

INTERNAL REVENUE SERVICE
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Team Manager,

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No.:

Years Involved:

Dates of Conferences:

LEGEND:

Corp A	=
Corp A-FSC	=
Date 1	=
Industry A	=
Possession A	=
Tax Year 1	=
Tax Year 2	=
Tax Year 3	=

ISSUE:

In determining the foreign sales corporation (FSC) commission payable by Corp A to Corp A-FSC, whether the taxpayer may compute the overall profit percentage (OPP) under Temp. Treas. Reg. § 1.925(b)-1T(c)(2) of the marginal costing rules for a

product by using the OPP for the product or product line grouping in which the product is included if, with respect to other products in the same product line, the taxpayer uses an OPP determined at a different, overlapping level of the product line hierarchy.

CONCLUSION:

This method of grouping transactions in computing the OPP under the FSC marginal costing rules is not permissible because it involves inclusion of a product in more than one product group in violation of the second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii).

FACTS:

Corp A is a domestic corporation that files a consolidated Federal income tax return with various wholly-owned domestic subsidiaries. Corp A-FSC is a wholly-owned subsidiary of Corp A, incorporated in Possession A on Date 1. For Tax Years 1, 2 and 3, Corp A-FSC had in place a valid election to be treated as a foreign sales corporation (FSC) pursuant to sections 922(a)(2) and 927(f)(1) of the Internal Revenue Code and in all other respects continuously maintained its status as a FSC as defined in section 922(a). Corp A and certain of its domestic subsidiaries are engaged in the manufacture and worldwide sale of products in Industry A and are related suppliers with respect to Corp A-FSC within the meaning of Temp. Treas. Reg. § 1.927(d)-2T(a). For purposes of this memorandum, Corp A and the other related suppliers are referred to collectively as Corp A.

Corp A-FSC acts as commission agent for export sales of Corp A, which 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).

In the original income tax returns filed for Tax Years 1, 2 and 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 some of its export transactions in applying the administrative pricing rules of section 925(a). In amended returns timely filed pursuant to Temp. Treas. Reg. §§ 1.925(a)-1T(e)(4) and 1.925(a)-1T(c)(8)(i) (as amended by T.D. 8764, 1998-1 C.B. 844), Taxpayer redetermined some of its FSC commissions using the combined taxable income (CTI) method under sections 925(a)(2) and 925(b)(2). For the full costing CTI method under section 925(a)(2), the commission was determined entirely on a transaction-by-transaction basis. However, with respect to those products for which Taxpayer chose to apply the marginal costing

rules under section 925(b)(2), Taxpayer grouped transactions for purposes of computing the overall profit percentage (OPP) pursuant to Temp. Treas. Reg. § 1.925(b)-1T(c)(2). At issue is the methodology used for this OPP grouping.

Corp A's products typically are categorized into a multi-tiered "tree" or "hierarchy" of product lines as shown in Diagram 1.

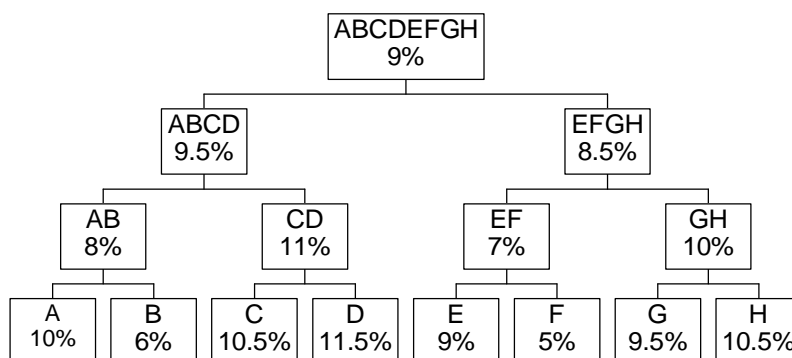


Diagram 1

The broadest product line, ABCDEFGH, comprises two narrower product lines, ABCD and EFGH. Product line ABCD, in turn, comprises two narrower product lines AB and CD, while product line EFGH comprises product lines EF and GH. Each of these narrower product lines comprise the various products. For example, product line AB includes products A and B. A product constitutes the narrowest level at which transactions are grouped. Taxpayer represents that all products and product lines are properly determined in accordance with recognized trade or industry usage within the meaning of Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii).

