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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE: September 19, 2001

MEMORANDUM FOR: Eric W. Johnson
Attorney-Advisor CC:LM:RFP:STP

FROM: Elizabeth Beck
Chief CC:INTL:6

SUBJECT: Transfer Pricing Product Line Grouping Under the
Recognized Trade or Industry Usage Standard

This Chief Counsel Advice responds to your memorandum dated June 20, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

CorpA =
CorpA-FSC =
CountryA =
Product Line A =
Product Line B =
Product Line C =
Item A =
Item B =
Item C =
Item D =
Item E =
Item F =
Taxable Year 1 =
Taxable Year 2 =
AmountA =
AmountB =
Storage Area =
ObjectA =

ISSUE

Whether, under the recognized trade or industry usage standard of the foreign sales corporation transfer pricing grouping rules set forth in section 927(d)(2)(B) and attendant regulations, Taxpayer's two product lines as defined in Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(ii) and 1.925(b)-1T(b)(3) fall within the same broader product line grouping.

CONCLUSION

No. Under the recognized trade or industry usage standard of the foreign sales corporation transfer pricing grouping rules set forth in section 927(d)(2)(B) and attendant regulations, Taxpayer's two product lines as defined in Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(ii) and 1.925(b)-1T(b)(3) do not fall within the same broader product line grouping because the product lines arise within different trades or industries. Moreover, even if the two product lines arose within the same industry, the product lines are too dissimilar to be grouped within a single product line.

FACTS

CorpA, a domestic corporation, wholly owns CorpA-FSC, a foreign sales corporation ("FSC"), pursuant to §§ 922(a)(2) and 927(f)(1). CorpA-FSC is incorporated in Country A. At all relevant times, CorpA produced Product Line A within the United States and sold a portion of Product Line A for resale outside the United States. Similarly, at all relevant times, CorpA purchased Product Line B grown within the United States. CorpA used approximately AmountA% of Product Line B in its production of Product Line A¹ and sold a portion of the remaining AmountB% of Product Line B for resale or consumption outside the United States. CorpA-FSC acted as CorpA's commission agent with respect to such sales of Product Lines A and B during Taxable Years 1 through 2. Based on its status as a related supplier as defined in Temp. Treas. Reg. § 1.927(d)-2T, CorpA calculated the commissions that it paid to CorpA-FSC using the combined taxable income ("CTI") marginal costing method under section 925(b)(2).

Sales of Product Lines A and B constitute substantially all of CorpA's business. CorpA carries out its merchandising activities for Product Lines A and B through separate business divisions. Division A carries out merchandising activities with respect to Product Line A, and Division B carries out merchandising activities with respect to Product Line B.

Divisions A and B have separate personnel and separate offices. The transportation and distribution systems of Divisions A and B are generally separate and the customers of the divisions are different. Whereas Division A usually transports

¹ Product Line B is used in the production of some, but not all, of the products within Product Line A.

shipments of Product Line A from manufacturing plants or distribution centers to third party purchasers, Division B usually transports shipments of Product Line B from Storage Area to third party purchasers. Division B generally realizes an overall profit on all sales of Product Line B. Division B charges Division A for Division A's use of Product Line B in the production of Product Line A. Division B generally realizes a profit on these sales of Product Line B to Division A. For financial reporting purposes, an overall profit or loss in Division B is reflected as a reduction or increase, respectively, in the cost of goods sold of Division A. It is our understanding that Divisions A and B are capable of operating independently of one another profitably.

Product Line A includes products such as Items A, B, C, D, E, and F. Product Lines A and B fall under different two-digit Standard Industrial Classification ("SIC") codes. Solely for purposes of this advice, we assume that Product Lines A and B are valid product lines within the meaning of section 927(d)(2)(B) and attendant regulations.

