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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

DATE: June 27, 2002

MEMORANDUM FOR: Tina K. Byrd, International Field Manager, LMSB
Attn: James Guidone, International Technical Advisor

FROM: Elizabeth G. Beck, Chief, CC:INTL:6

SUBJECT: FSC Grouping Issue

This Technical Assistance responds to your memorandum dated March 28, 2002, requesting advice on the application of the grouping rules in Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8) and 1.925(b)-1T. This Technical Assistance does not relate to a specific case and is not binding on Examination or Appeals. This document is not to be used or cited as precedent.

ISSUE

Whether, in computing the overall profit percentage limitation on combined taxable income determined under the marginal costing method of Temp. Treas. Reg. § 1.925(b)-1T, a foreign sales corporation ("FSC") must include sale transactions to which the full costing method of Temp. Treas. Reg. § 1.925(a)-1T was applied.

CONCLUSION

When computing the overall profit percentage limitation on combined taxable income determined under the marginal costing rules, a FSC must include all sale transactions that fall within the same product or product line elected pursuant to Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii), regardless of whether the full costing method was applied to the sales.

FACTS

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Taxpayer entered into 10 sales transactions ("Sales 1 through 10") with its wholly-owned FSC. Sales 1 through 5 involved Product A, and Sales 6 through 10 involved Product B. In the aggregate, Products A and B constitute Product Line C. Products A and B and Product Line C are valid product groupings within the meaning of Temp. Treas. Reg. § 1.925(a)-1T(c)(8), and all ten sales qualify for a FSC tax exemption under section 921(a).

Taxpayer determined the transfer prices for all ten sales on the basis of product groupings. Taxpayer used the full costing method to determine the transfer prices for the Product A grouping. Taxpayer used the marginal costing method to determine the transfer prices for the Product B grouping and elected to use Product Line C as the overall profit percentage grouping ("the OPP Product Line") applicable to Product B. The issue is whether Taxpayer must include Product A in the OPP Product Line used to determine the overall profit percentage applicable to Product B even though Taxpayer applied the full costing method to Product A.

LAW

Section 921 provides an income tax exemption for a portion of qualifying FSC income. If certain prerequisites are met, taxpayers may determine the amount of the FSC exemption for a transaction based on transfer prices calculated using the gross receipts method of section 925(a)(1), the combined taxable income method of section 925(a)(2), or the section 482 actual sale price method of section 925(a)(3).¹ I.R.C. § 923(a)(3) and Temp. Treas. Reg. § 1.925(a)-1T(a)(1). The combined taxable income method may be applied using either the full costing rules of Temp. Treas. Reg. § 1.925(a)-1T(c)(6) ("the full costing method") or the marginal costing rules of Temp. Treas. Reg. § 1.925(b)-1T ("the marginal costing method"). Combined taxable income determined under the marginal costing method may not exceed the overall profit percentage ("OPP") limitation, which is the product of the foreign trading gross receipts² that gave rise to the combined taxable income and the OPP.³ Temp. Treas. Reg. § 1.925(b)-1T(b)(2).

Generally, the full costing and marginal costing methods apply on a transaction-by-transaction basis. Section 927(d)(2)(B) provides that, to the extent provided in regulations, FSC provisions that would otherwise apply on a transaction-by-transaction

¹ The method grouping rules discussed in this memorandum do not apply to the section 482 actual sale price method. See generally Temp. Treas. Reg. § 1.925(a)-1T.

² See section 924(a) for the definition of foreign trading gross receipts.

³ OPP is defined below.

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basis may be applied by taxpayers “on the basis of groups of transactions based on product lines or recognized industry or trade usage.” Treas. Reg. § 1.925(a)-1(c)(8)(i) allows taxpayers to elect to group transactions for transfer pricing purposes (“method groupings”). Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) through (vii) contains guidelines for such method groupings.⁴ One rule is that “[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” (“the prohibition against double inclusion”). Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii). Another rule provides that a product grouping election “shall apply to all transactions with respect to that product or product line. . .” (“the full inclusion rule”). Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(iii).

Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i) provides that the grouping rules of Temp. Treas. Reg. § 1.925(a)-1T(c)(8) apply for purposes of the marginal costing method. The marginal costing rules continue:

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 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).

Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii). Thus, a special product grouping (“the OPP grouping”) is required for applying the OPP to limit transfer prices determined under the marginal costing method. Temp. Treas. Reg. § 1.925(b)-1T(b)(2).

⁴ Treas. Reg. § 1.925(a)-1(c)(8)(i) describes the procedures for making transfer pricing grouping elections; Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii)-(vii) provides substantive rules for transfer pricing groupings.

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The OPP is a fraction the numerator of which equals:

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. (Emphasis added).

Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(i)(A). The denominator of the OPP fraction equals “[t]he total gross receipts (determined under § 1.927(b)-1T) of the FSC and related supplier from all sales of the product or product line.” (Emphasis added).

Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(i)(B).

In a case involving Treas. Reg. § 1.994-2 – the direct predecessor of the FSC marginal costing regulations – the United States Tax Court described the function of the OPP limitation on marginal costing (“OPPL”) as follows:

The OPPL essentially limits the ‘profitability’ of export sales, for purposes of computing taxable income under marginal costing, to the ‘profitability’ of worldwide sales, or ‘overall’ profitability, of the product or product line (determined under a full costing method). (Emphasis added).

Brown-Forman Corp. v. Commissioner, 94 T.C. 919, 929 (1990), aff’d, 955 F.2d 1037 (6th Cir. 1992), cert. denied, 506 U.S. 827 (1992). The Tax Court also observed that the FSC marginal costing regulations are “virtually identical” to Treas. Reg. § 1.994-2. Id. at 947. See also Dow Corning Corp. v. United States, 984 F.2d 416, 421 (Fed. Cir. 1993) (observing that the OPPL “prevented taxable income, after deducting only direct labor and material, from exceeding the normal (overall) profitability of the product”).

In other words, the OPPL reduces a taxpayer’s combined taxable income under the marginal costing method to the amount that would result if the taxpayer’s profit percentage on sales of export property were equal to its worldwide profit percentage on all sales of the same product or product line.

DISCUSSION

Examination believes that sales priced under the full costing method may not be included in the OPPLs applicable to sales priced under the marginal costing method. Examination reasons that the inclusion of Product A in the OPP Product Line would violate the prohibitions against double inclusion under Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(ii) and 1.925(b)-1T(b)(3)(ii). In addition, Examination suggests the inclusion of Product A in the OPP Product Line improperly enables Taxpayer to apply the full

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costing method to higher-profit sales while simultaneously using such sales to “bootstrap” lower-profit sales under the marginal costing method.

The legislative histories of the FSC provisions and the predecessor domestic international sales corporation provisions do not address this issue. Therefore, we must analyze the language of the FSC grouping rules.

I. Basic Mechanics of FSC Transfer Pricing and Grouping Rules

The full costing method applies on a transaction-by-transaction basis unless the taxpayer elects to group its transactions on the basis of products or product lines. Treas. Reg. § 1.925(a)-1(c)(8)(i). Generally, product groupings must conform to the rules provided in Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) through (vii). Among these rules are the full inclusion rule and the prohibition against double inclusion.

A taxpayer’s method grouping for purposes of the full costing method also applies for purposes of the marginal costing method. Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i). Under the marginal costing method, the OPPL reduces a taxpayer’s marginal costing combined taxable income on sales of an item or product grouping to an amount that reflects the taxpayer’s worldwide profit percentage on all sales of the OPP product grouping that includes the item or product. Thus, an OPP grouping is required in order to calculate the OPP. The OPP grouping rules contain a prohibition against double inclusion similar to the prohibition that applies to method groupings. Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii).

Where a taxpayer applies the marginal costing method to an item or product grouping, the related OPP grouping must include all of the sales included in such method grouping and may include sales that were not included in the method grouping (“the broadness rule”). Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii). In addition, Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(i) provides that, for the purpose of calculating the OPP, a taxpayer must include the taxable income and gross receipts “from all sales” in the numerator and denominator of the OPP, respectively (“the all-products requirement”). In other words, the broadness rule and the all-products requirement in the marginal costing regulations specify – without qualification – that all constituent sales of a valid OPP grouping must be included in the OPP fraction.

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II. Analysis⁵

A. The Prohibition Against Double Inclusion

In the fact pattern, Taxpayer had three groupings – Product A, Product B, and the OPP Product Line.⁶ At first glance, the prohibition against double inclusion appears to be a potential issue in this scenario because Taxpayer included each of its transactions in two groupings – a method grouping and an OPP grouping. A closer examination reveals that the inclusion of a valid method grouping, such as Product A, within a valid OPP grouping, such as the OPP Product Line, does not violate the prohibition against double inclusion.

We observe that the FSC transfer pricing regulations provide two parallel prohibitions against double inclusion. The prohibition in Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) applies to method groupings whereas the prohibition in Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) applies to OPP groupings. Although the two prohibitions are materially similar, they apply in different contexts. The method grouping prohibition prevents the inclusion of a transaction in more than one method grouping; the OPP grouping prohibition prevents the inclusion of a sale in more than one OPP grouping. Method groupings form the base for application of the full costing or marginal costing method on the basis of product groups while OPP groupings form the base of the limitation on the marginal costing method (whether such method is applied on a transaction-by-transaction or group basis). Considering this important distinction between method groupings and OPP groupings, we do not believe that their respective prohibitions against double inclusion should be read together to require that sales included in a full costing method grouping be excluded from OPP groupings.

