



International Tax ADVISORY ■

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CFC's Income from Procurement Activities Not Foreign Base Company Sales Income

In PLR 201332007, the IRS ruled that income earned by a domestic parent's controlled foreign corporation (CFC) through a disregarded entity for procurement-related activities did not constitute foreign base company sales income (FBCSI) under Section 954(d) because the activities of the disregarded entity's employees substantially contributed to the manufacture, production or construction of the products under Regulations Section 1.954-3(a)(4)(iv), even though the CFC did not take title to the products manufactured and sold.

Background

A "U.S. shareholder" (as defined in Section 951(b)) of a CFC is required to include in gross income its proportionate share of the CFC's Subpart F income. Subpart F income includes "foreign base company income," which includes FBCSI. FBCSI is income derived by a CFC in connection with the purchase of personal property from a related person and its sale to any person, the sale of personal property to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person and the purchase of personal property from any person on behalf of a related person where (i) the property purchased (or sold on behalf of a related person) is manufactured or produced outside the country where the CFC is organized and (ii) the property is sold (or purchased on behalf of a related person) for use, consumption or disposition outside such country.

However, FBCSI does not include income derived in connection with the sale of personal property manufactured, produced or constructed by the CFC under the principles of Regulations Section 1.954-3(a)(4)(ii) or (iii). Under these regulations, respectively, personal property purchased by a CFC is considered manufactured, produced or constructed by the CFC if the property is "substantially transformed" by the CFC prior to sale or, if the purchased property is a component of the final product sold, the assembly or conversion of the component into the

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final product involves substantial activities that constitute the manufacture, production or construction of property. If property would be considered manufactured, produced or constructed prior to sale by the CFC, as described above, had all of the pre-sale manufacturing, production or construction activities been undertaken through activities of the CFC's employees, then Regulations Section 1.954-3(a)(4)(iv) applies. If Section 1.954-3(a)(4)(iv) applies and the facts show that the CFC made a "substantial contribution" through its employees' activities to the manufacture, production or construction of the personal property sold, the property is considered manufactured, produced or constructed by the CFC (the "substantial contribution exception"). Consequently, income derived in connection with the sale of such property would not be FBCSI pursuant to Regulations Section 1.954-3(a)(4)(i).

Facts

The taxpayer, a domestic corporation, and its subsidiaries comprise a U.S.-based multinational company involved in manufacturing, sales and services. The taxpayer indirectly owns "FSub," a foreign company treated as a corporation for U.S. tax purposes, which in turn owns "FDE," a company organized in the same country as FSub, but disregarded as an entity separate from FSub for U.S. tax purposes. The taxpayer and some of its subsidiaries buy products from unrelated, foreign manufacturers ("vendors"). The products are manufactured outside the United States and sold inside and outside the United States. The taxpayer, its foreign affiliates and FDE have a buying agency agreement whereby FDE performs procurement-related activities, such as ensuring that the products purchased meet the taxpayer's design, quality, vendor compliance and brand standards. In exchange for these services, the taxpayer and its affiliates pay FDE a commission based on a percentage of the price of the products ordered by the buyer. FDE has a number of employees, in the country where FDE is organized, who conduct the procurement-related services under the buying agency agreement.

In connection with the ruling request, the taxpayer made the following representations: FSub is a CFC; the vendors' manufacturing activities with respect to the products are "manufacturing" within the meaning of Regulations Section 1.954-3(a)(4)(ii) or (iii); FDE, through its employees, makes substantial contribution to the manufacture, production or construction of the products; FDE's commission is derived from FDE's contribution to the manufacture and sale of the products; and in all cases where a CFC controlled by the taxpayer derives income in connection with the sale (or purchase) of personal property to (or from) any person on behalf of a related person, the taxpayer would treat the income as FBCSI, subject to applicable exceptions, regardless whether the income could constitute foreign base company services income under Section 954(e).

Ruling

The taxpayer requested, and the IRS ruled, that the income from payments to FDE for its procurement-related services is not FBCSI because FDE met the substantial contribution exception. The IRS first observed that, unless the exception applied, FDE's income would be FBCSI under Section 954(d) because it was derived in connection with the purchase of personal property on behalf of a related person (despite the fact that FDE does not take title to the property). The IRS concluded that FDE's income was not FBCSI, relying primarily

on the taxpayer's representation that FDE makes substantial contribution through the activities of its employees to the manufacture, production and construction of the products purchased by the taxpayer.

Conclusion

This ruling is comparable to PLR 201325005, which also addressed the substantial contribution exception to FBCSI of a branch held indirectly by CFCs. In the prior ruling, the taxpayer had also represented that the branch, whose employees conducted manufacturing, marketing and sales activities, substantially contributed to the manufacture, production or construction of products to which it never took or passed legal title. Both rulings illustrate specific activities that may be considered in analyzing whether there is substantial contribution to manufacture, production or construction—e.g., FDE's procurement-related activities. Although the rulings offer little guidance on the extent of activities required to comprise a substantial contribution, they are significant in holding that the substantial contribution exception is available to a CFC even though the CFC does not take title to the personal property being manufactured and sold.

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