In grouping for OPP purposes, Taxpayer first computes an OPP for each product and product line level. A typical example is shown in Diagram 1. Taxpayer computes an OPP of 10% for product A by grouping all transactions in that product. Taxpayer also computes an OPP of 8% for product line AB, grouping all transactions in all products in that product line, including products A and B. The OPP for product line AB is less than the OPP for product A because the profitability of product B, which has a lesser individual OPP of 6%, is averaged with the profitability of product A to arrive at the OPP for product line AB. Similarly, working up the product line tree, Taxpayer computes an OPP of 9.5% for the broader product line ABCD, grouping all product lines under that product line, including product lines AB and CD. Finally, Taxpayer computes an OPP of 9% for the broadest product line, ABCDEFGH, grouping all product lines under it, including ABCD and EFGH.

Taxpayer then selects the OPP grouping to be used in its marginal costing administrative price (FSC commission) with respect to the transactions in each product. In making this selection for a product, Taxpayer chooses the greatest of the OPPs for all the levels of the product lines that comprise that product. For example, for product A, Taxpayer chooses the OPP computed separately for that product, since that OPP (10%) is greater than the OPP computed for product line AB (8%), product line ABCD (9.5%), or product line ABCDEFGH (9%). By contrast, in the case of product B, the OPP computed for the ABCD product line (9.5%) is greater than that computed for product B separately (6%) or at the level of product line AB (8%) or product line ABCDEFGH (9%). Therefore, Taxpayer uses the 9.5% OPP computed for the entire product line ABCD grouping as the operative OPP to be used in determining the FSC commission with respect to the transactions in product B, notwithstanding that such grouping overlaps the product A grouping used for OPP purposes for product A.

LAW:

For Tax Years 1, 2 and 3, a foreign corporation that properly 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 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, which include the combined taxable income (CTI) method under section 925(a)(2). Under this method, the FSC commission is computed by reference to full costing CTI, or in the alternative, marginal costing CTI pursuant to section 925(b)(2).

Section 927(d)(2)(B) provides:

(B) **GROUPING OF TRANSACTIONS.** -- To the extent provided in regulations, any provision of this subpart which, but for this subparagraph, would be applied on a transaction-by-transaction basis may be applied by the taxpayer on the basis of groups of transactions based on product lines or recognized industry or trade usage. Such regulations may permit different groupings for different purposes.

Temp. Treas. Reg. § 1.925(a)-1T(c)(8) provides, in pertinent part:

(8) *Grouping transactions.* (i) The determinations under this section are to be made on a transaction-by-transaction basis. However, at the annual choice made by the related supplier if the administrative pricing methods are used, some or all of these determinations may be made on the basis of groups consisting of products or product lines...

(ii) A determination by the related supplier as to a product or a product line will be accepted by a 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 as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President. A product shall be included in only one product line if a product otherwise falls within more than one product line classification.¹

(iii) A choice by the related supplier to group transactions for a taxable year 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. However, the choice of a product or product line grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are to be made on a transaction-by-transaction basis. For example, the related supplier may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year....

(Emphasis added)

Section 925(b)(2) provides:

(b) RULES FOR ... MARGINAL COSTING. -- The Secretary shall prescribe regulations setting forth --

* * *

(2) rules for the allocation of expenditures in computing combined taxable income under subsection (a)(2) in those cases where a FSC is seeking to establish or maintain a market for export property.

Temp. Treas. Reg. § 1.925(b)-1T provides, in pertinent part:

(a) *In general.* This section prescribes the marginal costing rules authorized by section 925(b)(2). If under paragraph (c)(1) of this section a FSC is treated for its taxable year as seeking to establish or maintain a foreign market for sales of an item, product, or product line of export property ... from which foreign trading gross receipts ... are derived, the

¹ This rule is illustrated in Example 11 of Temp. Treas. Reg. § 1.925(a)-1T(f).

marginal costing rules prescribed in paragraph (b) of this section may be applied at the related supplier's election to compute combined taxable income of the FSC and related supplier derived from those sales....

(b) **Marginal costing rules** -- (1) *In general.* Marginal costing is a method under which only direct production costs of producing a particular item, product or product line are taken into account for purposes of computing the combined taxable income of the FSC and its related supplier under section 925(a)(2)....

(2) *Overall profit percentage limitation.* Under marginal costing, the combined taxable income of the FSC and its related supplier may not exceed the overall profit percentage (determined under paragraph (c)(2) of this section) multiplied by the FSC's foreign trading gross receipts if the FSC is the principal on the sale (or the related supplier's gross receipts if the FSC is a commission agent) from the sale of export property.

(3) *Grouping of transactions.* (i) In general, for purposes of this section, an item, product, or product line is the item or group consisting of the product or product line pursuant to § 1.925(a)-1T(c)(8) used by the taxpayer for purposes of applying the full costing combined taxable income method of § 1.925(a)-1T(c)(3) and (6)....

