictions on the ownership of materials imported into China for manufacturing purposes, one form of contract manufacturing arrangement is a consignment, or tolling, arrangement (as opposed to a buy-sell), whereby the principal purchases all raw materials and supplies, retains title to those items as well as retaining the risk of loss, and consigns those raw materials and supplies to the contract manufacturing party, who incorporates those items into the manufacturing process and produces the finished goods. At the end of this cycle, the principal pays the manufacturer a negotiated services fee, and the principal sells and passes legal title to the finished goods directly to its customers.

In contrast, and more popular in China, a buy-sell, or turnkey, contract manufacturing arrangement is used, whereby the contract manufacturer agrees to take title to the raw materials and supplies (usually under the specifications and direction of the principal) and agrees to sell the finished goods only to the principal, which resells the goods. The principal may purchase raw materials and supplies and then sell them to the contract manufacturer. The principal retains all economic risk of loss even though the underlying legal ownership of the raw materials, supplies, work in process, and the finished goods are held by the contract manufacturer. Legal title to the finished goods is assigned to the principal on completion of the manufacturing process.

refund procedures, and beneficial depreciation and other deductions, as well as loss carryforward provisions. The ordinarily applicable tax rate for foreign-invested enterprises, as well as their related foreign enterprises in special economic zones, was a maximum 15 percent rate.

²⁷ See Cai Shui [2008] No. 1, approved by the State Council and jointly issued by the Ministry of Finance and the State Administration of Taxation on February 22, 2008.

²⁸ It is crucial for U.S. tax advisers to review all local in-country legal issues with a qualified and competent in-country adviser.

Similar to consignment arrangements, in buy-sell arrangements the amount paid to the contract manufacturer is effectively a services fee. The entire amount for the finished goods is paid to the contract manufacturer to absorb and recoup the cost of purchasing raw materials and supplies by the contract manufacturer on behalf of the principal, and the excess represents compensation for the contract manufacturer's services.

In both buy-sell and consignment contract manufacturing arrangements, the principal would typically provide blueprints, designs, technology, know-how, and other components required for incorporation into the manufacturing process, including plant and equipment if necessary. Moreover, the principal would control the timing, quality, inspection, and oversight of the manufacturing process (as well as overall managerial supervision).

B. Hong Kong — A Preferred Location

Hong Kong has been a preferred location for conducting manufacturing operations for many years and has historically provided a relatively low income tax rate. In the past 20 years, however, Hong Kong's manufacturing industry has dramatically shifted to the Mainland, primarily because of the low cost of labor, utilities, land, and factory costs in China.

Shifting those manufacturing operations from Hong Kong to the Mainland can also reduce the underlying Hong Kong tax liability by 50 percent; at the same time, the Hong Kong operation has limited permanent establishment exposure to the Chinese tax system (at least it has since 1998).²⁹ As a result, the Hong Kong business operation should be subject to an 8.75 percent net tax on profits and should not be subject to Chinese tax (although the Mainland-based contract manufacturer would be subject to Chinese tax on its profits). Moreover, as long as the Hong Kong operation satisfies exceptions to the FBCSI rules, then U.S. owners of the Hong Kong CFC may avoid constructive income taxation under subpart F.

Because of those favorable conditions, Hong Kong emerged as the favored jurisdiction for establishing a

²⁹This key issue needs to be revisited under the EIT law that became effective January 1, 2008. In 1998 the Chinese tax authorities issued a circular to clarify that even though in theory a Hong Kong business may be considered to have a PE on the Mainland by virtue of a related or unrelated contract manufacturing arrangement, the PE would not be treated as a taxable establishment. The same position effectively has been reinstated in circular Guo Shui Ham [2007] No. 403, the technical explanation of the 2006 DTA issued by the SAT on April 4, 2007. The circular provides that although literally the Hong Kong enterprise could have been deemed to have a permanent establishment in China under the DTA, this would not change the current practice that China would tax only the service fees charged by Chinese contract manufacturers under a contract manufacturing arrangement.

principal company through which to conduct contract manufacturing operations in China. Hong Kong remains the preferred location through which to route contract manufacturing arrangements, and the 2006 double tax arrangement (DTA) between Hong Kong and China further solidified the benefits of structuring manufacturing operations in this manner.

The DTA between Hong Kong and China was formally signed on August 28, 2006, and became effective December 8, 2006.³⁰ In summary, the new DTA significantly expands tax planning benefits for using Hong Kong as a gateway for investing in China. In particular, the new DTA expands the definition of residence, implements more guidance regarding transfer pricing, and addresses more favorable withholding tax treatment regarding dividends, interest, royalties, and capital gains.³¹

Recently, a second protocol to the 2006 DTA was signed by the governments of Hong Kong and China (the 2008 protocol).³² Among the provisions of the 2008 protocol is a clarification regarding how to calculate the time spent by one party in the other country for purposes of determining whether a PE is created. Under this clarification in the 2008 protocol, if a Hong Kong enterprise provides services in Mainland China for an aggregate of 183 days or more during any 12-month period, the Hong Kong entity will be considered to maintain a PE in China.

