DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
ASSOCIATE AREA COUNSEL
ATTN:

FROM: Anne P. Shelburne
Assistant to the Branch Chief, CC:INTL:Br6

SUBJECT:

This Chief Counsel Advice responds to your memorandum received September 27, 2000, as amended on January 29, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Amount A	=
Amount B	=
Amount C	=
Amount D	=
CFC 1	=
CFC 2	=
Date 1	=
Maquila 1	=
Maquila 2	=
Parent Co	=
Product 1	=
Product 2	=
Region A	=
Region B	=
US Co	=

Year 1	=
Year 2	=
Year 3	=

ISSUES:

1. Whether for purposes of sourcing US Co's income under section 863(b) US Co produces Products 1 and 2 in Mexico.

2. Whether for purposes of sourcing US Co's income under section 863(b) the activities of US Co's Mexican controlled foreign corporations, Maquila 1 and Maquila 2, pursuant to the agreements between US Co, Maquila 1, and Maquila 2, may be attributed to US Co.

CONCLUSIONS:

1. For purposes of sourcing US Co's income under section 863(b), a determination whether US Co itself should be considered to produce Products 1 and 2 in Mexico will require further factual development with respect to the specific functions performed, risks assumed, and assets employed by US Co itself in Mexico. It will be material, inter alia, to ascertain the roles and location of US Co personnel vis-à-vis the activities undertaken, risks assumed, or assets employed in any production process.

2. For purposes of sourcing US Co's income under section 863(b), the activities of Maquila 1 and Maquila 2, pursuant to the agreements between US Co, Maquila 1, and Maquila 2, cannot be attributed to US Co.

FACTS:

Parent Co, a United States company, owns 100 percent of US Co, a United States company, which is included for tax purposes in Parent Co's consolidated Federal income tax return.

During Years 1, 2, and 3, US Co owned two Mexican controlled foreign corporations, Maquila 1 and Maquila 2, which operated under the Maquiladora program. In Date 1, US Co entered into assembly (maquila) agreements with Maquila 1 and Maquila 2 for the assembly of Product 1 and Product 2, respectively. US Co also entered into written consignment (commadatum) agreements and administrative and technical assistance agreements with Maquila 1 and Maquila 2. These agreements were all in effect during the years at issue, Years 1 through 3.

Pursuant to the agreements, US Co sent parts and components on consignment to Maquila 1 and Maquila 2, which in turn assembled Product 1 and Product 2. US Co then sold the finished products to Parent Co, with title passing in the United States. US Co also sold to CFC 1 and CFC 2 (controlled foreign corporations of Parent Co), with title passing outside the United States. US Co also sold Maquila 1-assembled components to customers in Region A and Region B, areas outside the United States, with title passing outside the United States.

Parent Co's consolidated Federal income tax return for Year 2 reported foreign source income (pursuant to section 863(b)) from US Co's sales of Product 1 and Product 2 in the amount of $ Amount A. Of this amount, $ Amount C related to US Co sales to Parent Co. Parent Co's consolidated Federal income tax return for Year 3 reported foreign source income (pursuant to section 863(b)) from US Co's sales of Product 1 and Product 2 in the amount of $ Amount B. Of this amount, $ Amount D related to US Co sales to Parent Co. Parent Co has indicated that it intends to file a refund claim for Year 1 to source a portion of the income from similar US Co sales as foreign source income.

US Co maintains that the agreements with Maquila 1 and Maquila 2 make it the producer of the products assembled in Mexico. Parent Co represents that US Co owns and controls the tooling, machinery, plant, and equipment located at Maquila 1 and Maquila 2, and that US Co maintains title to raw materials, work-in-process, and ending inventory. According to Parent Co, US Co supplies technology; dictates design specifications, production volumes, and scheduling; and bears economic risk of loss with regard to production. Parent Co takes the position — based on an attribution of the activities of Maquila 1 and Maquila 2 to US Co — that US Co's sales income should be treated under section 863(b)(2) as income from the sale of inventory property produced by US Co partly within and partly without the United States.

We have not been provided information on the roles of U.S. personnel of US Co or Parent Co in connection with Products 1 and 2 and, importantly, on the location of such personnel, in Mexico or the United States, when they make any contributions to relevant functions performed, risks assumed, or assets employed in any production process.

LAW AND ANALYSIS:

Section 863(b)(2) applies to source income from sales of inventory property produced by the taxpayer partly within and partly without the United States. Section 863(b)(2) provides in relevant part:

> (b) INCOME PARTLY FROM WITHIN AND PARTLY FROM WITHOUT THE UNITED STATES.— . . . . Gains, profits, and income—

. . . . .

