

**§ 1.954-3**

December 31, 2004, then the election must also be made for paragraph (c) of this section.

(2) *Expiration date.* The applicability of § 1.954-2T(c) will expire on July 1, 2011.

[ T.D. 9406, 73 FR 38116, July 3, 2008]

**§ 1.954-3 Foreign base company sales income.**

(a) *Income included—(1) In general—(i) General rules.* Foreign base company sales income of a controlled foreign corporation shall, except as provided in paragraphs (a)(2), (a)(3) and (a)(4) of this section, consist of gross 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. See section 954(d)(1). For purposes of the preceding sentence, 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. This section shall apply to the purchase and/or sale of personal property, whether or not such property was purchased and/or sold in the ordinary course of trade or business, except that income derived in connection with the sale of tangible personal property will not be considered to be foreign base company sales income if such property is sold to a person that is not a related person, as defined in § 1.954-1(f), after substantial use has been made of the property by the controlled foreign corporation in its trade or business. This section shall not apply to the excess of gains over losses from sales or exchanges of securities or from futures transactions, to the extent such excess gains are includible in foreign personal

holding company income of the controlled foreign corporation under § 1.954-2; nor shall it apply to the sale of the controlled foreign corporation's property (other than its stock in trade or other property of a kind which would properly be included in its inventory if on hand at the close of the taxable year, or property held primarily for sale to customers in the ordinary course of its business) if substantially all the property of such corporation is sold pursuant to the discontinuation of the trade or business previously carried on by such corporation. The term "any person" as used in this paragraph (a)(1)(i) includes a related person as defined in § 1.954-1(f).

(ii) *Special rule—(a) In general.* The term "personal property" as used in section 954(d) and this section shall not include agricultural commodities which are not grown in the United States (within the meaning of section 7701(a)(9)) in commercially marketable quantities. All of the agricultural commodities listed in table I shall be considered grown in the United States in commercially marketable quantities. Bananas, black pepper, cocoa, coconut, coffee, crude rubber, and tea shall not be considered grown in the United States in commercially marketable quantities. All other agricultural commodities shall not be considered grown in the United States in commercially marketable quantities when, in consideration of all of the facts and circumstances of the individual case, such commodities are shown to be produced in the United States in insufficient quantity and quality to be marketed commercially. The term "agricultural commodities" includes, but is not limited to, livestock, poultry, fish produced in fish farms, fruit, furbearing animals as well as the products of truck farms, ranches, nurseries, ranges, and orchards. A fish farm is an area where fish are grown or raised (artificially protected and cared for), as opposed to merely caught or harvested. However, the term "agricultural commodities" shall not include timber (either standing or felled), or 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) (relating to the definition of export property). For purposes of applying such regulations, the term "processing" shall be deemed not to include handling, packing, packaging, grading, storing, transporting, slaughtering, and harvesting. Subdivision (ii) shall apply in the computation of foreign base company sales income for taxable years of controlled foreign corporations beginning after December 31, 1975, and to taxable years of U.S. shareholders (within the meaning of section 951(b)) within which or with which such taxable years of such foreign corporations end.

(b) Table.

TABLE I—AGRICULTURAL COMMODITIES GROWN IN THE UNITED STATES IN COMMERCIALY MARKETABLE QUANTITIES

Livestock and Products	
Beeswax	Horses
Cattle and calves	Milk
Chickens	Mink
Chicken eggs	Mohair
Ducks	Rabbits
Geese	Sheep and lambs
Goats	Turkeys
Hogs	Wool
Honey	
Crops	
Alfalfa	Lettuce
Almonds	Lime
Apples	Macadamia nuts
Apricots	Maple syrup and sugar
Artichokes	Mint
Asparagus	Mushrooms
Avocados	Nectarines
Barley	Oats
Beans	Olives
Beets	Onions
Blackberries	Oranges
Blueberries	Papayas
Brussel sprouts	Pecans
Broccoli	Peaches
Bulbs	Peanuts
Cabbage	Pears
Cantaloupes	Peas
Carrots	Peppers
Cauliflower	Plums and prunes
Celery	Potatoes
Cherries	Potted plants
Corn	Raspberries
Cotton	Rice
Cranberries	Rhubarb
Cucumbers	Rye
Cut flowers	Sorghum grain
Dates	Soybeans
Eggplant	Spinach
Escarole	Strawberries
Figs	Sugar beets
Filberts	Sugarcane
Flaxseed	Sweet potatoes
Garlic	Tangelos
Grapes	Tangerines
Grapefruit	

TABLE I—AGRICULTURAL COMMODITIES GROWN IN THE UNITED STATES IN COMMERCIALY MARKETABLE QUANTITIES—Continued

Grass seed	Tobacco
Hay	Tomatoes
Honeydew melons	Walnuts
Hops	Watermelons
Lemons	Wheat

(iii) The application of this subparagraph may be illustrated by the following examples:

*Example 1.* Controlled foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A purchases from M Corporation, a related person, articles manufactured in the United States and sells the articles to P, an unrelated person, for delivery and use in foreign country Y. Gross income of A Corporation derived from the purchase and sale of the personal property is foreign base company sales income.

*Example 2.* Corporation A in *Example 1* also purchases from P, an unrelated person, articles manufactured in country Y and sells the articles to foreign corporation B, a related person, for use in foreign country Z. Gross income of A Corporation derived from the purchase and sale of the personal property is foreign base company sales income.

*Example 3.* Controlled foreign corporation C, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation N. By contract, N Corporation agrees to pay C Corporation, a related person, a commission equal to 6 percent of the gross selling price of all personal property shipped by N Corporation as the result of orders solicited by C Corporation in foreign countries Y and Z. In fulfillment of such orders, N Corporation ships products manufactured by it in the United States. Corporation C does not assume title to the property sold. Gross commissions received by C Corporation from N Corporation in connection with the sale of such property for use in countries Y and Z constitute foreign base company sales income.

*Example 4.* Controlled foreign corporation D, incorporated under the laws of foreign country Y, is a wholly owned subsidiary of domestic corporation R. In 1964, D Corporation acquires a United States manufactured lathe from R Corporation. In 1972, after having made substantial use of the lathe in its manufacturing business, D Corporation sells the lathe to an unrelated person for use in foreign country Z. Gross income from the sale of the lathe is not foreign base company sales income since it is sold to an unrelated person after substantial use has been made of it by D Corporation in its business.

