

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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TY:

Legend

Taxpayer =

Corporation X =  
Corporation Y=

Country 1 =  
Country 2 =

Product 1 =  
Product 2 =

Business =

Region =

b =  
c =  
d =  
e =  
f =

Dear \_\_\_\_\_ :

This is in response to a letter dated May 18, 2011 requesting a ruling on behalf of Taxpayer with respect to the related party sale by Corporation X of Product 1 and Product 2 (collectively, "Products") purchased from Corporation Y. The ruling contained in this letter is based upon information and representations submitted by the taxpayer

and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for ruling, it is subject to verification on examination.

#### FACTS:

Taxpayer is a domestic corporation and the common parent of an affiliated group of corporations filing a U.S. consolidated federal income tax return. Taxpayer uses the accrual method for maintaining its accounting books and filing federal income tax returns.

Taxpayer is a publicly traded multinational company and a leading global provider of Products. Taxpayer conducts activities directly and through domestic and foreign subsidiaries. Taxpayer, directly or indirectly, wholly owns all of the issued and outstanding shares of certain controlled foreign corporations (“CFCs”), within the meaning of Internal Revenue Code (“Code”) section 957(a), including Corporation X, which was created under the laws of Country 1.

Corporation Y is a publicly traded multinational corporation that is not related to Taxpayer, or any of Taxpayer’s subsidiaries and other affiliated groups, within the meaning of Code section 954(d)(3). Corporation Y was created under the laws of Country 1. Corporation Y is a leading manufacturer of Products.

Pursuant to an agreement between Taxpayer affiliates and Corporation Y affiliates, Corporation Y and its affiliates perform physical manufacturing activities for Products (as described below), and sell finished Products to Taxpayer affiliates, including Corporation X, for distribution in Taxpayer’s supply chains in Region. Corporation X resells Products to various Taxpayer distribution center affiliates that are related persons within the meaning of Code section 954(d)(3). Taxpayer distribution center affiliates generally on-sell Products to Taxpayer sales entities, which, in turn, sell Products to third party customers generally within the same jurisdiction as the applicable Taxpayer sales entity. The distribution of Products makes up a significant portion of Taxpayer’s Business.

The manufacture of Products by Corporation Y and its affiliates is a multi-step process and entails several stages of manufacturing in multiple jurisdictions that involve component parts production and final assembly, with approximately b component parts embedded in each of the Products. Notwithstanding the total components, most of which are purchased as raw materials, Corporation Y manufactures several critical component parts incorporated in Products exclusively in Country 1, as described below.

In addition, Corporation Y and its affiliates conduct finishing manufacturing activities with respect to Products in countries other than Country 1, as set forth below.<sup>1</sup>

Certain component parts are critical to the finished Products from both a value and cost perspective ("Critical Component Parts"). Of the approximately b component parts in each of the Products, c parts, with respect to Product 1, and d parts, with respect to Product 2, are Critical Component Parts. Of the Critical Component Parts, e parts, with respect to Product 1, and f parts, with respect to Product 2, are manufactured by Corporation Y exclusively in Country 1 (collectively, "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 manufacturing of the component parts. Manufacturing activities are performed by a significant number of employees of Corporation Y in factories located in Country 1. However, 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.

The finishing manufacturing activities with respect to Products are performed outside of Country 1 at finishing manufacturing plants located outside of Country 1. The activities performed at the plants include the manufacture of component parts embedded in Products, the assembly of Products and packaging, labeling 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. Corporation Y's finishing manufacturing activities in jurisdictions outside of Country 1 are conducted through wholly-owned subsidiaries of Corporation Y in those jurisdictions. The largest finishing manufacturing subsidiary outside of Country 1 is located in Country 2.

Taxpayer represents that the manufacturing activities performed by Corporation Y in Country 1 with respect to the Country 1 Manufactured Component Parts are substantial in nature and "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.

In addition, Taxpayer believes that the manufacturing activities performed by Corporation Y and its affiliates with respect to Products in Country 2 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).

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<sup>1</sup> This ruling does not address Products with respect to which finishing manufacturing activities are conducted in Country 1.

**RULING REQUESTED:**

Income earned by Corporation X with respect to the sale of Products purchased from Corporation Y, or its affiliates, to a related person (within the meaning of Code section 954(d)(3)) is not foreign base company sales income within the meaning of Code section 954(d) because the income qualifies for the same country manufacturing exception under Code section 954(d)(1)(A).

**LAW:**

Code section 957 defines a CFC as a foreign corporation with respect to which more than 50 percent of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of the corporation is owned (directly, indirectly, or constructively) by U.S. shareholders.

Code section 951(b) defines a U.S. shareholder for CFC purposes as a U.S. person who owns (directly, indirectly, or constructively) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation. ("U.S. Shareholder").