Hong Kong retained its separate country status for U.S. tax purposes following the handover of Hong Kong from the United Kingdom to the P.R.C.³³ In Notice 97-40,³⁴ the IRS announced that it will continue to treat China and Hong Kong as separate countries for China-U.S. income tax treaty purposes, the reciprocal shipping exemption, and the IRC. Notice 97-40 explained that Chinese tax laws do not apply in Hong Kong and that the terms of the China-U.S. income tax treaty do not extend to Hong Kong.³⁵ In light of the

³⁰The DTA was signed with the proviso that it applies to income arising in China on or after January 1, 2007, and income arising in Hong Kong for the assessment year beginning April 1, 2007, onward. The 2006 DTA replaced the predecessor version signed in February 1988.

³¹For a discussion of the 2006 DTA, see P. Yip, T. Jasper, and F. Chan, "Redefining Hong Kong's Position as China's Gatekeeper: The New DTA," *Tax Notes Int'l*, Jan. 22, 2007, p. 261, *Doc 2007-165*, or *2007 WTD 18-7*.

³²See B. Lai, S. Sui, and C. Lam, "Hong Kong, China Sign Second Protocol to Tax Arrangement," *Tax Notes Int'l*, Feb. 25, 2008, p. 652, *Doc 2008-3544*, or *2008 WTD 35-7*.

³³Under the 1984 Sino-British Joint Declaration, Hong Kong reverted to Chinese control on July 1, 1997.

³⁴1997-2 C.B. 287. The P.R.C. does not, as a matter of sovereign law, include Macau and the Republic of China (Taiwan).

³⁵The applicable tax treaty, known formally as the Agreement Between the Government of the United States of America and

(Footnote continued on next page.)

separate treatment that Hong Kong and Mainland China recognize for Chinese tax purposes, the IRS determined to treat Hong Kong and China as separate countries for purposes of the IRC, including subpart F.

From a legal perspective, the Hong Kong enterprise typically enters into a joint venture or contract manufacturing arrangement with a Chinese-based enterprise, and that enterprise typically functions as the processing, manufacturing, or assembly operation. Those arrangements are commonly referred to as processing arrangements, and through them the Chinese operation provides the factory, workers, and utilities, and the Hong Kong enterprise provides the designs, prototypes, management expertise, quality control, raw materials shipping and coordination, finished goods shipping and coordination, finance, and other administrative and substantive support activities, most of which are handled in Hong Kong.

Once the goods are manufactured by the Chinese operation, they are sold, by the Hong Kong enterprise, either back to the United States or to non-U.S. destinations. Ultimately, the Hong Kong enterprise pays the Chinese manufacturer a processing fee for the contract services rendered. Title to the finished goods typically will be in the name of the Chinese company, as is the case for raw materials, but from an economic and contractual viewpoint the Hong Kong business always has underlying economic risk of loss and ownership over such items.

Although the use of a Hong Kong CFC as a principal company with manufacturing operations in China has become one of the most common modes of conducting low-cost manufacturing on the Mainland by U.S.-based businesses, several issues associated with the U.S. tax ramifications of those arrangements are raised in the context of subpart F's antideferral rules. Historically, U.S.-based businesses might structure operations through a contract manufacturing arrangement to be treated as a manufacturer, or to eliminate related-party transactions that otherwise could cause a transaction to be taxed in the U.S. as FBCSI. Thus, the U.S.-based business achieved effective tax deferral on the low-tax

income of CFCs by causing the CFC to act as a principal in a contract manufacturing arrangement.

The U.S. and Chinese tax implications of this common manufacturing structure may be significantly affected by the proposed regulations and Chinese tax reforms under the EIT law. Moreover, the ultimate tax consequences may depend, in part, on whether the Hong Kong CFC principal is dealing with a related or unrelated contract manufacturer. The consequences under both scenarios are addressed below.

C. Unrelated-Party Arrangement

1. Classic Fact Pattern

The following discussion is based on the typical fact pattern in which a U.S.-based business manufactures its products through an unrelated contract manufacturer based in Mainland China. As described above, in this situation the U.S.-based business establishes a subsidiary in Hong Kong (or potentially another tax-efficient Asian location) and this CFC serves as the principal in the contract manufacturing arrangement. The Hong Kong CFC principal arrangement may involve multiple unrelated Chinese-based contract manufacturers. Products manufactured under this arrangement will be sold by the Hong Kong CFC principal into the U.S. market or to other non-Chinese affiliates of the U.S.-based business for distribution throughout the world.

The overall goal of the Hong Kong CFC principal structure is to maximize the allocation of tax-favored profits to the Hong Kong CFC principal entity while avoiding potential subpart F taxation at the CFC's U.S. shareholder level. When subpart F income is inapplicable, a tax benefit is realized through the arbitrage of the general U.S. corporate income tax rate of 35 percent against the lower income tax rate in Hong Kong (and, if applicable, even the relatively lower Chinese tax rate will generate such an arbitrage).

The unrelated Chinese-based contract manufacturer would provide the manufacturing or assembly operation through its Mainland-based processing facility, and this entity would also employ and pay all manufacturing or assembly employees and handle all tax withholding and related compliance work regarding those employees. The Hong Kong CFC principal would have no responsibilities regarding those direct in-country activities.