*Example 5.* Controlled foreign corporation E, incorporated under the laws of foreign country Y, is a wholly owned subsidiary of

domestic corporation P. Corporation E purchases from P Corporation articles manufactured by P Corporation outside of country Y and sells the articles to F Corporation, an unrelated person, for use in foreign country Z. Corporation E finances the purchase of the articles by F Corporation by agreeing to accept payment over an extended period of time and receives not only the purchase price but also interest and service fees. All gross income of E Corporation derived in connection with the purchase and sale of the personal property, including interest and service fees derived from financing the sale to F Corporation, constitutes foreign base company sales income.

(2) *Property manufactured, produced, constructed, grown, or extracted within the country in which the controlled foreign corporation is created or organized.* Foreign base company sales income 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 paragraph (a)(1) of this section if the property is manufactured, produced, constructed, grown, or extracted in the country under the laws of which the controlled foreign corporation which purchases and sells the property (or acts on behalf of a related person) is created or organized. See section 954(d)(1)(A). The principles set forth in paragraphs (a)(4)(ii) and (a)(4)(iii) of this section apply under this paragraph (a)(2) in determining what constitutes the manufacture, production, or construction of personal property, excluding the requirement set forth in paragraph (a)(4)(i) of this section that the provisions of paragraphs (a)(4)(ii) and (a)(4)(iii) of this section may only be satisfied through the activities of employees of the corporation manufacturing, producing, or constructing the personal property. The principles of paragraph (a)(4)(iv) of this section apply under this paragraph (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 controlled foreign corporation within the meaning of § 1.954-1(f). The application of this paragraph (a)(2) may be illustrated by the following examples:

*Example 1.* Controlled foreign corporation A, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation A purchases coffee beans grown in country X from foreign corporation P, a related person, and sells the beans to M Corporation, a related person, for use in the United States. Income from the purchase and sale of the coffee beans by A Corporation is not foreign base company sales income since the beans were grown in country X.

*Example 2.* Controlled foreign corporation B, incorporated under the laws of foreign country X, is a wholly owned subsidiary of controlled foreign corporation C, also incorporated under the laws of country X. Corporation B purchases and imports into country X rough diamonds mined in foreign country Y; in country X it cuts, polishes, and shapes the diamonds in a process which constitutes manufacturing within the meaning of subparagraph (4) of this paragraph. Corporation B sells the finished diamonds to C Corporation, a related person, which in turn sells them for use in foreign country Z. Since for purposes of this subparagraph the finished diamonds are manufactured in country X, gross income derived by C Corporation from their sale is not foreign base company sales income.

(3) *Property sold for use, consumption, or disposition within the country in which the controlled foreign corporation is created or organized—(i) In general.* Foreign base company sales income 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 subparagraph (1) of this paragraph, (a) if the property is sold for use, consumption, or disposition in the country under the laws of which the controlled foreign corporation which purchases and sells the property (or sells on behalf of a related person) is created or organized or (b), where the property is purchased by the controlled foreign corporation on behalf of a related person, if such property is purchased for use, consumption, or disposition in the country under the laws of which such controlled foreign corporation is created or organized. See section 954(d)(1)(B).

(ii) *Rules for determining country of use, consumption, or disposition.* As a general rule, personal property which is sold to an unrelated person will be

presumed for purposes of this subparagraph to have been sold for use, consumption, or disposition in the country of destination of the property sold; for such purpose, the occurrence in a country of a temporary interruption in shipment of goods shall not constitute such country the country of destination. However, if at the time of a sale of personal property to an unrelated person the controlled foreign corporation knew, or should have known from the facts and circumstances surrounding the transaction, that the property probably would not be used, consumed, or disposed of in the country of destination, the controlled foreign corporation must determine the country of ultimate use, consumption, or disposition of the property or the property will be presumed to have been used, consumed, or disposed of outside the country under the laws of which the controlled foreign corporation is created or organized. A controlled foreign corporation which sells personal property to a related person is presumed to sell such property for use, consumption, or disposition outside the country under the laws of which the controlled foreign corporation is created or organized unless such corporation establishes the use made of the property by the related person; once it has established that the related person has disposed of the property, the rules in the two preceding sentences relating to sales by a controlled foreign corporation to an unrelated person will apply at the first stage in the chain of distribution at which a sale is made by a related person to an unrelated person. Notwithstanding the preceding provisions of this subdivision, a controlled foreign corporation which sells personal property to any person all of whose business except for an insubstantial part consists of selling from inventory to retail customers at retail outlets all within one country may assume at the time of such sale to such person that such property will be used, consumed, or disposed of within such country.

(iii) *Fungible goods.* For purposes of this subparagraph, a controlled foreign corporation which sells to a purchaser personal property which because of its fungible nature cannot reasonably be

specifically traced to other purchasers and to the countries of ultimate use, consumption, or disposition shall, unless such corporation establishes a different disposition as being proper, treat such property as being sold, for ultimate use, consumption, or disposition in those countries, and to those other purchasers, in the same proportions in which property from the fungible mass of the first purchaser is sold in the regular course of business by such first purchaser. No apportionment need be made, however, on the basis of sporadic sales by the first purchaser. This subdivision shall apply only in a case where the controlled foreign corporation knew, or should have known from the facts and circumstances surrounding the transaction, the manner in which the first purchaser disposes of goods from the fungible mass.

(iv) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

*Example 1.* Controlled foreign corporation A, incorporated under the laws of foreign country X, and controlled foreign corporation B, incorporated under the laws of foreign country Y, are related persons. Corporation A purchases from B Corporation electric transformers produced by B Corporation in country Y and sells the transformers to D Corporation, an unrelated person, for installation in a factory building being constructed in country X. Since the personal property purchased and sold by A Corporation is to be used within the country in which A Corporation is incorporated, income of A Corporation derived from the purchase and sale of the electric transformers is not foreign base company sales income.

*Example 2.* Controlled foreign corporation C, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation N. Corporation C purchases from N Corporation sewing machines manufactured in the United States by N Corporation and sells the sewing machines to retail department stores, unrelated persons, located in foreign country X. The entire activities of the department stores to which C Corporation sells the machines consist of selling goods from inventory to retail customers at retail outlets in country X. Under these circumstances, at the time of sale C Corporation may assume the sewing machines will be used, consumed, or disposed of in country X, and no attempt need be made by C Corporation to determine where the sewing machines will ultimately be used by the customers of the retail department stores. Gross income of C Corporation derived from the

sales to the department stores located in country X is not foreign base company sales income.

