1996 FSA LEXIS 463

[TEXT REDACTED]

US Internal Revenue Service

April 30, 1996

Reporter

1996 FSA LEXIS 463 *

Field Service Advice Memoranda

[*1]

Reference: CC:INTL:0103-96, Br2:VMark

Core Terms

manufacturing, products, sales income, written agreement, manufacturing activity, attributed, selling, raw material, finished product, credit card, specifications, verification, remainder, manufacturing process, separate corporation, subsidiary, taxpayer, factory

Text

date: APR 30 1996

to: Kenneth Chan, I.E., San Francisco

from: Phyllis Marcus, Chief, Branch 2, Office of the Associate Chief Counsel (International)

subject: [TEXT REDACTED]

THIS DOCUMENT CONTAINS PRIVILEGED INFORMATION UNDER *SECTION 6103 OF THE INTERNAL REVENUE CODE* AND INCLUDES STATEMENTS SUBJECT TO

THE ATTORNEY-CLIENT PRIVILEGE AND THE ATTORNEY WORK PRODUCT PRIVILEGE. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE IRS, INCLUDING THE TAXPAYER(S) INVOLVED, AND ITS USE WITHIN THE IRS SHOULD BE LIMITED TO THOSE WITH A NEED TO REVIEW THE DOCUMENT FOR USE IN THEIR OWN CASES.

This memorandum responds to your request for informal technical assistance with regard to the operation of the rules of *section 954(d)*. We were advised of your request on December 26, 1995 and we received additional information from you regarding this case on March 27, 1996.

FACTS:

[TEXT REDACTED] is a U.S. corporation that manufactures and markets credit card verification equipment used by retail merchants. The tax years of [TEXT REDACTED] under examination are [TEXT REDACTED], [TEXT REDACTED] and [TEXT REDACTED].

In [TEXT REDACTED] of [TEXT REDACTED], [TEXT REDACTED] formed [TEXT **[*2]** REDACTED] as its wholly-owned Hong Kong subsidiary. [TEXT REDACTED] had no offices or employees in Hong Kong. Instead, all of its assets and employees were located in its branch in [TEXT REDACTED], Taiwan.

From [TEXT REDACTED] to [TEXT REDACTED], [TEXT REDACTED] hired [TEXT REDACTED], an unrelated subcontractor in [TEXT REDACTED], Taiwan to manufacture the credit card verification products that were sold to [TEXT REDACTED]. The products were shipped directly from [TEXT REDACTED]'s factory in [TEXT REDACTED] to [TEXT REDACTED]'s distribution center in [TEXT REDACTED] California.

In [TEXT REDACTED], [TEXT REDACTED] formed [TEXT REDACTED], its wholly-owned Taiwan corporation. [TEXT REDACTED] acquired a factory in [TEXT REDACTED] to manufacture products for sale by [TEXT REDACTED] to [TEXT REDACTED]. When the factory was officially opened in [TEXT REDACTED], [TEXT

REDACTED] replaced [TEXT REDACTED] as manufacturer for the majority of [TEXT REDACTED]'s products although [TEXT REDACTED] continued to manufacture certain products that required extensive manual labor.

When [TEXT REDACTED] was formed in [TEXT REDACTED], [TEXT REDACTED] and [TEXT REDACTED] entered into an oral agreement which **[*3]** provided that [TEXT REDACTED] would consign raw materials and component parts to [TEXT REDACTED] for assembly into finished credit card verification products.

In the [TEXT REDACTED], [TEXT REDACTED] learned that it could obtain a Taiwan tax holiday only if took title to the raw materials and components that it processed for [TEXT REDACTED]. As a result, [TEXT REDACTED] and [TEXT REDACTED] entered into a formal written agreement on [TEXT REDACTED] (Written Agreement) that replaced the oral agreement. The Written Agreement was generally modeled on the prior oral agreement with three additional provisions that were designed to help [TEXT REDACTED] qualify for the tax holiday. Under Article [TEXT REDACTED] of the Written Agreement, [TEXT REDACTED] was to supply parts to [TEXT REDACTED]. Under Article [TEXT REDACTED], [TEXT REDACTED] was to purchase, at the direction of [TEXT REDACTED], all parts and components necessary to manufacture the products ordered by [TEXT REDACTED], and under Article [TEXT REDACTED], [TEXT REDACTED] was to purchase all of [TEXT REDACTED]'s existing inventory and materials when the manufacturing agreement was terminated. In actuality, [TEXT REDACTED] consigned **[*4]** parts to [TEXT REDACTED] and [TEXT REDACTED] purchased all materials and components which were then shipped to [TEXT REDACTED] for processing. [TEXT REDACTED] never owned any of these component parts or raw materials.