2. The Hong Kong CFC Principal

The Hong Kong CFC principal would negotiate the contractual relationship with the Chinese-based contract manufacturing party and also would provide production know-how, shipping and transportation logistics, quality control and related construction and overall logistics oversight. As mentioned above, the contract manufacturer would purchase legal title to the raw materials and thus would actually own the work-in-process inventory, as well as the finished goods.

the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, (the Convention) (see T.I.A.S. No. 12065, 1988-1 C.B. 414) provides that its geographical scope is limited to the areas in which the laws relating to Chinese tax (as defined in article 2(1) of the Convention) are in force. According to the Service, this limitation precludes application of the Convention to Hong Kong because the relevant law governing Hong Kong as of July 1, 1997, provides that the laws relating to Chinese tax will not apply in Hong Kong on or after July 1, 1997 (see the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China, articles 106 and 108 (1990); S. Exec. Rep. No. 7, 99th Cong., 1st Sess. 14-15, 18-19 (1985)).

Under the classic contract manufacturing agreement, the unrelated contract manufacturer would transfer legal title to the finished goods to the Hong Kong CFC principal upon payment of the manufacturing services fee. Because the Hong Kong CFC principal provides all specifications and processing and production know-how, the contract manufacturer's downside is a breach to fulfill the contractual processing obligations. Even though the unrelated contract manufacturer would hold legal title to the finished goods, it would be obligated to transfer title to the Hong Kong CFC principal. In the end, the Hong Kong CFC principal sells the finished goods to its U.S. parent (or other foreign affiliates of the U.S.-based business).

3. Summary of Material Tax Issues

From a non-U.S. tax planning perspective, a primary objective of this structure is to minimize the extent to which the profit element of the product sales is subject to Chinese regulation, reporting, and taxation, ultimately at the phased-in 25 percent tax rate under the EIT law (and thus to maximize applicability of Hong Kong's 17.5 percent tax rate or better yet an effective 8.75 percent tax rate). For the Hong Kong CFC principal to avoid Chinese taxation, it must not inadvertently trigger a taxable presence in China, based on the new Chinese EIT law and recently issued implementing regulations, as well as on the DTA.

The Hong Kong CFC principal must be careful not to cross the threshold into a taxable presence or PE in China.

As a general rule, the unrelated-party contract manufacturing arrangement should not trigger a taxable presence of the Hong Kong CFC principal in China. This is because a nonresident enterprise generally is not subject to Chinese tax under the EIT law, and because the unrelated contract manufacturer should not be viewed as a PE of the Hong Kong CFC principal for purposes of the China-Hong Kong DTA. However, the highly factual inquiry concerning taxable presence becomes a slippery slope when the Hong Kong CFC principal begins conducting on-the-ground activities in China, such as logistics, quality control, contractual negotiations, development of personnel, and other forms of support in an export processing zone or special economic zone.

The DTA between Hong Kong and China may provide some comfort, particularly given the EIT law's new rules, which could cause a foreign enterprise to be subject to the Chinese worldwide tax system if the en-

terprise's effective management is in China, as discussed above. Alternatively, even if the foreign enterprise avoids this Chinese tax trap and thus avoids Chinese residency status, the nonresident foreign enterprise should minimize the risk of having an establishment or site on the Mainland, as discussed above. Based on the 2008 protocol to the DTA, a PE on the Mainland may be created if individuals of the Hong Kong CFC principal perform services within the Mainland aggregating a total of 183 days during any 12-month period. Thus, the Hong Kong CFC principal must be careful, in carrying out its functions associated with the contract manufacturing arrangements, not to cross the threshold into a taxable presence or PE in China.³⁶

4. Formation of a WFOE or Rep Office

In the event the CFC principal requires a significant amount of presence on the Mainland to adequately manage and oversee the contract manufacturing operations, it may be possible to organize a WFOE or, alternatively, a Chinese rep office, through which these activities would be structured.³⁷ Although this approach might alleviate the exposure to Chinese taxation for all of the profits earned by the Hong Kong CFC principal, it also would adversely affect the U.S. tax implications by interposing a related party into the transaction mix or potentially creating a branch (either of which might cause FBCSI, as discussed above). For this reason, a separate WFOE or rep office may not be preferred in a U.S. subpart F tax deferral structure.

5. Tax Deferral With Limited Hong Kong Tax

In Hong Kong, the generally applicable corporate tax rate is 17.5 percent and applies only to Hong Kong-source income. Based on Hong Kong territorial tax law principles, however, 50 percent of the Hong Kong CFC principal's sales profits are treated as occurring offshore when the products are manufactured offshore (in China).³⁸ Thus, the effective rate is reduced

³⁶Even if the Hong Kong CFC principal were to create a taxable presence or PE under the DTA in China, the amount of income attributable to the taxable branch should be minimal in situations when the principal is only giving oversight and support to the contract manufacturing arrangement. Because critical sales functions associated with the finished product sales would occur outside of the Mainland, there should be little risk that distribution income of the Hong Kong CFC principal could be subject to tax in China.

³⁷A rep office generally cannot directly engage in commercial activities in China (for example, purchasing and reselling goods, or manufacturing). Thus, the scope of activities that it could perform in this context would be limited.

