

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

December 13, 2001

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Team Coordinator,

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No.:

Years Involved:

Date of Conference:

LEGEND:

Corp A	=
Corp B	=
Corp A-FSC	=
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 group transactions on the basis of both a broader product line and a narrower product line subsumed within the broader product line, where the taxpayer assigns each product to only one of such product lines.

CONCLUSION:

The taxpayer may not group transactions for purposes of FSC administrative pricing determinations on the basis of both a broader product line and narrower product lines subsumed within the broader product line, even if the taxpayer assigns each product to only one of such product lines. This grouping methodology violates the requirements under Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) and (iii) that grouping must be on the basis of products or product lines determined by recognized trade or industry usage and that a grouping must include all transactions in the product or product line. To the extent the taxpayer uses marginal costing, such a methodology also violates the corresponding requirements under Temp. Treas. Reg. § 1.925(b)-1T(b)(3). Example 11 of Temp. Treas. Reg. § 1.925(a)-1T(f) does not support such a methodology.

FACTS:

Corp A is a domestic corporation that files a consolidated Federal income tax return with its domestic parent, Corp B, and various wholly-owned domestic subsidiaries. Corp A-FSC, incorporated in Possession A, is a wholly-owned subsidiary of Corp A. 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 is engaged in the manufacture and worldwide sale of products in Industry A and is a related supplier with respect to Corp A-FSC within the meaning of Temp. Treas. Reg. § 1.927(d)-2T(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).

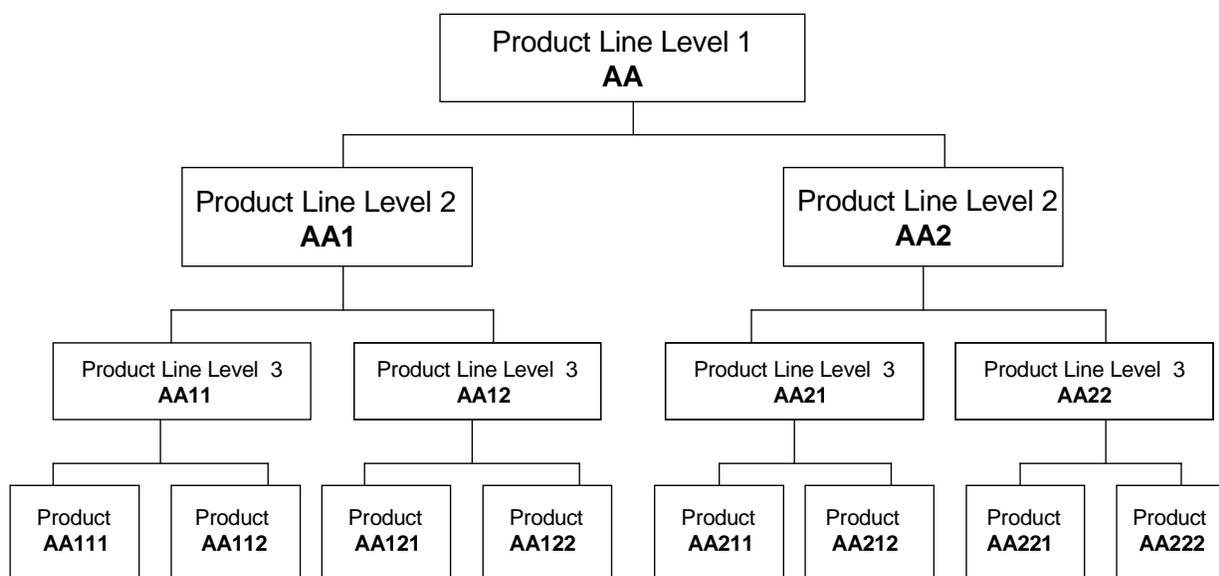
Corp A, Corp B and Corp A-FSC are collectively referred to as "Taxpayer." In the respective original income tax returns filed for Tax Years 1, 2 and 3, Taxpayer applied the administrative pricing rules of section 925(a), determining its respective FSC commissions using the combined taxable income (CTI) 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 elected, pursuant to section 927(d)(2)(B), Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(i) and 1.925(b)-1T(b)(3) to group transactions by product or product line (as determined by recognized trade or industry usage) for purposes of computing the overall profit percentage (OPP) under Temp. Treas. Reg. § 1.925(b)-1T(c)(2).

