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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DAVID R. SMITH
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ATTN: Tamara S. Moravia-Israel, Attorney (LMSB)

FROM: Anne P. Shelburne
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SUBJECT:

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LEGEND

Country A	=
FSC 1	=
PR Co	=
Products	=
Taxable Year 1	=
Taxable Year 2	=
US Co	=

ISSUE:

Whether a taxpayer that qualifies for the benefits of both section 936 and the foreign sales corporation (FSC) provisions may apply the profit split provisions of section 936 first and then apply the FSC provisions.

CONCLUSION:

A taxpayer that qualifies for the benefits of both section 936 and the FSC provisions must apply the FSC provisions first and then apply the section 936 profit split provisions.

FACTS:

US Co, a United States corporation, designs, manufactures, and sells Products, and provides Products-related services and support. US Co owns 100% of PR Co, a United States corporation, and FSC 1, a foreign sales corporation incorporated in Country A.

For Taxable Years 1 and 2, PR Co has made an election under section 936, and elected the profit split provisions under section 936(h)(5)(F) and section 936(h)(5)(C)(ii).

US Co Products are manufactured in the United States and Puerto Rico. In Taxable Years 1 and 2, PR Co sold manufactured Products to US Co, which then sold the Products to foreign distributors (both related and unrelated). PR Co also made some sales directly to foreign distributors (both related and unrelated). FSC

1 acted as a commission FSC with respect to these sales by US Co and PR Co to foreign distributors.

In the taxable years at issue, US Co applied the section 936 profit split provisions first to allocate combined taxable income (CTI) (as defined in section 936(h)(5)(C)(ii)(II)) between PR Co (the electing corporation) and US Co (the appropriate domestic member of the affiliated group). US Co then applied the FSC provisions' combined taxable income method to calculate the taxable income of FSC 1 and its related supplier attributable to sales of export property. As a result of this ordering, US Co's section 936 CTI calculation did not deduct the FSC 1 commissions associated with section 936 covered sales.

LAW AND ANALYSIS:

The Foreign Sales Corporation (FSC) Provisions: Sections 921 through 927

Under sections 921 through 927, portions of the foreign trade income of a FSC are exempt from United States income tax. Section 921(a) provides that the exempt foreign trade income of a FSC shall be treated as foreign source income not effectively connected with the conduct of a trade or business within the United States. "Exempt foreign trade income" is defined by section 923(a) as a certain percentage or fraction of the FSC's foreign trade income. "Foreign trade income" is defined by section 923(b) as the gross income of a FSC attributable to foreign trading gross receipts. "Foreign trading gross receipts" include gross receipts from the sale, exchange, or other disposition of export property by the FSC, or by any principal for whom the FSC acts as a commission agent. I.R.C. § 924(a)(1); Temp. Treas. Reg. § 1.924(a)-1T(b). Section 927(a)(1) defines "export property" as property:

> (A) manufactured, produced, grown, or extracted in the United States by a person other than a FSC,
>
> (B) held primarily for sale, lease or rental, in the ordinary course of trade or business, by, or to, a FSC, for direct use, consumption, or disposition outside the United States, and
>
> (C) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States.

Property manufactured in Puerto Rico by a section 936 corporation may qualify as "export property" for purposes of the FSC provisions. See I.R.C. § 927(d)(3) ("The term 'United States' includes the Commonwealth of Puerto Rico.").

Where a FSC acts on a commission basis for a related supplier[1] and commissions paid to the FSC give rise to gross receipts to the related supplier which would have been foreign trading gross receipts under section 924(a) had the FSC made the sale directly, special pricing rules may apply to determine the FSC's commission income.[2] Temp. Treas. Reg. § 1.925(a)-1T(d)(2). Generally, the amount of income that may be earned by a commission FSC is the amount that the FSC would have been permitted to earn under the gross receipts method, the combined taxable income method, or the section 482 method had the FSC made the sale directly. I.R.C. § 925(a), (b); Temp. Treas. Reg. § 1.925(a)-1T. For purposes of applying the combined taxable income method to transactions handled on a commission basis for a related supplier by a FSC, Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(iii) provides:

> The combined taxable income of a FSC and the related supplier from the transaction is the excess of the related supplier's gross receipts from the transaction which would have been foreign trading gross receipts had the sale been made by the FSC directly over the related supplier's and the FSC's total costs, excluding the commission paid or payable to the FSC, but including the related supplier's cost of goods sold and its and the FSC's noninventoriable costs (see § 1.471-11(c)(2)(ii)) which relate to the gross receipts from the transaction.