³⁸In addition to Hong Kong, Singapore and Macau represent potentially favorable jurisdictions in which to establish the CFC principal base operation. Singapore recently reduced its company tax rate to 18 percent, and profits in Macau may be exempt from taxation under the special administrative region's offshore law.

by 50 percent regarding profits earned with qualifying processing arrangements involving a China-based manufacturer, and thus the overall Hong Kong tax rate would fall to 8.75 percent. As a result, a U.S.-based business that manufactures products in China can significantly reduce its non-U.S. tax burden by structuring its operations to capture the manufacturing and sales profits in Hong Kong.³⁹

From the U.S. tax planning perspective, the primary tax planning objective is to achieve tax deferral by not triggering currently taxable subpart F income on the profits of the Hong Kong CFC principal. When the Hong Kong entity creates FBCSI that is currently taxable under subpart F, the income would be taxed at ordinary corporate income tax rates, generally at a rate of 35 percent. Assuming that the U.S.-based business is a corporate C entity, it would be entitled to claim foreign tax credits for any taxes paid in Hong Kong or China against its U.S. tax liability associated with the FBCSI. In that case, however, no tax deferral benefit exists on the tax rate differential between Hong Kong and the U.S. corporate income tax rates (17.5 percent and 35 percent, respectively).

6. Satisfaction of Substantial Contribution Requirement

Because the goods produced by the unrelated contract manufacturer will likely be sold by the Hong Kong CFC principal to related parties for distribution in the U.S. and other non-U.S. markets, the related-party sales would, initially, potentially give rise to FBCSI. As discussed above, however, even though the Hong Kong CFC principal sells goods to related parties, the income from those sales may avoid FBCSI treatment under the manufacturing exception. To qualify for the manufacturing exception under the proposed regulations, the U.S.-based business must show that the Hong Kong CFC principal made a substantial contribution to the physical manufacturing process conducted by the unrelated contract manufacturer.

To satisfy the requirement of the proposed regulations, the Hong Kong CFC principal must, *through the activities of its own employees*, perform a threshold of activities that represents a substantial contribution to the manufacturing process. As described above, the proposed regulations set forth a nonexclusive list of activities that will be considered in determining whether a CFC principal has made a substantial contribution to the manufacturing process. The primary difficulty in satisfying this test, however, may be that many of the activities listed in the regulations would likely be performed in close proximity to the physical manufacturing process, which in turn may subject the Hong Kong CFC principal to the branch rule.

In reviewing the list of activities set forth in the proposed regulations, it appears that many of these activities could indeed be performed by employees physically situated in Hong Kong. Others, however, appear to be more problematic, as discussed below.

For example, the first two activities listed in proposed Treas. reg. section 1.954-3(a)(4)(iv)(b) involve “oversight and direction of the activities or process” and “performance of activities that are considered in but that are insufficient to satisfy” the physical manufacturing test. Thus, both of these factors are closely tied to the physical manufacturing process, either from the aspect of overseeing and directing the physical manufacturing process, or participating in the physical manufacturing activities. In most Mainland contract manufacturing scenarios, it is difficult to imagine how these activities could be conducted from a remote location in any meaningful way. As discussed in more detail below, periodic visits to the Mainland-based contract manufacturer by the employees of the Hong Kong CFC principal (all of whom are based in Hong Kong) might overcome this obstacle.

Similarly, another of the listed activities to be considered in determining whether employees of a CFC substantially contribute to the manufacturing process is quality control. Depending on the nature of the products involved, it may be more reasonable in some situations to believe that employees could substantially contribute to the quality control process from a distant location. For example, for small products that can be shipped relatively easily, it may be easier to conduct quality control testing from outside the country in which physical manufacturing occurs. In such cases, it might be possible for products to be imported from the Mainland to the CFC principal’s Hong Kong operation for testing and quality control review. This may be of particular benefit to the Hong Kong CFC principal when manufactured components are imported from, for example, China into Hong Kong for quality control testing and then later reimported into the Mainland for incorporation of those finished components by another P.R.C.-based original equipment manufacturer.

In most cases, however, it may be unrealistic for a sampling of products manufactured in China to be pulled and shipped to Hong Kong for testing and quality control review. To the contrary, testing and quality control is often performed directly as products move through, or come off of, the production line. That way, adjustments for defects can be made in real time without a loss of production time and materials.

Alternatively, if quality control amounted to reviewing manufacturing run reports for purposes of assessing whether quantities of defective products fell within acceptable tolerance levels, this also might easily be conducted outside the country where physical manufacturing occurs, such as in Hong Kong. One should

³⁹The U.S.-based business’s ability to allocate manufacturing and distribution income to Hong Kong will be constrained by transfer pricing principles.

question whether this limited aspect of the quality control function would favorably contribute to a conclusion that employees of the Hong Kong CFC principal have substantially contributed to the manufacturing process. As discussed above, however, such a conclusion may result in the creation of a manufacturing branch in China when the Hong Kong CFC has employees based in the Mainland handling these functions, which for U.S. tax purposes would likely create FBCSI.

Other activities listed in the proposed regulations could more easily be performed from a remote location. For example, design work, material and vendor selection, control of logistics, and management of manufacturing profits through finance and administrative functions appear reasonably capable of being performed outside of the country in which physical manufacturing occurs. Nevertheless, because the proposed regulations clearly state that (i) the weight given to any activity will vary with the facts and circumstances, and (ii) the presence and number of listed activities is not determinative, it will be rare when a U.S.-based business can conclusively determine that it has satisfied the substantial contribution test.