*Example 3.* Controlled foreign corporation D, incorporated under the laws of foreign country Y, and controlled foreign corporation E, incorporated under the laws of foreign country X, are related persons. Corporation D purchases from E Corporation sulphur extracted by E Corporation from deposits located in country X. Corporation D sells the sulphur to F Corporation, an unrelated person, for delivery to F Corporation's storage facilities located in country Y. At the time of the sale of the sulphur from D Corporation to F Corporation, D Corporation knows that F Corporation is actively engaged in the business of selling a large amount of sulphur in country Y but also that F Corporation sells, in the normal course of its business, 25 percent of its sulphur for ultimate consumption in foreign country Z. However, D Corporation has no knowledge at the time of sale whether any portion of the particular shipment it sells to F Corporation will be resold by F Corporation for ultimate use, consumption, or disposition outside country Y. Moreover, delivery of the sulphur to F Corporation's storage facilities constitutes more than a temporary interruption in the shipment of the sulphur. Under such circumstances, D Corporation may, but is not required to, trace the ultimate disposition by F Corporation of the personal property sold to F Corporation; however, if D Corporation does not trace the ultimate disposition and if it does not establish a different disposition as being proper, 25 percent of the sulphur sold by D Corporation to F Corporation will be treated as being sold for consumption in country Z and 25 percent of the gross income from the sale of sulphur by D Corporation to F Corporation will be treated as foreign base company sales income.

*Example 4.* Controlled foreign corporation G, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation P. Corporation G purchases from P Corporation toys manufactured in the United States by P Corporation and sells the toys to R, an unrelated person, for delivery to a duty-free port in country X. Instructions for the assembly and operation of the toys are printed in a language which is not commonly used in country X. From the facts and circumstances surrounding the sales to R, G Corporation knows, or should know, that the toys will probably not be used, consumed, or disposed of within country X. Therefore, unless G Corporation determines the use to be made of the toys by R, such property will be presumed to have been sold by R for use, consumption, or disposition outside of country X, and the entire gross income of G Corporation derived from the sales will be considered foreign base company sales income.

(4) *Property manufactured, produced, or constructed 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. A controlled foreign corporation will have manufactured, produced, or constructed personal property which the corporation sells only if such corporation satisfies the provisions of paragraph (a)(4)(ii), (a)(4)(iii), or (a)(4)(iv) of this section through the activities of its employees (as defined in § 31.3121(d)-1(c) of this chapter) with respect to such property. A controlled foreign corporation will not be treated as having manufactured, produced, or constructed personal property which the corporation sells merely because the property is sold in a different form than the form in which it was purchased. 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 paragraph (a)(5) of this section.

(ii) *Substantial transformation of property.* If personal property purchased by a foreign corporation is substantially transformed by such foreign corporation prior to sale, the property sold by the selling corporation is manufactured, produced, or constructed by such selling corporation. The application of this paragraph (a)(4)(ii) may be illustrated by the following examples:

*Example 1.* Controlled foreign corporation A, incorporated under the laws of foreign country X, operates a paper factory in foreign country Y. Corporation A purchases from a related person wood pulp grown in country Y. Corporation A, by a series of processes, converts the wood pulp to paper which it sells for use in foreign country Z. The transformation of wood pulp to paper constitutes the manufacture or production of property for purposes of this subparagraph.

*Example 2.* Controlled foreign corporation B, incorporated under the laws of foreign country X, purchases steel rods from a related person which produces the steel in foreign country Y. Corporation B operates a machining plant in country X in which it utilizes the purchased steel rods to make screws and bolts. The transformation of steel

rods to screws and bolts constitutes the manufacture or production of property for purposes of this subparagraph.

*Example 3.* Controlled foreign corporation C, incorporated under the laws of foreign country X, purchases tuna fish from unrelated persons who own fishing boats which catch such fish on the high seas. Corporation C receives such fish in country X in the condition in which taken from the fishing boats and in such country processes, cans, and sells the fish to related person D, incorporated under the laws of foreign country Y, for consumption in foreign country Z. The transformation of such fish into canned fish constitutes the manufacture or production of property for purposes of this subparagraph.

(iii) *Manufacture of a product when purchased components constitute part of the property sold.* If purchased property is used as a component part of personal property which is sold, the sale of the property will be treated as the sale of a manufactured product, rather than the sale of component parts, if the assembly or conversion of the component parts into the final product by the selling corporation involves activities that are substantial in nature and generally considered to constitute the manufacture, production, or construction of property. Without limiting this substantive test, which is dependent on the facts and circumstances of each case, 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 (direct labor and factory burden) of such corporation account for 20 percent or more of the total cost of goods sold. In no event, however, will packaging, repackaging, labeling, or minor assembly operations constitute the manufacture, production, or construction of property for purposes of section 954(d)(1). The application of this paragraph (a)(4)(iii) may be illustrated by the following examples:

*Example 1.* Controlled foreign corporation A, incorporated under the laws of foreign country X, sells industrial engines for use, consumption, and disposition outside country X. Corporation A, in connection with the assembly of such engines, performs machining and assembly operations. In addition, A Corporation purchases, from related and unrelated persons, components manufactured

in foreign country Y. On a per unit basis, A Corporation's selling price and costs of such engines are as follows:

Selling price .....		\$400
Cost of goods sold:		
Material—		
Acquired from related persons .....	\$100	
Acquired from others .....	40	
Total material .....		\$140
Conversion costs (direct labor and factory burden) .....		70
Total cost of goods sold .....		210
Gross profit .....		190
Administrative and selling expenses .....		50
Taxable income .....		140

The conversion costs incurred by A Corporation are more than 20 percent of total costs of goods sold (\$70/\$210 or 33 percent). Although the product sold, an engine, is not sufficiently distinguishable from the components to constitute a substantial transformation of the purchased parts within the meaning of subdivision (ii) of this subparagraph, A Corporation will be considered under this subdivision to have manufactured the product it sells.

*Example 2.* Controlled foreign corporation B, incorporated under the laws of foreign country X, operates an automobile assembly plant. In connection with such activity, B Corporation purchases from related persons assembled engines, transmissions, and certain other components, all of which are manufactured outside of country X; purchases additional components from unrelated persons; conducts stamping, machining, and subassembly operations; and has a substantial investment in tools, jigs, welding equipment, and other machinery and equipment used in the assembly of an automobile. On a per unit basis, B Corporation's selling price and costs of such automobiles are as follows:

Selling price .....		\$2,500
Cost of goods sold:		
Material—		
Acquired from related persons .....	\$1,200	
Acquired from others .....	275	
Total material .....		\$1,475
Conversion costs (direct labor and factory burden) .....		25
Total cost of goods sold .....		1,800
Gross profit .....		700
Administrative and selling expenses .....		300
Taxable income .....		400

The product sold, an automobile, is not sufficiently distinguishable from the components purchased (the engine, transmission, etc.) to constitute a substantial transformation of

purchased parts within the meaning of subdivision (ii) of this subparagraph. Although conversion costs of B Corporation are less than 20 percent of total cost of goods sold (\$325/\$1800 or 18 percent), the operations conducted by B Corporation in connection with the property purchased and sold are substantial in nature and are generally considered to constitute the manufacture of a product. Corporation B will be considered under this subdivision to have manufactured the product it sells.