On examination, Taxpayer proposes to redetermine its FSC commissions by grouping its export transactions by product or product line (as determined by recognized trade or industry usage) for both full costing and marginal costing purposes. At issue is the methodology used for such grouping.

Corp A's products may be illustrated in the form of a multi-tiered "tree" or "hierarchy" of product lines as shown in Diagram 1.

Diagram 1

The broadest product line, AA, is at a level labeled in the diagram as product line level 1. AA comprises two narrower product lines, AA1 and AA2, at product line level 2. In



turn, at product line level 3, product line AA1 comprises two narrower product lines, AA11 and AA12, while product line AA2 comprises product lines AA21 and AA22. These narrowest product lines at product line level 3 comprise the various products. For example, product line AA11 includes products AA111 and AA112. 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).

Pursuant to its proposed grouping methodology, Taxpayer assigns each product to one of the product or product line levels in which it falls, but different products may be assigned to different levels, even within a single broader product line. For example, product AA111 potentially falls into product line AA at product line level 1, product line AA1 at product line level 2, and product line AA11 at product line level 3. Assume that Taxpayer selects product line level 1 (product line AA) as the grouping to be used for

administrative pricing purposes with respect to product AA111. Taxpayer does not, however, group with product AA111 every other product that falls in product line AA. With respect to product AA211, for example, Taxpayer groups transactions at the product level or at a product line level other than product line level 1. For example, product AA211 may be grouped in product line AA2, at product line level 2. Assume that as with product AA211, with respect to every product except products AA111 and AA222, Taxpayer groups transactions at product or product line levels other than product line level 1. The result in this example is that AA, potentially the broadest product line, will ultimately form a grouping that contains only two of the eight products, that is, AA111 and AA222, in product line AA for purposes of determining the FSC commission.

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.

For FSC administrative pricing determinations, Temp. Treas. Reg. § 1.925(a)-1T(c)(8), applicable to the tax years at issue, 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.

(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.)

Example 11 of Temp. Treas. Reg. § 1.925(a)-1T(f) illustrates, *inter alia*, the rule stated in Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) that a product may be included in only one product line. Example 11 provides, in pertinent part:

Assume ... that R ... manufactures products ... L, M, N and P all of which are export property as defined in section 927(a).... Assume further that products A, L and P are included within product line X and that products ... L, M and N are included within product line W.... Because of the special grouping rule of paragraph (c)(8)(ii) of this section, product L may be included for purposes of the administrative pricing rules in only one product line, at the option of R.

The administrative pricing computations in the example imply that R chooses to include product L in product line W, together with products M and N. Because product L may not also be included in product line X, R includes only products A and P in product line X.

Section 925(b)(2) authorizes the Secretary of the Treasury to prescribe marginal costing regulations. Pursuant to this authority, 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).... [T]he 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*

* * *

(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.
(Emphasis added.)

ANALYSIS:

At issue is whether the grouping methodology adopted by Taxpayer complies with the rules governing grouping of transactions in Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8) and 1.925(b)-1T(b)(3). The methodology at issue involves selecting a product line as the grouping with respect to one product in the product line while, with respect to another product that falls within that product line, selecting a narrower product line subsumed within the first product line (or selecting a broader product line that subsumes the first product line). This memorandum first analyzes the operation of the

applicable temporary regulations generally and then applies them to Taxpayer's grouping methodology

The temporary regulations set forth three major requirements for grouping transactions for FSC administrative pricing determinations under the full costing CTI method. First, the grouping must constitute a product or product line as determined by reference to SIC codes or recognized trade or industry usage (the "product-line requirement"). Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i), (ii). Second, the grouping must include all transactions that fall into the product or product line (the "full-inclusion requirement"). Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(iii). Third, a product may be included in only one product line (the "double-inclusion prohibition"). Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii).

