

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
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CASE MIS No.: TAM-107142-99
Index (UIL) No.: 925.01-01

District Director,

Taxpayers' Names:

Taxpayers' Address:

Taxpayers' Identification Nos.:

Years Involved:

Date of Conference:

LEGEND:

Corp A	=
Corp A-FSC	=
Corp B	=
Country A	=
Date 1	=
Product Line A	=
Product Line B	=
Product Line C	=
Product Line D	=
Year 1	=
Year 2	=
Year 3	=
x	=
y	=

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ISSUES:

- (1) For purposes of applying the foreign sales corporation (FSC) administrative pricing rules to the “full costing” combined taxable income (CTI) of a FSC and its related supplier under section 925(a) of the Internal Revenue Code (Code), if a taxpayer elects to group transactions into products, may products be selectively included in a second level of grouping that includes more than one product but less than every product in a product line determined in accordance with either the recognized trade or industry usage or SIC code standard under Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii)?
- (2) In computing the overall profit percentage (OPP) pursuant to the marginal costing rules under section 925(b) of the Code, is _____ a permissible method of grouping under Temp. Treas. Reg. § 1.925(b)-1T(b)(3)?

CONCLUSION:

- (1) All groupings of transactions for purposes of the FSC administrative pricing rules must be on a product or product line basis. Products may not be subjected to a second level of grouping that itself does not constitute a product line under the SIC code or recognized trade or industry usage standard of Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) and that includes less than every transaction in a qualifying product line in violation of Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(iii).
- (2) _____ is not a permissible method of grouping in computing the OPP under the FSC marginal costing rules. The method involves inclusion of a product in more than one group in violation of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) and fails to conform with the basic requirements for CTI grouping, which are incorporated by reference in the marginal costing rules under Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i).

FACTS:

Corp A is a domestic corporation engaged in the manufacture and worldwide sale of Product Line A. Corp A-FSC is a wholly-owned subsidiary of Corp A, incorporated in Country A on Date 1. Corp A-FSC timely elected foreign sales corporation (FSC) treatment pursuant to sections 922(a)(2) and 927(f)(1) for Year 1 and all subsequent taxable years, and in all other respects has continuously maintained its status as a FSC as defined in section 922(a). Corp A pays Corp A-FSC a commission equal to the maximum amount permitted under the administrative pricing provisions of section 925. The products sold by Corp A for export are export property within the meaning of section 927(a). The gross receipts derived from Corp A's export sales are foreign trading gross receipts within the meaning of section 924(a).

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Product Line A comprises three separate and distinct categories, Product Lines B, C and D. Each of these three narrower product lines, as well as Product Line A itself, constitutes a product line in accordance with recognized trade or industry usage within the meaning of Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii). Product Line B comprises x . Product Line B falls within a Standard Industrial Classification code, but none of the x falls within such a code. Each does, however, constitute a product line (“ Product Line”) in accordance with recognized trade or industry usage. The x Product Lines in turn comprise a total of y representing differing product characteristics. In accordance with recognized trade or industry usage, each of these y variations is treated as a product (“Product”).

Corp A files its Federal income tax return as part of a consolidated group of corporations of which Corp B, a domestic corporation, is the parent. In its original income tax returns filed for taxable Years 2 through 3, Corp A and Corp A-FSC (collectively “Taxpayer”) elected pursuant to section 927(d)(2)(B) and Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i) to group export transactions in applying the administrative pricing rules of section 925(a). In such original returns, all sales of Product Line A were combined into a single group. In amended returns timely filed pursuant to Temp. Treas. Reg. § 1.925(a)-1T(e)(4) for such taxable years, Taxpayer has changed its method of grouping.

Under the new method, transactions within Product Line B are first grouped into Products, and then two or more Products are further combined into broader operative groups. The Products to be combined in this second level of grouping are selected to maximize the commission payable to Corp A-FSC and therefore maximize Corp A’s FSC commission expense deduction. However, the products included in a second-level group may come from several different product lines, and the resulting claimed groupings do not themselves constitute product lines within the meaning of Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii). None of such groupings includes all transactions or Products included in any Product Line. For example, for Year 3, one of the new groupings comprises selected Products constituting groups of transactions from several different Product Lines within Product Line B, together with all transactions in Product Line D. Taxpayer contends that as long as the first level of grouping complies with the requirements of Temp. Treas. Reg. § 1.925(a)-1T(c)(8), there is no further requirement that the second level of grouping also comply with these requirements.

