Office of Chief Counsel
Internal Revenue Service

Memorandum

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to: , ,

from: Jacob Feldman, Special Counsel, CC:INTL

subject: **Sale of Component Parts**

This Chief Counsel Advice responds to your request for guidance dated April 4, 2003, regarding the captioned subject. In accordance with I.R.C. 6110(k)(3), Chief Counsel Advice may not be used or cited as precedent.

LEGEND

Taxpayer =
IndustryQ =
Final Product1 =
Final Product2 =
Final Product3 =
Final Product4 =
Final Product5 =
Final Product6 =
Final Product7 =
Component1 =
Component2 =
Component3 =
Customer Class1 =
Customer Class2 =
Customer Class3 =
End-User1 =
End-User2 =
RegulationsX =
Activity1 =

Activity2 =
Activity3 =
Taxable Year1 =
Taxable Year2 =

ISSUE

Whether Taxpayer's component parts described in this memorandum are precluded by Temp. Treas. Reg. § 1.927(a)-1T(d)(2)(iii) from qualifying as export property.

CONCLUSION

Yes. Taxpayer's component parts described in this memorandum are precluded by Temp. Treas. Reg. § 1.927(a)-1T(d)(2)(iii) from qualifying as export property.

FACTS

Taxpayer is a domestic corporation that manufactures components of IndustryQ Final Products1 and 2. Taxpayer's products include Component1, components of Component1, Component2 parts, Component3, and other components (collectively "Products") for Final Products3 through 6. These Products are manufactured in the United States and are installed in Final Products1 or 2 in the United States. This memorandum addresses only those Products that are installed as original equipment in Final Products1 or 2 that are used outside the United States within the meaning of section 927(a)(1)(B).

Products are not routinely removed from one Final Product1 or 2 and replaced on another Final Product1 or 2. When a Product is installed as original equipment in a Final Product1 or 2, the intention is for that Product to remain in that Final Product1 or 2 for the life of the Product. Although Products are not routinely moved from one Final Product1 or 2 to another, they are removable and interchangeable. These characteristics enable replacement of Products that are no longer usable or require major repair. In the case of Final Product5 components, Products are used only once and are destroyed in the process.

Taxpayer sells Products to Customer Classes1 through 3. Generally, Taxpayer directs its marketing and negotiating activities with respect to Products toward the purchasers of Products, rather than toward the end-users of the Final Products1 and 2 into which Products are installed (such as End-Users1 and 2). Although Taxpayer has indicated that it may direct its marketing and negotiations to end-users in rare cases, Taxpayer does not claim that it directed its marketing or negotiations in such a manner with respect to Products.

On its original income tax returns for Taxable Years1 through 2, Taxpayer did not claim foreign sales corporation ("FSC") benefits with respect to Products because Taxpayer believed that Products did not qualify as export property under Temp. Treas. Reg. § 1.927(a)-1T(d)(2)(iii). Following the decision in General Electric Co. and Subs. v. Commissioner, 245 F.3d 149 (2nd Cir. 2001), Taxpayer amended its returns for those years, claiming FSC benefits on its Product sales.

LAW AND ANALYSIS

I. The FSC Rules

Sections 921(a) and 923 provide a partial income tax exemption with respect to sales of export property. Property constitutes export property only if, among other things, it is "held primarily for sale, lease, or rental, in the ordinary course of trade or business, by, or to, a FSC, for direct use, consumption, or disposition outside the United States." I.R.C. § 927(a)(1)(B). Property is deemed to be sold for use outside the United States under section 927(a)(1)(B) if it satisfies, among other requirements, the destination test. Temp. Treas. Reg. § 1.927(a)-1T(d)(1)(i). Generally, the destination test requires that sold or leased property be delivered outside the United States in a specified manner within a specified time period following the sale or lease. Temp. Treas. Reg. § 1.927(a)-1T(d)(2)(i). A limitation on the destination test, known as the component parts test, provides:

> In no event is the destination test of this paragraph satisfied with respect to property which is subject to any use (other than a resale or sublease), manufacture, assembly, or other processing (other than packaging) by any person between the time of the sale or lease by such seller and the delivery or ultimate delivery outside the United States described in this paragraph (d)(2).

