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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE: December 14, 2000

MEMORANDUM FOR: Caryl Sharp
Team Manager 1622 LMSB Retailers, Food and Pharmaceuticals

FROM: Elizabeth Beck, Senior Technical Reviewer
CC:INTL:6

SUBJECT: Export Enhancement Program Bonus Payments

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LEGEND:

U.S. Corp. =

FSC X =

Product =

Tax Year A =

Tax Year B =

ISSUE:

Whether Export Enhancement Program bonus payments received by a U.S. producer with respect to Products exported through the producer's wholly-owned, commission foreign sales corporation ("FSC") qualify as (1) foreign trading gross receipts under § 924 of the Code, (2) a reduction in cost of goods sold in computing the foreign trading gross receipts of the U.S. producer and its foreign sales corporation, or (3) a non-taxable, non-shareholder capital contribution to the U.S producer under § 118(a) of the Code.

CONCLUSION:

Based upon the facts of this case, we believe that the Export Enhancement Program bonus payments are directly related to the amount received from the export sales of the Products at issue here. Accordingly, we conclude that Export Enhancement Program bonuses are part of the amount realized on sales of such Products under § 1001 and, thus, constitute foreign trading gross receipts under § 924 of the Code.

FACTS:

U.S. Corp., a domestic corporation, wholly owns FSC X, a foreign sales corporation pursuant to §§ 922(a)(2) and 927(f)(1). FSC X acted as U.S. Corp's commission agent with respect to sales of Product during Tax Year A through Tax Year B. Product qualifies as export property under § 927(a)(1). U.S. Corp. and FSC X determined some of FSC X's commissions using the "gross receipts method" of § 925(a)(1) and other commissions using the "combined taxable income method" of § 925(a)(2).

U.S. Corp. participated in the Export Enhancement Program ("EEP") during this time. Under the program, U.S. Corp. received EEP bonus payments from the Commodity Credit Corporation ("CCC") with respect to its export sales of Product. In the instant case, all of the export sales and related EEP bonus payments in question were made in connection with sales contracts that were conditioned upon the CCC's approval of such bonus payments. None of the Products giving rise to the EEP payments remained in inventory at the time U.S. Corp. was required to account for the bonus.

U.S. Corp. makes three arguments regarding the treatment of the resulting income to FSC X. Under the first two arguments, the bonus payments constitute either part of the amount realized on the the export sales of Product, or a reduction in the cost of the Product sold. Under either theory, the amount of the bonus payments would cause FSC X's tax-favored income to increase. In the alternative, U.S.Corp. argues that the bonus payments constitute non-taxable, non-shareholder contributions of capital to U.S. Corp.

LAW AND ANALYSIS:

I. Export Enhancement Payments

A. Statutory and Regulatory Background

In 1985, the Secretary of Agriculture established the EEP to address, in part, continuing declines in U.S. agricultural exports and to persuade foreign nations to reduce trade barriers and eliminate trade-distorting practices. See General Accounting Office, GAO/GGD-95-127, U.S. Department of Agriculture – Foreign-Owned Exporters' Participation in the Export Enhancement Program (May 11, 1995); S. Rep. No. 357, 101st Cong., 2d Sess. 186 (1990). The Secretary of Agriculture implemented the EEP using the general authority under the Commodity Credit Corporation Charter Act. See generally 15 U.S.C. §§ 714 and 714c.

Also in 1985, Congress enacted statutory provisions concerning the EEP. Section 1127 of the Food Security Act of 1985, Pub. L. No. 99-198, 99 Stat. 1354, 1483 (1985); see also H.R. Rep. No. 271, 99th Cong., 1st Sess., Part I at 71 and 276-278 (1985); S. Rep. No. 145, 99th Cong., 1st Sess. at 7-8, 93-94, 364-366 (1985); H.R. Conf. Rep. No. 447, 99th Cong., 1st Sess. 437-440 (1985). As enacted, the authority for the EEP under § 1127 of the Food Security Act of 1985 was scheduled to expire on September 30, 1990.

