DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR JOSEPH F. MASELLI
AREA COUNSEL — Edison, CC:LM:MCT
ATTN: William F. Halley
Associate Area Counsel — Newark (Group 1)
CC:LM:MCT:NEW:1

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

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated June 27, 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	=
Business 1	=
Date 1	=
Date 2	=
Division A	=
Division B	=

Employee 1	=
Employee 2	=
Employee 3	=
Employee 4	=
Employee 5	=
Employee 6	=
Employee 7	=
Employee 8	=
Employee 9	=
Employee 10	=
Employee 11	=
Employee 12	=
Employee 13	=
Employee 14	=
Employee 15	=
Employee 16	=
Employee 17	=
Location 1	=
Location 2	=
Markets	=
Maquila 1	=
Maquila 2	=
Maquila 3	=
Maquila 4	=
Number A	=
Number B	=
Number C	=
Number D	=
Number E	=
Number F	=
Number G	=
Parent Co	=
Product 1	=
Product 2	=
Product 3	=

Taxable Year 1	=
Taxable Year 2	=
Taxable Year 3	=
Taxable Year 4	=

ISSUES:

1. Whether, for purposes of sourcing under section 863(b) Parent Co's income from sales within the United States of inventory property produced in Mexico at Maquila 1, Maquila 2, Maquila 3, and Maquila 4 ("the Maquiladoras"), Parent Co itself produces the inventory property in Mexico.

2. Whether, for purposes of sourcing under section 863(b) Parent Co's income from sales within the United States of inventory property produced in Mexico at the Maquiladoras, the activities of the Maquiladoras, pursuant to the agreements between the Maquiladoras and Parent Co, may be attributed to Parent Co.

CONCLUSIONS:

1. For purposes of sourcing under section 863(b) Parent Co's income from sales within the United States of inventory property produced in Mexico at the Maquiladoras, a determination whether Parent Co itself should be considered to produce the inventory property produced in Mexico at the Maquiladoras requires further factual development with respect to the specific functions performed, risks assumed, and assets employed by Parent Co itself in Mexico. It is material, inter alia, to ascertain the roles and location of Parent Co personnel vis-à-vis the activities undertaken, risks assumed, or assets employed in any production process.

2. For purposes of sourcing under section 863(b) Parent Co's income from sales within the United States of inventory property produced in Mexico at the Maquiladoras, the activities of the Maquiladoras, pursuant to the agreements between the Maquiladoras and Parent Co, cannot be attributed to Parent Co.

FACTS:

Parent Co, a United States corporation, is a major supplier to Markets. Parent Co has four wholly-owned Mexican subsidiaries operating under the maquiladora program: Maquila 1, Maquila 2, Maquila 3, and Maquila 4 (hereinafter collectively referred to as "the Maquiladoras"). Parent Co entered into "Maquila Agreements"

with each of the Maquiladoras, which agreements remained in effect in Taxable Years 1, 2, 3, and 4.[1]

In Date 1, Parent Co filed an informal claim for additional foreign tax credits totaling $ Amount A for Taxable Year 1, $ Amount B for Taxable Year 2, $ Amount C for Taxable Year 3, and $ Amount D for Taxable Year 4. Parent Co's claim is based on its application of section 863(b)(2) to source income from the sale within the United States of inventory property produced in whole or in part in Mexico at the Maquiladoras.

Your incoming memorandum indicates that a substantial portion of the factual background information we have been provided is based on documentation prepared by Parent Co, which includes a "functional analysis" prepared in connection with Parent Co's application for a bilateral Advanced Pricing Agreement. We have assumed that the facts as presented in your incoming memorandum are accurate.

In Taxable Years 1, 2, 3, and 4, and pursuant to the Maquila Agreements, Parent Co shipped component parts, produced in Parent Co's United States plants, to the Maquiladoras for the final stage of production and/or assembly. The inventory property was then shipped back to Parent Co for sale within the United States.[2]

Under the Maquila Agreements, Parent Co retains title to the inventory property throughout the production process until the point of final sale. Parent Co owns a majority of the property and equipment used in the Maquiladoras' activities as well as all intangibles related to the Maquiladoras' operations. All research and development activities, including product design, are conducted in the United States. The Maquiladoras do not perform any R&D and do not have any design engineers on their payrolls. Original plant layout and processes are developed in the United States. Parent Co employees perform all day-to-day on-site management at the Maquiladoras. Parent Co is additionally responsible for the overall strategic decisions regarding development, design, and production at each of the Maquiladoras. Parent Co employees at the Maquiladoras are responsible for ordering and shipping raw materials to the Maquiladoras. Parent Co employees regularly travel to the Maquiladoras to monitor adherence to quality standards.

