

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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(Small Business/Self-Employed)

from: Jeffery Mitchell
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(International)

subject: Application of Agricultural Commodities Exception

This Chief Counsel Advice responds to your request for assistance dated April 1, 2015.
This advice should not be used or cited as precedent.

LEGEND

Raw Material =
Finished Product =
USC =
CFC Y =
CFC Z =
Country A =
Country B =

ISSUE

Whether the third sentence of Treas. Reg. § 1.954-3(a)(1)(i), added by T.D. 9438, eliminated the 50 percent manufactured or processed limitation on the definition of agricultural commodities for purposes of the agricultural commodities exception in Treas. Reg. § 1.954-3(a)(1)(ii).

CONCLUSION

The third sentence of Treas. Reg. § 1.954-3(a)(1)(i), added by T.D. 9438, did not eliminate the 50 percent manufactured or processed limitation on the agricultural commodities exception.

FACTS

CFC Y, incorporated in Country B, takes title to Raw Material that is purchased from farmers in Country A and delivered to CFC Z's manufacturing facility. CFC Z, incorporated in Country A, produces Finished Product from Raw Material pursuant to a contract with CFC Y. CFC Y sells Finished Product to USC, a domestic corporation. CFC Y, CFC Z, and USC are related parties within the meaning of section 954(d)(3). CFC Y does not qualify for the CFC manufacturing exception in Treas. Reg. § 1.954-3(a)(4) because it does not manufacture the Finished Product (which is produced by CFC Z in Country A), nor does it make a substantial contribution to CFC Z's manufacturing.

Taxpayer, the United States shareholder (within the meaning of section 951(b)) of CFC Y, argues that CFC Y's income from sales of Finished Product to USC does not meet the definition of foreign base company sales income (FBCSI) because Raw Material is an agricultural commodity and the third sentence of Treas. Reg. § 1.954-3(a)(1)(i), added by T.D. 9438, eliminated the 50 percent manufactured or processed limitation on the definition of agricultural commodities.

LAW AND ANALYSIS

Section 954(d)(1)(A) limits FBCSI to income derived in connection with the purchase (or sale) of personal property that is manufactured, produced, grown, or extracted outside of the CFC's country of organization. Consistent with the legislative history to section 954(d), the regulations thereunder provide manufacturing exceptions. The IRS and the Treasury Department have always interpreted the statute to require the relevant CFC itself to manufacture the product it sells to avoid FBCSI (the "CFC manufacturing exception"), unless the manufacturing is performed within the CFC's country of organization (the "same-country manufacturing exception"). In T.D. 9438, the IRS and the Treasury Department revised the regulations under section 954(d) to clarify that

interpretation of the statute.¹ Certain sentences were eliminated, revised, and added to the regulations to underscore that -- apart from physical manufacturing or a substantial contribution to such manufacturing, in both cases performed by employees of the CFC itself -- changes to the form of personal property are irrelevant for purposes of the CFC manufacturing exception.² Thus, the third sentence was added to Treas. Reg. § 1.954-3(a)(1)(i) to clarify that, in accordance with the plain language and intent of section 954(d), when the same-country manufacturing exception does not apply, the relevant CFC must perform the manufacturing to avoid FBCSI treatment.

Importantly, the 2009 Regulations did not revise the agricultural commodities exception in Treas. Reg. § 1.954-3(a)(1)(ii). Agricultural commodities that are not grown in commercially marketable quantities in the United States and that otherwise qualify for the exception are excluded from the term “personal property” as used in section 954(d).³ Therefore, sales of products that qualify for the exception do not generate FBCSI.

In addition to listing certain agricultural commodities that are grown in the United States in commercially marketable quantities (and thus are not eligible for the exception) and certain agricultural commodities that are not to be considered grown in the United

¹ See T.D. 9438 (Dec. 29, 2008) (the “2009 Regulations”).

² The 2009 Regulations added the following sentence (the third sentence) to Treas. Reg. § 1.954-3(a)(1)(i):

For purposes of the preceding sentence [relating to the definition of FBCSI], except as provided in paragraphs (a)(2) and (a)(4) of this section, personal property sold by a controlled foreign corporation will be considered to be the same property that was purchased by the controlled foreign corporation regardless of whether the personal property is sold in the same form in which it was purchased, in a different form than the form in which it was purchased, or as a component part of a manufactured product.

