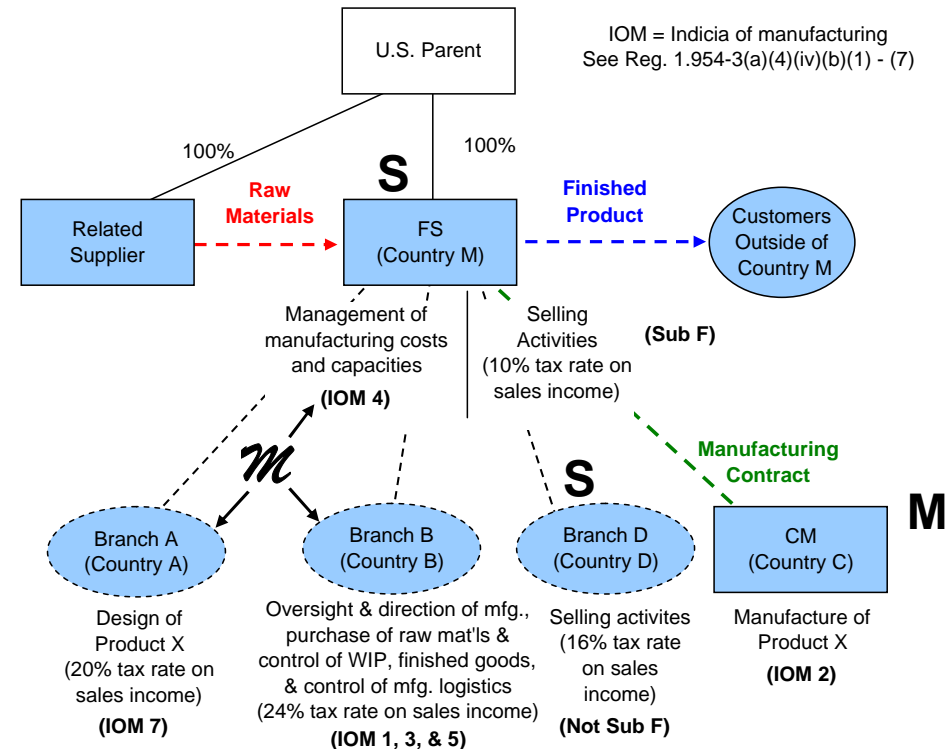


**Temp. Reg. 1.954-3T  
(b)(1)(ii)(c)(3)(v), Example 5**

**No Tax Rate Differential  
For Selling Branch**

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FS, a controlled foreign corporation organized in Country M, purchases raw materials from a related person. The raw materials are manufactured (under the principles of Reg. 1.954-3(a)(4)(ii) or (a)(4)(iii)) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion of the raw materials in Country C. FS has three branches, Branch A, Branch B, and Branch D, located in Country A, Country B and Country D respectively. Branch A, through the activities of employees of FS located in Country A, designs Product X. Branch B, through the activities of employees of FS located in Country B, controls manufacturing related logistics, provides oversight and direction during the manufacturing process, and controls the raw materials and work-in-process. Sales of Product X are also carried on through Branch D. FS manages the manufacturing costs and capacities related to the manufacture of Product X through employees located in Country M. Further, employees of FS located in Country M oversee the coordination between the branches. Employees of FS located in Country M also sell Product X to unrelated persons for use outside of Country M. Country M imposes an effective rate of tax on sales income of 10%. Country A imposes an effective rate of tax on sales income of 20%, and Country B imposes an effective rate of tax on sales income of 24%. Neither the remainder of FS, nor any branch of FS independently satisfies Reg. 1.954-3(a)(4)(i). However, under the facts and circumstances of the business, FS as a whole provides a substantial contribution to the manufacture of Product X within the meaning of Reg. 1.954-3(a)(4)(iv). In addition, under the facts and circumstances of the business, the activities of employees of FS located in Country A and Country M, considered together, would provide a demonstrably greater contribution to the manufacture of Product X than the activities of employees of FS located in Country B.



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