Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.

Telephone Number:

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Date:
July 10, 2009

In Re:

LEGEND

Taxpayer	=
Corporation A	=
Corporation B	=
Corporation C	=
Corporation D	=
Corporation E	=
Corporation F	=
Corporation G	=
Corporation H	=
Corporation I	=
a percentage	=
b percentage	=
Country 1	=
Country 2	=
Country 3	=
Country 4	=
Product X	=
Raw Materials	=
Year 1	=

Dear :

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is in response to a letter dated October 1, 2008, submitted on behalf of Taxpayer by its authorized representative, requesting a ruling regarding the application of Treas. Reg. §1.954-3(b)(1)(ii)(*b*) and (*c*) and the calculation of the actual and hypothetical effective tax rates that should be applied with respect to the manufacturing and sales branches of a controlled foreign corporation ("CFC"). The information submitted for consideration is set forth below.

FACTS

Taxpayer is a US corporation engaged in the manufacture of Product X. In Year 1, wishing to expand its international business presence, Taxpayer purchased a number of manufacturing facilities from an unrelated corporation. As a part of its recent purchase, Taxpayer intends to reorganize its corporate structure to improve control over its supply chain for exports from Country 1. This restructure will combine its operations in Country 1 with those in Country 2. The operations in Country 2 are operated under a wholly owned Corporation A located in Country 3. Taxpayer has stipulated that Corporation A is a CFC for purposes of US taxation. Corporation A will wholly own the stock of Corporation B, Corporation C, and Corporation D, which are all located in Country 2 and have elected to be treated as disregarded entities for purposes of US taxation. As part of this restructure, Corporation B will issue a note payable to Corporation A.

Corporation B wholly owns the stock of Corporation E located in Country 4, which is a disregarded entity for purposes of US taxation. Corporation E wholly owns Corporation F located in Country 1, which is a disregarded entity for purposes of US taxation. Corporation F wholly owns Corporation G located in Country 1, which is a disregarded entity for purposes of US taxation. Corporation F and Corporation G wholly own the stock of Corporation H located in Country 1, which is treated as a disregarded entity for purposes of US taxation, in a percentage and b percentage respectively. Corporation H will own a minority interest in Corporation I located in Country 1, which is a disregarded entity for purposes of US taxation, and the remaining interest is owned by Corporation F.

Corporation F and its Country 1 affiliates manufacture Product X using Raw Materials, and Taxpayer has stipulated that the operations in Country 1 constitute manufacturing as defined under §1.954-3(a)(4)(i). Corporation F and its Country 1 affiliates sell Product X to the operations in Country 2. Then, the entities in Country 2 sell Product X to unrelated persons outside Country 2.

Corporation F and its Country 1 affiliates will be subject to Country 1 corporate income tax on the net taxable income derived from the manufacture and sale of finished goods to Corporation B. However, because Country 1 does not have a consolidation regime, each entity will be treated as a separate taxable entity for Country 1 tax purposes. In computing their respective taxable income, Corporation F and its Country 1 affiliates, generally, will be entitled to a deduction for "interest on net equity" subject to a limit of 50% of the corporation's net profit. After taking into account all items of income and expense (including the deduction for interest on net equity), the taxable income of each entity will be subject to a Country 1 income tax rate of 34%.

Corporation B will derive income from the purchase of finished goods from Corporation F and sales to third party customers located outside Country 2 and Country 3. In addition, Corporation B will likely receive dividends from Corporation E; these dividends will be funded by dividends from Corporation F. The dividend income earned by Corporation B is subject to a 95% participation exemption in Country 2. Further, in computing its taxable income for Country 2 corporate income tax purposes, Corporation B will take into account interest expense paid or accrued with respect to the note held by Corporation A. The total taxable income of Corporation B will be subject to Country 2 corporate income tax of 33.99%.

RULINGS REQUESTED

Taxpayer requests a ruling on two separate issues. First, for purposes of determining the effective rate of tax to which the sales income derived by Corporation B is subject under Treas. Reg. §1.954-3(b)(1)(ii)(*c*), Taxpayer asks whether interest expense incurred by Corporation B with respect to the note payable held by Corporation A should be taken into account.

