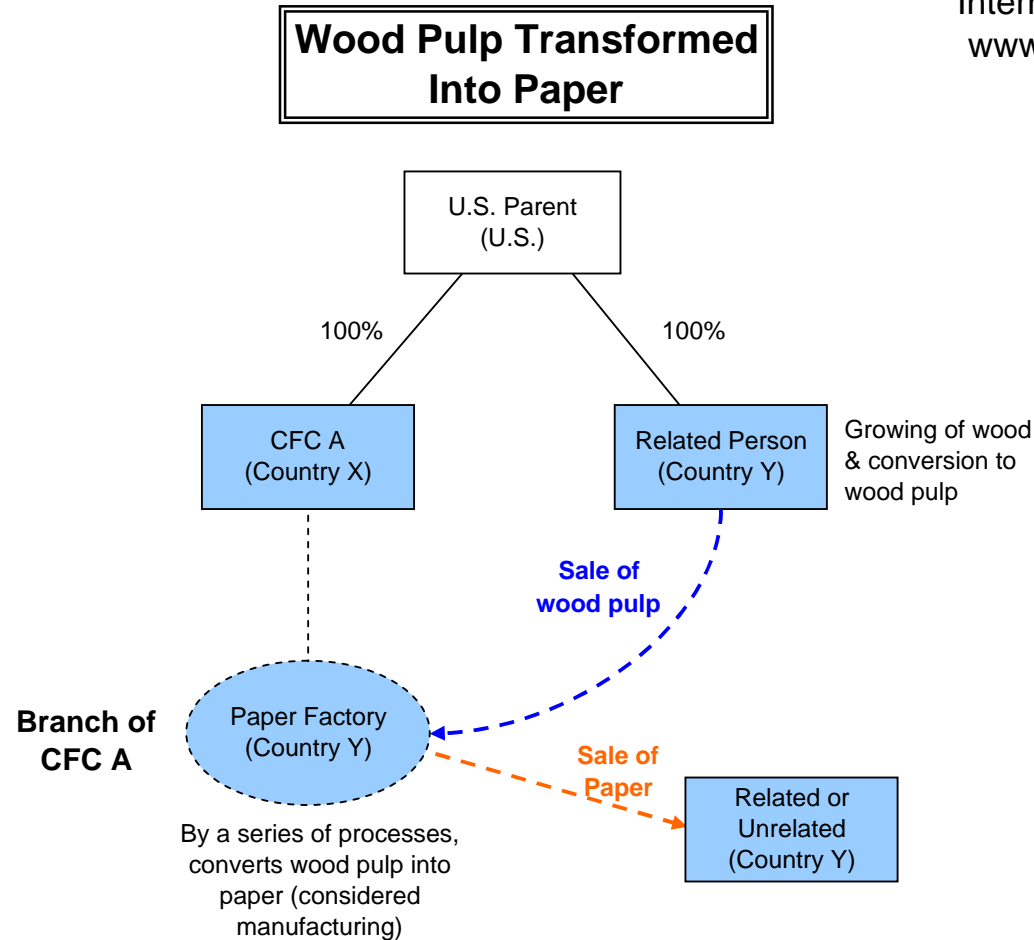


Reg. 1.954-3(a)(4)(ii), Example 1

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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. **Because CFC A is manufacturing, its income is not foreign base company sales income**

The example does not state if the branch rule applies to CFC A. It may be that there was an insufficient tax rate differential between Country X and Country Y. Alternatively, perhaps the branch rule did apply, but there was no purchasing or selling activities carried on or performed in Country X. As a result the foreign base company sales income would have been zero.

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