(2) from the sale or exchange of inventory property (within the meaning of section 865(i)(1)) produced (in whole or in part) by the taxpayer within and sold or exchanged without the United States, or produced (in whole or in part) by the taxpayer without and sold or exchanged within the United States, . . .

. . . . .

shall be treated as derived partly from sources within and partly from sources without the United States.

Section 864(a) provides that for purposes of the source rules, "the term 'produced' includes created, fabricated, manufactured, extracted, processed, cured, or aged." See also Treas. Reg. § 1.864-1.

Issue 1

The tax treatment of income derived from sources partly within and partly without the United States was first provided for in section 217(e) of the Revenue Act of 1921. In enacting section 217(e), which provided for allocation or apportionment of nonresidents'[1] income to sources within or without the United States, Congress was specifically concerned about collecting tax on export sales by foreign persons manufacturing in the United States.[2] The provision's legislative history discusses the connection between business activity and the source of income, and the purpose, in enacting section 217(e), to attribute income to manufacturing and other activities, not solely to sales.[3] Thus, although not stated on the face of the statute, the early history of the source rules shows an intent to source income based on the

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[1] The source rules were specifically made applicable to U.S. taxpayers in 1932 by a statutory cross reference (in section 131(e) of the Revenue Act of 1932), which incorporated the source rules for purposes of applying the foreign tax credit provisions.

[2] See H. Rep. No. 350, 67th Cong., 1st Sess., vol. 2 (1921) at 12, reprinted in 1939-1 C.B. (pt. 2) 168, 177; S. Rep. No. 275, 67th Cong., 1st Sess. (1921) at 16, reprinted in 1939-1 C.B. (pt. 2) 181, 192. In discussing the need for section 217(e), Congress specifically referred to a holding by the Attorney General that, under pre-1921 law, "where goods are manufactured or produced in the United States and sold abroad no part of the profit is derived from a source within the United States."

[3] See House Report 350, supra note 2, 1939-1 C.B. (pt. 2) at 177; Senate Report 275, supra note 2, 1939-1 C.B. (pt. 2) at 192.

location of the assets and activities that generate the income. See, e.g., Piedras Negras Broadcasting Co. v. Commissioner, 127 F.2d 260, at 261 (5th Cir. 1942) (noting that the statutory language of the source rules "denotes a concept of some physical presence, some tangible and visible activity"). See also Piedras Negras Broadcasting Co. v. Commissioner, 43 B.T.A. 297, at 309 (1941) (citing 4 Paul & Mertens Law of Federal Income Taxation 350 for the proposition that ". . . It [the 'source'] is not a place, it is an activity or property. As such it has a situs or location . . . ."). Accordingly, whether US Co should be considered to produce in Mexico within the meaning of sections 863(b) and 864(a) is an inherently factual question that can only be resolved through an evaluation of the unique facts and circumstances in this particular case as to the taxpayer's assets and activities in Mexico.

In this case, the statute's relevant requirements are twofold: that the inventory property is "produced . . . by the taxpayer," and that the taxpayer's production activities occur, in whole or in part, "without the United States (i.e., in Mexico). These statutory requirements must be interpreted based on section 863's statutory and regulatory language read as a whole, and the interpretation must be consistent with the statute's purpose. On its face, section 863(b) requires that US Co actively create or transform property in Mexico. Because we have not been provided with information regarding the functions performed, risks assumed, and assets employed, and the activities of US Co personnel, the resolution of this issue will require further factual development. In addition, it will be important to determine the location of the functions performed, assets used, and risks assumed, and the role of US Co personnel vis-à-vis those functions, assets, and risks, since the statute requires that the taxpayer's production activities occur in Mexico.

Issue 2

US Co has interpreted the phrase in section 863(b)(2) "produced (in whole or in part) by the taxpayer" to include activities carried out by Maquila 1 and Maquila 2 pursuant to the various agreements between US Co and these entities. In other words, US Co has taken the position that the activities of Maquila 1 and Maquila 2 in Mexico should be attributed to US Co based on US Co's contractual relationships with Maquila 1 and Maquila 2. US Co cites Rev. Rul. 75-7, 1975-1 C.B. 244, which was revoked by Rev. Rul. 97-48, 1997-2 C.B. 89, in support of this position.