*Example 3.* Controlled foreign corporation C, incorporated under the laws of foreign country X, purchases from related persons radio parts manufactured in foreign country Y. Corporation C designs radio kits, packages component parts required for assembly of such kits, and sells the parts in a knocked-down condition to unrelated persons for use outside country X. These packaging operations of C Corporation do not constitute the manufacture, production, or construction of personal property for purposes of section 954(d)(1).

(iv) *Substantial contribution to manufacturing of personal property—(a) In general.* If an item of personal property would be considered manufactured, produced, or constructed (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) prior to sale by the controlled foreign corporation had all of the manufacturing, producing, and constructing activities undertaken with respect to that property prior to sale been undertaken by the controlled foreign corporation through the activities of its employees, then this paragraph (a)(4)(iv) applies. If this paragraph (a)(4)(iv) applies and if the facts and circumstances evince that the controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture, production, or construction of the personal property sold, then the personal property sold by the controlled foreign corporation is manufactured, produced, or constructed by such controlled foreign corporation.

(b) *Activities.* The determination of whether a controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture, production, or construction of the personal property sold involves, but will not necessarily be limited to, consideration of the following activities:

(1) Oversight and direction of the activities or process pursuant to which the property is manufactured, produced, or constructed (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section).

(2) Activities that are considered in, but that are insufficient to satisfy, the tests provided in paragraphs (a)(4)(ii) and (a)(4)(iii) of this section.

(3) Material selection, vendor selection, or control of the raw materials, work-in-process or finished goods.

(4) Management of manufacturing costs or capacities (for example, managing the risk of loss, cost reduction or efficiency initiatives associated with the manufacturing process, demand planning, production scheduling, or hedging raw material costs).

(5) Control of manufacturing related logistics.

(6) Quality control (for example, sample testing or establishment of quality control standards).

(7) Developing, or directing the use or development of, product design and design specifications, as well as trade secrets, technology, or other intellectual property for the purpose of manufacturing, producing, or constructing the personal property.

(c) *Application of substantial contribution test.* When considering whether a controlled foreign corporation makes a substantial contribution to the manufacture, production, or construction of the personal property, the performance of any activity in paragraph (a)(4)(iv)(b) of this section will be taken into account. The performance or lack of performance of any particular activity in paragraph (a)(4)(iv)(b) of this section, or of a particular number of activities in (a)(4)(iv)(b) of this section, is not determinative. The weight accorded to the performance of any quantum of any activity (whether or not specified in paragraph (a)(4)(iv)(b) of this section) will vary with the facts and circumstances of the particular business. See paragraph (a)(4)(iv)(d) *Examples 8, 10 and 11* of this section. In determining whether the activities of the controlled foreign corporation constitute a substantial contribution, there is no minimum performance threshold before an activity can be considered. The fact that other persons

make a substantial contribution to the manufacture, production, or construction of the personal property prior to sale does not preclude the controlled foreign corporation from making a substantial contribution to the manufacture, construction, or production of that property through the activities of its employees. See paragraph (a)(4)(iv)(d) Example 9 of this section.

(d) *Examples.* The rules of this paragraph (a)(4)(iv) are illustrated by the following examples:

*Example 1. No substantial contribution to manufacturing.* (i) *Facts.* FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion outside of FS's country of organization. Product X is sold by FS for use outside of FS's country of organization. Under the terms of the contract, FS retains the right to control the raw materials, work-in-process, and finished goods, and the right to oversee and direct the activities or process pursuant to which Product X is manufactured by CM. FS owns the intellectual property used in the manufacturing process. However, FS does not exercise, through its employees, its powers to control the raw materials, work-in-process, or finished goods, and FS does not exercise its powers of oversight and direction. Likewise, FS does not, through its employees, develop or direct the use or development of the intellectual property for the purpose of manufacturing Product X.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. FS does not satisfy the test under this paragraph (a)(4)(iv) because it does not make a substantial contribution through the activities of its employees to the manufacture of Product X. Mere contractual rights to control materials, contractual rights to oversee and direct the manufacturing activities or process pursuant to which the property is manufactured, and ownership of intellectual property are not sufficient to satisfy this paragraph (a)(4)(iv). Therefore, under the facts and circumstances of the business, FS is not considered to have manufactured

Product X under paragraph (a)(4)(i) of this section.

*Example 2. Substantial contribution to manufacturing.* (i) *Facts.* Assume the same facts as in *Example 1*, except for the following. FS, through its employees, engages in product design and quality control and controls manufacturing related logistics. Employees of FS exercise the right to oversee and direct the activities of CM in the manufacture of Product X.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section. The analysis and conclusion would be the same if CM were related to FS because the relationship between CM and FS is irrelevant for purposes of applying paragraph (a)(4) of this section.

*Example 3. Raw materials procured by contract manufacturer.* (i) *Facts.* FS, a controlled foreign corporation, enters into a contract with CM to manufacture (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) Product X. CM physically performs the substantial transformation, assembly, or conversion required to manufacture Product X outside of FS's country of organization. Product X is sold by FS to a related person for use outside of FS's country of organization. Employees of FS select the materials that will be used to manufacture Product X. FS does not own the materials or work-in-process during the manufacturing process. FS, through its employees, exercises oversight and direction of the manufacturing process and provides quality control. FS manages the manufacturing costs and capacities with respect to Product X by managing the risk of loss and engaging in demand planning and production scheduling.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have



manufactured Product X under paragraph (a)(4)(i) of this section.

*Example 4. Physical conversion by employees of a person other than the contract manufacturer.* (i) *Facts.* FS, a controlled foreign corporation organized in Country M, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion required to manufacture Product X outside of FS's country of organization. Product X is sold by FS for use outside of FS's country of organization. CM contracts with another corporation for its employees in order to operate CM's manufacturing plant and transform, assemble, or convert the raw materials into Product X. Apart from the physical performance of the substantial transformation, assembly, or conversion of the raw materials into Product X, employees of FS perform all of the other manufacturing activities required in connection with the manufacture of Product X (for example, oversight and direction of the manufacturing process; vendor selection; control of raw materials, work-in-process, and finished goods; control of manufacturing related logistics; and quality control).