The Written Agreement specifically provided that [TEXT REDACTED] "wishes to source the Products [to be assembled by [TEXT REDACTED]] in accordance with the requirements of *Revenue Ruling 75-7*," and that [TEXT REDACTED] "is willing to

manufacture the Products and supply them to [[TEXT REDACTED]] in compliance with the requirements set forth in *Revenue Ruling 75-7*.

Under Article [TEXT REDACTED] of the Written Agreement, [TEXT REDACTED] agreed to manufacture exclusively for [TEXT REDACTED]. Article [TEXT REDACTED] provided that during each term that the Written Agreement was in effect, [TEXT REDACTED] agreed to purchase from [TEXT REDACTED] an amount of products valued at no less than [TEXT REDACTED] New Taiwan Dollars, based on the prices then in effect for the products. By mutual consent, the parties could change the minimum commitment for any term.

Under Article [TEXT REDACTED] of the Written Agreement, the parties agreed that in the performance of the agreement they were **[*5]** independent contractors and that neither party would be considered the agent of the other.

Under Article [TEXT REDACTED] and [TEXT REDACTED] of the Written Agreement, [TEXT REDACTED] was to provide [TEXT REDACTED] with all information regarding product specifications, including know-how and other technical information, that [TEXT REDACTED] would need to manufacture the products. [TEXT REDACTED] was allowed to adopt [TEXT REDACTED]'s existing manufacturing process or establish its own new production method as long as the products met the product specifications.

Under Article [TEXT REDACTED] of the Written Agreement, [TEXT REDACTED] retained the right to examine [TEXT REDACTED]'s purchasing records to determine whether necessary parts had been purchased from approved vendors, to inspect work in progress, and to conduct spot inspections of finished products. Under Article [TEXT REDACTED], [TEXT REDACTED] was to test the finished products using product tests and testing equipment designed by [TEXT REDACTED].

Article [TEXT REDACTED] of the Written Agreement provided that all purchase orders placed by [TEXT REDACTED] with [TEXT REDACTED] would be noncancellable. Article [TEXT REDACTED] provided **[*6]** that title to the products and risk of loss would pass

from [TEXT REDACTED] to [TEXT REDACTED] F.O.B. [TEXT REDACTED]'s facility in [TEXT REDACTED] or at a point of designation specified in the purchase order.

Under Article [TEXT REDACTED] of the Written Agreement, [TEXT REDACTED] warranted that the products, at the time of their delivery, would conform to product specifications and that it would promptly replace, at its own expense, any nonconforming or defective products.

Under Article [TEXT REDACTED] of the Written Agreement, [TEXT REDACTED] agreed to indemnify [TEXT REDACTED] against any claims arising in connection with design defects, violations of the law by [TEXT REDACTED], intentional or negligent acts or omissions by [TEXT REDACTED] or its employees, and any infringement of third party rights based on the distribution and sale of the products.

The taxpayer contends that, in actuality, the functions performed by [TEXT REDACTED] and [TEXT REDACTED] were as follows. [TEXT REDACTED] performed product development, component engineering and manufacturing engineering under [TEXT REDACTED]'s supervision. [TEXT REDACTED] performed continuation engineering, test engineering, and test **[*7]** equipment design. [TEXT REDACTED] also planned material requirements and component procurement, performed procurement, and owned the parts and inventory which it consigned. Under [TEXT REDACTED]'s supervision, [TEXT REDACTED] also received materials and warehoused them, and performed factory scheduling, assembly, shipment and distribution. The information we have received indicates that the Service does not necessarily agree with the Taxpayer's description of who performed the various functions and that some of these functions are performed by [TEXT REDACTED] in the United States.

[TEXT REDACTED] sold most of the finished products manufactured by [TEXT REDACTED] to [TEXT REDACTED] and its subsidiaries at cost plus [TEXT REDACTED]% profit. These finished goods were shipped directly from [TEXT REDACTED]'s factory to [TEXT REDACTED]'s distribution center in California. [TEXT

REDACTED] sold these finished goods to customers and distributors in the United States and around the world.

[TEXT REDACTED] files only Taiwan tax returns. Neither [TEXT REDACTED] nor [TEXT REDACTED] pays any Taiwan tax due to tax holidays.

ISSUE:

Whether the income earned by [TEXT REDACTED] from selling credit card **[*8]** verification products to [TEXT REDACTED] is foreign base company sales income under *section 954(d)*.

CONCLUSION:

The income of [TEXT REDACTED] from selling credit card verification products will be excluded from foreign base company sales income under the manufacturing exception if the manufacturing activities of [TEXT REDACTED] are attributed to [TEXT REDACTED] under *Rev. Rul. 75-7*. Even if [TEXT REDACTED] is not deemed to be the manufacturer of the products, however, [TEXT REDACTED]'s income should not be treated as foreign base company sales income because the selling and manufacturing activities occur within the same country.