In 1990, Congress enacted § 1531 of the Food, Agriculture, Conservation, and Trade Act of 1990 which replaced the statutory provisions enacted in 1985 and codified the new provisions at 7 U.S.C. §§ 5651-5653. Pub. L. No. 101-624, 104 Stat. 3359, 3668, 3678-3680 (1990); see also H.R. Conf. Rep. No. 916, 101st Cong., 2d Sess. 1018-1020 (1990).[1]

On June 3, 1991, the Secretary of Agriculture issued final regulations governing the operation of the EEP. 7 CFR subpart B of part 1494. The effective date of these regulations was July 3, 1991.[2]

On June 7, 1991, the Secretary of Agriculture issued regulations governing the criteria for evaluating and approving proposals for initiatives under the EEP. 7 CFR subpart A of part 1494. Section 1494.10 provides that the objectives of the EEP are to discourage unfair trade practices by other countries, to increase U.S. agricultural commodity exports, and to encourage other countries exporting agricultural commodities to undertake serious negotiations on agricultural trade problems.

Under the EEP, bonuses are made available by the CCC to enable exporters to meet prevailing world prices for targeted commodities in targeted destinations. Section 1494.20 of the EEP regulations provides the following four criteria that the CCC considers in reviewing proposals for initiatives:

> (a) the expected contribution of proposed initiatives in furthering trade policy negotiations and, in particular, in furthering the U.S. trade policy negotiating strategy of countering competitors' subsidies and other unfair trade practices by displacing such countries' subsidized exports in targeted countries;
>
> (b) the contribution that initiatives will make toward realizing U.S. agricultural export goals and, in particular, in developing, expanding, or maintaining markets for U.S. agricultural commodities;
>
> (c) the effect that sales facilitated by initiatives would have on non-subsidized exporters of agricultural products; and
>
> (d) the subsidy requirements of proposed initiatives compared to the expected benefits.

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[1] Since 1990, Congress has passed various amendments to 7 U.S.C. §§ 5651-5653. The only amendment that is noteworthy for purposes of this analysis is the amendment made by § 411 of the Uruguay Round Agreements Act, Pub. L. No. 103-465, 108 Stat. 4809, 4962-4963 (1994) which revised § 5651(a) to provide that activities under the EEP shall not be limited to responses to unfair trade practices.

[2] Later amendments to these regulations do not materially affect this analysis.

B. <u>Bonus Payment Procedures</u>

Under the EEP regulations, a bonus is paid pursuant to a specific EEP Agreement between the CCC and an eligible exporter in accordance with the process described below.

From time to time, the CCC issues public press releases announcing initiatives to facilitate the export of U.S. agricultural commodities to certain markets. Following a press release, the CCC issues a formal Invitation for Offers ("Invitation"). An Invitation specifies the eligible country or countries ("the targeted market"), the eligible commodity, the unit of measure, the maximum quantity of the commodity eligible for a bonus, quality specifications, the eligible buyers, the method and rate for determining liquidated damages and performance security requirements, and any other terms or conditions unique to that Invitation.

Invitations consist of two different types. In one type, the bonus rate is pre-determined by the CCC ("an announced bonus") while in the other type, the bonus rate is determined based on competition among exporters ("a competitive bonus"). <u>See</u> 7 CFR § 1494.101.

Exporters must be pre-qualified to participate in the EEP. <u>See</u> 7 CFR § 1494.301. After an Invitation is issued, eligible exporters may submit offers to the CCC. An offer must contain the information listed in 7 CFR subpart B of part 1494. <u>See</u> 7 CFR § 1494.501(c). Also, an offer must contain any additional information required by the Invitation. An offer must include either the announced bonus, if applicable, or an amount for a bonus deemed necessary by the exporter to make a commercial sale of the commodity for export to the eligible country competitive with export sales of the commodity by other exporting countries to buyers in the eligible country. <u>See</u> 7 CFR § 1494.101.

