

## Treasury Regulations Under Code Section 954 Foreign Base Company Income

### Reg. § 1.954-2 (2006) Foreign Personal Holding Company Income

(a) *Computation of foreign personal holding company income.* (1) *Categories of foreign personal holding company income.* For purposes of subpart F and the regulations under that subpart, foreign personal holding company income consists of the following categories of income—

- (i) Dividends, interest, rents, royalties, and annuities as described in paragraph (b) of this section;
- (ii) Gain from certain property transactions as described in paragraph (e) of this section;
- (iii) Gain from commodities transactions as described in paragraph (f) of this section;
- (iv) Foreign currency gain as described in paragraph (g) of this section; and
- (v) Income equivalent to interest as described in paragraph (h) of this section.

(2) *Coordination of overlapping categories under foreign personal holding company provisions.*

(i) *In general.* If any portion of income, gain or loss from a transaction is described in more than one category of foreign personal holding company income (as described in paragraph (a)(2)(ii) of this section), that portion of income, gain or loss is treated solely as income, gain or loss from the category of foreign personal holding company income with the highest priority.

(ii) *Priority of categories.* The categories of foreign personal holding company income, listed from highest priority (paragraph (a)(2)(ii)(A) of this section) to lowest priority (paragraph (a)(2)(ii)(E) of this section), are—

- (A) Dividends, interest, rents, royalties, and annuities, as described in paragraph (b) of this section;
- (B) Income equivalent to interest, as described in paragraph (h) of this section without regard to the exceptions in paragraph (h)(1)(ii)(A) of this section;
- (C) Foreign currency gain or loss, as described in paragraph (g) of this section without regard to the exclusion in paragraph (g)(2)(ii) of this section;
- (D) Gain or loss from commodities transactions, as described in paragraph (f) of this section without regard to the exclusion in paragraph (f)(1)(ii) of this section; and
- (E) Gain or loss from certain property transactions, as described in paragraph (e) of this section without regard to the exceptions in paragraph (e)(1)(ii) of this section.

(3) *Changes in the use or purpose for which property is held.*

(i) *In general.* Under paragraphs (e), (f), (g) and (h) of this section, transactions in certain property give rise to gain or loss included in the computation of foreign personal holding company income if the controlled foreign corporation holds that property for a particular use or purpose. The use or purpose for which property is held is that use or purpose

for which it was held for more than one-half of the period during which the controlled foreign corporation held the property prior to the disposition.

(ii) *Special rules.*

(A) *Anti-abuse rule.* If a principal purpose of a change in use or purpose of property was to avoid including gain or loss in the computation of foreign personal holding company income, all the gain or loss from the disposition of the property is treated as foreign personal holding company income. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(B) *Hedging transactions.* The provisions of paragraph (a)(3)(i) of this section shall not apply to bona fide hedging transactions, as defined in paragraph (a)(4)(ii) of this section. A transaction will be treated as a bona fide hedging transaction only so long as it satisfies the requirements of paragraph (a)(4)(ii) of this section.

(iii) *Example.* The following example illustrates the application of this paragraph (a)(3).

*Example.* At the beginning of taxable year 1, CFC, a controlled foreign corporation, purchases a building for investment. During taxable years 1 and 2, CFC derives rents from the building that are included in the computation of foreign personal holding company income under paragraph (b)(1)(iii) of this section. At the beginning of taxable year 3, CFC changes the use of the building by terminating all leases and using it in an active trade or business. At the beginning of taxable year 4, CFC sells the building at a gain. The building was not used in an active trade or business of CFC for more than one-half of the period during which it was held by CFC. Therefore, the building is considered to be property that gives rise to rents, as described in paragraph (e)(2) of this section, and gain from the sale is included in the computation of CFC's foreign personal holding company income under paragraph (e) of this section.

(4) *Definitions and special rules.* The following definitions and special rules apply for purposes of computing foreign personal holding company income under this section.

(i) *Interest.* The term interest includes all amounts that are treated as interest income (including interest on a tax-exempt obligation) by reason of the Internal Revenue Code or Income Tax Regulations or any other provision of law. For example, interest includes stated interest, acquisition discount, original issue discount, de minimis original issue discount, market discount, de minimis market discount, and unstated interest, as adjusted by any amortizable bond premium or acquisition premium.

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(iii) *Inventory and similar property.*

(A) *Definition.* The term inventory and similar property (or inventory or similar property) means property that is stock in trade of the controlled foreign corporation or other property of a kind that would properly be included in the inventory of the controlled foreign corporation if on hand at the close of the taxable year (if the controlled foreign corporation were a domestic corporation), or property held by the controlled foreign corporation primarily for sale to customers in the ordinary course of its trade or business.

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(vii) *Debt instrument.* The term debt instrument includes bonds, debentures, notes, certificates, accounts receivable, and other evidences of indebtedness.