(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.

* * *

(c) *Definitions.* -- (1) *Establishing or maintaining a foreign market.* A FSC shall be treated for its taxable year as seeking to establish or maintain a foreign market with respect to sales of an item, product, or product line of export property from which foreign trading gross receipts are derived if the combined taxable income computed under paragraph

(b) of this section is greater than the full costing combined taxable income....

(2) *Overall profit percentage.* (i) For purposes of this section, the overall profit percentage for a taxable year of the FSC for a product or product line is the percentage which --

(A) The combined taxable income of the FSC and its related supplier from the sale of export property plus all other taxable income of its related supplier from all sales (domestic and foreign) of such product or product line during the FSC's taxable year, computed under the full costing method, is of

(B) The total gross receipts ... of the FSC and related supplier from all sales of the product or product line.

(ii) At the annual option of the related supplier, the overall profit percentage for the FSC's taxable year for all products and product lines may be determined by aggregating the amounts described in subdivision (i)(A) and (B) of this paragraph of the FSC, and all domestic members of the controlled group (as defined in section 927(d)(4) and § 1.924(a)-1T(h)) of which the FSC is a member, for the FSC's taxable year and for taxable years of the members ending with or within the FSC's taxable year.

(Emphasis added)

Prior to the enactment of the FSC provisions, certain export transactions were subject to the Domestic International Sales Corporation (DISC) regime of sections 991-997, which contained administrative pricing rules similar to the corresponding FSC provisions. The legislative history of the FSC regime states:

In general, where the provisions of the bill are identical or substantially similar to the DISC provisions under present law, the committee intends that rules comparable to the rules in regulations issued under those provisions will be applied to the FSC.

S. Prt. No. 169, 98th Cong., 2d Sess. (Vol. I) 636 (1984).

With respect to grouping transactions of a DISC for full costing CTI purposes, the first three paragraphs of Treas. Reg. § 1.994-1(c)(7) provide:

(7) *Grouping transactions.* (i) Generally, the determinations under this section are to be made on a transaction-by-transaction basis. However, at the annual choice of the taxpayer some or all of these

determinations may be made on the basis of groups consisting of products or product lines.

(ii) A determination by a taxpayer as to a product or a product line will be accepted by a district director if such determination conforms to any one of the following standards: (a) a recognized industry or trade usage, or (b) the two-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President.

(iii) A choice by the related supplier to group transactions for a taxable year 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. However, the choice of a product or product line grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are made on a transaction-by-transaction basis. For example, the taxpayer may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year.

With respect to grouping transactions of a DISC for marginal costing CTI purposes, Treas. Reg. § 1.994-2(c)(3) provides:

(3) *Grouping of transactions.* (i) In general, for purposes of this section, an item, product, or product line is the item or group consisting of the product or product line pursuant to § 1.994-1(c)(7) used by the taxpayer for purposes of applying the intercompany pricing rules of § 1.994-1.

(ii) However, for purposes of determining the overall profit percentage under subparagraph (2) of this paragraph, any product or product line grouping permissible under § 1.994-1(c)(7) may be used at the annual choice of the taxpayer, even though it may not be the same item or grouping referred to in 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 such subdivision (i).

The Technical Memorandum accompanying the Treasury Decision issuing the DISC administrating pricing regulations states, in pertinent part:

§ 1.994-2(c)(3)

Paragraph (c)(3) provides the rules with respect to grouping of transactions for purposes of marginal costing. The groups consisting of products or product lines adopted by the related supplier under § 1.994-1(c)(7) for purposes of applying the intercompany pricing rules of § 1.994-1 must also be used for purposes of applying the marginal costing rules. Items not grouped under § 1.994-1(c)(7) should not be grouped for marginal costing purposes. However, for purposes of determining the overall profit percentage under paragraph (c)(2), the option is given to adopt broader groups of products and product lines than were adopted under § 1.994-1(c)(7). This liberalization of the grouping rule is intended to make simpler and easier the computation of the overall profit percentage limitation. Also, if broader groups may be adopted, marginal costing may be permitted with respect to some items, products, or product lines for which marginal costing would not otherwise be available. This approach is consistent with the theory of § 1.994-1(c)(7) which is to give taxpayers maximum flexibility in determining groups of products and product lines in order to obtain maximum benefit from the intercompany pricing rules and to simplify computations.

Tech. Mem., T.D. 7364, 1974 TM Lexis 30, at 68-69 (Oct. 29, 1974).

ANALYSIS:

At issue is whether the OPP grouping method adopted by Taxpayer, *i.e.*, the selection of overlapping OPP groupings at different levels of the product line hierarchy for different products, complies with the restriction stated in the second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii):

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.