Prior to the submission of an offer to the CCC, the eligible exporter must have entered into a sales contract with an eligible buyer for the sale and the delivery of the eligible commodity to the eligible country. The date of sale of the exporter's sales contract with an eligible buyer must be later than the issuance date of the applicable Invitation. The sales contract may be conditioned upon the exporter's entering into an Agreement with the CCC under the EEP for the payment of a bonus. <u>See</u> 7 CFR § 1494.501(a).

For each Invitation, the CCC establishes acceptable sales prices and bonus amounts. In determining acceptable sales prices, the CCC considers available relevant market data. In determining acceptable bonus amounts, the CCC may consider factors such as the prevailing domestic market price for the eligible commodity, the price of the same commodity exported by other countries to the eligible country, and the freight rates for shipment from the U.S. and other exporting countries. Offers for a competitive bonus are first reviewed by the CCC to determine if the offer contains an acceptable sales price. If the sales price is acceptable, then the requested bonus amount is reviewed to determine if it is acceptable. If both the sales price and the requested bonus amount with respect to an offer for a competitive bonus payment are acceptable, the offer will be accepted beginning with the offer that has the lowest bonus amount and then proceeding to the next highest bonus amount until the EEP bonuses have been granted for the maximum eligible quantity of the commodity. Offers for an announced bonus that have an acceptable sales price are accepted on a first-come, first-served basis. See 7 CFR § 1494.601.

If an exporter furnishes the required performance security and its offer is acceptable to the CCC, the CCC will notify the exporter that the offer has been accepted. See 7 CFR § 1494.601(d). Bonuses may be paid in cash or in CCC commodity certificates.[3] See 7 CFR § 1494.701(a).[4]

The time a bonus is paid depends on whether an eligible exporter has selected Option A or Option B. Under Option A, the exporter can request payment after export of the eligible commodity, but before entry of the commodity into the eligible country. 7 CFR § 14.94.701(c). Under Option B, the exporter cannot request payment until the eligible commodity has entered the eligible country. 7 CFR § 1494.701(d). Certain documentation is required when requesting payment. 7 CFR § 1494.701(c) and (d); see also 7 CFR § 1494.301(g) (as amended in 1995, requiring exporters without proven EEP participation to follow Option B).

Payment of the bonus to the exporter does not indicate that the bonus has been earned. The bonus is not earned until the eligible commodity has entered the eligible country in accordance with the terms and conditions of the Agreement and the exporter submits proof of the entry to the CCC. 7 CFR §§ 1494.701(b) and 1494.801(a)(3).

The failure of an exporter to perform in full and to fulfill all of its obligations under the Agreement constitutes a breach of the Agreement. An exporter that breaches the Agreement may be required to forfeit its right to receive or retain part or all of the bonus authorized or paid under the Agreement and may also be liable to the CCC for damages. See 7 CFR § 1494.801(a)(4).

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[3] It is our understanding that before 1991 bonus payments were made almost exclusively in the form of CCC commodity certificates. Since that time, bonuses have been paid in cash.

[4] A CCC commodity certificate is a negotiable instrument that may be sold or redeemed for a designated commodity in the CCC inventory. See 7 CFR part 1470 (redesignated to part 1401 by 61 Fed. Reg. 37544, 37547 and 37575 (July 18, 1996)).

Under 7 CFR § 1494.801(h)(1), the CCC may terminate the Agreement, in whole or in part, if the exporter fails to carry out any of the provisions of the Agreement or fails to perform other specified acts. Likewise, 7 CFR § 1494.801(h)(2) provides that the CCC may terminate an Agreement, in whole or in part, if the CCC determines it to be in the best interest of the CCC. If an Agreement is so terminated, the CCC is required to compensate the exporter for reasonable losses, as determined by the CCC, resulting from such termination. The compensated losses do not include lost profits and cannot exceed the bonus value under the Agreement.

Although the regulations that set forth EEP procedures, operations, and implementation were not promulgated until 1991, the CCC employed similar policies and practices with respect to the EEP between 1986 and the issuance of the regulations in 1991. See, e.g., Commodity Credit Corporation Announcement GSM-500 (July 28, 1986) (providing terms and conditions for all future Product initiatives under the EEP – rules substantially similar to the current EEP regulations). Therefore, the principles of the EEP regulations outlined above apply to all of the taxable years at issue in this case.