Taxpayer argues that, although Product Lines A and B fall under different two-digit SIC codes, it may group Product Lines A and B together in a single Product Line C for purposes of FSC transfer pricing pursuant to recognized trade or industry usage ("RTIU") within the meaning of section 927(d)(2)(B) and attendant regulations because Product Lines A and B are produced and merchandised within the same industry or business.

The Service opposes the grouping of Product Lines A and B on two independent grounds. First, the Service argues that product lines that fall under different two-digit SIC codes may be grouped together under the RTIU standard only in exceptional situations and that this case does not constitute such an exceptional situation. Second, the Service argues that a trade or industry does not constitute a valid basis for a product line grouping under the RTIU standard.

LAW

I. Grouping under the FSC Administrative Pricing Rules

Sections 921 through 927 of the Internal Revenue Code contain rules for FSCs. Generally, determinations of transfer prices paid by a FSC to a related supplier or commissions paid to a FSC by a related supplier are made on a transaction-by-transaction basis. I.R.C. § 925(a) and (b); Temp. Treas. Reg. § 1.925(a)-1T(b)(2)(iii) and (d)(2). However, 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.

Pursuant to this authority, the regulations provide that, if the CTI or gross receipts administrative pricing method is used to calculate FSC transfer prices or commissions, the related supplier may elect annually to make such determinations on the basis of groups consisting of products or product lines. Temp. Treas. Reg. § 1.925(a)-1(c)(8)(i).

Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) provides:

A determination by the related supplier as to a product or 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 for purposes of this section if a product otherwise falls within more than one product line classification.

Thus, transactions are grouped into products, and products are grouped into product lines. A FSC transfer pricing grouping is valid if the product or product line is recognized in a trade or industry (the "RTIU standard") or if all products included in the product line fall within the same two-digit SIC code or any inferior classification or combination thereof (the "SIC standard"). Under Temp. Treas. Reg. § 1.925(b)-1T(b)(3), these rules also apply where a taxpayer uses the CTI marginal costing method to determine FSC transfer prices or commissions.

The domestic international sales corporation ("DISC") regulations under Treas. Reg. § 1.994-1(c)(7) contain the predecessor grouping regulations with respect to Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(ii) and 1.925(b)-1T(b)(3). The evolution of the DISC grouping regulations shows that the transfer pricing grouping rules were designed to simplify compliance with the administrative pricing methods. In particular, the RTIU standard is intended to "permit sufficiently broad groupings of products or product lines to promote efficiency in determining" prices, while the SIC standard is intended to provide a safe harbor and "certainty for taxpayers choosing to group transactions." See Prop. Treas. Reg. § 1.994-1(c)(7), 37 Fed. Reg. 19625 (Sept. 20, 1972) (providing only the RTIU standard for DISC grouping purposes); T.D. 7364, 1975-2 C.B. 315 (providing that the additional SIC standard for DISC grouping purposes eliminates uncertainty with respect to the validity of groupings); Tech. Memo. T.D. 7364, 1974 TM Lexis 30, at *68-69 (Oct. 29, 1974) (explaining the addition of the SIC standard to the DISC regulations in response to taxpayer comments regarding the proposed regulations for grouping); Tech. Memo. T.D. 7364, 1972 TM Lexis 14, at *10 (June 29, 1972) (stating that "flexibility is intended to be given to the taxpayer in choosing which products make up a

product line”). The SIC standard was adopted in Treas. Reg. § 1.994-1(c)(7) to the exclusion of other standards such as a “reasonable basis under the facts and circumstances . . . [p]ast individual company grouping practices for any purpose . . . if based upon a corporation’s divisional structure . . . [with respect to] specialized machinery, raw materials, or manufacturing techniques, or . . . end use . . . [or] product lines set up for purposes of external accounting; or . . . product lines understood by its customers or disclosed on Form 10-K filed with the SEC.” Tech. Memo. T.D. 7364, 1974 TM Lexis 30, above, at *22. The FSC grouping regulations substantially adopted the DISC transfer pricing grouping regulations.