This restriction prohibits “product groups” from being counted more than once in a taxpayer’s OPP computations. Thus we refer to the restriction as a prohibition against double inclusion, or the “double-inclusion prohibition.” In Diagram 1, for example, assuming Taxpayer receives the benefit of product A’s own relatively large product-level OPP (10%) with respect to product A, we must determine whether Taxpayer’s use of the OPP for product line ABCD (9.5%) with respect to product B involves a double counting of the OPP for product A in violation of the double-inclusion prohibition.

Taxpayer defines the term “product group” in a manner, described below, such that Taxpayer’s OPP grouping methodology does not violate the double-inclusion prohibition. We have considered Taxpayer’s arguments but conclude that the prohibition applies to taxpayer’s OPP grouping methodology as well.

Temp. Treas. Reg. § 1.925(b)-1T(b)(3) governs grouping for marginal costing CTI purposes. Subdivision (i) of this paragraph sets forth a general rule that “an item, product, or product line” for marginal costing purposes must conform with the “item or group consisting of the product or product line” used for full costing purposes. This initial language expressly imports the product or product line concept as the model for grouping to be used in marginal costing and additionally requires the marginal costing group to be congruent with the full costing group. As a textual matter, this language internally defines a “group” as a “product or product line” (“group consisting of the product or product line”), consistent with the usage in Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i) (“groups consisting of products or product lines”).

Subdivision (ii) provides an exception to the required congruence with the full costing group for purposes of determining the OPP limitation on marginal costing CTI. The first sentence of subdivision (ii) provides that the OPP “item or grouping” need not be the same as its full costing counterpart, with two qualifications. First, it must be a “product or product line grouping permissible under” the full costing grouping rules at Temp. Treas. Reg. § 1.925(a)-1T(c)(8). Second, it must be “at least as broad as” the full costing grouping (as imported for marginal costing purposes under subdivision (i)). Again, as a textual matter, this sentence initially refers to “any product or product line grouping” and then repeatedly uses “grouping” as the shorthand for this usage.

The second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii), the double-inclusion prohibition here at issue, states: “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.” Because this sentence is qualified by “however,” we interpret the sentence as a qualification on the first sentence. Therefore, the term “product group” refers to the grouping consisting of a product or product line that has been selected pursuant to the first sentence as the grouping used for the OPP computation.

The third sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) states: “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.” This sentence is linked to the preceding sentences by “Thus,” and serves to clarify the first sentence by pointing out that if a grouping is at least as broad as the full costing grouping, it will necessarily include all products that were included in the narrower grouping. Once again, as a textual matter, it is plain that the terms “group” and “regrouping,” like the terms “group,” “grouping” and “product group” in the other two sentences, are used interchangeably to be synonymous with the phrase, “group consisting of the product or product line” in Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i) and its antecedent in Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i).

The textual linkage to the concept of groups constituting products or product lines is also reflected in the specific restrictions on OPP grouping, which correspond to counterparts under full costing and adapt the full costing restrictions to the OPP

context. Thus the first sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) clarifies that OPP groupings generally follow the groupings used for full costing purposes but may be different as long as they would be permissible under the full costing standards and are at least as broad as the full costing groupings.

The second sentence is the OPP counterpart to the double-inclusion prohibition of Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii), which states: “A product shall be included in only one product line if a product otherwise falls within more than one product line classification.” The OPP version uses the term “product group” instead of “product line,” but for the reasons stated above and following, we find that “product group” means a product or product line grouping permissible for full costing grouping purposes and used for OPP grouping purposes.

Finally, the third sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) is the OPP counterpart to the full-inclusion rule of Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(iii) (grouping “shall apply to all transactions” in the selected product or product line). The OPP version of this sentence (grouping fails if it “does not include any product (or products)” included for full costing purposes) is slightly modified to clarify that the averaging computations of the OPP inherently involve grouping of entire products rather than individual transactions.

Taxpayer’s OPP grouping methodology, insofar as it involves overlapping groupings, violates the OPP double inclusion provision in the second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii). The use of OPPs selected from different levels in the product line hierarchy necessarily results in the inclusion of a product in more than one grouping whenever the levels are within the same product line and thus overlap. In Diagram 1, such OPP grouping would include product A in both the OPP grouping of transactions consisting of product A and, with respect to product B, the OPP grouping consisting of product line ABCD. In the product line hierarchy, Product A falls within both of these levels and could be grouped in either one of them. For example, the individual product-level OPPs could be used for OPP grouping with respect to each of products A, B, C and D, or the OPP determined at the level of product line ABCD could be used with respect to each of the four products. In the latter case, none of the products would violate the double-inclusion prohibition because each product would be used in only one OPP grouping -- ABCD. However, the double-inclusion prohibition prevents any one of the products from being grouped at both levels in determining the total FSC commission because then it would be used in more than one OPP computation in determining the FSC commission for the taxable year. If Taxpayer uses the 10% OPP determined at the product A level with respect to product A, Taxpayer is prohibited from using the optimal 9.5% OPP determined at the product line ABCD level with respect to product B. Otherwise, product A would be used in a second OPP grouping, that of product line ABCD.