Section 863(b)(2) requires that a taxpayer, as a prerequisite to sourcing its income under this section, itself produce in the United States and sell outside the United States, or vice versa. A taxpayer cannot attribute the activities of another for purposes of meeting section 863(b)(2)'s requirement that a taxpayer itself produce in a country other than the country of sale in order to source its income under section 863(b). The language in the parenthetical, "in whole or in part," means the inventory property sold by the taxpayer may be produced in part by the taxpayer and in part by another party. For example, some other party may produce a component, which is incorporated into the final product ultimately sold by the

taxpayer. In addition, the parenthetical language means the taxpayer may also produce inventory property in part in the United States and in part in a foreign country. However, neither of these alternatives change, alter, or remove the statute's fundamental requirement that the taxpayer itself must produce in the United States and sell outside the United States (or vice versa). The plain language of both the statute and the regulations implementing section 863(b)(2), focusing on the taxpayer's own activities and assets, and the statute's purpose, all support and are fully consistent with this interpretation of the statute.

The plain meaning of the language of section 863(b)(2) requires that the inventory property be produced, at least in part, by the taxpayer itself in a jurisdiction different from that in which it is sold. "There is a venerable rule of statutory construction which states: expressio unius est exclusio alterius (the expression of one thing implies the exclusion of another thing)." Martz v. Commissioner, 77 T.C. 749, at 753 (1981). Here, the statute refers exclusively to inventory property produced "by the taxpayer" and does not provide for the attribution of third party production activities such as contract manufacturing. In contrast, Congress in section 263A, for example, explicitly permits attribution in interpreting the phrase "produced by the taxpayer." For purposes of section 263A, section 263A(g) provides: "The taxpayer shall be treated as producing any property produced for the taxpayer under a contract with the taxpayer . . . ." Significantly, Congress did not say, nor did it suggest, that another entity's production activities could be attributed to a taxpayer in order to source the taxpayer's income under section 863(b)(2).

This interpretation is confirmed by a close reading of Treas. Reg. § 1.863-3(b)(2), Example (2),[4] which illustrates how taxable income is to be apportioned under section 863(b). Example (2)'s repeated references to inventory property produced "by the taxpayer" must be interpreted to mean that solely the production activities of the taxpayer itself should be considered for purposes of Example (2). Example (2)(i) (1957) provides:

> Where an independent factory or production price has not been established as provided under example (1), the taxable income shall first be computed by deducting from the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States, the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part

[4] In the taxable years at issue, the applicable version of Treas. Reg. § 1.863-3 is that found in T.D. 6258, 1957-2 C.B. 368, at 379-383 (hereinafter "Treas. Reg. § 1.863-3 (1957)"). For taxable years beginning after December 30, 1996, the applicable version of Treas. Reg. § 1.863-3 is that found in T.D. 8687, 1996-2 C.B. 47, at 54-57 (hereinafter "Treas. Reg. § 1.863-3 (1996)").

> of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

(Emphasis added.) Similarly, Example (2)(iii) (1957) provides:

> The term "gross sales" as used in this example, refers only to the sales of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States.

(Emphasis added.) A reading of the statute's and regulations' language as a whole thus makes clear there is no provision for the attribution of third party production activities.

Additional guidance in interpreting the language "produced by the taxpayer" to mean what it says is provided by Phillips Petroleum Co. v. Commissioner, 101 T.C. 78 (1993), a case in which the Tax Court interpreted certain language in the section 863 regulations. There, the Tax Court stated:

> [To] determine the meaning of a legislative regulation . . . the rules of interpretation applicable to statutes are appropriate tools of analysis. With respect to the interpretation of statutes we have employed the rule that statutes are to be construed so as to give effect to their plain and ordinary meaning unless to do so would produce absurd or futile results, and where a statute is clear on its face, we require unequivocal evidence of legislative purpose before construing the statute so as to override the plain meaning of the words used therein. Furthermore, all parts of a statute must be read together, and each part should be given its full effect.

101 T.C. at 97 (1993) (citations omitted).

In Phillips Petroleum, the Tax Court used a "plain meaning" analysis to interpret Treas. Reg. § 1.863-3 (1957).[5] For example, the court looked closely at the language used to define the property apportionment fraction in Treas. Reg. § 1.863-3(b)(2), Example (2)(ii) (1957):

> Of the amount of taxable income so determined [under Example (2)(i)], one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the

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[5] Phillips Petroleum involved Phillips' taxable years 1975 through 1978. Thus, as here, the applicable version of Treas. Reg. § 1.863-3 is that found in T.D. 6258.