Code section 951(a)(1)(A)(i) provides that a U.S. Shareholder of a CFC must include in gross income its pro rata share of the CFC's subpart F income for the year.

Code section 952(a)(2) defines subpart F income to include foreign base company income.

Code section 954(a)(2) defines foreign base company income to include the foreign base company sales income for the taxable year.

Code section 954(d)(1) defines foreign base company sales income ("FBCSI") to mean income (whether in the form of profits, commissions, fees, or otherwise) derived 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, or the purchase of personal property from any person on behalf of a related person where (A) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the CFC is created or organized, and (B) the property is sold for use, consumption, or disposition outside such foreign country, or, in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country.

Code section 954(d)(3) provides that a person is a related person with respect to a CFC if: (1) such person is an individual, corporation, partnership, trust, or estate which

controls, or is controlled by, the CFC; or (2) such person is a corporation, partnership, trust, or estate which is controlled by the same person or persons which control the CFC. Control is defined as the direct or indirect ownership of more than 50 percent of the total voting power of all classes of stock entitled to vote or the total value of a corporation, or more than 50 percent of the beneficial interest in a partnership.

Treas. Reg. §1.954-3(a)(2) provides that FBCSI does not include income derived in connection with the purchase and sale of personal property (or purchase or sale of personal property on behalf of a related person) in a transaction described in Treas. Reg. §1.954-3(a)(1) if the property is manufactured, produced, constructed, grown or extracted in the country under the laws of which the CFC that purchases and sells the property (or acts on behalf of a related person) is created or organized. The principles set forth in Treas. Reg. §1.954(a)(4)(ii) and (a)(4)(iii) apply under Treas. Reg. §1.954(a)(2) in determining what constitutes the manufacture, production, or construction of personal property, excluding the requirement set forth in Treas. Reg. §1.954(a)(4)(i) that the provisions of Treas. Reg. §1.954(a)(4)(ii) and (a)(4)(iii) may only be satisfied through the activities of employees of the corporation manufacturing, producing or constructing the personal property. The principles of Treas. Reg. §1.954(a)(4)(iv) apply under Treas. Reg. §1.954(a)(2) in determining what constitutes the manufacture, production or construction of personal property but only when the personal property is manufactured, produced or constructed by a person related to the CFC within the meaning of Treas. Reg. §1.954-1(f).

Treas. Reg. §1.954-3(a)(4)(ii) provides that purchased personal property that is substantially transformed prior to sale is treated as having been manufactured by the selling corporation.

Treas. Reg. §1.954-3(a)(4)(iii) 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. Additionally, Treas. Reg. §1.954-3(a)(4)(iii) includes a safe harbor that provides that the operations of the selling corporation in connection with the use of the purchased property as a component part of the personal property which is sold will be considered to constitute the manufacture of a product if in connection with such property conversion costs of such corporation account for at least 20 percent of the cost of goods sold.

#### ANALYSIS:

Taxpayer is a U.S. Shareholder of Corporation X, which is a CFC. Accordingly, Taxpayer is required to include amounts in income under Code section 951(a)(1), including its pro rata share of Corporation X's subpart F income.

One type of subpart F income is FBCSI. In general, income derived by a CFC from the purchase and sale of property is FBCSI if the property is sold to a person that is a related person with respect to the CFC within the meaning of Code section 954(d). However, pursuant to Code section 954(d)(1)(A), the income is not FBCSI if the property is manufactured in the country in which the CFC is organized (“same country manufacturing exception”).

Corporation X, which was created under the laws of Country 1, derives income from the sale of Products to related persons. However, pursuant to the same country manufacturing exception, Corporation X’s sale of products will not generate FBCSI if another person physically manufactures the Products in Country 1.

Corporation X purchases Products from Corporation Y and its affiliates. Corporation Y and its affiliates manufacture Products in a multi-step process, which involves component parts production and final assembly, in multiple jurisdictions. Employees of Corporation Y and its affiliates conduct manufacturing activities with respect to Products in Country 1 and outside of Country 1. Specifically, the manufacturing activities with respect to the Country 1 Manufactured Component Parts are conducted by Corporation Y exclusively in Country 1, and manufacturing activities with respect to some component parts and final assembly are conducted by Corporation Y and its affiliates outside of Country 1.

Taxpayer has represented 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 Products as a whole.

#### RULING:

Based on the information submitted and the representations made, we rule as follows:

Income earned by Corporation X with respect to the sale of Products purchased from Corporation Y, or its affiliates, to a related person (within the meaning of Code section 954(d)(3)) is not FBCSI within the meaning of Code section 954(d) because the income qualifies for the same country manufacturing exception under Code section 954(d)(1)(A).

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Code section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

Sincerely,

Jeffrey G. Mitchell  
Branch Chief, Branch 2  
(International)

cc: