



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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE TECHNICAL ASSISTANCE

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MEMORANDUM FOR

FROM:

SUBJECT:

This Technical Assistance responds to your memorandum dated January 7, 1999. Technical Assistance is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

ISSUE(S):

Is CFC2's interest income export financing income, under section 954(c)(2)(B) of the Internal Revenue Code, or factoring income, under section 864(d)(6), in any of the three hypothetical scenarios presented.

CONCLUSION:

In Scenarios #2 and #3, CFC2's interest income is not export financing interest because the property that it financed is manufactured outside the United States. This interest income is included in foreign personal holding company income. The result in Scenario #1 is the same as the result in Scenarios #2 and #3 if the assembly activities of CFC1 in Country A constitute manufacturing under §1.954-3(a)(4). Whether those activities constitute manufacturing is a question of fact. In addition, for the 1998 and 1999 tax years of CFC2, a special exception contained in section 954(h) for income derived in the active conduct of a banking business may apply to exclude CFC2's interest income from foreign personal holding company income.

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FACTS:

US1 is a domestic corporation that owns all of the stock of two Country A corporations, CFC1 and CFC2. It is assumed that all of the interest income of CFC2, from the loans described below, is stated interest. You have presented the following hypothetical scenarios.

Scenario #1

US1 manufactures kits in the United States to be used for the assembly of Product X and sells the kits to CFC1. Less than 50 percent of the fair market value of the kits sold by US1 is attributable to products imported into the United States. CFC1 assembles Product X in Country A from the kits purchased from US1 and sells Product X for use in Country A. CFC2 provides loans to unrelated persons in Country A for the purchase of Product X from CFC1. CFC2 engages in all the activities in which banks customarily engage in issuing and servicing these loans.

Scenario #2

CFC1 manufactures Product X in Country A from component parts that were manufactured by US1 in the United States. CFC2 provides loans to unrelated persons in Country A for the purchase of Product X from CFC1. CFC2 engages in all the activities in which banks customarily engage in issuing and servicing these loans.

Scenario #3

CFC1 manufactures Product X in Country A from component parts that were manufactured by unrelated persons in the United States. CFC2 provides loans to unrelated persons in Country A for the purchase of the Product X from CFC1. CFC2 engages in all the activities in which banks customarily engage in issuing and servicing these loans.

LAW AND ANALYSIS

Under section 954(c)(1)(A), foreign personal holding company income includes interest income. Section 954(c)(2)(B), however, excludes from foreign personal holding company income any interest that is derived in the conduct of a banking business and that is export financing interest, as defined in section 904(d)(2)(G).

Section 1.954-2(b)(2)(iii) provides that export financing interest is considered derived in the conduct of a banking business if, in connection with the financing from which the interest is derived, the CFC, through its own officers or staff of

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employees, engages in all the activities in which banks customarily engage in issuing and servicing a loan.

Section 904(d)(2)(G) defines export financing interest as any interest derived from financing the sale (or other disposition) for use or consumption outside the United States of any property (1) that is manufactured, produced, grown or extracted in the United States by the taxpayer or a related person, and (2) not more than 50 percent of the fair market value of which is attributable to products imported into the United States.

Section 864(d)(5)(A)(iii) provides that Section 954(c)(2)(B) (relating to certain export financing) shall not apply to any amount from related party factoring that is treated as interest under sections 864(d)(1) or (6).

Section 864(d)(1) provides that if any person directly or indirectly acquires a trade receivable from a related person, any income of such person from the trade receivable that it acquired is treated as if it were interest on a loan to the obligor under the receivable.

Section 864(d)(6) provides that any income of a CFC from a loan to a person for the purpose of financing the purchase of section 1221(1) property of a related person or the payment for the performance of services by a related person shall be treated as interest as described in paragraph (1).

Scenario #1

US1 manufactures kits in the United States that are used for the assembly of Product X and sells the kits to CFC1, which then uses them to assemble Product X in Country A. In order to determine whether the exception for export financing interest applies to exclude CFC2's interest income from foreign personal holding company income, it must be determined whether Product X, whose sale CFC2 is financing, is manufactured in the United States. If CFC1, through its operations in Country A, manufactures the product that it sells, Product X, this product will be considered to be manufactured outside the United States and the interest income of CFC2 will not be treated as export financing interest.

Section 1.954-2(b)(2)(i) provides that, solely for purposes of determining whether interest is export financing interest, property is treated as manufactured, produced, grown, or extracted in the United States if it is so treated under §1.927(a)-1T(c). Section 1.927(a)-1T(c) applies the definition of manufacturing contained in §1.954-3(a)(4), with minor modifications. Section 1.954-3(a)(4)(i) provides that a foreign corporation will be considered to have manufactured personal property that it sells if the property sold is in effect not the property that it

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purchased. The property sold will be considered not to be the property that is purchased if the provisions of §1.954-3(a)(4)(ii) or (iii) are satisfied.

Under §1.954-3(a)(4)(iii), the assembly of purchased components by CFC1 will constitute the manufacture of Product X if its operations in connection with the assembly of the Product X are substantial in nature and generally considered to constitute the manufacture, production or construction of property. Section 1.954-3(a)(4)(iii) also contains a 20% conversion test which, as modified by §1.927(a)-1T(c), provides that assembly operations will be considered to constitute the manufacture of property if, in connection with the property, conversion costs (direct labor and factory burden, including assembly and packaging costs but not the value of parts provided pursuant to a service contract as described in §1.924(a)-1T(d)(3)) of the corporation account for 20 percent or more of the total cost of goods sold. Whether CFC1's assembly operations constitute manufacture under §1.954-3(a)(4)(iii) therefore is determined based on facts and circumstances or on whether CFC1's operations can satisfy the 20% conversion test.

Assuming CFC1 is treated, under §1.954-3(a)(4), as having manufactured the product that it sells in Country A, CFC2's interest income will not be treated as export financing interest for purposes of the exception contained in section 954(c)(2)(B) of the Code and thus will be included in foreign personal holding company income. The treatment of the interest under section 864(d)(6) is irrelevant to whether the income is foreign personal holding company income where the income is actual interest that does not qualify for any exceptions applicable to interest under section 954(c).

If it is determined that Product X is not manufactured by CFC1, the application of the export financing interest exception will depend on whether such product was the product manufactured by US1 in the United States and exported by US1 to Country A, and whether the interest is related party factoring income under sections 864(d)(1) or (6).

Scenario #2

CFC1 manufactures Product X in Country A from component parts that were manufactured by US1 in the United States. Because Product X is manufactured outside the United States, CFC2's interest income will not be treated as export financing interest for purposes of the exception contained in section 954(c)(2)(B) and will be included in foreign personal holding company income.

Scenario #3

Scenario #3 involves the same fact pattern as Scenario #2 except that Product X that CFC1 manufactures in Country A is made from component parts that

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were manufactured by unrelated persons in the United States. Whether the component parts are made by related or unrelated persons will not affect the result. Assuming the product that is sold by CFC1, the finished Product X, is manufactured by CFC1 outside the United States, CFC2's interest income from financing the sale of Product X will not be treated as export financing interest for purposes of the exception contained in section 954(c)(2)(B) and will be included in foreign personal holding company income.

Active banking income exceptions for tax years 1998 and 1999

For the tax years 1998 and 1999, CFC2's interest income may be excluded under the special active banking income exceptions contained in section 954(h). Section 954(h), as in effect only for the tax year of a CFC that begins within the 1998 calendar year, provides that foreign personal holding company income does not include income derived by a CFC in the active conduct of a banking, financing or similar business, but only if the CFC is predominately engaged in the active conduct of such business. Section 954(h), as in effect only for the tax year of a CFC that begins within the 1999 calendar year, is similar to the provision as in effect for 1998. The exception applies to the qualified banking or financing income of an eligible CFC. An eligible CFC is a CFC that is predominately engaged in the active conduct of a banking, financing or similar business and conducts substantial activity with respect to that business.

The hypothetical facts you have provided do not contain sufficient information for us to determine whether the active banking income exceptions would apply to exclude the interest income of CFC2 from foreign personal holding company income for the 1998 or 1999 tax year. Please contact this office if you need assistance in applying these provisions to a specific case.

If you have any further questions, please call (202) 622-3840.

/s/ Phyllis E. Marcus
PHYLLIS E. MARCUS
Branch Chief