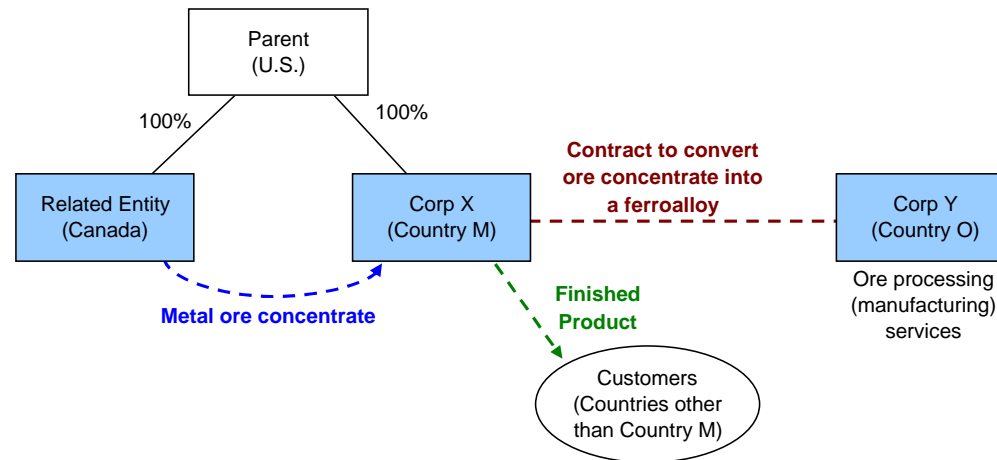


Revenue Ruling 97-48

Contract Manufacturing - No Branch, But No Attribution of Manufacturing

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See [Rev. Rul. 75-7](#) for a description of the facts.

If Corp X is not considered to have manufactured the finished product in Country M, then at least part of the income of Corp X would be subpart F income under the statute ("income . . . derived in connection with the purchase of personal property from a related person and its sale to any person . . . where . . . the property . . . is manufactured . . . outside [Country M], and . . . the property is sold for use . . . outside [Country M]" Section 954(d)(1).) Query whether any of Corp X's income was derived in connection with manufacturing activity that was separate and apart from income derived in connection with the "purchase" and "sale" of the property?

It seems clear that the product was not manufactured in Country M. It is unlikely that the raw materials, work-in-process, or finish product ever entered Country M. A product cannot be manufactured in a country where neither the raw materials nor the finish product have ever been located. As a result, it would seem, that under the statute, part or all of Corp X's income should be subpart F income (foreign base company sales income).

However, the regulations have 3 exceptions to foreign base company sales income. Under the first exception, the property must be manufactured in Country M (not necessarily by Corp X). (the "same country manufacturing exception"). Reg. 1.954-3(a)(2). Under the second exception, the property must be sold for use or consumption in Country M. (the "same country use exception"). Reg. 1.954-3(a)(3). Neither of these first two exceptions apply to Corp X. Under the third exception, Corp X must manufacture the property. (the "CFC manufacturing exception"). Reg. 1.954-3(a)(4). The regulation for the third exception has a **very** broad definition of manufacturing ("A foreign corporation will be considered . . . to have manufactured . . . personal property which it sells if the property sold is in effect not the property which it purchased." Reg. 1.954-3(a)(4)(i). "If purchased personal property is substantially transformed prior to sale, the property sold will be treated as having been manufactured . . . by the selling corporation." Reg. 1.954-3(a)(4)(ii).) This third exception makes no mention of **where** the manufacturing activity must take place. If the activity takes place in Country O, the CFC manufacturing exception would still apply to Corp X (as long as Corp X does not have a branch in Country O and Corp X is treated as the manufacturer).

Rev. Rul 97-48 announced that it will follow the Ashland Oil Co. (95 T.C. 348) and Vetco, Inc. (95 T.C. 579) decisions in that Corp X will not be treated as having a branch in Country O. However, Rev. Rul 97-48 also provides that "[t]he activities of a contract manufacturer cannot be attributed to a [CFC] for purposes of either section 954(d)(1) or section 954(d)(2) . . . to determine whether the income of a [CFC] is foreign base company sales income." This statement in the ruling is not supported any by references to statutory, regulatory, or judicial authority. In Rev. Rul. 75-7 (which this ruling revokes) there were a number of factors identified (title held by Corp X, risk of loss borne by Corp X, control of time, quantity, and quality of production by Corp X) which would indicate that Corp X was the principal and Corp Y was its agent (similar to an independent contractor or even an employee [corporations can only act thru their agents]), for purposes of determining which entity should be considered manufacturing.

In this ruling the IRS has conceded that no branch exists for Corp X. The IRS has not, however, provided any rationale as to why Corp X would not be considered to have manufactured the product. The activities of Corp X, the "selling corporation", appear to fall within the literal definition of manufacturing as set out in Reg. 1.954-3(a)(4).

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