7. Example 3 in Proposed Regulations

Despite the ambiguity associated with applying the substantial contribution test, the proposed regulations appropriately make the point that a CFC principal could satisfy the substantial contribution requirement through activities performed outside the country in which physical manufacturing occurs. In Example 3 of the proposed regulations,⁴⁰ the CFC principal in a contract manufacturing arrangement with an unrelated contract manufacturer performs the following activities regarding the manufacture of product X:

- design, testing, quality control, and oversight regarding the manufacture of product X;
- direct the use of intellectual property used in the manufacture of product X;
- control the raw material, work in process, and finished goods; and
- control logistics, select vendors, and manage the risk of loss from the manufacture of product X.

In this example, the quality control and manufacturing oversight activities are conducted by employees of the CFC who regularly travel to the country where the contract manufacturer is located. Design work that is “supplemental to the bulk of the design work” is performed by a branch, Branch A, of the CFC. All other activities are performed by employees located within the CFC’s country of organization.

⁴⁰See prop. Treas. reg. section 1.954-3(b)(1)(ii)(c)(3)(f), Example 3.

Based on the facts presented, Example 3 concludes that the CFC (including the activities of Branch A) has provided a substantial contribution to the manufacture of product X and that the CFC, rather than Branch A, provided the predominant contribution regarding product X.

Although Example 3 is welcomed because it confirms that a principal company (such as a Hong Kong CFC principal) in a contract manufacturing arrangement need not “turn the screws” to qualify for the manufacturing exception, it also raises several questions in a real-world application. For instance, what weight was given to each of the enumerated activities in reaching this conclusion (since Treasury and the IRS have said that the weight will vary with the facts and circumstances), and what was the basis for weighting those activities? Further, how much time did the traveling employees actually spend in the country of physical manufacture, and how would their presence in that country and the nature of their activities be viewed under the applicable in-country PE-type principles? Did they spend, in any 12-month period, 60, 90, or 183 days in the country? Also, what factors were considered in determining that the remainder CFC made a significantly greater contribution to the manufacture of product X than did Branch A? Those real-world issues — and others — will likely plague taxpayers forced to analyze their own facts and circumstances under the proposed regulations.

Another interesting aspect of Example 3 concerns an indirect tie-in to the branch rule. In the context of a Hong Kong CFC principal structure, it appears that only the activities *performed in Hong Kong* by the employees of the Hong Kong CFC principal will be considered in determining whether the Hong Kong CFC has made a substantial contribution to the manufacturing process, *unless* the activities of those employees are attributable to a separate branch of the Hong Kong CFC principal in another country.

This crucial concept is reflected in the analysis of Example 3 of the proposed regulations. In Example 3, employees of the CFC principal, a Country M corporation, regularly travel to Country C, where the contract manufacturer is located, to perform quality control and oversight of the manufacturing process. Even though employees of the CFC principal regularly travel to the country in which the physical manufacturing occurs, their presence and activities do not under the facts of the example create a branch in the country of manufacture.⁴¹ The conclusion to Example 3 states that the fact those employees traveled to Country C will not prevent their activities “while located in Country M”

⁴¹Example 3 notes that the only branch of the CFC principal is located in Country A, which is different from the country in which physical manufacturing occurs (Country C).

from being considered in determining the applicability of the substantial contribution test to the CFC principal.

8. Satisfaction Through a CFC's Branch Activities

Notwithstanding that Example 3 disregards the non-branch activities of the CFC principal that are performed outside of its country of organization, the proposed regulations clearly indicate that the activities of employees may satisfy the substantial contribution test when conducted through a branch of the CFC principal. Prop. Treas. reg. section 1.954-3(b)(1)(ii)(c)(3)(c) provides that, if no branch or the remainder of the CFC satisfies the physical manufacturing test but the CFC as a whole makes a substantial contribution to the manufacturing process, the location of manufacturing will be any branch or the remainder of the controlled foreign corporation where employees of the CFC make a predominant contribution to the manufacturing process. Thus, although it is clear that activities of employees of the CFC principal may satisfy the substantial contribution test when it is performed outside of the CFC principal's country of organization, those activities apparently will be considered only if they are attributable to a branch of the CFC. This, of course, prevents a CFC from satisfying the substantial contribution test (and thus, the manufacturing exception) through activities outside of its country of incorporation unless the branch rule can be invoked.⁴²

Based on the foregoing, a predominant amount of activities contributing to the manufacturing process must be performed directly by employees of the Hong Kong CFC principal while those employees are physically located in Hong Kong, to avoid creating FBCSI. Alternatively, if a predominant amount of the activities are performed by employees while they are traveling to the Mainland, where the physical manufacturing activities occur, it would appear that those activities may only constitute manufacturing if the Hong Kong CFC principal is deemed to have a branch in the Mainland.

Obviously, if the Hong Kong CFC principal has a branch in the Mainland, this raises the potential application of the branch rule. In that case, the Hong Kong CFC principal would be deemed to maintain a manufacturing branch in China while the product sales activ-

ity occurs in Hong Kong. For branch rule purposes, the effective rate of tax imposed by Hong Kong on the sales income must be compared against the effective rate of tax that would apply to that income in China. When the effective tax rate in Hong Kong is less than 90 percent of, and at least 5 percentage points less than, the effective tax rate in China, the Chinese branch would be treated as a separate CFC.