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[1] Please note that we have not reviewed the Maquila Agreements. Our discussion of these agreements is based on the information regarding the agreements contained in your incoming memorandum.

[2] Parent Co also sold some of the inventory property outside the United States. The sourcing of Parent Co's income from such sales is outside the scope of the present advice.

Production scheduling is overseen and approved by Parent Co employees, and Parent Co engineers oversee the production process at the plants.

We set forth below a description of the activities of the individual Maquiladoras and their respective Maquila Agreements with Parent Co.

Maquila 1

Maquila 1 is located in Location 1. In the taxable years at issue, Maquila 1 performed assembly and production activities connected with Business 1. Number A Parent Co employees assigned to Maquila 1 were responsible for oversight of several areas of Maquila 1's operations. These employees included the Employee 1, Employee 2, Employee 3, Employee 4, Employee 5, and Employee 6.

The Maquila Agreement between Parent Co and Maquila 1 provides that Maquila 1 will contract exclusively with Parent Co for the fabrication of Parent Co products, utilizing engineering, design, and manufacturing processes provided and specified by Parent Co. All components, materials, parts, and machinery used by Maquila 1 are provided by Parent Co and remain at all times the sole property of Parent Co. Parent Co determines which products will be manufactured, the quantity produced, and the type or quality of materials used. Parent Co provides to Maquila 1 the necessary commercial, technical, and practical know-how related to the production of Parent Co products.

Maquila 1 was divested in Date 2, a date near the end of Taxable Year 4.

Maquila 2

Maquila 2 is located in Location 1 and comprises Number B plants. At present, approximately Number C employees work at the facility. Maquila 2 performs assembly and manufacturing activities connected with Product 1. Maquila 2 owns the land and buildings and a limited amount of supplies for maintenance and shipping. Parent Co employees at Maquila 2 include the Employee 1, Employee 7, and Employee 8. As new product lines are brought to Maquila 2, Parent Co employees from the United States provide on-site training necessary to manufacture the product at Maquila 2.

The Maquila Agreement between Parent Co and Maquila 2 provides that Maquila 2 shall perform all activities related to the production, assembly, and reconstruction of Product 1, utilizing the materials, machinery, equipment, designs, specifications, and quality standards provided by Parent Co. Maquila 2 agrees to bear all expenses incurred for the safekeeping of any property left under its responsibility. Parent Co is responsible for providing work orders and the respective materials. Parent Co may, at its discretion, send its technical personnel to perform detailed or

at-random tests to check product quality and adherence with Parent Co management policies.

Maquila 3

Maquila 3 is located in Location 2. Maquila 3 assembles Product 2 for Parent Co's Division A and Division B, using materials, components, machinery, and equipment provided by Parent Co. Maquila 3 has approximately Number D employees. Parent Co has Number E United States payroll employees located at the Maquila 3 facility who directly oversee several areas of operations. These Parent Co employees include the Employee 1, Employee 2, Employee 5, Employee 9, Employee 10, Employee 11, Employee 12, Employee 13, Employee 14, and Employee 15. Employees of Maquila 3 are trained in Mexico using videos and handbooks as well as hands-on training on the production floor. As with the other Maquiladoras, Parent Co owns the machinery, equipment, furniture, fixtures, and raw materials used in the production process. Maquila 3 owns the land and buildings and a minimal amount of leasehold improvements, automobiles, office furniture, and supplies.

The Maquila Agreement between Parent Co and Maquila 3 provides that Maquila 3 shall perform all activities related to the production, assembly, and reconstruction of Product 1, utilizing the materials, machinery, equipment, designs, specifications, and quality standards provided by Parent Co. Maquila 3 agrees to bear all expenses incurred for the safekeeping of any property left under its responsibility. Parent Co is responsible for providing work orders and the respective materials. Parent Co may, at its discretion, send its technical personnel to perform detailed or at-random tests to check product quality and adherence with Parent Co management policies.

Maquila 4

Maquila 4 is located in Location 2 and has approximately Number F employees. Maquila 4 performs processing, inspection, and packaging activities connected with Product 3, using materials, components, machinery, and equipment supplied by Parent Co. Parent Co has Number G employees assigned to the maquiladora operation, including the Employee 1, Employee 2, Employee 4, Employee 16, and Employee 17.