II. Other Regulatory Provisions

A. Foreign Economic Process Grouping Rules

Pursuant to the grouping provision in section 927(d)(2)(B), taxpayers may also group transactions for the purpose of satisfying the FSC foreign economic process requirements of FSCs under section 924(b)(1)(B) and (d). Treas. Reg. § 1.924(d)-1(c)(5) and (e). Foreign economic process groupings are permitted under three² separate and distinct standards: (1) by product or product line based either on a RTIU or a two-digit major SIC code (or any inferior classification or combination thereof); (2) on the basis of customers so that a grouping includes all transactions of a FSC with a particular customer during a taxable year; and (3) on the basis of contracts so that a grouping includes all transactions of a FSC under a particular contract during a taxable year. Treas. Reg. § 1.924(d)-1(c)(5)(i) and (e)(1). Grouping elections under Treas. Reg. § 1.924(d)-1(c)(5) and (e) do not apply, however, for purposes of determining FSC transfer prices and commissions. Treas. Reg. § 1.924(d)-1(c)(5)(iii) and Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(viii).

B. Section 6038A Definition of “Product Line”

Our search reveals that the only provision in the Code or regulations that defines “product line” is in the section 6038A regulations relating to the reporting of – and record keeping for – transactions between certain related parties. For this purpose, Treas. Reg. § 1.6038A-3(c)(7)(ix) defines “product line” to mean a group of products that are aggregated

into a single classification for accounting, marketing or other business purposes. Examples of product lines are groups of products that perform similar functions; products that are marketed under the same trade names, brand names, or trademarks; and products that are related economically (that

² Treas. Reg. §§ 1.924(d)-1(c)(5)(i)(D) and (e)(1)(iv) also permit groupings based on products or product lines within customer or contract groupings.

is, having similar rates of profitability, similar degrees of risk, and similar opportunities for growth).

Treasury issued the section 6038A regulations in 1991, four years after the issuance of the FSC transfer pricing regulations and sixteen years after the issuance of the final DISC intercompany pricing regulation precursors to the FSC regulations. T.D. 8353, 1991-2 C.B. 402; T.D. 8126, 1987-1 C.B. 184; T.D. 7364, 1975-2 C.B. 315. Although guidance may be taken from this regulation, Treas. Reg. § 1.6038A-3(c)(7)(ix) has no substantive relationship to the FSC transfer pricing rules aside from the usage of the term “product line” in both regulations.

Analysis

I. Invalidity under SIC Standard Is Irrelevant to Application of RTIU Standard

Product Lines A and B may be grouped together into broader Product Line C if Product Lines A and B fall within the same two-digit SIC code or if they constitute a single product line under the RTIU standard. Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(ii) and 1.925(b)-1T(b)(3). Although Product Lines A and B do not fall within the same two-digit SIC code, the grouping may nevertheless be permitted under the RTIU standard because the SIC and RTIU standards are alternative means of qualifying as a product or product line under the FSC regulations. To interpret Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) to mean that products that fall within different two-digit SIC codes may be grouped together under the RTIU standard only under extraordinary circumstances would render the provision of alternative standards virtually meaningless. In short, the RTIU and SIC standards are two separate and distinct tests for the validity of product or product line groupings. This conclusion is consistent with the regulatory history that indicates that the SIC standard was intended as a safe harbor alternative to provide taxpayers certainty in their grouping choices, not to further limit application of the RTIU standard. See T.D. 7364, above, at 315.

Therefore, the Service must determine the validity of Taxpayer’s proposed Product Line C grouping using the RTIU standard without consideration of its invalidity under the SIC standard.