> numerator of which consists of the value of the taxpayer's property within the United States, and the denominator of which consists of the value of the taxpayer's property both within the United States and within the foreign country.[6]

The Tax Court ruled, inter alia, that the "ordinary and plain meaning" of Example (2)(ii) is that the apportionment fraction "includes only property within the United States and within the foreign country. . . . [and] does not include property that is neither within the United States nor within the foreign country." Id. at 109. The Tax Court thus excluded from the apportionment fraction property that was in international waters. Here, the attribution of third party production activities carried out pursuant to a contract manufacturing arrangement would effectively read the plain meaning out of the statutory and regulatory language.

An interpretation of section 863(b)(2) to permit attribution would, moreover, be inconsistent with the purpose of section 863, which is to determine the source of a taxpayer's income, based on the activities and assets employed by a taxpayer within a tax jurisdiction.[7] The source rules operate to allocate or apportion the

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[6] Treas. Reg. § 1.863-3(c)(ii)(A) (1996) similarly provides:

> Where the taxpayer's production assets are located both within and without the United States, income from sources without the United States will be determined by multiplying the income attributable to the taxpayer's production activity by a fraction, the numerator of which is the average adjusted basis of production assets that are located outside the United States and the denominator of which is the average adjusted basis of all production assets within and without the United States. The remaining income is treated as from sources within the United States.

[7] Although a taxpayer may argue that attribution is allowed based on case law interpreting other Code sections, such case law is distinguishable because it turns on the unique requirements and structure of those other sections. For example, in Suzy's Zoo v. Commissioner, 114 T.C. 1 (2000), the Tax Court held that, for purposes of section 263A, a taxpayer was the producer of property produced by a contract manufacturer based on a unique requirement of the section 263A regulations — that the producer be the owner of the property. See Treas. Reg. § 1-263A-2(a)(1)(ii). This requirement is not relevant in interpreting the term "produced" in section 863(b)(2). Since the taxpayer owned the copyright to cartoon characters reproduced on the products, the contract manufacturer could not sell the products, and the Tax Court rejected the taxpayer's characterization of its transaction with the contract manufacturer as a purchase and sale. Section 263A(g)(2) also expressly provides that, for purposes of section 263A, a taxpayer shall be treated as producing any property produced for the taxpayer under contract, but in Suzy's Zoo the products were considered outside its meaning due to the taxpayer's exclusive right to sell them and the taxpayer's extensive involvement in their production. In two excise tax cases cited by the Suzy's Zoo court,

income of a single taxpayer, doing business in different taxing jurisdictions, between those jurisdictions by splitting the income between U.S. and foreign sources. Under U.S. law, the jurisdiction in which income arises — the source country — in many cases has primary jurisdiction to tax the income arising within its borders, with the United States then providing its residents a tax credit to prevent double taxation of the same income. Thus, the source rules in effect determine jurisdiction to tax, with a U.S. taxpayer subject to tax on worldwide income, but permitted a foreign tax credit to offset foreign taxes paid on foreign source income. A nonresident is generally subject to tax only on U.S. source income, but, in limited circumstances, is taxed on certain types of foreign source income as well.

When a taxpayer determines it will not perform an activity directly, but will instead outsource that function to a second, separate taxpayer, and pay that separate taxpayer an arm's length charge for the goods and services supplied under the outsourcing agreement, the second taxpayer is taxed on the income earned under the contractual arrangement. The income of the second taxpayer is not attributed to the first taxpayer. Since only the first taxpayer's income is allocated or apportioned between U.S. and foreign sources, the literal language of section 863 and the regulations appropriately does not take into account the activities or assets of a separate taxpayer.

Any argument for attributing the activities of a separate taxpayer when applying the sourcing regime, notwithstanding the literal language to the contrary, would also suggest attributing assets of the separate taxpayer when applying the sourcing regime.[8] Such an approach would not only conflict with the plain language of the

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the term "manufacturer" was interpreted based on the unique statutory design of the Federal excise tax. The excise tax is imposed on the first or initial sale by the manufacturer, producer, or importer. The excise tax regulations provide that the person for whom a taxable article is manufactured, not the person who actually manufactures or produces it, will be considered the manufacturer under certain circumstances. Thus, the excise tax is imposed on only one of two parties who may produce the goods, and it must be imposed on the party that sells the product. In these cases, the taxpayers engaged contract manufacturers to fabricate patented products. Since only the taxpayers held the intellectual property rights, the contract manufacturers could not sell the products. The taxpayers were accordingly considered the manufacturers for excise tax purposes, based on the statutory language and structure of the excise tax. See Charles Peckat Mfg. Co. v. Jarecki, 196 F.2d 849 (7th Cir. 1952); Polaroid Corp. v. United States, 235 F.2d 276 (1st Cir. 1956).