Taxpayer maintains that “product group” in the second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) means only a grouping not constituting a product or product

line within the meaning of Temp. Treas. Reg. § 1.925(a)-1(c)(8). Taxpayer acknowledges that using the OPP of the product with respect to the product itself and in a "product group" (so defined) would be impermissible because it would violate the double-inclusion prohibition, as in Technical Advice Memorandum 199948003 (Aug. 13, 1999).² However, Taxpayer's methodology involves only grouping on a product or product line basis. Consequently, under Taxpayer's narrow interpretation of "product group," Taxpayer's methodology is not within the scope of the double-inclusion prohibition in Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii). For example, in Diagram 1, Taxpayer does not dispute that once product A is used in the product line hierarchy (whether grouped alone or as part of product line AB, product line ABCD, or product line ABCDEFGH), product A could not then be grouped with product F in determining the OPP for F. (We refer to this below as the "AF example.") Taxpayer maintains, however, that the OPP for the broadest product line, ABCDEFGH, could be used as the OPP for F.

We have considered, individually and in combination, the arguments that Taxpayer advances in support of its position, but we find them flawed:

1. Taxpayer maintains that in the absence of a definition of the term "product group" in the second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii), the term must mean something different from the term "product or product line" used in the corresponding full costing rule in Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii). We disagree. First, there is nothing inherent in the plain meaning of the words "product group" that is inconsistent with either a product or a product line. A product is a group of transactions, so "product group" is susceptible to the meaning of a grouping that consists of a product. It is equally susceptible to being defined as a product line. A product line is a group of products, and "product group" is a natural contraction of "group of products." Second and more important, as discussed in detail above, a textual analysis of the regulations demonstrates that "product group" merely serves as the OPP counterpart to the "product or product line" language in full costing and is one in a series of correspondences between the requirements of the OPP grouping regulations and the requirements of the full costing grouping regulations. As earlier indicated, throughout the text of the OPP regulations, the terms "group," "grouping" and "regrouping" are consistently used as interchangeable equivalents of "group consisting of the product or product line." The term "product group" must be similarly construed as a matter of textual consistency.

Moreover, Taxpayer has not proffered a coherent definition of this key regulatory term. Taxpayer posits that a "product group" is a grouping not constituting a "product or

² Because the grouped products do not constitute a product line in accordance with the SIC code or recognized trade or industry usage standard of Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii), as adopted by the first sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii), the grouping would additionally fail for that reason, as in TAM 199948003.

product line" within the meaning of Temp. Treas. Reg. § 1.925(a)-1T(c)(8). In the AF example, the first OPP grouping selected (used with respect to product A) is that of product A alone. A grouping that is a product cannot be a product group as defined by Taxpayer. The second OPP grouping selected (used with respect to product F) is that of AF, which is a product group as defined by Taxpayer. Product A has been used in one product group as defined. However, the second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) prohibits inclusion of a product in more than one product group. Taxpayer's own example does not fit Taxpayer's proposed definition. One could possibly refine the definition to better fit the kind of grouping that Taxpayer believes is caught by the double-inclusion prohibition (e.g., a product group is either (i) a product; or (ii) a grouping of products not constituting a product or product line), but this would depart farther from the plain language and textual analysis of the regulations.

We conclude, contrary to Taxpayer's position, that the regulations do not create a "product group paradigm" for OPP purposes separate from the product line concept that prevails in CTI determinations.

