

# *US Outbound Tax Newsalert*

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*IRS applies same-country exception  
to CFC's sales, despite subsequent  
manufacturing elsewhere*

In a private letter ruling ("PLR"), the IRS addressed the application of the same-country manufacturing exception under Treas. Reg. §1.954-3(a)(2) to product sales made by a controlled foreign corporation ("CFC") to a related foreign corporation. The products sold by the CFC were purchased from an unrelated corporation organized in the same foreign country as the CFC. Specifically, PLR 201206003 analyzes whether the same-country manufacturing exception applies in the case where the unrelated seller of the product manufactures critical components of the product in the CFC's country of organization but the manufacture of other components and the assembly of the final product are performed by affiliates of the unrelated corporation outside of the CFC's country of incorporation. The IRS issued the letter on November 9, 2011 and released it on February 10, 2012.

## *Summary of key issue*

Foreign base company sales income ("FBCSI") does not include income from related party sales by a CFC if the product sold is physically manufactured in the CFC's country of organization. PLR 201206003 addresses whether the manufacture of critical components of the product sold can be treated as the manufacture of the product for purposes of satisfying the same-country manufacturing exception. Treas. Reg. §1.954-3(a)(4)(iii) provides a subjective test for determining whether the sale of property will be treated as the sale of a manufactured product when purchased components constitute part of the property sold (component physical manufacturing test). The test requires that the selling corporation, in connection with the property



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purchased and sold, perform activities that are substantial in nature and generally considered to constitute the manufacture of property. The taxpayer has represented that the manufacturing activities conducted by the unrelated seller in the CFC's country of organization (manufacture of critical components) constitute manufacturing within the meaning of Treas. Reg. §1.954-3(a)(4)(iii) and are substantial with respect to the products as a whole. Accordingly, the ruling concludes that the same-country manufacturing exception applies to the sale of products by the CFC.

**Observation:** This is the first time that the IRS has treated the manufacture of critical components of a product as the manufacture of the product for purposes of applying the same-country manufacturing exception. The analysis in PLR 201206003 lacks detail. Nevertheless, even though the taxpayer's facts do not fit squarely within the language of Treas. Reg. §1.954-3(a)(4)(iii) (component physical manufacturing test) because it is not purchasing property that is used as a component in property that is sold, it appears that the IRS is applying that physical manufacturing test to the activities of the unrelated seller in the CFC's country of organization (manufacture of the critical components) to determine whether the products sold by the CFC were manufactured in its country of organization.

## *Facts*

The taxpayer in PLR 201206003 ("TP") is a U.S. corporation that is a leading global provider of Products. It wholly owns (directly and indirectly) CFCs, including Corporation X, which was created under the laws of Country 1.

Corporation Y is a leading manufacturer of Products and is not related within the meaning of section 954(d)(3) to TP or TP's affiliates. Corporation Y was also created under the laws of Country 1.

Under an agreement between affiliates of TP and Corporation Y, Corporation Y and its affiliates perform physical manufacturing activities for Products (as described below) and sell finished Products to TP's affiliates, including Corporation X, for distribution in TP's supply chain in Region. Corporation X resells Products to various TP distribution affiliates that are related to Corporation X. TP's distribution affiliates generally on-sell Products to TP-related party sales entities that sell Products to unrelated customers, generally within the same country as the applicable TP sales entity. The distribution of products makes up a significant portion of TP's business.

The manufacture of Products by Corporation Y and its affiliates is a multi-step process that entails several stages of manufacturing in multiple countries, involving component parts production and final assembly. Certain component parts are critical to the finished Products from both a value and cost perspective. Corporation Y manufactures an unknown amount of those critical parts for Products exclusively in Country 1 ("Country 1 Manufactured Component Parts"). The Country 1 Manufactured Component Parts are manufactured exclusively in Country 1 for certain essential competitive reasons, including quality control and protection of critical, competitively-advantaged intellectual property inherent in the component part manufacturing. Manufacturing activities of Corporation Y are performed by a significant number of employees of Corporation Y in factories located in Country 1. However, the Products do not bear the moniker "Made in Country 1" and are identified in certain reports provided by Corporation Y as non-Country 1 manufactured Products.