Section 936

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[1] Temp. Treas. Reg. § 1.927(d)-2T(a) provides:

> (a) *Definition of related supplier*. For purposes of section 921 through 927 and the regulations under those sections, the term "related supplier" means a related party which directly supplies to a FSC any property or services which the FSC disposes of in a transaction producing foreign trading gross receipts, or a related party which uses the FSC as a commission agent in the disposition of any property or services producing foreign trading gross receipts. . . .
>
> (b) *Definition of related party*. The term "related party" means a person which is owned or controlled directly or indirectly by the same interests as the FSC within the meaning of section 482 and § 1.482-1(a).

[2] The administrative pricing methods of section 925(a)(1) and (2) may be used only if the prerequisites of section 925(c) are met.

The section 936 tax credit is designed to encourage investment and employment in Puerto Rico and other possessions of the United States. Under the general rule of section 936(h)(1)(A), the intangible property income of a section 936 corporation is included on a pro rata basis in the gross income of all its shareholders, unless the section 936 corporation elects one of two methods of computation of taxable income: the cost sharing method of section 936(h)(5)(C)(i) or the profit split method of section 936(h)(5)(C)(ii).

Under the profit split method, the electing corporation's taxable income from the active conduct of a trade or business in a possession with respect to a product produced or service rendered, in whole or in part, by the electing corporation is equal to fifty percent of the affiliated group's combined taxable income (CTI) from covered sales of the product or service. I.R.C. § 936(h)(5)(C)(ii)(I). CTI must be separately computed for each product produced or type of service rendered. For section 936 purposes, CTI is computed by deducting from the gross income of the affiliated group (other than foreign affiliates) derived from covered sales of each product or type of service all expenses, losses, and other deductions properly apportioned or allocated to gross income from such sales, and a ratable part of all expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income, which are incurred by the affiliated group (other than foreign affiliates). I.R.C. § 936(h)(5)(C)(ii)(II).

We conclude the language of section 936(h)(5)(C)(ii)(II) should be interpreted consistently with its plain meaning to mean that PR Co is required to apply the FSC provisions first, to calculate FSC 1 commissions from covered sales, before determining CTI for section 936 purposes. In a case involving the interpretation of section 936 and Treas. Reg. § 1.936-6(b)(1), Q&A 1, the Tax Court stated:

> Where a statute is clear on its face, we require unequivocal evidence of legislative purpose before construing the statute so as to override the plain meaning of the words used therein. Halpern v. Commissioner, 96 T.C. 895 (1991). . . . Unless circumstances dictate otherwise, when we find the terms of a statute unambiguous, judicial inquiry is complete. Burlington N. R.R. v. Oklahoma Tax Comm'n, 481 U.S. 454, 461 (1987); United States v. NEC Corp., 931 F.2d 1493, 1498 (11th Cir. 1990).
>
> Thus, the party who seeks to convince a court to adopt a reading of a statute which is at odds with its plain meaning labors under a heavy burden. United States v. NEC Corp., supra at 1499.

Coca-Cola Co. v. Commissioner, 106 T.C. 1, at 20 (1996).

In determining CTI from sales of a possession product under the profit split option, Treas. Reg. § 1.936-6(b)(1), Q&A 1 provides that "[e]xpenses, losses, and other deductions are to be allocated and apportioned on a 'fully-loaded' basis under § 1.861-8 to the combined gross income of the possessions corporation and other members of the affiliated group (other than foreign affiliates)." As the legislative history to section 936(h) explains:

> The combined taxable income of the island affiliate and its mainland affiliates from the sale of the product produced in whole or in part in the possession is the excess of the gross receipts from the sale of such product to third parties or foreign affiliates over the total costs relating to such product incurred by the island affiliate and its mainland affiliates. Costs which are treated as relating to a product produced in whole or in part in the possession are all direct and indirect expenses, losses, and other deductions (including marketing expenses) with respect to sales of such product; i.e., the expenses will be "fully-loaded."

H.R. Rep. No. 760, 97th Cong., 2d Sess. 511 (1982). See also Joint Committee on Taxation Staff, General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982, 97th Cong., 2d Sess. 92 (1982). In this context, "fully-loaded" means that all expenses factually related to the Products shall be allocated and apportioned in full to the income derived from the sale of the Products. See Coca-Cola Co., 106 T.C. at 11 (1996).