II. Similarity Is Proper Basis for Grouping under RTIU Standard

A. The RTIU Standard

Determining whether a product or product line grouping satisfies the RTIU standard is a more difficult task than applying the “bright line” rule of the SIC standard safe harbor because neither “product line” nor “recognized trade or industry usage” are

defined in the FSC statute and regulations.³ It is clear, however, that the grouping rules were intended to provide taxpayers flexibility in choosing which products constitute a product line. Tech. Memo. T.D. 7364, 1972 TM Lexis, above, at *10. Yet, the RTIU standard was also intended to be an objective standard that does not permit any and all conceivable combinations of products.

Under the RTIU standard, product lines may not be determined in a haphazard or random fashion chosen for the sole purpose of lessening a taxpayer's tax liability but must be "recognized" as a product or product line by the relevant trade or industry. The District Director's⁴ authority to reject a grouping demonstrates that some groupings are unacceptable. The addition of the SIC standard safe harbor to the DISC predecessor of Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(ii) and 1.925(b)-1T(b)(3) to provide certainty for grouping validity unavailable under the RTIU standard further demonstrates that certain groupings are considered invalid under the RTIU standard. Thus, taxpayers do not have free rein when grouping products and product lines for purposes of FSC administrative pricing. The remainder of this advice addresses the particulars of the RTIU standard and an application of such standard to CorpA's proposed Product Line C grouping.

Because "product line" is not defined for purposes of the FSC provisions or regulations, we may look to a dictionary definition to understand the common meaning of the term. Webster's New Collegiate Dictionary ("Webster's"), defines "product" as "something produced." Webster's defines "produce" as "give being, form, or shape to: make: esp. manufacture." Webster's defines "line" as "merchandise or services of the same general class for sale or regularly available." Webster's defines "class" as "a group, set, or kind sharing common attributes." Thus, the plain language meaning of "product line" is manufactured merchandise or services that belong to a group that shares common attributes. This commonality or similarity of attributes is the characteristic that distinguishes a product line from other collections of manufactured items or services for sale or regularly available.

We observe that, like the plain language meaning of "product line," the SIC code structure reflects relationships among products and product lines on the basis of similarity. All products or product lines included within the same two-digit SIC code share some similarity that they do not share with other products or product lines. The SIC code offers one out of many possible categorizations of products and product lines

³ The definition of "product line" under Treas. Reg. § 1.6038A-3(c)(7)(ix) is not determinative in the context of FSC transfer pricing grouping.

⁴ We are aware that the position of District Director is now obsolete. Our reference to "District Director" includes any Service official or office that performs the duties of the former office of District Director as described under Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(ii) and 1.925(b)-1T(b)(3).

on the basis of similarity for the purpose of providing a safe harbor method for determining valid groupings.

B. Common Trade or Industry Requirement

The RTIU standard, by definition under Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(ii) and 1.925(b)-1T(b)(3), permits product line groupings in accordance with the product lines recognized within the taxpayer's trade or industry. Thus, the product line must meet an objective standard of being recognized or commonly accepted by the specific trade or industry in which the taxpayer is engaged. If two products or product lines arise from separate trades or industries, the RTIU standard is inapplicable. Thus, a taxpayer that engages in more than one trade or industry may not use the RTIU standard to group products or product lines that fall under different trades or industries. A trade or industry is necessarily determined by the nature of its activities.

In the instant case, CorpA uses Divisions A and B to process and market Product Lines A and B. Division A purchases raw materials, including Product Line B, uses such materials to manufacture and process Product Line A, and sells Product Line A. Division B purchases unprocessed Product Line B which it then resells in the same unprocessed form. In short, Division A engages in processing and manufacturing activities that result in Product Line A while Division B engages in distribution activities involving unprocessed raw materials. Divisions A and B perform dissimilar activities except to the extent that both are vendors. We conclude that Divisions A and B engage in separate and distinct trades or industries within the meaning of the RTIU standard under Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(ii) and 1.925(b)-1T(b)(3). Thus, CorpA may not use the RTIU standard to justify a FSC transfer pricing grouping of Product Lines A and B into Product Line C.