2. In support of its narrow interpretation of "product group," Taxpayer asserts that the OPP regulations expressly allow double inclusion within the product line hierarchy because grouping is permitted at any level in the product line hierarchy, subject only to the restriction that the OPP grouping be at least as broad as the full costing CTI grouping. This proposition confuses the ability to choose among multiple overlapping levels in arriving at the operative grouping with the ability to use more than one overlapping operative grouping simultaneously. The operative grouping to which a regulatory restriction applies is the group that the taxpayer ultimately uses to make the relevant transfer pricing determination, rather than any tentative grouping that the taxpayer may consider as an intermediate step in the process of arriving at the operative grouping. With respect to the OPP limitation under marginal costing, the relevant determination is the computation of the OPP, so the operative grouping is the OPP grouping under Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii). The plain language of the first sentence states that the requirements set forth apply to "the grouping chosen for determining the [OPP]," and the second sentence confirms that the double-inclusion prohibition applies "for this purpose." This operative grouping is separate and distinct from the grouping for full costing CTI purposes under Temp. Treas. Reg. § 1.925(a)-1T(c)(8) or the grouping for marginal costing CTI purposes, prior to application of the OPP limitation, under Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i). A taxpayer may refer to these CTI groupings as tentative possibilities in choosing the operative OPP grouping, but they should not be confused with the operative OPP grouping itself.

Thus we find that this operative OPP grouping is the "product group" referred to in the double-inclusion prohibition. In the context of the provision in which the term appears, and as noted in our textual analysis above, we find that a "product group" is the operative grouping used by the taxpayer for OPP purposes as distinct from grouping under Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i) (which adopts full costing CTI groups for marginal costing purposes), whether at the product or product line level. The

double-inclusion prohibition in the second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) prevents inclusion of a product in overlapping operative OPP groupings.

Our interpretation of "product group" is supported by the analogous double-inclusion provision for full costing CTI purposes under Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii). That provision permits inclusion of a product in only one product line. Taxpayer does not dispute that the term "product line" refers to the operative grouping for purposes of the relevant transfer pricing determination -- there, full costing CTI. The term "product group" serves the identical function with respect to OPP grouping; it describes the operative grouping and has no other special meaning.

3. Taxpayer asserts that its definition of "product group" captures a distinction between its method of grouping within the product line hierarchy used for CTI purposes (which Taxpayer calls "vertical" OPP grouping) and the grouping of products in a way that does not constitute a product line (which Taxpayer calls "horizontal" grouping). However, the two types of grouping posited by Taxpayer have the same characteristic of overlapping groupings resulting in the same mathematical effect. In both cases a high-profit product (A in the examples) is double-counted as both the source of a large OPP (10%) with respect to its own transactions and an enhancement to the OPP of a product with lower profitability (B in the example of Taxpayer's methodology and F in the AF example). This kind of distortion is targeted by the plain language of the second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii).

Taxpayer observes that "horizontal" grouping is prone to one kind of abuse and manipulation absent in "vertical" grouping. In "horizontal" grouping a taxpayer may potentially form a large number of mathematically advantageous groups by "mixing and matching" unlike products, as in TAM 199948003. By contrast, Taxpayer's methodology confines its OPP groupings to the established product line hierarchy. Taxpayer thus characterizes its own methodology as more "natural" than the "horizontal" variety of OPP grouping and argues that this distinction justifies application of the double-inclusion prohibition to only the "unnatural" methodology.

The double-inclusion prohibition is concerned with the distortive mathematical effect of overlapping groupings that result in double counting. It appears possible that a "natural" product line hierarchy in a given case could be manipulated to yield a mathematical distortion similar in magnitude to the mathematical effect of an "unnatural" grouping across hierarchical lines. However, we need not speculate. The double-inclusion prohibition by its terms abides no double counting.

We conclude that the term "product group" simply means the operative OPP grouping, irrespective of whether such OPP grouping is "horizontal" or "vertical."

4. Taxpayer asserts that a prohibition on OPP groupings within the product line hierarchy is inconsistent with Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(ii), which permits taxpayers in a controlled group (as defined in section 927(d)(4) and Temp. Treas. Reg.

§ 1.924(a)-1T(h)) to aggregate the worldwide profits and worldwide receipts of all such taxpayers in computing the numerator and denominator of the operative OPP. We disagree. This aggregation rule is not structurally or analytically part of the grouping rules. The aggregation option simply permits taxpayers in a controlled group to treat all transactions in a qualifying product or product line as entered into by a single entity for OPP computation purposes. The OPP rules, including the grouping provisions of Temp. Treas. Reg. § 1.925(b)-1T(b)(3), apply to the combined product array of the controlled entities. Accordingly, the second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) would prohibit the use of overlapping groupings with respect to different products in that array.