Also, a new method of grouping, referred to as was adopted with respect to those Products for which Taxpayer chooses to apply the marginal costing rules under section 925(b). Under the method, for purposes of computing the overall profit percentage (OPP) pursuant to Temp. Treas. Reg. § 1.925(b)-1T(c)(2), the Products are first listed in the order of their separately computed OPPs, with the Product having the greatest OPP listed first. The OPP for that Product is used in calculating the OPP limitation (OPPL) for the group of transactions constituting that Product. The OPP numerator and denominator for that Product are then combined with

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those of the Product with the next-highest separate OPP. This aggregate then forms a new OPP, used in calculating the OPPL for that second-highest Product. A new OPP for the Product with the third-highest separate OPP is similarly computed by reference to an aggregate of that Product with the preceding two Products. This pattern is repeated until the Product with the lowest separate OPP has been aggregated with all of the other Products in computing its OPPL. The result of such grouping is a higher OPP for all except the first Product, and therefore a greater commission payable to the FSC under the marginal costing rules, than would have resulted from using the separate OPP for each Product. Taxpayer contends that as long as the regrouping is within a larger product line and is at least as broad as the full costing CTI group, there is no restriction on the use of the method.

LAW AND ANALYSIS:

A foreign corporation which elects FSC treatment pursuant to sections 922(a)(2) and 927(f)(1) may, under section 921(a), exclude from its taxable income portions of its foreign trade income derived from foreign trading gross receipts. Under Code section 924(a)(1) and Temp. Treas. Reg. § 1.924(a)-1T(b), foreign trading gross receipts of a FSC generally include gross receipts from the sale of export property (as defined in section 927(a)) by either the FSC or any principal for whom the FSC acts as a commission agent. The commission payable to the FSC by a related supplier may be determined under the administrative pricing rules of section 925. Section 925(a) and the temporary regulations thereunder provide administrative pricing rules by reference to “full costing” CTI, while section 925(b) and the temporary regulations thereunder provide alternative administrative pricing rules by reference to “marginal costing” CTI.

Full Costing CTI Grouping Issue

Section 927(d)(2)(B) provides generally that FSCs and their related suppliers may, to the extent provided in regulations, apply the FSC administrative pricing provisions under section 925 on the basis of groups of transactions based on product lines or recognized industry or trade usage, rather than on a transaction-by-transaction basis.

Temp. Treas. Reg. § 1.925(a)-1T(c) prescribes the rules for computing the allowable transfer price charged the FSC (or commission paid to the FSC). Paragraph (c)(8)(i) further provides:

... However, at the annual choice made by the related supplier if the administrative pricing rules are used, some or all of these determinations may be made on the basis of groups consisting of products or product lines....

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Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) provides that the related supplier's determination as to a product or product line will be accepted by the district director if such determination conforms to either of the following standards: recognized trade or industry usage, or the two-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification (commonly referred to as "SIC codes") as prepared by the Office of Management and Budget. The temporary regulation further provides that a product shall be included in only one product line if a product otherwise falls within more than one product line classification.

Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(iii) provides that an elected grouping on a product or product line basis shall apply to all transactions with respect to that product or product line consummated during the taxable year.

Example 11 of Temp. Treas. Reg. § 1.925(a)-1T(f) provides an illustration of a valid grouping on the basis of product line. In demonstrating a special rule excluding military property from groupings and the rule that a product otherwise appropriate to more than one product line may be included in only one product line for FSC grouping purposes, the example illustrates the general rule that a product line grouping must include all products (and therefore all transactions) in the product line.

In pertinent part, Example 11 states:

Assume the same facts as in *Example 6*. In addition, assume that R also manufactures products K, L, M, N and P all of which are export property as defined in section 927(a). Product K is military property as defined in section 923(a)(5) and § 1.923-1T(b)(3)(ii). Assume further that products A, L and P are included within product line X and that products K, L, M and N are included within product line W. R has entered into a written agreement with F under which F is granted a sales franchise with respect to exporting the products. Under this agreement, F will receive commissions with respect to those exports equal to the maximum amount permitted to be received under the administrative pricing rules. The table set forth below details F's foreign trading gross receipts, R's costs of goods sold and R's and F's expenses allocable and apportioned under § 1.861-8 to the sale of products A, L, M, N and P. ... Because of the special grouping rule of paragraph (c)(8)(ii) of this section, product L may be included for purposes of the administrative pricing rules in only one product line, at the option of R. Also for these purposes, product K, which is military property, may not be grouped with products L, M and N. See paragraph (c)(8)(iv) of this section. ...

On the facts presented, the new groupings adopted by Corp A and Corp A-FSC do not conform to the legal requirements of Code section 927(d)(2)(B) and Temp. Treas. Reg.

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§ 1.925(a)-1T(c)(8). Contrary to Taxpayer's position, it is the operative or final grouping of transactions used in the determination (computation) of full costing CTI, rather than interim groupings, to which the requirements of paragraph (c)(8) apply. For qualified transactions, Temp. Treas. Reg. § 1.925(a)-1T specifically permits a related party to a FSC to "determine" the commission payable to a FSC by choosing among transfer pricing methods. Temp. Treas. Reg. § 1.925(a)-1T(c) prescribes the rules for such "determinations." Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i) expressly states that the "determinations" under that section may be made on the basis of groups consisting of products or product lines. Thus, it is the group or groups upon which the transfer pricing determination ultimately is made which is the relevant group subject to those provisions, not any interim grouping. The temporary regulations implement Congress's intent as expressed in section 927(d)(2)(B) to permit transfer pricing "determinations" to be made on the basis of groups of transactions based on product lines or recognized industry or trade usage, not merely on the basis of the most favorable mathematical result. Using interim groupings as the operative groupings would render the grouping rules virtually meaningless, since taxpayers could at will "mix and match" subgroups within any two-digit SIC code or a well-defined broad product line.