The interplay of these three requirements is illustrated in Example 11 of Temp. Treas. Reg. § 1.925(a)-1T(f) ("Example 11"), which is quoted above in pertinent part. In Example 11, the taxpayer first determines that two product lines, X and W, will be used for purposes of determining the FSC commission. One product, L, is common to product lines X and W. Under the product-line and full-inclusion requirements, product L must be included in each of these product lines, but the double-inclusion prohibition would be violated if product L were included in both a group consisting of product line X and a group consisting of product line W. In this situation, Example 11 states that the taxpayer may choose to include product L in either product line X or product line W. The taxpayer chooses product line W. Product line X, the product line not chosen for inclusion of product L, is a valid grouping even though product L has been excluded from it and it therefore does not include all products ordinarily falling in the product line as required by the product-line and full-inclusion requirements. In calculating the FSC commission, Example 11 recognizes product line X as a valid grouping because the exclusion of product L was effected to comply with the double-inclusion prohibition.

Thus, Example 11 provides an implicit principle for coordination of the requirements of Temp. Treas. Reg. § 1.925(a)-1T(c)(8): Where the taxpayer complies with the double-inclusion prohibition by including a common product in one product line while excluding it from another product line, such compliance does not adversely affect compliance with the product-line and full-inclusion requirements.

Under this regulatory structure, Taxpayer could choose, for example, to use product line AA1 as a grouping for purposes of determining its FSC commission, but then each of the four products within that product line -- AA111, AA112, AA121 and AA122 -- would by definition be included in that grouping. Taxpayer could not use product line AA1 as the grouping with respect to product AA111 while using product line AA12 as the grouping with respect to product AA122, since all products within product line AA12, including product AA122, are already part of the selected AA1 grouping. Thus, the double-inclusion prohibition does not come into play. Taxpayer has selected AA1 in its entirety as the grouping to be used in determining the FSC commission, and

no subset of that selected grouping constitutes a separate grouping to which AA1 could be compared in applying the double-inclusion prohibition.

Alternatively, Taxpayer could use product lines AA1, AA21 and AA22 as its groupings, provided that all transactions in those product lines were included in such groupings. In that situation, the double-inclusion prohibition would apply if, for example, the characteristics of product AA122 were such that it could appropriately fall within either product line AA1 or product line AA21. Taxpayer then could, pursuant to Example 11, choose to include product AA122 in either one of those selected product lines.

In applying the requirements of Temp. Treas. Reg. § 1.925(a)-1T(c)(8) to Taxpayer's grouping methodology, we note preliminarily that the marginal costing provisions of Temp. Treas. Reg. § 1.925(b)-1T(b)(3), quoted above, provide corresponding requirements and require generally that the grouping used for marginal costing CTI purposes be the same grouping used for full costing CTI purposes, except that in computing the OPP, the taxpayer may use a grouping broader than the full costing CTI grouping. Taxpayer states its position by reference only to the full costing CTI rules but represents that it uses the same grouping methodology for both full costing and marginal costing CTI purposes. Because neither the legal analysis nor the result under the temporary regulations differs depending on the use of full costing as distinct from marginal costing, this memorandum focuses on the full costing rules discussed by Taxpayer, but the analysis and conclusions herein would apply equally to marginal costing.

With respect to the product-line requirement, the "product line" referred to in the temporary regulations is the operative grouping actually used to determine the FSC commission. Taxpayer represents that the products and product lines in the product-line hierarchy or tree are determined in accordance with recognized trade or industry usage. However, Taxpayer's grouping methodology does not use the products or product lines in the hierarchy as its operative groupings. Rather, Taxpayer uses the products and product lines in the hierarchy merely as tentative groupings -- or an intermediate step -- in the process of arriving at the operative grouping. For example, in Diagram 1 and the fact pattern set forth above, products AA111 and AA222 could form a grouping under Taxpayer's grouping methodology. However, these products do not constitute any of the groupings in the product line hierarchy and do not in themselves constitute a product line in accordance with recognized trade or industry usage. Since Taxpayer's operative groupings do not constitute products or product lines, its grouping methodology violates the product-line requirement.