Under the EIT law, the new income tax rate applicable to enterprises either incorporated or resident in China is 25 percent (once it is fully phased in from 2008 through 2012). The statutory tax rate in Hong Kong is 17.5 percent and may be reduced to an effective rate of 8.75 percent after taking into account the favorable Hong Kong sourcing principles. Thus, by any measure, the effective tax rate in Hong Kong is less than 90 percent of, and at least 5 percentage points less than, the effective tax rate in China. This could cause the Chinese manufacturing branch to be treated as a separate CFC for subpart F purposes.

The proposed regs place a premium on ensuring that the contract manufacturing arrangement is carefully structured to achieve U.S. tax deferral.

As described above, the branch rule effectively overrides the manufacturing exception to FBCSI. By treating the Chinese branch as a separate CFC, the Hong Kong CFC principal would not be treated as the manufacturer, but rather, would be treated as purchasing finished goods from a related party. As a result, income recognized by the Hong Kong CFC principal from the sale of products manufactured in China would be characterized as FBCSI taxable for U.S. tax purposes.

To avoid FBCSI in light of the proposed regulations, the Hong Kong CFC principal will need to establish that it is substantially contributing to the manufacturing process carried out by the unrelated contract manufacturer. Moreover, the Hong Kong CFC principal will need to establish that it is performing a predominant amount of the activities in Hong Kong, as opposed to in China or elsewhere, to avoid invoking the exposure of the branch manufacturing rule.

The proposed regulations place a high premium on ensuring that the contract manufacturing arrangement is carefully structured to achieve U.S. tax deferral. From a contractual standpoint, this means clearly establishing the nature of the relationship with the unrelated contract manufacturer and detailing the critical

⁴²The IRS similarly tried to force taxpayers into the branch rule in Rev. Rul. 97-48, 1997-49 I.R.B. 5 (revoking Rev. Rul. 75-7, 1975-1 C.B. 244). In Rev. Rul. 97-48, the IRS stated that if a taxpayer relies on attribution (under Rev. Rul. 75-7) to claim the manufacturing exception, the taxpayer must treat the contract manufacturing activities as being performed through a branch of the CFC for purposes of section 954(d)(2) (the branch rule). To the contrary, however, the Tax Court has held that an unrelated contract manufacturer or a wholly owned subsidiary that acts as a contract manufacturer cannot be a branch. See *Ashland Oil v. Comm'r*, 95 T.C. 348 (1990); and *Vetco, Inc. v. Comm'r*, 95 T.C. 579 (1990).

terms and functions provided by the Hong Kong CFC principal, such as assumption of economic risks, selection and control of raw materials and work in process, supervision over manufacturing processes, management of logistics, and quality control. This means creating substantive operations in the Hong Kong CFC principal's Hong Kong office, including *employees* (not agents) who must conduct these critical functions. Finally, from a U.S. substantial contribution and branch exposure perspective, as well as from the Mainland's taxable presence perspective, the Hong Kong CFC principal's employees' travel activities to the Mainland to conduct key substantial contribution functions will need to be properly structured and then closely monitored.

D. Related-Party Contract Manufacturing

1. Classic Fact Pattern

A related-party contract manufacturing arrangement raises a number of issues in addition to those addressed above in the discussion of unrelated contract manufacturing context. First, by definition, a related-party contract manufacturing arrangement means that a related party will be actively conducting the physical manufacturing activities in China on behalf of its Hong Kong CFC principal. As a result, the entity that is directly engaged in manufacturing in China will be subject to Chinese income tax under the new EIT law. Second, because the entity that is physically manufacturing goods in China is related to the Hong Kong CFC principal, this increases the likelihood that the Hong Kong CFC principal's income will be treated as FBCSI (that is, taxed on a current basis in the United States).

Given the historic tax holidays and incentives provided under Chinese law, it would not be unusual for a U.S.-based business to already have established a WFOE for purposes of manufacturing in China. Moreover, based on the position historically adopted by many U.S.-based businesses — that the manufacturing activities of the contract manufacturer may be attributed to its principal — it would not be unusual for a U.S.-based business to have already structured the physical manufacturing activities in China through a Hong Kong CFC principal with a related contract manufacturer in the Mainland. On a prospective basis, the related-party contract manufacturing structure will likely become much less attractive due to the exposure to increased taxes in China and the increased likelihood of generating FBCSI.

The attractive tax incentives historically offered to U.S.-based businesses making a foreign direct investment into the Chinese market are being displaced by new tax incentives that are directed toward specific industries. For Chinese operations that were approved for tax incentives on or before March 16, 2007, the pre-existing tax holiday benefits should remain available. Under this transition provision, however, the Chinese

entity must begin claiming the tax holiday benefits beginning January 1, 2008, even if the Chinese operation is not yet profitable.⁴³ If an existing WFOE already has burned through its two + three tax holiday, or if a newly created WFOE manufactures in China and is not eligible for tax incentives under the EIT law's narrowed tax incentive regime, the WFOE would be subject to the new EIT law and taxed on its profits at the fully phased-in unified rate of 25 percent.