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

*Example 5. Automated manufacturing supervised by another person.* (i) *Facts.* FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation selected by FS, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion outside of FS's country of organization. Product X is sold by FS to related and unrelated persons for use outside of FS's country of organization. At all times, FS retains ownership of the raw materials, work-in-process, and finished goods. FS retains the right to oversee and direct the activities or process pursuant to which Product X is manufactured

by CM, but does not exercise, through its employees, its powers of oversight and direction. FS is the owner of sophisticated software and network systems that remotely and automatically (without human involvement) take orders, route them to CM, order raw materials, and perform quality control. FS has a small number of computer technicians who monitor the software and network systems to ensure that they are running smoothly and apply any necessary patches or fixes. The software and network systems were developed by employees of DP, the U.S. corporate parent of FS. DP's employees supervise the computer technicians, evaluate the results of the automated manufacturing business, and make ongoing operational decisions, including decisions related to acceptable performance of the manufacturing process, stoppages of that process, and decisions related to product and manufacturing process design. DP's employees develop and provide to FS all of the upgrades to the software and network systems. DP also has employees who direct and control other aspects of the manufacturing process such as vendor and material selection, management of the manufacturing costs and capacities, and the selection of CM. The need for DP's employees to direct the activities of the FS employees and otherwise contribute to the manufacturing process evinces that substantial operational responsibilities and decision making are required to be exercised by parties other than CM in order to manufacture Product X.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstance of the business, FS does not satisfy the test under this paragraph (a)(4)(iv) because it does not make a substantial contribution through the activities of its employees to the manufacture of Product X. Mere ownership of materials and intellectual property along with contractual rights to exercise powers of direction and control are not sufficient to satisfy this paragraph (a)(4)(iv). The employees of FS do not perform the amount of activity necessary to constitute a substantial contribution. FS is not considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

*Example 6. Automated manufacturing supervised by FS.* (i) *Facts.* Assume the same facts as in *Example 5*, except for the following. FS, through its employees, engages in the activities undertaken by DP's employees in *Example 5*. DP's employees also contribute to product and manufacturing process design, and provide support and oversight to FS in

connection with functions performed by FS through its employees.

(i) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. This determination does not require a comparison between the activities of FS and the activities of DP. Selection of the contract manufacturer, even though not specifically identified in paragraph (a)(4)(iv)(b) of this section, is considered under paragraph (a)(4)(iv)(c) of this section in determining whether FS makes a substantial contribution to the manufacture of Product X through its employees. FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

*Example 7. Automated manufacturing supervised by FS with purchased intellectual property.* (i) *Facts.* Assume the same facts as in *Example 6*, except for the following. The software and network systems, and the upgrades to those systems, were purchased by FS rather than developed by employees of FS.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. The lack of performance of software and network system development activities is not determinative under the facts and circumstances of the business. Therefore, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. This determination does not require a comparison between the activities of FS and the activities of DP. FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

*Example 8. Manufacture without intellectual property.* (i) *Facts.* FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion outside of FS's country of organization. Product X is sold by FS for use outside

of FS's country of organization. At all times, FS controls the raw materials, work-in-process, and finished goods. FS controls the manufacturing related logistics, manages the manufacturing costs and capacities, and provides quality control with respect to CM's manufacturing process and product. No intellectual property of significant value is required to manufacture Product X. FS does not own any intellectual property underlying Product X, or hold an exclusive or non-exclusive right to manufacture Product X.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Because use of intellectual property plays little or no role in the manufacture of Product X, it is not important to the substantial contribution analysis under paragraph (a)(4)(iv) of this section. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

*Example 9. Substantial contribution by more than one CFC.* (i) *Facts.* FS1 and FS2, unrelated controlled foreign corporations, contract with CM, an unrelated corporation, to manufacture (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) Product X. CM physically performs the substantial transformation, assembly, or conversion required to manufacture Product X outside of FS1's and FS2's respective countries of organization. Neither FS1 nor FS2 owns the materials or work-in-process during the manufacturing process. Product X is sold by FS1 and FS2 to persons related to FS1 and FS2, respectively, for disposition outside of FS1's and FS2's respective countries of organization. FS1, through its employees, designs Product X. FS1 directs the use of the product design and design specifications, and other intellectual property, for the purpose of manufacturing Product X. Employees of FS1 also select the materials that will be used to manufacture Product X, and the vendors that provide those materials. FS2, through its employees, designs the process for manufacturing Product X. FS2, through its employees, manages the manufacturing costs and capacities with respect to Product X. FS1 and FS2 each provide quality control and oversight and direction of CM's manufacturing activities with respect to different aspects of the manufacture of Product X.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior

to sale had been undertaken by FS1 or FS2 through the activities of their employees, FS1 or FS2 would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. The fact that other persons make a substantial contribution to the manufacture of personal property does not preclude a controlled foreign corporation from making a substantial contribution to the manufacture of personal property through the activities of its employees. In the analysis of whether FS1 or FS2 make a substantial contribution to the manufacture of Product X, each company takes into account its individual activities, including those of providing quality control and oversight and direction of the manufacture of Product X. In addition, no threshold level of activity is required, including with respect to providing quality control or oversight and direction of the activities or process pursuant to which Product X is manufactured, before FS1 and FS2 can take into account their respective activities. Under the facts and circumstances of the business, both FS1 and FS2 satisfy the test under this paragraph (a)(4)(iv) because each independently makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS1 and FS2 are each considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

*Example 10. Manufacture of products designed by CFC.* (i) *Facts.* FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion outside of FS's country of organization. Product X is sold by FS for use outside of FS's country of organization. Products in the X industry are distinguished (and vary widely in value) based on the raw materials used to make the product and the product design. FS designs the product and selects the materials that CM will use to manufacture Product X. FS also manages the manufacturing costs and capacities. Product X can be manufactured from the raw materials to FS's design specifications without significant oversight and direction, quality control, or control of manufacturing related logistics. The activities most relevant to the substantial contribution analysis under these facts are material selection, product design and management of the manufacturing costs and capacities.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through

the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS makes a substantial contribution through the activities of its employees to the manufacture of Product X. FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

*Example 11. Direction and oversight of manufacturing and quality control through periodic visits.* (i) *Facts.* FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are manufactured (under the principles of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation, pursuant to a contract manufacturing arrangement. CM physically performs the substantial transformation, assembly, or conversion outside of FS's country of organization. Product X is sold by FS for use outside of FS's country of organization. FS controls the raw material, work-in-process, and finished goods, manages the manufacturing costs and capacities, and provides oversight and direction of the manufacture of Product X. Employees of FS visit CM's manufacturing facility for one week each quarter and perform quality control tests on a random sample of the units of Product X produced during the week. In the X industry, quarterly visits to a manufacturing facility by qualified persons are sufficient to control the quality of manufacturing.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale had been undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. Under the facts and circumstances of the business, FS satisfies the test under this paragraph (a)(4)(iv) with respect to Product X because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