Second, for purposes of determining the hypothetical effective rate of tax under Treas. Reg. §1.954-3(b)(1)(ii)(*b*) and (*c*), Taxpayer asks whether the Country 1 deemed deduction for interest on net equity, as well as other deductions incurred that are reasonably allocated or apportioned to the income (including the sales income) should be taken into account. If so, may Taxpayer use the deductions in a hypothetical scenario where the income derived by Corporation B would be subject under Treas. Reg. §1.954-3(b)(1)(ii)(*b*) and (*c*), if the income was derived from doing business in Country 1 through, and allocable to Corporation F located in Country 1?

LAW

Treas. Reg. §1.954-3(b)(1)(i)(*a*) provides that if a CFC 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 such 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 CFC, the branch or similar establishment and the remainder of the CFC will be treated as separate corporations for the purposes of determining FBCSI.

Treas. Reg. §1.954-3(b)(1)(i)(*b*) provides that the use of a branch or similar establishment for selling activities will be considered to have substantially the same tax effect as if it were a wholly owned subsidiary corporation of the CFC if the income attributed to the activities of the sales branch or similar establishment is taxed in the year when earned at an effective rate of tax that is both less than 90% of and at least 5 percentage points less than, the effective rate of tax that would apply to such sales branch income if earned from sources within the CFC's country of incorporation through a permanent establishment therein.

Treas. Reg. §1.954-3(b)(1)(ii)(*a*) provides that if a CFC carries on manufacturing by or through a branch or similar establishment ("branch") located outside the country under the laws of which the CFC is created or organized and the use of such branch has substantially the same tax effect as if the branch were a wholly owned subsidiary corporation of the CFC then the branch will be treated as a separate corporation for purposes of determining FBCSI.

Treas. Reg. §1.954-3(b)(1)(ii)(*b*) provides that use of a manufacturing branch will have substantially the same tax effect as if the branch were a wholly owned corporation of the CFC if the effective tax rate imposed on the sales income earned by the remainder (i.e., location(s) where the manufactured property is being sold) is less than 90 percent of and at least 5 percentage points less than the effective tax rate of the manufacturing branch location. If there is income tax disparity between the two locations, then the branch is treated as a separate corporation for purposes of determining FBCSI. Consequently, under Treas. Reg. §1.954-3(b)(2)(ii), one must then test the income earned by the remainder to see whether it is FBCSI under section 954(d)(1).

Treas. Reg. §1.954-3(b)(2)(i)(*e*) provides that tax determinations shall be made by taking into account only the income, war profits, excess profits, or similar tax laws (or the absence of such laws) of the countries involved.

ANALYSIS

For purposes of determining the effective rate of tax to which the sales income derived by Corporation B is subject under Treas. Reg. §1.954-3(b)(1)(ii)(*c*), the effective rate of tax is determined by applying local law. The effective rate of tax in Country 2 with regards to Corporation B is calculated by taking the Country 2 income taxes paid by Corporation B attributable to its FBCSI, which may require adjustments to allocate or apportion expenses in accordance with the laws of Country 2. This will include the allocation or apportionment of Corporation B's interest expense between its income categories in accordance with Country 2 tax law. Thus, Corporation B will compute its

Country 2 income tax liability with respect to the sales income taking into account its items of expense or deduction, including deductions attributable to interest on the note held by Corporation A.

For purposes of determining the hypothetical effective rate of tax to which the income derived by Corporation B would be subject under Treas. Reg. §1.954-3(b)(1)(ii)(*b*) and (*c*) one must divide the hypothetical income tax that would have been imposed on an item of FBCSI by the item of FBCSI taking into account all deductions properly allocable thereto. Under Treas. Reg. §1.954-3(b)(1)(ii)(*c*) the Country 2 branch should be treated as a separate CFC for purposes of applying the tax rate disparity test of the branch rule. Also, Treas. Reg. §1.954-3(b)(2)(i)(*e*) provides that tax determinations shall be made by taking into account only the income, war profits, excess profits, or similar tax laws of the countries involved. The hypothetical effective rate of tax is computed by considering the deductions available under the local law to which the sales income of Corporation B is hypothetically superimposed. Consequently, the Country 1 deductions for interest on net equity, if any, as well as other deductions that are reasonably allocated and apportioned to Corporation B's FBCSI are considered when calculating the hypothetical rate of tax to the extent that these deductions are currently available in Country 1. However, this hypothetical calculation is an annual event, and Taxpayer may only account for the special deduction in a year that a qualifying distribution has been distributed.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. Pursuant to a power of attorney on file in this office, a copy of this letter is being provided to your authorized representative.

Sincerely,

Ethan Atticks
Senior Technical Reviewer
(International)