5. Taxpayer points to the absence of a double-inclusion prohibition in Treas. Reg. §§ 1.994-1(c)(7) and 1.994-2(c)(3), the corresponding DISC grouping regulations, and notes that such absence was confirmed by a 1987 Technical Advice Memorandum. Indeed, TAM 8807001 (Oct. 30, 1987) found that once the taxpayer met the requirement that OPP grouping be "at least as broad as" grouping for full costing CTI purposes, "[t]here are no other restrictions on the allowable grouping."³ The Service had similarly ruled favorably on overlapping OPP grouping for different products in TAM 8105017 (Oct. 14, 1980).⁴ Taxpayer further notes that the legislative history of the FSC provisions states that "[i]n general, where the provisions of the bill are identical or substantially similar to the DISC provisions under present law, the committee intends that rules comparable to the rules in regulations issued under those provisions will be applied to the FSC." S. Prt. No. 169, 98th Cong., 2d Sess. (Vol. I) 636 (1984).

In light of this background, Taxpayer maintains that the double-inclusion prohibition in Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) must be construed narrowly so as not to apply to Taxpayer's methodology of grouping at different overlapping levels within the product line hierarchy. Taxpayer suggests in this regard that had Treasury and the Service intended to change the taxpayer-favorable DISC result with respect to OPP grouping within the product line hierarchy, the preamble to the FSC regulations, T.D. 8126, 1987-1 C.B. 184, would have expressly indicated that such grouping was within the scope of the FSC prohibition on double inclusion.

We do not agree that this background supports Taxpayer's position. To the contrary, we believe that the history of this issue in transition under the DISC and FSC regimes is inconsistent with Taxpayer's interpretation. Although the legislative history contemplates FSC regulations that are "[i]n general ... comparable" to the DISC

³ The precise issue in this ruling was not grouping at different overlapping levels for marginal costing OPP purposes but rather grouping at one level for marginal costing OPP purposes and at a different overlapping level to determine an OPP for purposes of the "special no-loss rule" of Treas. Reg. § 1.994-1(e)(1).

⁴ This earlier ruling, too, involved the "special" OPP under Treas. Reg. § 1.994-1(e)(1) rather than the marginal costing OPP.

regulations, nothing mandates that the FSC and DISC regulations be interpreted identically in all particulars. The explicit double-inclusion prohibition in Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii), as well as the treatment of the issue in 1980 technical advice, reflects that Treasury and the Service were aware that there was no such restriction in the DISC regime and affirmatively intended to change the DISC result. Moreover, absent any basis in the regulations for distinguishing between taxpayer's methodology and any other yielding the same mathematical result, the explicit FSC prohibition cannot be said to have been limited to only "other" methods of overlapping OPP grouping.

No inference can be drawn from the fact that the preamble to the FSC regulations did not focus in detail on particular restrictions adopted in a comprehensive set of regulations. A preamble is a general summary and overview. Its silence on the purpose of the second sentence is inapposite to the interpretation of the sentence.

6. Taxpayer correctly observes that the administrative pricing rules in general, and the marginal costing and OPP grouping rules in particular, afford taxpayers certain choices and flexibility in determining FSC treatment. See Tech. Mem., T.D. 7364, 1974 TM Lexis 30, at 68-69 (Oct. 29, 1974) (accompanying DISC marginal costing regulations). However, Taxpayer erroneously extrapolates from these general statements of policy to a position that the FSC provisions must be construed to permit unrestricted flexibility. The flexibility afforded in the administrative pricing rules is not unbridled. The OPP limitation itself is a significant restriction on the marginal costing method.

Taxpayer's argument ignores well-established principles of statutory construction. The FSC provisions in general, and in particular the marginal costing and grouping rules enabled by sections 925(b)(2) and 927(d)(2)(B), effectively confer a partial exemption of income. The Tax Court has held that grouping issues under the DISC regime are subject to the doctrine of narrow construction of tax exemption provisions.⁵ In Napp Systems, Inc. v. Commissioner, T.C. Memo. 1993-196, the court

⁵ This doctrine has been consistently applied in a variety of tax cases by the Supreme Court and Circuit Courts of Appeal. See United States v. Burke, 504 U.S. 229, 248 (1992) (Title VII back-pay award held not within scope of section 104 exclusion of damages for personal injury; "exclusions from income must be narrowly construed"); Commissioner v. Clark, 489 U.S. 726, 739 (1989) ("In construing provisions such as § 356, in which a general statement of policy is qualified by an exception, we usually read the exception narrowly in order to preserve the primary operation of the provision"); Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 265 (1958) (rate exception for capital gain "has always been narrowly construed so as to protect the revenue against artful devices"); Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 52 (1956) ("Since [capital gain treatment] is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be

(continued...)

held invalid a country-by-country basis of grouping, finding that "since the regulation results in a tax deduction, we are ... required to construe it narrowly."