In permitting grouping of transactions "on the basis of groups consisting of products or product lines," Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i) requires that grouping be either by product or by product line. Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(iii) requires that an elected grouping on a product or product line basis include all transactions in such product or product line. These provisions may not fairly be read in the way Taxpayer asserts, which contemplates groupings of multiple products without regard to whether the products grouped themselves constitute a product line or include all transactions in a product line.

The operative group used by Taxpayer is a second level of grouping formed by combining selected disparate Products for mathematical advantage. The Products grouped by Taxpayer do not constitute a product line under recognized trade or industry usage, nor are such combinations described by any single SIC code. Unlike the illustration of grouping on a product line basis in Example 11 of Temp. Treas. Reg. § 1.925(a)-1T(f), none of Taxpayer's groupings includes all transactions or Products in Product Line A, B, C, D, or any other identifiable product line. Accordingly, Taxpayer's groupings are not valid and may not be used in applying the administrative pricing rules for the taxable years at issue.

Marginal Costing CTI Grouping Issue

Section 925(b)(2) directs the Secretary to prescribe rules for the allocation of expenditures in computing CTI in those cases where a FSC is seeking to establish or maintain a market for export property. Such rules are set forth in Temp. Treas. Reg. § 1.925(b)-1T, which generally provides that in computing CTI, a FSC and its related supplier may choose to take into account only direct material and labor costs. Temp.

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Treas. Reg. § 1.925(b)-1T(b)(2) provides that CTI may not exceed the overall profit percentage limitation (OPPL). Temp. Treas. Reg. § 1.925(b)-1T(c) provides that the OPPL, for each product or product line, is the ratio of the full costing profit on worldwide sales to worldwide gross receipts of the product or product line (the overall profit percentage or OPP) multiplied by the foreign trading gross receipts derived from the product or product line.

Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i) provides that the basis for determining the marginal costing CTI is generally the group consisting of the product or product line pursuant to Temp. Treas. Reg. § 1.925(a)-1T(c)(8) used by the taxpayer for purposes of applying the full costing CTI method.

Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) provides:

(ii) However, for purposes of determining the overall profit percentage under paragraph (c)(2) of this section, any product or product line grouping permissible under § 1.925(a)-1T(c)(8) may be used at the annual choice of the FSC even though it may not be the same item or grouping referred to in the above subdivision (i) of this paragraph as long as the grouping chosen for determining the overall profit percentage is at least as broad as the grouping referred to in the above subdivision (i) of this paragraph. A product may be included for this purpose, however, in only one product group even though under the grouping rules it would otherwise fall in more than one group. Thus, the marginal costing rules will not apply with respect to any regrouping if the regrouping does not include any product (or products) that was included in the group for purposes of the full costing method.

The OPP groupings adopted by Corp A and Corp A-FSC under the _____ method do not conform to the marginal costing CTI rules under Temp. Treas. Reg. § 1.925(b)-1T(b)(3). The method involves inclusion of a Product in more than one grouping, in violation of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii).

As in full costing CTI grouping, the operative grouping to which regulatory restrictions apply is the group used to make the relevant transfer pricing determination, which in marginal costing is the computation of the OPP. In setting forth its prohibition against inclusion of a product in more than one group, Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) specifically refers to “the grouping chosen for determining the [OPP].” This provision may not fairly be read in the way Taxpayer asserts, which would allow multiple inclusions of a product in the operative grouping merely because the products grouped fall within a common product line.

Moreover, although an OPP grouping may be broader than a grouping for full costing CTI purposes, an OPP grouping must be permissible under the grouping standards for

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full costing CTI. In at least three respects the OPP groupings adopted by Corp A and Corp A-FSC, except for the initial OPP group consisting of a single Product, are impermissible under full costing CTI standards. First, the operative grouping of transactions must constitute a product or product line qualifying under the SIC code or recognized trade or industry usage standard. Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii). It is questionable whether Taxpayer's OPP groups meet this basic CTI grouping requirement. Second, as discussed above in connection with the full costing CTI grouping issue, the operative grouping must include all transactions in the product or product line. Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(iii). The new OPP groupings do not include all transactions in Product Line B or any other identifiable product line but merely represent a regrouping of Products for mathematical advantage. Third, like the marginal costing rules, the full costing CTI rules prohibit use of a product in more than one operative grouping. Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii). As discussed above in connection with the marginal costing provisions, the Taxpayer's method inherently involves the use of Products in multiple operative groups.

Finally, section 925(b) permits marginal costing only to the extent provided in regulations. The Temporary Regulations do not provide for a method of OPP grouping.

Accordingly, Corp A and Corp A-FSC may not use the method of grouping in determining OPP under marginal costing.

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.