Taxpayer's grouping methodology also violates the full-inclusion requirement. Again referring to Diagram 1 and the fact pattern set forth above, the operative grouping of products AA111 and AA222 fails to include six of the eight products in product line AA.

Under the temporary regulations, as noted above, once Taxpayer has selected a broad product line as its operative grouping, the double-inclusion prohibition is not implicated with respect to narrower product line levels subsumed in the broad product line because no such subset of the broad product line is properly recognized as a separate product line. Nevertheless, Taxpayer's methodology treats such subsets as separate product lines to which the double-inclusion prohibition applies. Although each product potentially falls into more than one of these alternative product lines of varying levels of the product-line hierarchy, Taxpayer does not include any one product in more than one operative grouping. In this sense, Taxpayer's methodology complies with the double-inclusion prohibition.

Taxpayer maintains that the implicit coordination principle of Example 11 applies to its methodology, with the result that its methodology should be treated as complying with all requirements under Temp. Treas. Reg. § 1.925(a)-1T(c)(8). Taxpayer reasons, for example, that products AA111 and AA112 are common to what Taxpayer characterizes as three different product lines -- AA11, AA1 and AA -- and that Example 11 therefore permits Taxpayer to include each of these products in an operative grouping consisting of whichever one of such product lines it chooses, for example, product AA111 in product line AA and product AA112 in product line AA11. Similarly, Taxpayer reasons that product lines AA, AA2 and AA22 have in common products AA221 and AA222, so that Taxpayer may group product AA222 in product line AA while grouping the product AA221 transactions in product line AA22. Thus, although all eight products fall under product line AA in the hierarchy, Taxpayer maintains that after application of Example 11, it is permissible for product line AA to consist entirely of products AA111 and AA222, and each of the remaining six products may be assigned at Taxpayer's option not to AA but to an operative grouping consisting of any of the other narrower product lines (or the respective individual product) subsumed by product line AA.

In Taxpayer's view, this methodology is merely a multiple application of the principles illustrated in Example 11 in that any failure to comply with the product-line and full-inclusion requirements results from compliance with the double-inclusion prohibition. Accordingly, Taxpayer maintains that its resulting groupings, like those in Example 11, should be treated as in compliance with those requirements. For the following reasons, we disagree.

First, Taxpayer's methodology differs fundamentally from the grouping concept underlying the structure of the temporary regulations and as reflected in Example 11. Unlike the regulatory grouping process, Taxpayer's methodology does not begin with a basic choice of product lines as its operative grouping and then follow through by including all products consistently with that selection. Rather, Taxpayer selects not only the broadest product line, AA, but also narrower product lines, such as AA1 and AA11, within the selected product line as operative groupings with respect to individual products. This approach artificially creates overlapping product lines rather than resolving the kind of existing overlap illustrated in Example 11.

The temporary regulations do not contemplate simultaneous use of a broad product line and a narrower one (or a single product) subsumed within it as operative groupings and do not contemplate the creation of overlaps within an operative grouping. Once a product line is selected as the operative grouping, Taxpayer forgoes the choice of any narrower product line subsumed in the chosen product line; rather, all products in the chosen product line must be included in the operative grouping based on that product line. This is exactly what Example 11 illustrates. The product lines in the example are those selected as the operative groupings. The products in these product lines may fall into a hierarchy of product lines in which the identified product lines are broader or narrower than other product lines in the hierarchy. However, it is not necessary for the example to mention any such hierarchy because, contrary to Taxpayer's premise, other levels of the hierarchy that subsume or are subsumed by the operative grouping are not themselves separate, overlapping product lines.

Had Treasury and the Service intended to address the kind of overlap created by Taxpayer's methodology, it is reasonable to expect that the temporary regulations would have done so explicitly. This is particularly so because the overlap that Taxpayer posits with subsets of a product line would be present in every case of a business with multiple products that fall into a product-line hierarchy. Instead, Example 11 addresses those cases in which a product falls into more than one of a taxpayer's product lines that otherwise are separate and distinct.

