

Revenue Ruling 75-7 (1975-1 C.B. 244)

Section 954 – Foreign Base Company Income

26 CFR 1.954-3: Foreign base company sales income.

Foreign base company income; ore processed by unrelated foreign corporation. A controlled foreign corporation does not realize foreign base company income within the meaning of section 954(a) of the Code from the sale of a ferroalloy derived from ore concentrate purchased from related persons in the U.S. and Canada, converted for a fee by a controlled process in the plant of a foreign corporation in a country with a lower tax rate, and sold to unrelated foreign persons.

Advice has been requested whether a controlled foreign corporation realizes foreign base company income, within the meaning of section 954(a) of the Internal Revenue Code of 1954, under the circumstances described below.

X, a controlled foreign corporation within the meaning of section 957(a) of the Code, was incorporated in country M. X purchased specific metal ore concentrate in the United States and Canada from related persons, within the meaning of section 954(d)(3).

Conversion of the ore concentrate into a ferroalloy was accomplished by X, pursuant to an arm's length contract, through Y, an unrelated foreign corporation incorporated in country O. The conversion of the ore concentrate required intricate chemical and metallurgical processing involving highly skilled labor working in accordance with scientific controls. Y's plant in country O was one of the few plants in the world equipped to accomplish the conversion.

Y had no present, nor was it contemplated that it would have any future affiliation, directly or indirectly, with X, other than contractual obligations arising under arm's length contracts. Y had no present, nor was it contemplated that it would have any future financial participation in the nature of a joint venture or other risk or profit sharing arrangement in the manufacture of the ferroalloy.

Under the terms of the contract X paid Y a conversion fee. The ore concentrate, before and during processing, and the finished product remained the sole property of X at all times. X alone purchased all raw material and other ingredients necessary in the processing operation and bore the risk of loss at all times in connection with the operation. Complete control of the time and quantity of production was vested in X. Complete control of the quality of the product was also vested in X, and Y was at all times required to use such processes as were directed by X. X could, when the occasion warranted it, send engineers or technicians to Y's plant to inspect, correct, or advise with regard to the processing of the ore concentrate into the finished product. The negotiation and consummation of the sale of the finished product were solely the responsibility of X. Profits or losses resulting from the sale of the finished product were solely X's. Y's only financial interest in the entire transaction was the fee paid by X for the conversion of the ore. The finished product was sold by X to unrelated parties in foreign countries, other than M, for use, consumption, or disposition in such other foreign countries. The effective tax rate in country M was 46 percent while the effective tax rate in country O was 38.5 percent.

Section 954(a) of the Code provides, in general, that the term "foreign base company income" means the sum of the foreign personal holding company income, the foreign base company sales income, and the foreign base company services income, for the taxable year.

Section 954(d)(1) of the Code provides, in part, that the term "foreign base company sales income" means income 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, or the purchase of personal property from any person on behalf of a related person when the property which is purchased is extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and the property is sold for use or disposition outside such foreign country.

Section 1.954-3(a)(4)(i) of the Income Tax Regulations provides, in part, that 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 section 1.954-3(a)(4)(i), 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

A discussion of the revocation of Revenue Ruling 75-7 by Revenue Ruling 97-48 appears as part of the Pillsbury Madison & Sutro LLP January 1998 International Tax Bulletin, available on the world wide web in printed Adobe Acrobat form at www.pmstax.com/ftp/intl/bull9801.pdf. That discussion can also be found at the firm's Tax Page at www.pmstax.com/intl/rr9748-9801.html.

the case of the manufacture, production, or construction of personal property, the property sold will be considered, for purposes of section 1.954-3(a)(4)(i), as not being the property which is purchased, if the provisions of section 1.954-3(a)(4)(ii) are satisfied.

Section 1.954-3(a)(4)(ii) of the regulations provides, in part, that if purchased personal property is substantially transformed prior to sale, the property sold will be treated as having been manufactured, produced, or constructed by the selling corporation.

Section 1.954-3(b)(1)(ii) of the regulations provides, in relevant part, that if a controlled foreign corporation carries on manufacturing, producing, constructing, growing, or extracting activities by or through a branch or similar establishment located outside the country under the laws of which such corporation is created or organized and the use of the branch or similar establishment for such activities with respect to personal property purchased or sold by or through the remainder of the controlled foreign corporation has substantially the same tax effect as if the branch or similar establishment were a wholly-owned subsidiary corporation of such controlled foreign corporation, the branch or similar establishment and the remainder of the controlled foreign corporation will be treated as separate corporations for purposes of determining foreign base company sales income of such corporation. See section 954(d)(2) of the Code.

The use of the branch or similar establishment will be considered to have substantially the same tax effect as

if it were a wholly-owned subsidiary corporation of the controlled foreign corporation if income allocated to the remainder of the controlled foreign corporation is, by statute, treaty obligation, or otherwise, taxed in the year when earned at an effective rate of tax that is less than 90 percent of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income under the laws of the country in which the branch or similar establishment is located.

Under the contractual arrangement between X and Y, the performance by Y of the operations whereby the ore concentrate is processed into a ferroalloy is considered to be a performance by X. Therefore, X will be treated as having “substantially transformed personal property” within the meaning of section 1.954-3(a)(4) of the regulations.

Furthermore, since X is conducting a manufacturing activity outside country M it will be considered to do so through a branch or similar establishment within the meaning of section 1.954-3(b)(1)(ii) of the regulations. However, since the effective rate of tax in country M is higher than the rate of tax in country O, the manufacturing activity of X conducted in country O will not be considered to have substantially the same tax effect as a wholly-owned subsidiary corporation of X within the meaning of section 1.954-3(b)(1)(ii).

Accordingly, the income derived by X upon the sale of the ferroalloy will not constitute “foreign base company income” within the meaning of section 954(a) of the Code.