In addition, the finishing manufacturing activities with respect to Products are performed by wholly owned subsidiaries of Corporation Y in countries other than

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Country 1 at finishing manufacturing plants located outside of Country 1. Those activities include the manufacture of component parts embedded in Products, the assembly of Products and packaging, labelling and shipping of Products. Products finished in these plants are designated as "Made in \_\_\_\_\_", with the jurisdiction of the finishing manufacturing plant determining the applicable designation.

TP has represented that the manufacturing activities performed by Corporation Y in Country 1 with respect to the Country 1 Manufactured Component Parts are substantial in nature, constitute the "manufacture, production, or construction of property" with respect to finished Products within the meaning of Treas. Reg. §1.954-3(a)(4)(iii), and are substantial with respect to the manufacture of the finished Products as a whole.

TP also expressed its belief that the finishing manufacturing activities performed by Corporation Y's affiliates outside of Country 1 may constitute the "manufacture, production, or construction of property" with respect to finished Products, within the meaning of Treas. Reg. §1.954-3(a)(4)(iii).

## *Discussion*

As stated in PLR 201206003, FBCSI includes income from the purchase of personal property from any person and its sale to a related person, where (i) the property that is purchased is manufactured outside the country where the CFC is created or organized and (ii) the property is sold for use outside that country. Section 954(d)(1). Treas. Reg. §1.954-3(a)(2) provides the exception to FBCSI for property manufactured in the country where the CFC that purchases and sells the property is organized. (Same-country manufacturing exception)

PLR 201206003 recites the physical manufacturing rules found in Treas. Reg. §1.954(a)(4)(ii) (substantial transformation rule) and (a)(4)(iii) (component physical manufacturing rule), which apply to determine what constitutes the manufacture of personal property for purposes of the same-country manufacturing exception. It appears that the PLR applies Treas. Reg. §1.954-3(a)(4)(iii) to reach its favorable conclusion. That regulation provides that, if purchased property is used as a component of property that is sold, and the operations conducted by the selling corporation in connection with the property purchased and sold are substantial in nature and generally considered to constitute the manufacture of property, then the sale of the property will be treated as the sale of a manufactured product. (There is also a safe harbor test under the component physical manufacturing rule if conversion costs constitute at least 20% of total cost of goods sold. The PLR does not apply this test.)

PLR 201206003 does not discuss how it applied the component physical manufacturing rule TP's facts. Prior to this PLR, that rule was applied only to determine whether a selling corporation has manufactured a finished product from components it purchased. In the PLR, Corporation Y is not assembling the finished product and it is the manufacturer, not the purchaser, of the critical components. Yet, the IRS appears to be applying this rule based upon the relationship between the manufacture of the critical components and the manufacture of the finished product as a whole. The TP not only represents that the activities conducted by Corporation Y in Country 1 constitute manufacturing within the meaning of Treas. Reg. §1.954-3(a)(4)(iii), but also represents that Corporation Y's activities in Country 1 are substantial with respect to the manufacture of the finished Products as a whole. The favorable ruling is based on TP's representation.

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## Conclusion

Because TP represents that the activities conducted by Corporation Y in Country 1 constitute manufacturing within the meaning of Treas. Reg. §1.954-3(a)(4)(iii), and are substantial with respect to the manufacture of Products as a whole, PLR 201206003 concludes that the income earned by Corporation X with respect to the sale of Products purchased from Corporation Y or its affiliates is not FBCSI because the income qualifies for the same-country manufacturing exception.

**Observation:** The PLR also includes TP's representation that it believes the manufacturing activities performed by Corporation Y and its affiliates with respect to Products outside of Country 1 may constitute the manufacture, production, or construction of property with respect to finished Products within the meaning of Treas. Reg. §1.954-3(a)(4)(iii). Although the PLR does not discuss or rule on whether the Products are also manufactured outside of Country 1, the inclusion of TP's representation suggests that the IRS believes that it is possible to have a product physically manufactured in more than one country for purposes of applying the same-country manufacturing exception.

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