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(b) *Dividends, interest, rents, royalties, and annuities.*

(1) *In general.* Foreign personal holding company income includes—

(i) Dividends, except certain dividends from related persons as described in paragraph (b)(4) of this section and distributions of previously taxed income under section 959(b);

(ii) Interest, except export financing interest as defined in paragraph (b)(2) of this section and certain interest received from related persons as described in paragraph (b)(4) of this section;

(iii) Rents and royalties, except certain rents and royalties received from related persons as described in paragraph (b)(5) of this section and rents and royalties derived in the active conduct of a trade or business as defined in paragraph (b)(6) of this section;

(iv) Annuities.

(2) *Exclusion of certain export financing interest.*

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(3) *Treatment of tax-exempt interest.* For taxable years of a controlled foreign corporation beginning after March 3, 1997, foreign personal holding company income includes all interest income, including interest that is described in section 103 (see section 1.952-2(c)(1)).

(4) *Exclusion of dividends or interest from related persons.*

(i) *In general.*

(A) *Corporate payor.* Foreign personal holding company income received by a controlled foreign corporation does not include dividends or interest if the payor—

(1) Is a corporation that is a related person with respect to the controlled foreign corporation, as defined in section 954(d)(3);

(2) Is created or organized under the laws of the same foreign country (the country of incorporation) as is the controlled foreign corporation; and

(3) Uses a substantial part of its assets in a trade or business in its country of incorporation, as determined under this paragraph (b)(4).

(B) *Payment by a partnership.* For purposes of this paragraph (b)(4), if a partnership with one or more corporate partners makes a payment of interest, a corporate partner will be treated as the payor of the interest—

(1) If the interest payment gives rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent that the item of deduction is allocable to the corporate partner under section 704(b); or

(2) If the interest payment does not give rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent that a partnership item reasonably related to the payment would be allocated to that partner under an existing allocation under the partnership agreement (made pursuant to section 704(b)).

(ii) *Exceptions.*

(A) *Dividends.* Dividends are excluded from foreign personal holding company income under this paragraph (b)(4) only to the extent that they are paid out of earnings and profits that are earned or accumulated during a period in which—

(1) The stock on which dividends are paid with respect to which the exclusion is claimed was owned by the recipient controlled foreign corporation directly, or indirectly through a chain of one or more subsidiaries each of which meets the requirements of paragraph (b)(4)(i)(A) of this section; and

(2) Each of the requirements of paragraph (b)(4)(i)(A) of this section is satisfied or, to the extent earned or accumulated during a taxable year of the related foreign corporation ending on or before December 31, 1962, during a period in which the payor was a related corporation as to the controlled foreign corporation and the other requirements of paragraph (b)(4)(i)(A) of this section were substantially satisfied.

(3) This paragraph (b)(4)(ii)(A) is illustrated by the following example:

*Example.* A, a domestic corporation, owns all of the stock of B, a corporation created and organized under the laws of Country Y, and C, a corporation created and organized under the laws of Country X. The taxable year of each of the corporations is the calendar year. In Year 1, B earns \$100 of income from the sale of products in Country Y that it manufactured in Country Y. C had no earnings and profits in Year 1. On January 1 of Year 2, A contributes all of the stock of B and C to Newco, a Country Y corporation, in exchange for all of the stock of Newco. Neither B nor C earns any income in Year 2, but at the end of Year 2 B distributes the \$100 accumulated earnings and profits to Newco. Newco's income from the distribution, \$100, is foreign personal holding company income because the earnings and profits distributed by B were not earned or accumulated during a period in which the stock of B was owned by Newco and in which each of the requirements of paragraph (b)(4)(i)(A) of this section was satisfied.

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(c) *Excluded rents.*

(1) *Active conduct of a trade or business.* Rents will be considered for purposes of paragraph (b)(6) of this section to be derived in the active conduct of a trade or business if such rents are derived by the controlled foreign corporation (the lessor) from leasing any of the following—

(i) Property that the lessor has manufactured or produced, or has acquired and added substantial value to, but only if the lessor is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind;

(ii) Real property with respect to which the lessor, through its own officers or staff of employees, regularly performs active and substantial management and operational functions while the property is leased;

(iii) Personal property ordinarily used by the lessor in the active conduct of a trade or business, leased temporarily during a period when the property would, but for such leasing, be idle; or

(iv) Property that is leased as a result of the performance of marketing functions by such lessor if the lessor, through its own officers or staff of employees located in a foreign

country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property.