(5) *Rules for apportionment of income derived from the sale of purchased components used in property not manufactured, produced, or constructed.* The foreign base company sales income derived by a controlled foreign corporation for the taxable year from sales of personal

property purchased and used as a component part of property which is not manufactured, produced, or constructed by such corporation within the meaning of subparagraph (4) of this paragraph shall, unless the records of the controlled foreign corporation show that a different apportionment of income is proper or unless all the income from such sales is treated as foreign base company sales income, be determined by first making for such year the following separate classifications and subclassifications with respect to the property which is sold and then by apportioning the income for such year from such sales in accordance with the rules of this subparagraph:

(i) A classification of the cost of components used in the property which is sold into two classes consisting of the cost of components manufactured, produced, constructed, grown, or extracted—

(a) Within the country under the laws of which the controlled foreign corporation is created or organized, and

(b) Outside such country;

(ii) A subclassification of the class described in subdivision (i) (b) of this subparagraph into—

(a) The cost of such components purchased from unrelated persons, and

(b) The cost of such components purchased from related persons;

(iii) A classification of the income derived from such sales into two classes consisting of income derived from sales for use, consumption, or disposition—

(a) Within the country under the laws of which the controlled foreign corporation is created or organized, and

(b) Outside such country; and

(iv) A subclassification of the class described in subdivision (iii) (b) of this subparagraph into income from—

(a) Sales to unrelated persons, and

(b) Sales to related persons.

The foreign base company sales income for the taxable year from purchases of the property from related persons and sales to unrelated persons shall be the amount which bears to the amount described in subdivision (iv) (a) of this subparagraph the same ratio that the amount described in subdivision (ii) (b)

of this subparagraph bears to the total cost of components used in the product which is sold. The foreign base company sales income for the taxable year from purchases of the property from related persons and sales to related persons is the amount which bears to the amount described in subdivision (iv) (b) of this subparagraph the same ratio that the amount described in subdivision (ii) (b) of this subparagraph bears to the total cost of components used in the product which is sold.

The foreign base company sales income for the taxable year from purchases of the property from unrelated persons and sales to related persons is the amount which bears to the amount described in subdivision (iv) (b) of this subparagraph the same ratio that the amount described in subdivision (ii) (a) of this subparagraph bears to the total cost of components used in the product which is sold. The application of this subparagraph may be illustrated by the following examples:

*Example 1.* Controlled foreign corporation C, which is incorporated under the laws of foreign country X, uses the calendar year as the taxable year. For 1964, C Corporation purchases radio parts of which some are manufactured in foreign country Y; and others, in country X. Some of the parts manufactured in country Y are purchased from related persons. Corporation C uses the purchased parts in radio kits which it designs and sells for assembly by its customers, unrelated persons, some of whom use the kits outside country X. Unless the records of C Corporation show that a different apportionment of income is proper, the foreign base company sales income for 1964 is determined in the following manner upon the basis of the following factual classifications for such year:

Cost of components purchased from all persons:	
Manufactured within country X .....	\$20
Manufactured outside country X .....	40
<b>Total cost .....</b>	<b>60</b>
Cost of components manufactured outside country X:	
Purchased from unrelated persons .....	10
Purchased from related persons .....	30
<b>Total cost .....</b>	<b>40</b>
Gross income from sales:	
Gross receipts from sales .....	120
Cost of goods sold:	
Components .....	\$60
Direct labor and factory burden .....	10
<b>Gross income .....</b>	<b>50</b>

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Gross income from sales:	
For use within country X .....	26
For use outside country X .....	24
	50
Foreign base company sales income from purchases from related persons and sales to unrelated persons (\$24×\$30/\$60) .....	12

*Example 2.* The facts are the same as in example 1 except that none of the purchases are from related persons and some of the sales for use outside country X are to related persons. Unless the records of C Corporation show that a different apportionment of income is proper, the foreign base company sales income for 1964 is determined in the following manner upon the basis of the following additional factual classification for such year:

Gross income from sales for use outside country X—	
To unrelated persons .....	\$8
To related persons .....	16
	24
Foreign base company sales income from purchases from unrelated persons and sales to related persons (\$16×\$40/\$60) .....	10.67

*Example 3.* The facts are the same as in example 1 except that some of the sales for use outside country X are to related persons as in example 2. Unless the records of C Corporation show that a different apportionment of income is proper, the foreign base company sales income for 1964 is determined in the following manner:

Foreign base company sales income from purchases from related persons and sales to unrelated persons (\$8×\$30/\$60) .....	\$4.00
Foreign base company sales income from purchases from related persons and sales to related persons (\$16×\$30/\$60) .....	8.00
Foreign base company sales income from purchases from unrelated persons and sales to related persons (\$16×\$10/\$60) .....	2.67
	14.67

(6) *Special rule applicable to distributive share of partnership income—(i) In general.* To determine the extent to which a controlled foreign corporation's distributive share of any item of gross income of a partnership would have been foreign base company sales income if received by it directly, under §1.952-1(g), the property sold will be considered to be manufactured, produced, or constructed by the controlled foreign corporation, within the meaning of paragraph (a)(4)(i) of this section, only if the manufacturing exception of paragraph (a)(4)(i) of this section would

have applied to exclude the income from foreign base company sales income if the controlled foreign corporation had earned the income directly, determined by taking into account only the activities of the employees of, and property owned by, the partnership.

(ii) *Example.* The application of paragraph (a)(6)(i) of this section is illustrated by the following example:

*Example.* CFC, a controlled foreign corporation organized under the laws of Country A, is an 80 percent partner in Partnership X, a partnership organized under the laws of Country B. Partnership X performs activities in Country B that would constitute the manufacture of Product O, within the meaning of paragraph (a)(4) of this section, if performed directly by CFC. Partnership X, through its sales offices in Country B, then sells Product O to Corp D, a corporation that is a related person with respect to CFC, within the meaning of section 954(d)(3), for use within Country B. CFC's distributive share of Partnership X's sales income is not foreign base company sales income because the manufacturing exception of paragraph (a)(4) of this section would have applied to exclude the income from foreign base company sales income if CFC had earned the income directly.

(iii) *Effective date.* This paragraph (a)(6) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

(b) *Branches of controlled foreign corporation treated as separate corporations—(1) General rules for determining when to apply separate treatment—(i) Sales or purchase branch—(a) In general.* If a controlled foreign corporation carries on purchasing or selling 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 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).

