North Carolina Department of Revenue

Roy Cooper
Governor

Ronald G. Penny
Secretary

June 20, 2023

[redacted]

Re: Request for Private Letter Ruling
[redacted]

Dear [redacted]

This letter is a response to your request for a private letter ruling dated [redacted], wherein you requested on behalf of our client, [redacted] or "the Company"), that the North Carolina Department of Revenue ("Department") provide a written ruling regarding the proper allocation and apportionment of the Company's contract manufacturing service fees. Specifically, your client is requesting clarification regarding the sourcing of service fees received from its foreign parent [redacted] in accordance with the North Carolina statutes associated with market based sourcing for tax years beginning on or after January 1, 2020.

The statement of facts submitted for the Department's consideration of your request is summarized as follows:

[redacted] is organized as a limited partnership electing to be treated as a corporation for federal tax purposes. The Company is indirectly wholly owned by [redacted], a multinational [redacted] company based in [redacted]. [redacted] utilizes affiliate owned and operated strategic production facilities located in five countries: [redacted], [redacted]. [redacted] operates three separate manufacturing facilities in NC and serves as [redacted] primary source for products manufactured and sold in the U.S.

Although [redacted] manufacturing facilities are located in NC, the Company has employees conducting business activities related to its manufacturing operations in a number of other states. In 2020, these states included [redacted], [redacted]. For example, in [redacted], [redacted] employees perform Human Relations functions. The Company also leases equipment storage space, is registered to do business, and files a corporate income tax return in [redacted].

[redacted] Manufacturing Services Agreement with [redacted]

In accordance with the Manufacturing Services Agreement (the "Agreement"), [redacted] receives the following service fees from [redacted] as described below:

1. Production Cost Reimbursement Fee - an amount equal to [redacted] actual production costs of manufacturing and related cost of the product manufactured.

2. Service Fee - an amount equal to an arms-length rate of return on capital employed ("ROCE"), to be determined and finally settled each year on an annual basis. The ROCE is defined as [redacted] operating income divided by its operating assets.

3. Fee Upon Termination of Services - an amount equal to the difference between the realized value and the net book value of all assets owned by [redacted] related to manufacturing services agreed to under the Agreement. This amount is payable to [redacted] in the event the Company ceases to do business or is no longer required to provide manufacturing services to [redacted].

The production cost reimbursement fee and the service fee (collectively the "service fees") represent the annual revenue stream for which [redacted] seeks to determine the proper sourcing. The service fees are deemed to be at arm's-length per the current Advance Pricing Agreement with the IRS and constitute [redacted] compensation for the manufacturing services the Company provides to [redacted].

From its principal place of business in [redacted], [redacted] primary objective is to manufacture product in order to be sold to third parties worldwide. As the global parent of a multinational organization, [redacted] owns intellectual property related to certain pharmaceutical products it manufactures. Globally, the [redacted] maintains strategic production facilities in five different countries and [redacted] oversees the production plans and capacity of these subsidiaries in order to exploit its intellectual property and produce finished goods. On this premise, [redacted] and [redacted] entered into the aforementioned Agreement to have [redacted] produce certain finished goods according to specifications and protocols as provided by [redacted].

In accordance with the Agreement, [redacted] is responsible for establishing and maintaining all Standard Operating Procedures ("SOPs") for organizing, monitoring and controlling [redacted] manufacturing process. The SOPs are sets of clearly written instructions, which outline the exact steps and tasks needed to complete a job, operation, or operate a piece of machinery as part of the agreement manufacturing process. The SOPs utilized by [redacted] were developed by [redacted] and reflect the same processes used in [redacted] other manufacturing operations, including the utilization of the same raw materials.

Under the Agreement, [redacted] receives the raw materials necessary for production from [redacted] or may be responsible for procuring the raw materials from third-party suppliers, as necessary, in accordance with [redacted] procedures. The Company uses those raw materials for manufacturing the agreed upon semi-finished and finished product to [redacted] specifications as set forth in the Agreement. Inventories under production, including semi-finished and finished goods, remain the property of [redacted] at all times.

Upon completion of the manufacturing process, [redacted] obligations under the Agreement cease and the Company moves the product from the manufacturing facilities to a temporary warehousing facility where the product awaits distribution as coordinated by [redacted]. Final sale and delivery of the product is handled by [redacted] and [redacted] manufacturing service compensation is not dependent on the market success or failure of the product or on the volume of product sold. [redacted] does not engage in any marketing or selling activities, and because [redacted] never takes title to the product, bears little risk with regard to the work-in-process and finished goods inventory.

The manufacturing services provided by [redacted], similar to the other manufacturing facilities located outside the U.S. (see above), allow [redacted] to coordinate worldwide product distribution from its principal place of business in [redacted]. For instance, the finished product manufactured by [redacted] is sold by [redacted] to [redacted] for U.S. distribution and other global affiliates for non-U.S. distribution. [redacted] distributes more than 50 percent of [redacted] total manufactured product on behalf of [redacted] in the U.S. market, and [redacted] sells the remaining output to countries outside of the U.S. Product for sale outside the U.S. is exported at the expense of [redacted]. [redacted] is responsible for all freight and transportation costs related to the transport of products from [redacted] facilities to the final destination as determined by [redacted]. Through a proprietary information technology system provided by [redacted], [redacted] monitors customer inventory levels throughout the world.

ISSUE:

How should [redacted] source the service fees the Company receives from [redacted]?

Department's Response:

Based on our review of the information provided and the pertinent North Carolina statutes and regulations, we have determined that [redacted] service fees should be sourced to North Carolina if the finished product is ultimately delivered by a related entity to a customer located in North Carolina, regardless of F.O.B. terms.

The Department's administrative rule, 17 NCAC 05G.0303, states:

> "Where a taxpayer has receipts subject to this Subchapter from transactions with a related entity customer, information that the customer has regarding the sourcing of receipts from these transactions shall be imputed to the taxpayer."

[redacted] is providing contract manufacturing services to its foreign parent, [redacted]. Under an agreement between the two entities, [redacted] receives the raw materials for production from [redacted]. [redacted] uses those raw materials for manufacturing the agreed upon semi-finished and finished product to [redacted] specifications as set forth in the agreement. The inventories under production, including semi-finished and finished goods, remain the property of [redacted] at all times. In return for their contract manufacturing services, [redacted] receives a reimbursement of production costs and a service fee.

After its manufacturing services are completed, [redacted] obligations under the agreement ends, and according to the statement of facts, it transfers the product from its manufacturing facilities to a temporary warehousing facility where the product awaits distribution as coordinated by [redacted]. The finished product is then sold to [redacted] for distribution in the United States and around the world. The sale and delivery of the product to [redacted] is handled by [redacted]. At no point does [redacted] engage in any marketing or selling activities. Furthermore, [redacted] does not take title to the product, and bears little risk with regard to the work-in-process and finished goods inventory.

According to aforementioned rule, the gross receipts derived from [redacted] contract manufacturing services should be sourced to the ultimate destination of the finished product. The rule is applicable in this situation because the companies are related entities, and the finished product is a tangible property.

[redacted]The North Carolina statute addressing the proper sourcing sales of tangible personal property in this State is N.C. Gen. Stat. §105-130.4(*l*)(3). It states that a taxpayer's market for its receipts are in North Carolina if:

> "In the case of sale of tangible personal property, if and to the extent the property is received in this State by the purchaser. In the case of delivery of goods by common carrier or by other means of transportation, including transportation by the purchaser, the place at which the goods are ultimately received after all transportation has been completed is considered the place at which the goods are received by the purchaser. Direct delivery into this State by the taxpayer to a person or firm designated by a purchaser from within or without the State constitutes delivery to the purchaser in this State."

Based on the above, [redacted] must source its service fees in the same manner as its related customer – as the sale of tangible personal property. Importantly, the finished product is sold in the United States and other countries. Since these products are ultimately shipped and delivered after it is sold to [redacted], [redacted] should source the service fees derived from its contract manufacturing services based on information provided by its related customer pertaining to its sales and the ultimate destination of the finished products to the ultimate purchaser. If [redacted] is not provided the ultimate destination and cannot determine the locations where the products are ultimately delivered, then the service fees in this situation should be sourced to North Carolina, the location where [redacted] performs the contract manufacturing services.

This ruling answers the question presented in the ruling request and does not address any other issues unrelated to the questions. It is based solely on the facts submitted to the Department of Revenue for consideration of the transactions described. Your statement of facts and our findings are subject to audit verification. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material aspect from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that this document is not to be cited as precedent and that a change in statute, a regulation, or case law could void this ruling.

Should you have any questions, please contact me.

Very truly yours,

[redacted]

[redacted] Administrative Officer
Corporate Tax Division
Telephone: (919) 814-1162
Fax: (919) 733-1821