



Letter to Grassley/Baucus, April 14, 2004 seeking amendment to contract manufacturing proposal

To:
The Honorable Charles E. Grassley
Chairman
Committee on Finance
U.S. Senate
Washington, DC 20510

The Honorable Max Baucus
Ranking Member
Committee on Finance
U.S. Senate
Washington, DC 20510

Dear Chairman Grassley and Senator Baucus,

The Silicon Valley Tax Directors Group (SVTDG) wants to express its strong concern over a recent amendment to the FSC/ETI bill, S 1637, attempting to broaden current taxation of foreign earnings by U.S. companies who use contract manufacturers. This provision would expand the Subpart F rules by eliminating attribution of contract manufacturing activities to controlled foreign corporations. The SVTDG sees an urgent and important need to further amend this provision contained in Section 662 of SA 2886 to the bill.

U.S. High Tech companies with foreign affiliates that use contract manufacturers in the production process would be further at risk of losing deferral of U.S. taxes on the active earnings and profits of their foreign affiliates if the Section 662 amendment is approved without further amendment. This loss of deferral would be a serious disadvantage to many companies in competition with vertically integrated global competitors. This competitive disadvantage would also reduce U.S. tax revenue over the long term.

Since 1968 and until recently, Congress, the Courts, Treasury and the IRS attributed the activities of a contract manufacturer to its principal if certain conditions were met. This attribution is important for avoiding the loss of U.S. tax deferral.

In 1975, Revenue Ruling 75-7 was issued. This was helpful but not conclusive with respect to attributing the contract manufacturing activities to the principal. Subsequently in 1997, Revenue Ruling 97-48 was issued and it eliminated the activities of a contract manufacturer as attributable to its principal.

From a U.S. policy perspective, it is important to consider that many High Technology companies are forming strategic contract manufacturing alliances to compete more effectively globally, improve overall customer service, and increase profitability. These are all important High Technology industry growth objectives and some of the key factors relevant to these High Technology trends include:

- Integration of the global supply chain
- Alternative to high cost capital investments and on-going need to implement cutting edge technological advances

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- Emphasis on internal high value core competencies
- Lower costs of production
- Faster ramp-up and ramp-down of production
- Need for superior delivery time, customized services, and customer solution value

With this in mind, the Silicon Valley Tax Directors Group recommends that the activities of contract manufacturers be attributed to a controlled foreign corporation (CFC). This would be accomplished by amending Sec. 662 of SA 2886 to the bill S. 1637 as follows:

SEC. 662. NONATTRIBUTION OF CERTAIN MANUFACTURING BY PERSONS OTHER THAN CONTROLLED FOREIGN CORPORATION.

(a) **IN GENERAL.**--Section 954(d) (defining foreign base company sales income) is amended by adding at the end the following new paragraph:

“(5) **NONATTRIBUTION OF CERTAIN MANUFACTURING ACTIVITIES.**--For purposes of this subsection, in determining whether income of a controlled foreign corporation is foreign base company sales income, any manufacturing, production, or construction by a person other than an individual who is an employee of the corporation, unless the manufacturing, production or construction of the property is by a person under a contract with the controlled foreign corporation where (i) the controlled foreign corporation demonstrates the authority to control and approve the quality of the property; (ii) bears risk of loss for property during the manufacturing process, or (iii) the person under contract may not sell the property to any other person because of intellectual property or other legal rights held by the controlled foreign corporation, shall not be attributed to the corporation.”

(b) **EFFECTIVE DATE.**--

(1) **IN GENERAL.**--The amendment made by this section shall apply to taxable years of controlled foreign corporations beginning on or after the date of the enactment of this Act, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

(2) **NO INFERENCE.**--Nothing in the amendment made by this section shall be construed to infer the proper treatment of manufacturing, production, or construction for taxable years beginning before the date of the enactment of this Act.

This amendment to Sec 662 would result in stabilizing and leveling the global competitive environment by permitting U.S. tax deferral for active business income of foreign affiliates that use contract manufacturers. This will also result in a partnership between U.S. High Technology companies and the U.S. government that is mutually beneficial to economic growth of the High Technology Industry and the U.S. economy.

Respectfully,

The Silicon Valley Tax Directors Group