(b) *Allocation of income and comparison of effective rates of tax.* The determination as to whether such use of the branch or similar establishment has the same tax effect as if it were a wholly owned subsidiary corporation of the controlled foreign corporation shall be made by allocating to such branch or similar establishment only that income derived by the branch or establishment which, when the special rules of subparagraph (2)(i) of this paragraph are applied, is described in paragraph (a) of this section (but determined without applying subparagraphs (2), (3), and (4) of such paragraph). The use of the branch or similar establishment for such activities 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 the income allocated to the branch or similar establishment under the immediately preceding sentence 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 which would apply to such income under the laws of the country in which the controlled foreign corporation is created or organized, if, under the laws of such country, the entire income of the controlled foreign corporation were considered derived by the corporation from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the corporation were managed and controlled in such country.

(c) [Reserved] For further guidance, see § 1.954-3T(b)(1)(i)(c).

(ii) *Manufacturing branch—(a)* [Reserved] For further guidance, see § 1.954-3T(b)(1)(ii)(a).

(b) *Allocation of income and comparison of effective rates of tax.* The determination as to whether such use of the branch or similar establishment has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of the controlled foreign corporation shall be made by allocating to the remainder of such controlled foreign corporation only that income de-

derived by the remainder of such corporation, which, when the special rules of subparagraph (2)(i) of this paragraph are applied, is described in paragraph (a) of this section (but determined without applying subparagraphs (2), (3), and (4) of such paragraph). The use of the branch or similar establishment for such activities 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 under the immediately preceding sentence 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 which would apply to such income under the laws of the country in which the branch or similar establishment is located, if, under the laws of such country, the entire income of the controlled foreign corporation were considered derived by such corporation from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the corporation were created or organized under the laws of, and managed and controlled in, such country.

(c) [Reserved] For further guidance, see § 1.954-3T(b)(1)(ii)(c).

(2) *Special rules—(i) Determination of treatment as a wholly owned subsidiary corporation.* For purposes of determining under this paragraph whether the use of a branch or similar establishment which is treated as a separate corporation has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of a controlled foreign corporation—

(a) *Treatment as separate corporations.* The branch or similar establishment will be treated as a wholly owned subsidiary corporation of the controlled foreign corporation, and such branch or similar establishment will be deemed to be incorporated in the country in which it is located.

(b) [Reserved] For further guidance, see § 1.954-3T(b)(2)(i)(b).

(c) *Activities treated as performed on behalf of branch.* With respect to manufacturing, producing, constructing, growing, or extracting activities performed by or through the branch or similar establishment, purchasing or selling activities performed by or through the remainder of the controlled foreign corporation with respect to the personal property manufactured, produced, constructed, grown, or extracted by or through the branch or similar establishment shall be treated as performed on behalf of the branch or similar establishment.

(d) [Reserved] For further guidance, see § 1.954-3T(b)(2)(i)(d).

(e) *Tax laws to be taken into account.* Tax determinations shall be made by taking into account only the income, war profits, excess profits, or similar tax laws (or the absence of such laws) of the countries involved.

(ii) *Determination of foreign base company sales income.* Once it has been determined under subparagraph (1) of this paragraph that a branch or similar establishment and the remainder of the controlled foreign corporation are to be treated as separate corporations, the determination of whether such branch or similar establishment, or the remainder of the controlled foreign corporation, as the case may be, has foreign base company sales income shall be made by applying the following rules:

(a) [Reserved] For further guidance, see § 1.954-3T(b)(2)(ii)(a).

(b) [Reserved] For further guidance, see § 1.954-3T(b)(2)(ii)(b).

(c) *Activities treated as performed on behalf of branch.* With respect to manufacturing, producing, constructing, growing, or extracting activities performed by or through the branch or similar establishment, purchasing or selling activities performed by or through the remainder of the controlled foreign corporation with respect to the personal property manufactured, produced, constructed, grown, or extracted by or through the branch or similar establishment shall be treated as performed on behalf of the branch or similar establishment.

(d) *Items not to be twice included in income.* Income which is classified as foreign base company sales income as a

result of the application of subdivision (i) of subparagraph (1) of this paragraph shall not be again classified as foreign base company sales income as a result of the application of subdivision (ii) of such subparagraph.

(e) [Reserved]

(f) *Priority of application.* If income derived by the branch or similar establishment, or by the remainder of the controlled foreign corporation, from a transaction would be classified as foreign base company sales income of such controlled foreign corporation under section 954(d)(1) and paragraph (a) of this section, the income shall, notwithstanding this paragraph, be treated as foreign base company sales income under paragraph (a) of this section and the branch or similar establishment shall not be treated as a separate corporation with respect to such income.

(3) *Inclusion of amounts in gross income of United States shareholders.* A branch or similar establishment of a controlled foreign corporation and the remainder of such corporation shall be treated as separate corporations under this paragraph solely for purposes of determining the foreign base company sales income of each such corporation and for purposes of including an amount in subpart F income of the controlled foreign corporation under section 953(a). See section 954(b)(3) and paragraph (d)(4) of § 1.954-1 for rules relating to the treatment of a branch or similar establishment of a controlled foreign corporation and the remainder of such corporation as separate corporations for purposes of independently determining if the foreign base company income of each such corporation is less than 10 percent, or more than 70 percent, of its gross income. For all other purposes, however, a branch or similar establishment of a controlled foreign corporation and the remainder of such corporation shall not be treated as separate corporations. For example, if the controlled foreign corporation has a deficit in earnings and profits to which section 952(c) applies, the limitation of such section on the amount includable in the subpart F income of such corporation will apply. Moreover, income, war profits, or excess profits

taxes paid by a branch or similar establishment to a foreign country will be treated as having been paid by the controlled foreign corporation for purposes of section 960 (relating to special rules for foreign tax credit) and the regulations thereunder. Also, income of a branch or similar establishment, treated as a separate corporation under this paragraph, will not be treated as dividend income of the controlled foreign corporation of which it is a branch or similar establishment.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

*Example 1.* Controlled foreign corporation A, incorporated under the laws of foreign country X, is engaged in the manufacturing business in such country. Corporation A negotiates sales of its products for use outside of country X through a sales office, branch B, maintained in foreign country Y. These activities constitute the only activities of A Corporation. Country X levies an income tax at an effective rate of 50 percent on the income of A Corporation derived by the manufacturing plant in country X but does not tax the sales income of A Corporation derived by branch B in country Y. Country Y levies an income tax at an effective rate of 10 percent on the sales income derived by branch B but does not tax the income of A Corporation derived by the manufacturing plant in country X. If the sales income derived by branch B were, under the laws of country X, derived from sources within country X by A Corporation, such income would be taxed by such country at an effective rate of 50 percent. In determining foreign base company sales income of A Corporation, branch B is treated as a separate wholly owned subsidiary corporation of A Corporation, the 10 percent rate of tax on branch B's income being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate. Income derived by branch B, treated as a separate corporation, from the sale by or through it for use, consumption, or disposition outside country Y of the personal property produced in country X is treated as income from the sale of personal property on behalf of A Corporation, a related person, and constitutes foreign base company sales income. The remainder of A Corporation, treated as a separate corporation, derives no foreign base company sales income since it produces the product which is sold.

*Example 2.* Controlled foreign corporation C is incorporated under the laws of foreign country X. Corporation C maintains branch B in foreign country Y. Branch B manufactures articles in country Y which are sold through the sales offices of C Corporation lo-

cated in country X. These activities constitute the only activities of C Corporation. Country Y levies an income tax at an effective rate of 30 percent on the manufacturing profit of C Corporation derived by branch B but does not tax the sales income of C Corporation derived by the sales offices in country X. Country X does not impose an income, war profits, excess profits, or similar tax, and no tax is paid to any foreign country with respect to income of C Corporation which is not derived by branch B. If C Corporation were incorporated under the laws of country Y, the sales income of the sales offices in country X would be taxed by country Y at an effective rate of 30 percent. In determining foreign base company sales income of C Corporation, branch B is treated as a separate wholly owned subsidiary corporation of C Corporation, the zero rate of tax on the income derived by the remainder of C Corporation being less than 90 percent of, and at least 5 percentage points less than, the 30 percent rate. Branch B, treated as a separate corporation, derives no foreign base company sales income since it produces the product which is sold. Income derived by the remainder of C Corporation, treated as a separate corporation, from the sale by or through it for use, consumption, or disposition outside country X of the personal property produced in country Y is treated as income from the sale of personal property on behalf of branch B, a related person, and constitutes foreign base company sales income.

*Example 3.* [Reserved] For further guidance, see §1.954-3T(b)(4) *Example (3)*.

*Example 4.* Controlled foreign corporation F, incorporated under the laws of foreign country X, is a wholly owned subsidiary of domestic corporation M. Corporation F, through its branch B in foreign country Y, purchases from controlled foreign corporation G, a wholly owned subsidiary of M Corporation incorporated under the laws of foreign country Z, personal property which G Corporation manufactures in country Z. Corporation F sells such property for use in foreign country W. Since the income of F Corporation from such purchases and sales is classified as foreign base company sales income under section 954(d)(1) and paragraph (a) of this section, branch B will not be treated as a separate corporation with respect to such income even if the tax differential between countries X and Y would otherwise justify such treatment.

*Example 5.* Controlled foreign corporation A, incorporated under the laws of foreign country X, is engaged in manufacturing articles through its home office, located in country X, and selling such articles through branch B, located in foreign country Y, and through branch C, located in foreign country Z, for use outside country X. These activities constitute the only activities of A Corporation for its taxable year 1963. Each such



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country levies an income tax on only the income derived from sources within such country, and all income derived in 1963 by the home office, branch B, and branch C, respectively, is derived from sources within countries X, Y, and Z, respectively. The income and income taxes of A Corporation for 1963 are as follows:

	X Country	Y Country	Z Country
Income of:			
Home office ....	\$200,000	.....	.....
Branch B .....	.....	\$100,000	.....
Branch C .....	.....	.....	\$100,000
Income tax .....	\$100,000	\$20,000	\$20,000
Effective rate of tax .....	50%	20%	20%

By applying subparagraph (1)(i) of this paragraph and by treating branch B as though it were the only branch of A Corporation, branch B is treated as a separate wholly owned subsidiary corporation of A Corporation in determining foreign base company sales income of A Corporation for 1963, the 20 percent rate of tax on the income of such branch being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of branch B under the laws of country X if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch B were derived from sources within country X. Moreover, by applying subparagraph (1)(i) of this paragraph and by treating branch C as though it were the only branch of A Corporation, branch C is treated as a separate wholly owned subsidiary corporation of A Corporation, the 20 percent rate of tax on the income of such branch being less than 90 percent of, and at least 5 percentage points less than, the 50 percent rate of tax which would apply to the income of branch C under the laws of country X if, under the laws of such country, all the income of A Corporation for 1963 derived through the home office and branch C were derived from sources within country X. The income derived by branch B and branch C, respectively, each treated as a separate corporation, from the sale by or through each of them for use, consumption, or disposition outside country Y and country Z, respectively, is treated as income from the sale of personal property on behalf of A Corporation, a related person, and constitutes foreign base company sales income for 1963. The home office of A Corporation, treated as a separate corporation, derives no foreign base company sales income for 1963 since it produces the articles which are sold.

*Example 6* [Reserved]

*Example 7* [Reserved]

(c) *Effective/applicability date.* Paragraphs (a)(1)(i), (a)(1)(iii) *Example 1*, (a)(1)(iii) *Example 2*, (a)(2), (a)(4)(i),

(a)(4)(ii), (a)(4)(iii), (a)(4)(iv) and (a)(6)(i) shall apply to taxable years of controlled foreign corporations beginning after June 30, 2009, and for taxable years of United States shareholders in which or with which such taxable years of the controlled foreign corporations end.

(d) *Application of regulations to earlier taxable years.* A taxpayer may choose to apply these regulations and the regulations under § 1.954-3T retroactively with respect to its open taxable years. The taxpayer may so choose if and only if the taxpayer and all members of the taxpayer's affiliated group (within the meaning of § 1504(a)) apply both these regulations and the regulations under § 1.954-3T, in their entirety, to the earliest taxable year of each controlled foreign corporation that ends with or within an open taxable year of the taxpayer and to all subsequent taxable years of the taxpayer.

[T.D. 6734, 29 FR 6392, May 15, 1964, as amended by T.D. 7545, 43 FR 32754, May 8, 1978; T.D. 7893, 48 FR 22508, May 19, 1983; T.D. 7894, 48 FR 22523, May 19, 1983; T.D. 9008, 67 FR 48025, July 23, 2002; T.D. 9438, 73 FR 79344, T.D. 9438, Dec. 29, 2008; 74 FR 11844, Mar. 20, 2009]

**§ 1.954-3T Foreign base company sales income (temporary).**

(a) Through (b)(1)(i)(b) [Reserved] For further guidance, see § 1.954-3(a) through (b)(1)(i)(b).

(c) *Use of more than one branch.* If a controlled foreign corporation carries on purchasing or selling activities by or through more than one branch or similar establishment located outside the country under the laws of which such corporation is created or organized, then § 1.954-3(b)(1)(i)(b) shall be applied separately to the income derived by each such branch or similar establishment (by treating such purchasing or selling branch or similar establishment as if it were the only branch or similar establishment of the controlled foreign corporation and as if any such other branches or similar establishments were separate corporations) in determining whether the use of such branch or similar establishment has substantially the same tax effect as if such branch or similar establishment were a wholly owned subsidiary corporation of the controlled