LAW AND ANALYSIS:

Section 954(d)(1) provides that the term, "foreign base company sales income," includes income derived in connection with the purchase of personal property from any person and its sale to a related person where the property is manufactured outside the controlled foreign corporation's (CFC's) country of incorporation and sold for use outside that country.

In this case, [TEXT REDACTED] is a CFC, as defined in *section 957*. It sold property to [TEXT REDACTED], a related person, within the meaning of *section 954(d)(3)*. The property sold was manufactured **[*9]** in Taiwan, outside [TEXT REDACTED]'s country of

incorporation, Hong Kong and sold for use outside of Hong Kong. Thus, the elements of *section 954(d)(1)* are present in this case.

Under the manufacturing exception of *Treas. Reg. § 1.954-3(a)(4)*, however, foreign base company sales income does not include income of a CFC derived in connection with the sale of personal property manufactured, produced or constructed by such corporation in whole or in part from personal property which it has purchased.

The application of the manufacturing exception is limited by the branch rule. *Treas. Reg. § 1.954-3(b)(1)(ii)(a)* provides that if a CFC carries on manufacturing activities by or through a branch located outside the CFC's country of incorporation, and the use of the branch for manufacturing personal property purchased or sold by or through the remainder of the CFC has substantially the same tax effect as if the branch were a wholly owned subsidiary of the CFC, the branch and the remainder of the CFC will be treated as separate corporations for purposes of determining foreign base company sales income. The selling activities performed by the remainder of the corporation will then be treated **[*10]** as performed on behalf of the manufacturing branch. *Treas. Reg. § 1.954-3(c)*.

Treas. Reg. § 1.954-3(b)(1)(ii)(b) provides that, in the case of a manufacturing branch, the use of the branch will be considered to have substantially the same tax effect as if the branch were a wholly owned subsidiary of the CFC if the income allocated to the remainder of the CFC is, by statute, treaty or otherwise, taxed in the year when earned at an effective rate of tax that is less than 90% of and at least 5 percentage points less than, the effective rate of tax that would apply to the income in the country where the branch is located if, under the laws of that country, the entire income of the CFC were considered derived by such corporation from sources within that country from doing business through a permanent establishment and the corporation were organized under the laws of that country.

The taxpayer takes the position that, under *Rev. Rul. 75-7*, the manufacturing activities of [TEXT REDACTED] would be attributed to [TEXT REDACTED] so that the

manufacturing exception of *Treas. Reg. § 1.954-3(a)(4)* would apply to exclude the income of [TEXT REDACTED] from foreign base company sales income and that **[*11]** the branch rule would not change this result.

In *Rev. Rul. 75-7* [1], the manufacturing activities of an unrelated contract manufacturer that was hired by the CFC to convert metal ore concentrate into ferroalloy were attributed to the CFC. The attribution of manufacturing activities was determined to be appropriate where: the contract manufacturer did not share in the profits but was paid only a conversion fee; the CFC always owned the raw materials and the finished product; the CFC purchased the raw material; the CFC bore the risk of loss; the CFC retained control of the time and quantity of production; the CFC retained control of the quality of production and the manufacturer was at all times required to use the processes directed by the CFC; the CFC sent personnel to inspect, correct or advise with regard to the manufacturing process; the CFC, alone, negotiated the sale of finished products; and the manufacturing process was complicated and required a highly skilled work force.

Because the activities of the contract manufacturer, in *Rev. Rul. 75-7*, were attributed to the CFC, the CFC was deemed to be the manufacturer of the ferroalloy. The contract manufacturer was located outside the **[*12]** CFC's country of incorporation. Therefore, the CFC was treated as conducting its manufacturing activities through a branch located in the country where the contract manufacturer performed the manufacturing activities. Because the tax rate was higher in the country where the CFC's selling income was subject to tax than in the country where the manufacturing occurred, the branch rule of *Treas. Reg. § 1.954-3(b)(1)(ii)* did not apply and the income was excluded from foreign base company sales income under the manufacturing exception.

It is possible that the manufacturing activities of [TEXT REDACTED] will be attributed to [TEXT REDACTED] under *Rev. Rul. 75-7*. The following provisions of the Written

---

[1] While the Tax Court in *Ashland Oil Corporation v. Commissioner, 95 T.C. 348 (1990),* declined to follow *Rev. Rul 75-7* within the context of the branch rule of *section 954(d)(2)*, the Service will continue to apply *Rev. Rul. 75-7* until it issues further guidance in this area.