"Covered sales" are defined by section 936(h)(5)(C)(ii)(IV) as "sales by members of the affiliated group (other than foreign affiliates) to persons who are not members of the affiliated group or to foreign affiliates." Sales of Products, produced in whole or in part by PR Co and by US Co, and sold by US Co to related and unrelated foreign distributors are covered sales. Where FSC 1 derives commissions from these covered sales, the FSC 1 commissions are an expense incurred by the affiliated group properly allocated to the covered sales, which must be taken into account for purposes of the section 936 CTI calculation. Accordingly, the FSC provisions must first be applied to calculate FSC 1's commissions from covered sales before it is possible to determine CTI under the profit split method of section 936. In other words, given the explicit statutory language that CTI shall be computed by deducting from gross income from covered sales all expenses, losses, and other deductions properly apportioned or allocated to such sales, CTI cannot be correctly determined without first applying the FSC provisions to compute the relevant FSC commission.

As noted by the Claims Court in a case interpreting the Domestic International Sales Corporation (DISC) provisions, the predecessor provisions to the FSC regime: "Statutes that confer special tax reduction benefits are to be construed strictly. Exceptions from the normal tax requirements of the Internal Revenue Code are to be defined narrowly." Dow Corning Corp. v. United States, 22 Cl. Ct. 184, at 188 (1990) (citation omitted). Section 936(h)(5)(C)(ii)(II) provides that CTI shall be computed by deducting from gross income from covered sales all expenses, losses, and other deductions properly apportioned or allocated to such sales. US Co maintains that the FSC commission "is not an actual expense but merely an accounting mechanism to ensure the appropriate FSC exemption." We note, however, that the FSC commission is an amount actually paid or payable by the related supplier to the FSC. FSC commission expense is reported as a deduction on the related supplier's U.S. Corporation Income Tax Return (Form 1120). See, e.g., Union Carbide Corp. v. Commissioner, 110 T.C. 375 (1998) (discussing a redetermination of the taxpayer's FSC commission expense, as reported on its 1987, 1988, and 1989 Forms 1120). Neither section 936 nor the regulations promulgated thereunder provide that FSC commission expense, to the extent properly allocated or apportioned to covered sales, is not to be considered in the section 936 CTI calculation. This is in contrast to the FSC CTI computation, which expressly excludes the FSC commission for its determination. See Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(iii). Accordingly, we consider it appropriate to construe strictly section 936(h)(5)(C)(ii)(II) and interpret the language "all expenses . . . and other deductions" as used therein to include FSC commission expense. PR Co is thus required to apply the FSC provisions first, to calculate FSC 1 commissions from covered sales, before determining CTI for section 936 purposes.

Interaction of section 936 and the FSC provisions

The basis on which the taxpayer's affiliated group is claiming both a partial exemption under the FSC provisions and the benefits of section 936 (more specifically, the section 936(h)(5)(C)(ii) profit split provisions) is the definition of the term "United States" under section 927(d)(3). Under that definition, Puerto Rico, but no other U.S. possession, is treated as part of the United States for FSC purposes. Therefore, for FSC purposes, property manufactured in Puerto Rico is treated as manufactured in the United States.

Historically, one could look back to the DISC provisions, which were in existence at the time section 936 was enacted. The DISC provisions were even broader: under section 993(g), the term "United States" is defined to include "the Commonwealth of Puerto Rico and the possessions of the United States." The definition for DISC purposes applied in 1976 when section 936 was first enacted and in 1982 when section 936(h) was enacted. However, the legislative history of neither section 936, section 936(h), nor the FSC provisions provides any discussion of the interactions of the two provisions. Rather, the legislative history of the section 936(h) profit split method provides that, in computing combined taxable income, the expenses to be allocated and apportioned to combined gross income should be fully loaded. See Treas. Reg. § 1.936-6(b)(1), Q&A 1 (which also provides that royalties paid to foreign affiliates are to be treated as research, developmental, and experimental expenses for purposes of computing combined taxable income under section 936(h)(5)(C)(ii)). Thus, because the section 936 profit split method provides for fully loaded expenses and specifically includes expenses paid to a foreign affiliate, FSC commission expenses must be included in computing CTI under the profit split method. As neither the FSC provisions nor section 936 provide a different rule, FSC commission expenses must be included in determining CTI under the section 936(h)(5)(C)(ii) profit split provisions. Since this is the case, the FSC provisions must be applied first in cases where both provisions apply.

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

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