C. Example of Bonus Payment Determination

Generally, the CCC bonus is intended to close the gap between the going price for the commodity in the targeted country and the U.S. market price, taking into account delivery costs. Thus, the CCC rejects bids proposing bonus payments that would undercut world prices as well as bids proposing bonus payments that exceed the gap between world prices and U.S. prices. We understand that the following example illustrates how the CCC determines a competitive bonus amount.

Assume that the “landed price” in an eligible country (that is, the market price being offered upon delivery to that country) is $120 per metric ton for a specific commodity. Also assume a European exporter’s “cost” of that commodity, delivered to the eligible country, is $140 per metric ton. After the European exporter gets the export permit, the European Union will provide a $20 subsidy per metric ton.

The CCC would study the eligible country and determine the “landed price” ($120 per metric ton) and the U.S. exporter’s “cost” of getting the commodity to the eligible country (assume $130 per metric ton in this example). The CCC would then announce the initiative for a competitive bonus covering that commodity sold to an eligible buyer in that country. An eligible exporter would then contract for a sale conditioned on receiving a bonus payment from the CCC.

If the exporter in the example intends to sell at $100 per metric ton and requests a bonus of $30 per metric ton, the CCC would reject the offer because the sale price would be too low (as compared with the $120 “landed price”). If the exporter sells at $120 per metric ton and requests a bonus of $20 per metric ton, the CCC would reject the offer because the bonus payment is too great; the total ($140 per metric ton) would exceed the exporter’s calculated “cost” ($130 per metric ton) of getting the commodity to the eligible country.

However, if the exporter sells at $121 per metric ton and requests a bonus of $8 per metric ton, such an offer could be acceptable because the total ($129 per metric ton) would be within the calculated range ($130 per metric ton) of getting the commodity to the eligible country and because the sale price would not undercut the landed price ($120 per metric ton) of the commodity. In short, a U.S. exporter may not use a bonus payment to undercut competition or increase its total sale price (sale price plus bonus payment) above the calculated “cost” of getting the commodity to the eligible country.

II. Taxation of Export Enhancement Program Bonus Payments

The initial issue here is whether the EEP bonus payments received by U.S. Corp. constitute foreign trading gross receipts (“FTGR”) with respect to export sales of Product. As discussed below, we believe that under the specific facts of this case, the EEP bonus payments constitute FTGR. Therefore, we do not address the two remaining issues set forth above.

A FSC receives certain tax benefits under sections 921 through 927 of the Code. These benefits are determined with respect to FTGR. FTGR include gross receipts of a FSC from the sale of export property. § 924(a)(1). FTGR also includes gross receipts from a sale of export property where a FSC acts as a commission agent with respect to such sale. Temp. Treas. Reg. § 1.924(a)-1T(b).

A FSC commission that is calculated using the gross receipts method under § 925(a)(1) equals 1.83% of the FTGR earned with respect to a sale of export property. A FSC commission that is calculated using the combined taxable income (“CTI”) method under § 925(a)(2) equals 23% of the CTI of the FSC and the related supplier attributable to FTGR derived from the sale of export property. In either scenario, a FSC’s tax-favored commission (and the related U.S. exporter’s corresponding commission deduction) increases as FTGR increases.

As stated above, FTGR include gross receipts from the sale of export property. § 924(a)(1). The Product in this case qualifies as export property under § 927(a)(1). Therefore, whether the EEP bonus payments at issue constitute FTGR depends on whether they are “gross receipts.”

Gross receipts include the total receipts from the sale of property held primarily for sale in the ordinary course of business. § 927(b)(1)(A); Temp. Treas. Reg. § 1.927(b)-1T(a)(1). A similar definition applies in the case of a commission FSC. § 927(b)(2). In other words, in the FSC context, gross receipts include the amount realized by a taxpayer on a sale of export property.