[8] The section 863 regulations implement section 863(b) by providing an apportionment method for sourcing income from sales of property produced by the taxpayer in one jurisdiction and sold in another. Under the method in effect during the years at issue, a taxpayer's income is first split equally between production and sales activity. See Treas. Reg. § 1.863-3(b)(2), Example (2)(ii) (1957). Accord Treas. Reg. § 1.863-3(b)(1)(i) (1996). Both the production and sales amounts are then apportioned

regulation, which includes in the apportionment fraction only the assets owned by the taxpayer, but would also be practically and administratively impossible to carry out. In most cases, it would not be possible for the first taxpayer to determine the basis or fair market value of the second taxpayer's assets in order to include those assets in the first taxpayer's apportionment fraction.

Such a result would also conflict with the purpose of the statute. If a taxpayer like US Co could use section 863(b) to source its production income to foreign sources when the taxpayer itself does not produce in a foreign country, the taxpayer could use Example (2)'s formula to claim foreign source income, which income would not be subject to tax in the foreign country. This foreign source income could then be used to increase the taxpayer's section 904 foreign tax credit limitation (i.e., increase the total amount of the foreign tax credit allowed to the taxpayer). The taxpayer could accordingly use any excess foreign tax credits to offset the United States tax on that foreign source production income. As a result, the United States would forgo tax on production income in fact earned by the taxpayer from U.S. activities and U.S.-situs assets. This result would be inconsistent with the statute's purpose.

US Co relies on Rev. Rul. 75-7,[9] revoked effective December 8, 1997, by Rev. Rul. 97-48, 1997-2 C.B. 89, as the basis for an argument under section 863(b) that it should be treated as the "manufacturer" of the products assembled by Maquila 1 and Maquila 2.

Rev. Rul. 75-7 dealt with the application of the subpart F rules to a specific set of facts. Treas. Reg. § 601.601(d)(2)(v)(e) generally provides:

> [S]ince each Revenue Ruling represents the conclusion of the Service as to the application of the law to the entire [set] of facts involved, taxpayers, Service personnel, and others concerned are cautioned

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between U.S. and foreign sources by a production and a sales fraction, respectively. See Treas. Reg. § 1.863-3(b)(2), Example (2)(ii) (1957). Accord Treas. Reg. § 1.863-3(c) (1996). As with any formula apportioning income, the factors used in the fraction represent a proxy for the income subject to apportionment. The Example (2)(ii) production fraction uses assets owned by the taxpayer to apportion the taxpayer's production income between U.S. and foreign sources, based on the location of the taxpayer's assets. See Treas. Reg. § 1.863-3(b)(2), Example (2)(ii) (1957). Accord Treas. Reg. § 1.863-3(c)(1) (1996).

[9] In Rev. Rul. 75-7, a controlled foreign corporation (CFC) entered into an arm's length contract with an unrelated contract manufacturer located outside its country of incorporation. Under the facts described in Rev. Rul. 75-7, for purposes of section 954(d)(1) and (2), the activities of the unrelated contract manufacturer constituted a branch of the CFC — i.e., the activities were considered to be performed by the CFC.

against reaching the same conclusion in other cases unless the facts and circumstances are substantially the same.

See also Stark v. Commissioner, 86 T.C. 243, at 250-251 (1986) ("[A] revenue ruling merely represents the Commissioner's position with respect to a specific factual situation."). Revenue rulings are not binding on the Commissioner or the courts. Schuster v. Commissioner, 800 F.2d 672 (7th Cir. 1986), aff'g 84 T.C. 764 (1985) (citing Dickman v. Commissioner, 465 U.S. 330 (1984)); Stubbs, Overbeck & Associates v. United States, 445 F.2d 1142 (5th Cir. 1971). Accordingly, it is not appropriate for US Co to rely on Rev. Rul. 75-7, a revenue ruling that applied subpart F rules in a different factual context, to attribute the activities of Maquila 1 and Maquila 2 to US Co for purposes of the source rules.

US Co also cannot claim that Maquila 1 and Maquila 2 constitute foreign branches. See Ashland Oil, Inc. v. Commissioner, 95 T.C. 348 (1990); Vetco, Inc. v. Commissioner, 95 T.C. 579 (1990).

Please call (202) 874-1490 if you have any further questions.

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