Second, and more importantly, the requirements under Temp. Treas. Reg. § 1.925(a)-1T(c)(8) would be effectively nullified if they were construed to permit Taxpayer's grouping methodology. Virtually any combination of products could be grouped under Taxpayer's interpretation of Example 11, regardless of whether such operative grouping constitutes a product line by recognized trade or industry usage and regardless of how few of the transactions in any valid product line are included in the operative grouping.

In failing to make an initial selection of an operative group, Taxpayer's methodology applies the double-inclusion prohibition in a way that effectively overrides the product-line and full-inclusion requirements. Statutes and regulations must be construed in such a way as to give meaning to each provision. National Labor Relations Board v. Jones & Laughlin Steel Corp., 301 U.S. 1, 30 (1937) ("The cardinal principle of statutory construction is to save and not to destroy"); Gustafson v. Alloyd Co., Inc., 513 U.S. 561, 574-75 (1995) ("[W]e decline to say [Congress] included the words ... for no purpose"); Exxon Corp. v. United States, 26 Fed. Cl. 581, 661-62 (1999) ("[I]t is our duty to construe [the applicable Treasury Regulation] so as to give effect to its every term, and not to render one part altogether inoperative... [Taxpayer's] interpretation..., if sustained, would effectively render meaningless the operative regulatory phrase....").

Taxpayer acknowledges that its methodology potentially results in groupings that would not be permissible if created directly. Referring again to Diagram 1, Taxpayer

acknowledges that it would be impermissible to form an operative grouping by directly superimposing on the product-line hierarchy a second level of grouping in which the relatively disparate products AA111 and AA222 are grouped together to the exclusion of other products in their respective product lines. Taxpayer recognizes that such a methodology would be invalid because the operative grouping would fail to constitute a product or product line within the meaning of Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) and would violate the full-inclusion requirement under Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(iii). Nevertheless, Taxpayer takes the position that the same group consisting of products AA111 and AA222 is valid if it results, as illustrated above, from Taxpayer's multiple applications of Example 11. We conclude that the temporary regulations should not be read to permit Taxpayer to do indirectly what it may not do directly.

Finally, we have considered Taxpayer's argument that its methodology is consistent with that of the temporary regulations in the context of determining product lines by SIC code. Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) provides that product lines may conform to "the two-digit major groups (or any inferior classifications or combinations thereof, within a major group)" in the SIC classification system. Taxpayer maintains that the reference to a combination of inferior classifications contemplates that inferior classifications may be combined into groupings without regard to whether a broader classification has already been used.

Since the facts presented do not involve grouping by SIC code, we do not exhaustively analyze the application of the temporary regulations to such grouping. However, we observe that a more obvious interpretation of a "combination" of inferior classifications is that the term refers to operative groupings drawn from different non-overlapping levels of the SIC classification, consistent with the alternative method of determining products and product lines by recognized trade or industry usage. For example, assume that Diagram 1 is organized by SIC codes rather than recognized trade or industry usage, such that product line AA is represented by a two-digit SIC code and the lower-level product lines are represented by three- and four-digit SIC codes. The products in the four-digit SIC codes AA11 and AA12 could be grouped together at the level of three-digit SIC code AA1, but once AA1 is selected, all inferior classifications under that code must be grouped together under the full-inclusion requirement of Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(iii). At the same time, products in the four-digit SIC codes AA21 and AA22 could be grouped separately at the four-digit level. In this way, Taxpayer would make use of two different levels (a "combination") of inferior classifications. The SIC approach is not inconsistent with the recognized trade or industry usage approach in this respect.

Accordingly, we conclude that Taxpayer may not group transactions on the basis of both a broader product line and narrower product lines subsumed within the broader product line, even if Taxpayer assigns each product to only one of such product lines.

CAVEATS:

The sole issue addressed by this memorandum is the permissibility of the 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 Temp. Treas. Reg. § 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.