By structuring the manufacturing activities in China through a contract manufacturing arrangement, one goal of the U.S.-based business would be to minimize the profits that are subject to tax in China by shifting more profits to the Hong Kong CFC principal.⁴⁴ In the typical buy-sell related-party contract manufacturing arrangement, however, any attempt to minimize profits in China at the WFOE level may be scrutinized from a Chinese transfer pricing perspective. Indeed, in recent years the Chinese tax authorities have become much more sophisticated and aggressive in pursuing transfer pricing adjustments for related-party transactions. Transactions between the Hong Kong CFC principal and a related WFOE contract manufacturer must adhere to arm's-length principles in establishing that the income earned is commensurate with the level of substantive activities performed by each party. Thus, a related-party contract manufacturing arrangement raises additional transfer pricing issues that typically are avoided in an unrelated contract manufacturing arrangement.

In the context of forward planning for a new operation, it may clearly be preferable to establish the operation as a conventional contract manufacturing arrangement, to minimize the degree to which Chinese tax would be imposed on the "stripped down" manufacturing operation (that is, based on the fact that the contract manufacturer bears minimal risks). However, if the U.S.-based business has owned and operated a Chinese-based manufacturer that has been in business for years and has been working as a full-fledged manufacturer, it may be problematic under Chinese tax principles to strip down this operation to a limited risk manufacturer by converting it to a conventional contract manufacturing arrangement.

In addition to transfer pricing concerns and potential issues associated with the conversion of a full-fledged Chinese manufacturer to a stripped down contract manufacturer, the related-party contract

⁴³This represents a change under the recent Chinese tax reform from the historic application of tax holiday benefits whereby the Chinese entity did not need to begin claiming tax holiday benefits until the entity became profitable.

⁴⁴As described above, the effective tax rate in Hong Kong may be as low as 8.75 percent, in contrast to the 25 percent rate under the EIT law, once the new rate is fully phased in.

manufacturing arrangement would also involve the same taxable presence issues regarding the Mainland facing the Hong Kong CFC principal in the unrelated contract manufacturing context.

2. U.S. Directly Owned WFOE

From the U.S. tax planning perspective, a related Chinese manufacturer could simply sell finished products directly back to the U.S.-based business or to other non-U.S. affiliates. Because the Chinese manufacturer is clearly engaged in the physical manufacturing process, no issue would be triggered as to whether the WFOE qualifies for the manufacturing exception to FBCSI. Thus, the related Chinese manufacturer (the WFOE) could sell its goods to its ultimate U.S. parent or other non-U.S. affiliates without generating subpart F income. In that case, however, the tax arbitrage benefits would be limited because the WFOE would be taxed at the fully phased-in 25 percent rate imposed under the new EIT law (assuming no tax incentives apply). Moreover, withholding tax would be imposed on the repatriation of profits from China (generally at a rate of 10 percent).⁴⁵

3. Hong Kong CFC Principal Owns WFOE

Alternatively, by structuring the operations as a related-party contract manufacturing arrangement through a Hong Kong CFC principal, profits would be minimized in the WFOE and maximized in the Hong Kong CFC. Under this structure, the Hong Kong CFC principal would directly own the WFOE (treated as a C corporation for U.S. federal tax purposes), and the WFOE would conduct the physical manufacturing operations as a stripped down manufacturer.

Under the proposed regulations, to achieve U.S. tax deferral on the Hong Kong profits, the U.S.-based business must establish that the Hong Kong CFC principal provided a substantial contribution to the manufacture of those products (similar to the unrelated contract manufacturing scenario discussed above). Moreover, even if the Hong Kong CFC principal substantially contributes to the manufacturing process, there is an increased likelihood under the proposed regulations that product sales by the Hong Kong CFC principal will give rise to FBCSI as a result of the branch rule, assuming that the Hong Kong CFC principal is required to render substantial contribution activities on the Mainland and that those activities rise to the level of a branch for U.S. federal tax purposes.

⁴⁵Although China historically has provided a withholding tax exemption for outbound dividends paid by foreign-invested enterprises, this exemption was revoked by the EIT law as of January 1, 2008, with the new statutory rate of 20 percent reduced to 10 percent by the EIT law's implementing regulations. The appropriate withholding tax reduction provisions of the China-U.S. income tax treaty would need to be reviewed assuming the distributee is a treaty-qualified recipient.

4. Check the Box on Hong Kong CFC Principal's WFOE?

The Hong Kong CFC principal might be inclined to "check the box" on the WFOE subsidiary to be treated as a disregarded entity. In that manner, the Hong Kong CFC principal could be treated for U.S. tax purposes as the entity that directly conducts the manufacturing in China. Unfortunately, this will not enable the U.S.-based business to successfully avoid generating subpart F income because of the branch rule. Rather, the proposed regulations include a rebuttable presumption that, if a branch satisfies the physical manufacturing test, then the CFC principal will be presumed *not* to have manufactured that same item of personal property, even if the CFC principal otherwise could have satisfied the substantial contribution test.⁴⁶