Section 1001(b) defines the amount realized from the sale or other disposition of property as the sum of any money received plus the fair market value of any property received. In determining the amount realized (or FTGR) in the instant case, Notice 87-26, 1987-1 C.B. 470, is instructive.

In Notice 87-26, the Service addressed the federal income tax treatment of payments received by milk producers under the Dairy Termination Program ("DTP") authorized by § 101(b) of the Food Security Act of 1985. Under the DTP, the CCC made payments to a milk producer if the producer entered into a contract that provided that it would sell all of its dairy cattle for slaughter or export and that it would agree, for a period of five years, not to acquire any interest in dairy cattle or the production of milk or make available to any person any milk production facility. The payments were intended to compensate the milk producer for lost receipts from the following two sources: (1) the difference between the amount received when the dairy cattle were sold under the DTP for slaughter and the higher price that could have been received if the cattle were sold for dairy purposes; and (2) lost receipts from the terminated milk production operation. The Notice instructed taxpayers that, to the extent that a portion of the DTP payment compensated the milk producer for selling dairy cattle at a lower price, that portion represents an additional amount realized on the sale of the cattle. The Notice further advised that the portion of the DTP payment in excess of that amount is not an amount realized on the sale of the cattle, but is a replacement for milk production receipts, and thus is ordinary income.

This position, which recognizes that an amount may be includible in the amount realized from an item even though it does not come from the purchaser of the item, is consistent with the position taken by the Service and accepted by the Tax Court in Standley v. Commissioner, 99 T.C. 259 (1992), aff'd without published opinion, 24 F.3d 249 (9th Cir. 1994). In Standley, the CCC accepted a dairy farmer's bid and entered into a contract under the DTP. Pursuant to the contract and the guidelines of the DTP, the dairy farmer ceased dairy production, sold his dairy cows for slaughter, and used his farm for non-dairy purposes. In return, the CCC paid the dairy farmer an amount based on his milk production over a measuring period.

The central question in Standley was whether the DTP payments constituted an amount realized with respect to the sale of the cows or ordinary income not connected to a sale or disposition of property. The Tax Court accepted without discussion the Service's concession, based on Notice 87-26, that a portion of the payments – the portion representing the difference between the price that the taxpayer actually received on the sale of cows for slaughter and the price the taxpayer would have received on a sale of the cows as dairy animals – was taxable as capital gain from the sale of the cows and, therefore, implicitly part of the amount realized from that sale. The Tax Court held that the remainder of the payments constituted ordinary income because they were made in exchange for the taxpayer's forbearance from dairy production for a period of years, rather than in exchange for the cows or any other asset.

In the instant case, unlike the DTP payments considered in Notice 87-26 and Standley, the EEP bonus payments consist of only a single component which we believe is directly related to export sales of Product. In this regard, we note that the purpose and operation of the EEP is to enable exporters to meet prevailing world prices for targeted commodities in targeted destinations. The CCC establishes the amount of a bonus with regard to the amount deemed necessary to make a commercial export sale of a commodity to an eligible country competitive with export sales of the commodity by other exporting countries to buyers in the eligible country. For each Invitation, the CCC establishes acceptable sales prices and bonus amounts that govern eligibility for a bonus. The bonus is not earned until the eligible commodity has entered the eligible country in accordance with the terms and conditions of the Agreement and the exporter submits proof of such entry to the CCC. None of the commodity giving rise to the EEP bonus payments in this case remained in inventory at the time the taxpayer would be required to account for the bonus amount. Moreover, the failure of an exporter to perform in full and to fulfill all of its obligations under the Agreement constitutes a breach of the Agreement, and breach of an Agreement may result in the exporter forfeiting its right to receive or retain part or all of the bonus, and potential liability to the CCC for damages.

These factors combined with the fact that export sales contracts were contingent on CCC approval and acceptance of EEP bonus payments, convinces us that the bonus amount should be treated as part of the amount realized on the sale of the commodity under § 1001. Accordingly, we conclude that such receipts are part of FTGR under § 924 with respect to export sales of Product.

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

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