Prior to revision by the 2009 Regulations, Treas. Reg. § 1.954-3(a)(4)(i) read as follows:

(4) Property manufactured or produced by the controlled foreign corporation—(i) In general. Foreign base company sales income does not include income of a controlled foreign corporation 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. A foreign corporation will be considered, for purposes of this subparagraph, to have manufactured, produced, or constructed personal property which it sells if the property sold is in effect not the property which it purchased. In the case of the manufacture, production, or construction of personal property, the property sold will be considered, for purposes of this subparagraph, as not being the property which is purchased if the provisions of subdivision (ii) or (iii) of this subparagraph are satisfied. For rules of apportionment in determining foreign base company sales income derived from the sale of personal property purchased and used as a component part of property which is not manufactured, produced, or constructed, see subparagraph (5) of this paragraph. (Emphasis added.)

³ Treas. Reg. § 1.954-3(a)(1)(ii)(a).

States in commercially marketable quantities (and thus are potentially eligible for the exception), the regulations set forth a manufacturing test: “the term ‘agricultural commodities’ shall not include ... any commodity at least 50 percent of the fair market value of which is attributable to manufacturing or processing, determined in a manner consistent with the regulations under section 993(c)” (the “50 percent manufactured or processed limitation”).⁴

Therefore, under the 50 percent manufactured or processed limitation, if at least 50 percent of the fair market value of the agricultural product is attributable to manufacturing or processing by anyone, the agricultural commodities exception is not available to the selling CFC because the regulations define the term “agricultural commodities” to exclude such product. In other words, the processed commodity no longer constitutes an “agricultural commodity” for purposes of the exception.

The 2009 Regulations did not eliminate the 50 percent manufactured or processed limitation on the agricultural commodities exception. As described above, the third sentence was added to Treas. Reg. § 1.954-3(a)(1)(i) to clarify that the relevant CFC itself must perform the manufacturing for purposes of the CFC manufacturing exception. In stark contrast, the 50 percent manufactured or processed limitation (like the same-country manufacturing exception) has never depended on the identity of the manufacturer. The agricultural commodities exception, unchanged by the clarifying revisions in the 2009 Regulations with respect to the CFC manufacturing exception, remains a narrow exception for certain foreign-grown agricultural commodities that have not been processed to the point that 50 percent or more of the fair market value of the property sold is attributable to manufacturing or processing.

Taxpayer maintains that the sentence added to Treas. Reg. § 1.954-3(a)(1)(i) effectively overrides or erases the express language and outcome of the 50 percent manufactured or processed limitation. However, the IRS and the Treasury Department did not strike the 50 percent manufactured or processed limitation upon the issuance of the 2009 Regulations – the limitation remains in the regulations. As noted above, the 2009 Regulations added a sentence to Treas. Reg. § 1.954-3(a)(1)(i) and eliminated and revised certain other sentences in Treas. Reg. § 1.954-3(a)(4) pertaining to the CFC manufacturing exception – but did not revise the agricultural commodities exception in Treas. Reg. § 1.954-3(a)(1)(ii). Thus, the plain language of the 50 percent manufactured or processed limitation must be applied in accordance with the express terms of the regulation. Even if it were necessary to consider Treas. Reg. § 1.954-3(a)(1)(i) when construing the 50 percent manufactured or processed limitation, then, under the canons of regulatory interpretation, it would be necessary to adopt an interpretation that reconciles and gives meaning to both provisions – not to assert, as Taxpayer does, that the former provision effectively overrides or erases the latter provision. The two provisions are reconciled, as indicated above, by interpreting the former provision as providing the scope of application of the CFC manufacturing

⁴ *Id.*

exception, and the latter provision as providing the scope of application of the agricultural commodities exception. Therefore, these two distinct provisions address different issues and the sentence added to Treas. Reg. § 1.954-3(a)(1)(i) in the 2009 Regulations does not override the 50 percent manufactured or processed limitation.

In sum, Taxpayer's argument is incorrect. The 2009 Regulations did not eliminate the 50 percent manufactured or processed limitation to the agricultural commodities exception. At least 50 percent of the fair market value of the property sold by CFC Y, whether the property is considered to be Raw Material or Finished Product, is attributable to manufacturing or processing. Therefore, the property is not included in the term "agricultural commodities" for purposes of section 954(d).⁵ CFC Y's income from sales to USC does not qualify for the CFC manufacturing exception or the agricultural commodities exception and therefore constitutes FBCSI.

Please call (202) 317-6934 if you have any further questions.

⁵ See Exam's prior submissions; Treas. Reg. § 1.954-3(a)(1)(ii)(a); Treas. Reg. §§ 1.993-3(g)(4)(iii) and (iv), and 1.993-3(c)(2)(iv).