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(d) *Excluded royalties.*

(1) *Active conduct of a trade or business.* Royalties will be considered for purposes of paragraph (b)(6) of this section to be derived in the active conduct of a trade or business if such royalties are derived by the controlled foreign corporation (the licensor) from licensing—

(i) Property that the licensor has developed, created, or produced, or has acquired and added substantial value to, but only so long as the licensor is regularly engaged in the development, creation or production of, or in the acquisition of and addition of substantial value to, property of such kind; or

(ii) Property that is licensed as a result of the performance of marketing functions by such licensor if the licensor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of such property.

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(e) *Certain property transactions.*

(1) *In general.*

(i) *Inclusions.* Gain from certain property transactions described in section 954(c)(1)(B) includes the excess of gains over losses from the sale or exchange of—

(A) Property that gives rise to dividends, interest, rents, royalties or annuities, as described in paragraph (e)(2) of this section;

(B) Property that is an interest in a partnership, trust or REMIC; and

(C) Property that does not give rise to income, as described in paragraph (e)(3) of this section.

(ii) *Exceptions.* Gain or loss from certain property transactions described in section 954(c)(1)(B) and paragraph (e)(1)(i) of this section does not include gain or loss from the sale or exchange of—

(A) Inventory or similar property, as defined in paragraph (a)(4)(iii) of this section;

(B) Dealer property, as defined in paragraph (a)(4)(v) of this section; or

(C) Property that gives rise to rents or royalties described in paragraph (b)(6) of this section that are derived in the active conduct of a trade or business from persons that are not related persons (as defined in section 954(d)(3)) with respect to the controlled foreign corporation.

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[T.D. 8618, 60 FR 46500-46530, Sept. 7, 1995; corrected at 60 FR 58731, Nov. 28, 1995; 60 FR 62024-62026, Dec. 4, 1995; amended by T.D. 8704, 62 FR 17-22, Jan. 2, 1997; T.D.

*8985, 67 FR 12863-12871, Mar. 20, 2002; T.D. 9008, 67 FR 48020-48025, July 23, 2002; amended by T.D. 9039, 68 FR 4916-4918, Jan. 31, 2003; amended by T.D. 9141, 69 FR 43304-43317, July 20, 2004; amended by T.D. 9240, 71 F.R. 2462-2464, Jan. 17, 2006.]*

## Reg. § 1.954-3 (2002)

### 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 subparagraphs (2), (3), and (4) of this paragraph, consist of gross income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with (a) the purchase of personal property from a related person and its sale to any person, (b) the sale of personal property to any person on behalf of a related person, (c) the purchase of personal property from any person and its sale to a related person, or (d) the purchase of personal property from any person on behalf of a related person. See section 954(d)(1). 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 an unrelated person, as defined in paragraph (e)(2) of section 1.954-1, 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 section 1.954-2 or foreign base company shipping income under section 1.954-6; 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 trade or 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 subparagraph includes a related person, as defined in paragraph (e)(1) of section 1.954-1.

(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. [*Omitted.*]

(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 in the form in which purchased to P, not a related 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, not a related person, articles manufactured in country Y and sells the articles in the form in which purchased 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 subparagraph (1) of this paragraph 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 subparagraph (4) of this paragraph with respect to the manufacture, production, or construction of personal property shall apply under this subparagraph in determining what constitutes manufacture, production, or construction of property. 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 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 reasonable 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 or produced by the controlled foreign corporation.*

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

(ii) *Substantial transformation of property.* 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. The application of this subdivision 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 operations conducted by the selling corporation in connection with the property purchased and sold are substantial in nature and are 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).

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[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 48020-48025, July 23, 2002.]

**Reg. § 1.954-3 (2002)****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 subparagraphs (2), (3), and (4) of this paragraph, consist of gross income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with (a) the purchase of personal property from a related person and its sale to any person, (b) the sale of personal property to any person on behalf of a related person, (c) the purchase of personal property from any person and its sale to a related person, or (d) the purchase of personal property from any person on behalf of a related person. See section 954(d)(1). 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 an unrelated person, as defined in paragraph (e)(2) of section 1.954-1, 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 section 1.954-2 or foreign base company shipping income under section 1.954-6; 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 trade or 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 subparagraph includes a related person, as defined in paragraph (e)(1) of section 1.954-1.

(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. [*Omitted.*]

(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 in the form in which purchased to P, not a related 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, not a related person, articles manufactured in country Y and sells the articles in the form in which purchased 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 subparagraph (1) of this paragraph 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 subparagraph (4) of this paragraph with respect to the manufacture, production, or construction of personal property shall apply under this subparagraph in determining what constitutes manufacture, production, or construction of property. 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 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 reasonable 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 or produced by the controlled foreign corporation.*

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

(ii) *Substantial transformation of property.* 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. The application of this subdivision 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 operations conducted by the selling corporation in connection with the property purchased and sold are substantial in nature and are 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).

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(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).

\* \* \*

(ii) *Manufacturing branch.* (a) *In general.* 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).

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