In Brown-Forman Corp. v. Commissioner, 94 T.C. 919, 939-40 (1990), aff'd, 955 F.2d 1037, 1040 (6th Cir. 1992), the court rejected a taxpayer's argument that the OPP regulations must be interpreted in every case to maximize the benefit of marginal costing. The court held:

Petitioner's argument is essentially that, if its method produces a result in harmony with the [general regulatory] purpose ..., it is correct.... [S]uch "end justifies the means" argument ... must fail where the "means" contravenes the

⁵(...continued)

narrowly applied..."); Commissioner v. Jacobson, 336 U.S. 28, 49 (1949) ("The income taxed is described in sweeping terms and should be broadly construed in accordance with an obvious purpose to tax income comprehensively. The exemptions, on the other hand, are specifically stated and should be construed with restraint in the light of the same policy"); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934) ("[O]nly in exceptional situations, clearly defined, has there been provision for an allowance for losses suffered in an earlier year"); Finley v. United States, 123 F.3d 1342, 1348 (10th Cir. 1997) ("[W]e must narrowly construe the 'reasonable cause' exception to § 6672 liability in order to ... further the basic purpose of § 6672 to protect government revenue"); Estate of Shelfer v. Commissioner, 86 F.3d 1045, 1050 (11th Cir. 1996) ("Because the terminable property rule is an exception to this general public policy, it should be narrowly construed"); Commissioner v. Miller, 914 F.2d 586, 590 (4th Cir. 1990) (defamation damages held not within scope of section 104 exclusion of damages for personal injury; "it is a well-recognized, even venerable, principle that exclusions to income are to be narrowly construed"); Commissioner v. Baertschi, 412 F.2d 494, 499 (6th Cir. 1969) (deferral of gain on residence denied; "income tax provisions which exempt taxpayers under given circumstances from paying taxes (or as here, postponing them) are strictly construed"); Kentucky Utilities Co. v. Glenn, 394 F.2d 631, 637 (6th Cir. 1968) (dividend credit denied; "[i]t is standard tax law that income deductions and tax credits are narrowly construed. And the taxpayer has the burden of showing he comes within the provision relied upon"); Holt v. Commissioner, 364 F.2d 38, 40, 42 (8th Cir. 1966) (income of Native American lessee of tribal land not entitled to statutory exemption relating to fee interests; "exemptions from taxation are matters of legislative grace" while here there was "no treaty or statute expressly or impliedly exempting such income"); United States v. Foster, 324 F.2d 702, 706 (5th Cir. 1963) ("This treatment is an exception to the general rule of taxing all net income as ordinary income, and, as an exception, it should be narrowly construed"); O'Gilvie v. United States, 92-2 USTC ¶ 50,344 (D. Kan. 1992), mot. for recons. granted, 92-2 USTC ¶ 50,567, rev'd, 66 F.3d 1550 (10th Cir. 1995), aff'd, 519 U.S. 79 (1996) (punitive damages held not within scope of section 104 exclusion; "[i]t is a cardinal rule of taxation that exclusions to income are to be narrowly construed").

plain language of [the regulations].... [W]e are unwilling to rewrite the regulation....

The Sixth Circuit affirmed, stating: "Given the clarity of [the OPP regulation at issue], we are unmoved by [the taxpayer's] argument."

Applying the same principle to this case, the scope of permitted OPP grouping should be narrowly construed. As in Brown-Forman, the OPP regulation in this case is unambiguous. We decline to adopt Taxpayer's interpretation, which in effect would rewrite the second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii). Had Treasury and the Service intended to narrow the scope of the double-inclusion prohibition in the very specific way that Taxpayer suggests, we would expect that explicit language limiting the scope of the prohibition would have been added to the provision. As adopted, the double-inclusion prohibition is not limited to overlapping OPP grouping methodologies not used by Taxpayer. Rather, it applies to all overlapping OPP grouping methodologies, including that used by Taxpayer.

We conclude that in applying the marginal costing rules under section 925(b)(2) to determine Corp A's FSC commission for Tax Years 1, 2 and 3, Taxpayer may not compute the OPP with respect to a product by using the OPP for the product or product line grouping in which the product is included if, with respect to other products in the product line, the Taxpayer determines the OPP at a different, overlapping level in the product line hierarchy. This method of grouping transactions for OPP purposes involves inclusion of a product in more than one product group in violation of the second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii).

CAVEATS:

The sole issue addressed by this memorandum is the permissibility of the OPP grouping methodology described. No opinion is expressed on any other issue, including whether any specific product or product line conforms with the requirements of Temp. Treas. Reg. § 1.925(a)-1T(c)(8) or 1.925(b)-1T(b)(3) or whether any grouping redetermination was timely filed or otherwise conformed with the procedural requirements of Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i) or 1.925(a)-1T(e)(4).

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