C. The Measure of Similarity under the RTIU Standard

If a taxpayer's products or product lines arise within a single trade or industry, the taxpayer may apply the RTIU standard to determine whether the products or product lines share enough similarity to justify grouping under Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(ii) and 1.925(b)-1T(b)(3). The measure of similarity required under the SIC standard is predetermined by the categorization of products and product lines under the two-digit SIC codes. No such predetermined measure of similarity under the RTIU standard is set forth in Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(ii) and 1.925(b)-1T(b)(3). Therefore, this advice identifies not only factors that may indicate the degree of similarity that justifies grouping under the RTIU standard but also factors that should not be taken into account for purposes of applying the RTIU standard.

1. Common Customer or Contract Not Equivalent to Similarity under RTIU Standard

As a preliminary matter, we reject the possibility of using customers or contracts

as the sole basis for measuring similarity among products or product lines under the RTIU standard. Support for this conclusion is found in an analysis of the FSC regulatory scheme for grouping. The FSC regulations provide separate grouping rules for purposes of applying the foreign economic process tests. These grouping rules provide three alternative methods for grouping: 1) on a product or product line basis using the SIC or RTIU standard, 2) on a customer basis, and 3) on a contract basis. Because each of these three alternative methods provides an independent basis for grouping under the foreign economic process regulations, we conclude that neither customers nor contracts may be, in themselves, measures of similarity for purposes of grouping by product or product line.

2. Other Factors Irrelevant to the RTIU Standard

We can also reject other possible factors under the RTIU standard. In adopting the SIC standard, the Service and Treasury rejected suggested additional grouping practices based solely on business divisions, raw materials, product end use, accounting, manufacturing techniques, or Form 10-K filed with the SEC. Tech. Memo. T.D. 7364, 1974 TM Lexis 30, above, at *22. Thus, standing alone, groupings on these bases do not constitute products or product lines under the RTIU standard. Packaging and trade dress also do not determine product or product line similarity for purposes of the RTIU standard because the tested item is the product, not the wrapper or container. Moreover, economic factors such as a product or product line's rate of profitability, risk, or opportunity for growth are irrelevant to the determination of similarity under the RTIU standard because they do not define the product or product line. Finally, the RTIU standard does not permit groupings on a geographical basis. See Napp Systems, Inc. v. Commissioner, T.C. Memo. 1993-196, 65 T.C.M. (CCH) 2567, 2570 (1993).

3. Indicators of RTIU Standard Similarity

We believe the presence of any of the indicators described below with respect to two or more products or product lines may signal a degree of similarity between such products or product lines. Each factor should be carefully considered in light of all facts and circumstances. In one set of circumstances, a factor may accompany products that share a relatively high degree of similarity. Under different circumstances, the same factor may be present where overwhelming dissimilarity prevents grouping under the RTIU standard. The presence or absence of any indicator is irrelevant unless considered in the context of all other pertinent factors. Thus, the mere fact that any indicator is present does not, by itself, prove that two products or product lines share the requisite similarity necessary for grouping under the RTIU standard. Conversely, the absence of any factor is not dispositive of the level of dissimilarity that would preclude a valid grouping.

Product Form

Some products are marketed in a manner that allows the consumer to choose

from a variety of attributes available with respect to a core product or product line. For example an automobile purchaser may be able to choose between the standard and automatic models or the six-cylinder and eight-cylinder models. In both cases, the core product is an automobile and the optional attributes serve not only to differentiate the otherwise identical core products but also to emphasize their fundamental similarity. To the extent that attributes are mere variations on a single core product or product line without changing the nature of the core product or product line, such attributes may indicate similarity under the RTIU standard. To the extent that attributes change the nature of the core product or product line so substantially that a distinct and dissimilar product or product line results, such attributes indicate dissimilarity for purposes of the RTIU standard.