The Maquila Agreement between Parent Co and Maquila 4 provides that Maquila 4 will contract exclusively with Parent Co for the fabrication and manufacture of Product 3 and other similar products, utilizing components, parts, materials, machinery, tools, and spare parts supplied by Parent Co. Such components shall at all times continue to be the sole property of Parent Co. Parent Co shall determine which products will be manufactured, the amounts produced, and the

type or quality of materials used. Parent Co is responsible for all transportation costs between the United States and Mexico. Pursuant to the Maquila Agreement, Parent Co provides to Maquila 4, among other things, the following services and assistance: (1) assistance with hiring decisions; (2) assistance with the purchasing function; (3) assistance with production and quality control processes; (4) financial assistance; (5) training of Maquila 4 employees; and (6) assistance with the installation of new equipment and related training.

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

We address first whether Parent Co itself produces in Mexico, entitling Parent Co to source its income under section 863(b)(2) as income derived from sources partly within and partly without the United States. 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'[3] income to sources within or without the United States, Congress was specifically concerned about collecting

[3] 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.

tax on export sales by foreign persons manufacturing in the United States.[4] 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.[5] 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 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 Parent 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 Parent Co'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. Section 863(b) requires that Parent Co actively create or transform property in Mexico.

We are unable to conclude that Parent Co itself produces inventory property in Mexico based on the facts submitted by Parent Co and provided to us in your incoming memorandum. The resolution of this issue will require further factual development with respect to the location of the specific functions performed, assets used, and risks assumed, and the role of Parent Co personnel vis-à-vis those functions, assets, and risks, given the statute's requirement that the taxpayer's production activities occur outside the United States (in this case, in Mexico). Facts which should be developed include:

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[4] 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."

[5] See House Report 350, supra note 4, 1939-1 C.B. (pt. 2) at 177; Senate Report 275, supra note 4, 1939-1 C.B. (pt. 2) at 192.

- Specific details as to the activities and functions involved in the day-to-day on-site management of the Maquiladoras, the Parent Co employees who perform them, the locations where these activities and functions are performed, and information as to the time spent by these Parent Co employees in Mexico.

- The Parent Co employees responsible for overall strategic decisions regarding development, design, and production for each of the Maquiladoras, specific details as to the activities and functions involved in such strategic decision-making, the locations where these decisions are made, and information as to the time spent by these Parent Co employees in Mexico.

- Specific details as to the activities and functions involved in ordering and shipping raw materials to the Maquiladoras, the Parent Co employees who perform them, the locations where these activities and functions are performed, and information as to the time spent by the relevant Parent Co employees in Mexico.

- The Parent Co employees who oversee and approve production scheduling and planning, the nature of their production-related activities and functions, the locations where these activities and functions are performed, and information as to the time spent by these Parent Co employees in Mexico.

- The areas of the Maquiladoras' operations overseen by Parent Co employees, the Parent Co employees involved, specific details as to the activities and functions performed by these Parent Co employees, the locations where these activities and functions are performed, and information as to the time spent in Mexico by the relevant Parent Co employees.

- The content and nature of the reports reviewed by Parent Co personnel in the United States, who is responsible for generating these reports, and where these reports are produced.

- Specific details as to the activities and functions performed by the Parent Co employees directly responsible for all costs related to sales, raw material purchases, inventory value, capital expenditures, and human resources expenditures, the locations where these activities and functions are performed, and information as to the time spent in Mexico by these Parent Co employees.

- The nature of the discretionary testing functions performed by Parent Co technical personnel at the Maquiladoras and the frequency with which these tests are performed.

- The nature of the activities and functions involved in the “control” of the Maquiladoras by Parent Co, the Parent Co employees who perform these

activities and functions, the locations where these activities and functions are performed, and information as to the time spent in Mexico by these Parent Co employees.

- The activities and functions performed for Maquila 1 by the Employee 1, Employee 2, Employee 3, Employee 4, Employee 5, and Employee 6, and the locations where these activities and functions are performed.

- The activities and functions performed for Maquila 2 by the Employee 1, Employee 7, and Employee 8, and the locations where these activities and functions are performed.

- The activities and functions performed for Maquila 3 by the Employee 1, Employee 2, Employee 5, Employee 9, Employee 10, Employee 11, Employee 12, Employee 13, Employee 14, and Employee 15, and the locations where these activities and functions are performed.

- The activities and functions performed for Maquila 4 by the Employee 1, Employee 2, Employee 4, Employee 16, and Employee 17, and the locations these activities and functions are performed.