We find support for our view in the plain language of the marginal costing regulations. For example, the broadness rule of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) contains two requirements for OPP groupings: (1) an OPP grouping may be broader than the method grouping to which it is being applied and (2) the marginal costing method may not be used if the OPP grouping does not include all of the items or products included in the method grouping to which it is being applied. In simple terms, an OPP grouping must contain the sales included in the method grouping to which the OPP will be applied, and it may also contain additional sales. Thus, the

⁵ The following analysis would be the same if Taxpayer applied the gross receipts method or section 482 method to Product A instead of the full costing method, except that the section 482 method applies only on a transaction-by-transaction basis. See footnote 1, above.

⁶ The OPP Product Line is the same as Product Line C which consists of Products A and B.

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marginal costing rules permit Taxpayer to apply an OPP grouping to Product B that is broader than Product A. Accordingly, we consider the OPP Product Line to be a valid OPP grouping for Product B because it contains all of the transactions included in Product B and because the expansion of the OPP grouping to include Product A is expressly permitted by the broadness rule.

Once Taxpayer elected to combine Products A and B to form the OPP Product Line grouping for Product B, the all-products requirement of Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(i) compelled Taxpayer to include all sales from Products A and B in the OPP Product Line. The all-products requirement parallels the full inclusion rule of Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(iii) which requires full inclusion of transactions in all groupings. Taken together, the broadness rule, the all-products requirement, and the full inclusion rule suggest that the prohibition against double inclusion does not disqualify otherwise includible valid method groupings from valid OPP groupings. To deny inclusion of Product A within the OPP Product Line would ignore all three of these grouping rules.

We find additional support for our view in the function of the OPPL within the framework of the marginal costing rules. As the Tax Court and Federal Circuit observed in the Brown-Forman and Dow Corning cases, respectively, the OPPL limits the profitability of FSC sales of an item, product, or product line to no more than the taxpayer's worldwide profitability on all sales of an OPP grouping that includes such item, product, or product line. In order to properly achieve this specific limitation, the OPP must reflect all properly includible sales regardless of whether the sales were priced under the full costing method. Exclusion of a Product A sale from the OPP Product Line would improperly distort the calculation of worldwide profitability.⁷

We note that the double inclusion issue is not relevant where FSC transfer prices are determined on a transaction-by-transaction basis, rather than on the basis of groups. That is, if Taxpayer had applied the full costing and marginal costing methods on a transaction-by-transaction basis, the prohibition against double inclusion would have been inapplicable because Taxpayer would have used only one grouping – the OPP grouping.⁸ Thus, our view yields consistent OPP calculations regardless of

⁷ This analysis is not restricted to situations involving only two products. For example, this analysis would apply similarly where a product line includes three products, two of which are priced under the full costing method and one of which is priced under the marginal costing method (or two of which are priced under the marginal costing method and one of which is priced under the full costing method).

⁸ Double inclusion is a logical impossibility where a taxpayer has only one grouping – in this altered fact pattern, it is the OPP grouping.

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whether a taxpayer applies a transfer pricing method on a transaction-by-transaction or group basis.

B. High-Profit “Bootstrapping”

Examination also expresses a concern that the inclusion of full costing method sales in OPP groupings improperly enables higher-profit sales to “bootstrap” lower-profit sales resulting in a higher OPP and, thus, greater FSC benefits. We believe that the relative profitability of sale transactions is not relevant in determining the validity of OPP groupings. Similarly, the fact that one product grouping will generate greater FSC benefits than another product grouping does not factor into the validity of an OPP grouping. The marginal costing regulations expressly state that taxpayers may use any OPP grouping that conforms to the rules of Temp. Treas. Reg. § 1.925(a)-1T(c)(8) and includes the marginal costing method item or grouping. The OPP grouping must, however, comply with, among other requirements, the broadness rule.

The marginal costing rules do not restrict inclusion of products in OPP groupings on the basis of profitability. On the contrary, the OPP formula reflects the worldwide profitability of the OPP grouping by averaging sales of varying profitability.⁹

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

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⁹ The well-established principle that tax deduction provisions must be construed narrowly is inapplicable in this case because we believe the plain language of the marginal costing rules leaves no room for interpretation. See, e.g., Napp Systems, Inc. v. Commissioner, T.C. Memo 1993-196 (1993) (in a case involving the predecessor domestic international sales corporation regulations, construing the grouping regulations narrowly “since the regulation results in a tax deduction. . .”).