Indeed, the preamble to the proposed regulations expressly states that this rebuttable presumption is needed so that taxpayers will not be encouraged to check the box on manufacturing subsidiaries. The preamble states that checking the box in those circumstances would "obfuscate" the division of manufacturing labor and income between the CFC and its branches and thus make the manufacturing exception difficult to administer. The preamble suggests that the presumption might be rebutted by incorporating the branch that conducts the physical manufacturing test. Short of incorporating the branch (or not electing disregarded entity treatment), it is not clear what a taxpayer must show to rebut the presumption that the principal company has not manufactured the same personal property that was physically manufactured by a subsidiary company.⁴⁷

Based on the rebuttable presumption rule, if a Hong Kong CFC principal checks the box on a WFOE that performs the physical manufacturing activities, the Hong Kong CFC principal will not be treated as manufacturing the items that it sells back to the U.S. market or elsewhere. Further, the checked WFOE would be treated as a manufacturing branch for purposes of applying the branch rule. As discussed above in the context of an unrelated Chinese contract manufacturer, the effective tax rate in Hong Kong should be less than 90 percent of, and at least 5 percentage points less than, the effective tax rate in China (once the 25 percent rate is phased in). As a result, product sales by the Hong Kong CFC principal would be subject to the branch rule and characterized as currently taxable FBCSI. For this reason, a U.S.-based business typically would not want to check the box on a manufacturing WFOE subsidiary of a Hong Kong CFC.

⁴⁶Prop. Treas. reg. section 1.954-3(b)(2)(ii)(c)(2).

⁴⁷In prop. Treas. reg. section 1.954-3(b)(2)(ii)(c)(2) Example 1, the taxpayer successfully rebutted the presumption "by proving to the satisfaction of the Commissioner that the remainder of [the CFC] makes a substantial contribution to the manufacture."

5. No Check the Box and WFOE Treated as C Corporation

Assuming that the Hong Kong CFC principal does not elect to treat the WFOE subsidiary as a disregarded entity (and thus the WFOE is treated as a C corporation for U.S. federal tax purposes), the Hong Kong CFC principal must satisfy the substantial contribution requirement through the activities of its own employees, much like the situation discussed above involving an unrelated contract manufacturer.⁴⁸ Again, those activities generally must be performed in Hong Kong by employees of the Hong Kong CFC principal. Otherwise, it is likely that even if the Hong Kong entity is considered a manufacturer by satisfying the substantial contribution requirement, the location of that manufacturing would be deemed to occur outside of the Hong Kong CFC principal's country of organization. This would also implicate the branch rule and could cause the Hong Kong CFC principal's income to be taxable in the United States as FBCSI.

6. Competing Chinese Transfer Pricing Concerns

Based on the foregoing, a related-party contract manufacturing arrangement generally does not provide any advantages to the U.S.-based business from a subpart F perspective. Rather, the Hong Kong CFC principal will need to independently establish its ability to qualify as a manufacturer by satisfying the substantial contribution requirement in the proposed regulations. Thus, in this context, the related-party contract manufacturing arrangement is no different than an arrangement involving an unrelated contract manufacturer. However, from a Chinese tax perspective, the related-party nature of the relationship with the contract manufacturer may increase pressure to justify the relative amount of profit earned by the Hong Kong CFC principal in light of transfer pricing principles. Further, because of the changes brought by the EIT law, U.S.-

⁴⁸By treating the WFOE as a separate legal entity for U.S. tax purposes, the related-party manufacturer cannot alone cause the branch rule to apply. In *Vetco, Inc. v. Comm'r*, 95 T.C. 579 (1990), the U.S. Tax Court held that a wholly owned subsidiary cannot be treated as a branch for section 954(d)(2) purposes.

based businesses manufacturing in China may look to significantly shift income from the manufacturing entity to a principal in Hong Kong or elsewhere.

IV. Summary

Given the explosive economic growth in China and the continuing favorable conditions for low-cost manufacturing on the Mainland, it is likely that manufacturing operations in China will continue to escalate for many years to come. The challenge for U.S.-based businesses will be to structure those operations in a manner that will provide the greatest amount of global tax efficiency. In the context of international tax planning, this may often be achieved through a tax deferral structure whereby profits generated from the manufacture of goods in China (or elsewhere) remain offshore until the U.S.-based business has a need to repatriate the earnings.

To defer U.S. income tax on profits attributable to goods manufactured outside the United States, many U.S.-based businesses rely on contract manufacturing arrangements to capture profits that are associated with foreign manufactured goods in a low-tax jurisdiction. The proposed regulations recently released by the IRS provide some guidance under the substantial contribution requirement that addresses the level of activities required to be performed by employees of a principal company to satisfy the manufacturing exception to the FBCSI rules. To qualify for the manufacturing exception under the proposed regulations and qualify for U.S. tax deferral treatment, however, careful planning and oversight of the operations of the CFC principal must be undertaken to minimize the risk that the CFC will be deemed to have created a manufacturing branch in China, thereby resulting in FBCSI.

The future of the proposed regulations and their prospects for being finalized in substantially current form is not clear. Nevertheless, if U.S.-based businesses carefully structure the substantive activities associated with a contract manufacturing arrangement and create an adequate record of these activities, it may remain possible in the future to achieve U.S. tax deferral treatment for contract manufacturing arrangements involving physical manufacturing in China. ◆