Temp. Treas. Reg. § 1.927(a)-1T(d)(2)(iii). The applicability of the component parts test to sales of engines as equipment on commercial aircraft was litigated in GE, 245 F.3d 149, described below.[1]

GE manufactured engines and sold them to airframe-makers. The airframe-makers hired contractors to attach the engines to the airframes. The airframe-makers then sold the completed aircraft to airlines for use outside the United States. At issue in GE was a single legal question: Whether the engine attachment activities constituted

[1] GE involved the domestic international sales corporation component parts test in Treas. Reg. § 1.993-3(d)(2)(iii), which is the materially similar predecessor of the FSC component parts test. Therefore, the analysis of Treas. Reg. § 1.993-3(d)(2)(iii) in GE applies to the FSC component parts test in Temp. Treas. Reg. § 1.927(a)-1T(d)(2)(iii).

assembly after sale but before delivery outside the United States and, thus, whether the component parts test was violated.[2] If engine attachment constituted assembly, the engines would not qualify as export property.

The Government prevailed in the United States Tax Court. General Electric Co. and Subs. v. Commissioner, T.C. Memo. 1995-306. The Second Circuit Court of Appeals reversed the Tax Court decision and held that engine attachment activities did not constitute assembly within the meaning of the component parts test. GE, 245 F.3d at 151. The court reasoned that, because engines and airframes are separate and distinct from one another legally, physically, and contractually, the attachment of an engine to an airframe constitutes mere "affixing" of one item of export property to another. Legal separateness is reflected in Federal Aviation Administration ("FAA") regulations and Service decisions. Id. at 157. Physical separateness is embodied in the routine removal and replacement of the engines from one airframe to another (as compared with mere interchangeability). Id. Contractual separateness is exemplified by the fact that GE marketed its products directly to the airlines (rather than the airframe manufacturers) and negotiated all material terms of sale with the airlines only. Id. at 157-158. As a result, the Second Circuit determined that GE's engines constituted property that (1) was not subject to assembly after sale, (2) did not violate the component parts test, and (3) thus constituted export property.

II. Non-Tax Rules

[2] The additional question of whether attachment of thrust reversers to an airframe violates the component parts test was not answered.

III. Discussion

The component parts test of Temp. Treas. Reg. § 1.927(a)-1T(d)(2)(iii) provides, in relevant part, that property does not constitute export property if it is subject to manufacture, assembly, or other processing after sale but prior to delivery outside the United States. We believe this rule, standing alone, would prevent Products from qualifying as export property because Products are subject to assembly or other processing after sale but prior to delivery outside the United States. However, the Second Circuit's GE opinion states that, for purposes of the component parts test, a component is treated as not subject to assembly or other processing if it remains separate and distinct from the product into which it is installed. Specifically, the component must remain separate and distinct physically (for example, routine removal and replacement), legally (for example, under FAA regulations and Government determinations), and contractually (for example, separate marketing and negotiations between the component-maker and the end-user of the final product).

These three factors are not present in Taxpayer's case. First, Taxpayer's Products do not remain physically separate from the Final Product1 or 2 into which they are installed. Products are intended to remain with the Final Product1 or 2 for the life of the Products. They are not routinely removed and replaced onto other Final Products1 or 2. Second, Taxpayer's Products are not legally separate and distinct. RegulationsX generally apply to Final Products2 and 7. RegulationsX generally do not apply to the components that comprise Final Products2 and 7 for purposes of Activities1 through 3. Third, Products were not the subject of separate negotiations between Taxpayer and end-users.

In summary, the attachment activities performed to install Products in Final Products1 and 2 constitute assembly or other processing within the meaning of Temp. Treas. Reg. § 1.927(a)-1T(d)(2)(iii). Moreover, the Second Circuit's holding in GE – regarding component parts that remain separate and distinct from the product into which they are installed -- does not apply to Products. The elements of physical and contractual separateness are not present in this case. The element of legal separateness, if present, does not rise to the level of legal separateness in the GE case. Therefore, we believe that Products do not qualify as export property that generates FSC benefits.

Please call CC:INTL:6 at (202) 435-5265 if you have any further questions.

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