We again emphasize that whether Parent Co itself should be considered to produce at the Maquiladoras within the meaning of sections 863(b) and 864(a) depends upon the specific facts and circumstances of Parent Co's activities and functions at the individual Maquiladoras. Parent Co should be considered to produce in Mexico only where Parent Co personnel in Mexico are directly involved in the active creation or transformation of property in Mexico.

Issue 2

Parent Co has argued in the alternative that the activities of Maquila 1, Maquila 2, Maquila 3, and Maquila 4 in Mexico should be attributed to Parent Co, entitling Parent Co to source its income under section 863(b)(2) as income derived from sources partly within and partly without the United States. Parent Co cites authorities including Rev. Rul. 75-7, 1975-1 C.B. 244 in support of its 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),[6] 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 of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

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[6] In Taxable Years 1, 2, and 3, 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, which include Taxable Year 4, 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)").

(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.)

Treas. Reg. § 1.863-3 (1996) clarified the Service's longstanding position with respect to attribution. Treas. Reg. § 1.863-3(c)(1)(i)(A) (1996) provides:

> For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See § 1.864-1. Subject to the provisions in § 1.1502-13 or paragraph (g)(2)(ii) of this section, the only production activities that are taken into account for purposes of §§ 1.863-1, 1.863-2, and this section are those conducted directly by the taxpayer.

Similarly, Treas. Reg. § 1.863-3(c)(1)(i)(B) (1996) provides:

> Subject to the provisions in § 1.1502-13 or paragraph (g)(2)(ii) of this section, production assets include only tangible and intangible assets owned directly by the taxpayer that are directly used by the taxpayer to produce inventory described in paragraph (a) of this section. Production assets do not include assets that are not directly used to produce inventory described in paragraph (a) of this section.

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).[7] 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 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.[8]

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 of "produced by the taxpayer" 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

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[7] Phillips Petroleum involved Phillips' taxable years 1975 through 1978, and the applicable version of Treas. Reg. § 1.863-3 was thus that found in T.D. 6258.

[8] 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.

taxpayer's income, based on the activities and assets employed by a taxpayer within a tax jurisdiction.[9] The source rules operate to allocate or apportion the 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.

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[9] Although a taxpayer may argue that attribution is allowed based on authorities interpreting other Code sections, such authorities are distinguishable because they turn 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 in Suzy's Zoo 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, 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). MedChem (P.R.), Inc. v. Commissioner, 116 T.C. No. 25 (2001), made clear the limited scope of Suzy's Zoo. In that case, the Tax Court said MedChem P.R. could not rely on Suzy's Zoo to argue that it met the "active conduct of a trade or business within a possession" requirement of section 936(a)(2)(B) based on the activities of a contract manufacturer.

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 under section 863's rules 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.[10] Such an approach would not only conflict with the plain language of the 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 (of Parent Co) 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.

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[10] 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. Generally, 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); Treas. Reg. § 1.863-3(b)(1)(i) (1996). Both the production and sales amounts are then apportioned 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); 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 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); Treas. Reg. § 1.863-3(c)(1) (1996).

Parent Co cites Rev. Rul. 75-7,[11] 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 the Maquiladoras.

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 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 Parent 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 the Maquiladoras to US Co for purposes of the source rules.

Parent Co additionally cites regulations interpreting Code sections other than section 863 in support of its argument for attribution of the production activities of the Maquiladoras. By their terms, however, these regulations were promulgated to further the legislative objectives of particular Code sections, and none of the cited regulations are relevant for purposes of section 863. Treas. Reg. § 1.263A-2(a)(1)(ii)(B) is part of a paragraph expressly intended to provide guidance on the "principal terms related to the scope of section 263A with respect to producers." Treas. Reg. § 1.263A-2(a). Treas. Reg. § 1.993-3(c)(2)(i) provides guidance on who will be considered to manufacture or produce section 993(c) "export property" for purposes of the Domestic International Sales Corporation provisions (sections 991-994). Prop. Treas. Reg. § 1.482-2(g), 1992-1 C.B. 1164,[12] provided rules for "qualified cost sharing arrangements" under section 482. Prop. Treas. Reg. § 1.482-2(g)(3)(iii) was intended to provide guidance in determining whether an

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[11] 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.

[12] The 1992 proposed section 482 regulations were withdrawn and replaced with the temporary 1993 section 482 regulations, 58 Fed. Reg. 5263 (1993).

intangible developed under such an arrangement is used in the active conduct of a participant's trade or business. None of the cited regulations were intended to be applied outside their very specific statutory contexts, and it is not appropriate for Parent Co to rely on them for section 863 purposes.

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

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