Agreement would support attribution under *Rev. Rul. 75-7*. [TEXT REDACTED] was to manufacture exclusively for [TEXT REDACTED]. [TEXT REDACTED] was to provide all information regarding product specifications, including know-how and other technical information, that [TEXT REDACTED] would need to manufacture the products. [TEXT REDACTED] was to retain control over the manufacturing process by: 1) retaining the right to examine [TEXT REDACTED]'s purchasing records to make sure the appropriate parts **[*13]** were ordered; 2) retaining the right to inspect work in progress and to conduct spot checks of finished products and 3) providing tests and testing equipment that were to be used to check the manufactured products. [TEXT REDACTED] retained some of the risk of loss by: 1) agreeing to purchase from [TEXT REDACTED] a specified amount of products at prices then in effect, 2) by making purchase orders non-cancellable and 3) by agreeing to indemnify [TEXT REDACTED] against any claims arising from its negligent or intentional acts in the manufacture of the products.

The following provisions of the Written Agreement, however, would not support attribution under *Rev. Rul. 75-7*. [TEXT REDACTED] had control over the manner in which the products were manufactured as long as the products met certain specifications. [TEXT REDACTED] was not to be considered the agent of [TEXT REDACTED] in performing the manufacturing. [TEXT REDACTED] retained some of the risk of loss by agreeing to replace any products that failed to meet the specifications. [TEXT REDACTED] also agreed to purchase and take title to the raw materials. The taxpayer takes the position, however, that [TEXT REDACTED] rather than [TEXT **[*14]** REDACTED] actually purchased and owned the raw materials throughout the manufacturing process. It is unnecessary to resolve whether the manufacturing activities of [TEXT REDACTED] can be attributed to [TEXT REDACTED] under *Rev. Rul. 75-7*, however, because, as explained below, in either case the income of [TEXT REDACTED] will not be foreign base company sales income.

If the manufacturing activities of [TEXT REDACTED] can be attributed to [TEXT REDACTED] under *Rev. Rul 75-7*, [TEXT REDACTED] will be deemed to be the manufacturer. [TEXT REDACTED]'s manufacturing activities would be attributed to

[TEXT REDACTED]'s Taiwanese branch because the manufacturing occurs in Taiwan. Since [TEXT REDACTED] also conducts all its sales activities through this Taiwanese branch, however, even if the branch rule were to apply to treat the branch as a separate corporation, [TEXT REDACTED]'s income would be excluded from foreign base company sales income. *Treas. Reg. § 1.954-3(b)(2)(ii)(e)* provides that if the branch rule applies, the income of the branch will not be considered to be foreign base company sales income if the income would not be so considered if it were derived by a separate CFC under like **[*15]** circumstances. If [TEXT REDACTED]'s Taiwanese branch were a separate CFC conducting both selling and manufacturing activities, the manufacturing exception would apply to exclude the sales income from foreign base company sales income.

If *Rev. Rul. 75-7* does not apply to attribute the manufacturing activities of [TEXT REDACTED] to [TEXT REDACTED], [TEXT REDACTED] will not be treated as the manufacturer of the products that it sells. Nevertheless, the Service has issued a technical advice memorandum, *TAM 8509004*, which takes the position that even if a branch is determined not to be a manufacturer under *Rev. Rul. 75-7*, its income will be excluded from foreign base company sales income if the product it sells is manufactured in the same country in which the sales branch is located. The TAM seems to presume that this result would occur if the branch rule first applied to treat the branch as a separate subsidiary.

Whether the branch rule would apply to treat [TEXT REDACTED]'s sales branch in Taiwan as a separate corporation from the remainder of the CFC in Hong Kong is determined under *Treas. Reg. 1.954-3(b)(1)(i)*. Under that regulation, the sales branch will be treated as a separate corporation **[*16]** if the income allocated to the branch is taxed at an effective rate that is less than 90% of, and at least five percentage points less than the effective rate of tax that would apply to the income if it were taxed in the country where the remainder of the CFC is organized. In this case, the products were manufactured in Taiwan, where [TEXT REDACTED]'s selling branch would be deemed to be incorporated if the branch rule applied. Therefore, if the branch rule does apply,

[TEXT REDACTED]'s income would be excluded from foreign base company sales income because this sales income would be so excluded if the branch were a separate CFC selling products that were manufactured in the country where it was incorporated. See *Treas. Reg. § 1.954-3(b)(2)(ii)(e)*.

Even if the branch rule does not apply to treat the branch as a separate corporation, however, the income earned by [TEXT REDACTED] should not be foreign base company sales income. The branch rule is a punitive rule that is directed at CFCs that move their sales activities outside of the country where the manufacturing occurs to take advantage of lower tax rates. A taxpayer should not be in a less favorable tax position when the branch rule **[*17]** does not apply. Further, since the manufacturing and selling activities occur in the same country, this case does not present the abuse to which the foreign base company sales income rules were directed. Therefore, we do not recommend that you pursue the position that [TEXT REDACTED]'s income from selling credit card verification products to [TEXT REDACTED] is foreign base company sales income.

If you have any questions about this memorandum, please call Valerie Mark at (202) 622-3840.

cc: San Francisco District Counsel

Load Date: 2006-01-19