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IRS practice unit: Substantial contribution test for CFC manufacturing exception

The IRS Large Business and International (LB&I) division today publicly released a “practice unit”—one of a series of IRS examiner “job aides” and training materials intended to describe for IRS agents leading practices about tax concepts in general and specific types of transactions.

The title of the practice unit is: *Substantial contribution test for CFC manufacturing exception*.

Text of the practice unit is available on the IRS practice unit [webpage](#).

Summary

The practice unit explains that a U.S. shareholder of a foreign corporation generally is not subject to tax on the income of the corporation until the shareholder receives a distribution from the corporation. However, under subpart F, certain types of income earned by a controlled foreign corporation (CFC) are included in the current income of the CFC's U.S. shareholders even if the CFC does not distribute the income to its shareholders in that year.

One such type of income is foreign base company sales income (FBCSI)—income derived by a CFC in connection with a purchase or sale of personal property involving a related party in which the goods are manufactured and sold for use/consumption outside the CFC's country of organization. The provisions of subpart F generally require a U.S. shareholder to include its pro-rata share of the CFC's FBCSI in its current income. However, when Congress enacted the FBCSI rules, it was focused on “income from the purchase and sale of property, without any appreciable value being added to the product by the selling corporation.” Reg. section 1.954-3(a)(4) provides that FBCSI does not include income in connection with the purchase or sale of

property manufactured, produced, or constructed by the CFC itself (that is, the “CFC manufacturing exception”).

The CFC is generally eligible for the CFC manufacturing exception if it satisfies one of the three tests—the substantial transformation test, the component parts test, and the substantial contribution test. The first two tests are known as the “physical manufacturing tests.”

The practice unit focuses on the substantial contribution test—the test that may apply when a CFC is involved in the manufacturing process but does not satisfy the physical manufacturing tests.

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