Product Function or Related Activity

Multiple products often fulfill a similar function or purpose. For instance, screws and nails are both used to fasten objects together. In some cases, they are interchangeable and, thereby, share a similarity to be taken into account in determining whether the two products are similar enough to justify RTIU standard grouping. In short, products that serve a common function or fulfill a common purpose may share a degree of similarity.

Two products may be used with respect to related activities if both products are commonly associated with, or necessary to, similar activities, events, or practices. For example, although hammers and screwdrivers are different products, they are commonly associated together because both are hand-powered tools often used in construction, building, and assembly activities. The carpenter's tool belt and variety tool packs sold in hardware stores emphasize the special relationship between screwdrivers and hammers. Indeed, both products fall under the common label "tools." Thus, some products may share a similarity to the extent that they are used with respect to related activities.

Common Labor

Some businesses that market more than one product have separate or semi-independent work forces for different products or product lines. The fact that a business uses the same employees with respect to more than one product or product line may suggest a similarity among such products because the skill level of laborers required to produce similar products is likely to be similar. For instance, if a company uses the same assembly line team to construct two products, such commonality may indicate the kind of similarity required to justify a product line grouping. However, the mere fact that two products share labor in common does not indicate similarity where such commonality is the only element of similarity between two products.

Common Raw Materials

Many manufacturers make more than one product using the same raw materials. For instance, a company might manufacture writing paper, gift wrap paper, and news print. The common use of the raw material wood as a major constituent of multiple products may signal a similarity among such products. However, this indicator should not be considered to be a similarity in itself. For instance, news print and mahogany furniture are dissimilar products despite the fact that they share their principal raw material in common. Thus, a differential in the extent of processing or manufacturing of raw materials may militate against a grouping on the basis of common raw materials.

Common Customer

As stated above, the fact that a taxpayer sells two products or product lines to the same customer does not justify grouping under the RTIU standard. However, a common customer may indicate that products or product lines share similarities just as different customers for products or product lines may suggest dissimilarity.

D. Application of the Similarity Principle to Product Lines A and B

Even if Product Lines A and B arose within the same trade or industry contrary to our determination above, we conclude that Product Lines A and B do not share the degree of similarity necessary to justify a broader Product Line C grouping under the RTIU standard of Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(ii) and 1.925(b)-1T(b)(3). Applying the above indicators, our analysis is as follows.

Product Form -- Product Lines A and B are dissimilar in form. Whereas Product Line A consists of products processed and manufactured by Division A, Product Line B consists of unprocessed raw materials that never change form in the possession of Division B. Moreover, Product Lines A and B are distinguished by greater differences than mere product attributes.

Common Function or Related Activity – Product Lines A and B are dissimilar in function. CorpA markets Product Line A specifically and strictly as ObjectA and but markets Product Line B for numerous uses other than as ObjectA. Product Lines A and B do not share a related activity. Consumers do not routinely or commonly use both Product Lines A and B in similar activities, events, or practices.

Common Labor – CorpA uses separate and different labor forces and processes to produce and deliver Product Lines A and B. Divisions A and B use separate personnel and offices.

Common Raw Materials – Product Lines A and B do not consist of similar raw materials. Product Line B is itself a raw material used in the production of some, but not all, items that compose Product Line A.

Common Customer – The customers that purchase Product Line A are different from those that purchase Product Line B. This fact is not merely coincidental but springs from the dissimilar natures of the two product lines.

None of the indicators listed above suggest a meaningful similarity between Product Lines A and B. The only evident relationship between the two product lines is that Product Line A consists of a processed product while Product Line B consists of unprocessed, raw materials that can be, and are, used by CorpA to produce some products included in Product Line A. This degree of similarity is too attenuated to justify a Product Line C grouping under the RTIU standard. Therefore, even if Divisions A and B were engaged in the same trade or industry, we conclude that Product Lines A and B would, nevertheless, be too dissimilar to be grouped under Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(ii) and 1.925(b)-1T(b)(3).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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