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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (FINANCIAL SERVICES:
BOSTON)
CC:LM:F:BOS

FROM: Assistant to the Branch Chief
CC:INTL:BR3

SUBJECT: Allocation and apportionment of bid and proposal costs on
lost, abandoned, or cancelled contracts

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

LEGEND

Taxpayer =
taxable years at
issue =
Product A =

ISSUE

Are Taxpayer's bid and proposal costs for lost, abandoned, or cancelled contracts allocated and apportioned to Taxpayer's gross income arising from awarded contracts for purposes of determining the combined taxable income of Taxpayer and its commission foreign sales corporation (FSC) under section 925¹ of the Internal Revenue Code?

¹All references to the Code and to Treasury regulations are to the Code and Treasury regulations as in effect during the years at issue.

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CONCLUSION

Taxpayer's bid and proposal costs for its lost, abandoned, or cancelled contracts should be allocated and apportioned to gross income arising from awarded contracts for purposes of determining the combined taxable income of Taxpayer and its commission FSC attributable to awarded contracts.

FACTS

During the taxable years at issue, Taxpayer manufactured and sold product A. Some of the sales of product A resulted in foreign trading gross receipts as defined under section 924(a)(1) of the Code.

In trying to win contracts to develop, manufacture, and sell product A, Taxpayer incurred costs to prepare its bids and proposals ("B&P costs") for its long-term contracts. Included in the B&P costs were labor overhead costs, in-house engineering, supplies, travel, and legal and professional fees. Several years could elapse from the time Taxpayer began work on a bid for a contract until the contract was awarded to a successful bidder.

Taxpayer capitalized its B&P costs for contract proposals on which the bid remained pending. Taxpayer reports the income from an awarded long-term contract on the percentage-of-completion ("PCM") method of accounting. Taxpayer deducted the amount of B&P costs incurred with respect to each long-term contract awarded to it, including each such contract that produced foreign trading gross receipts, in the taxable year of award as contract costs for each such contract. Taxpayer expensed B&P costs for the long-term contracts not awarded to it either because the contract was awarded to another bidder, Taxpayer abandoned its proposal before award, or the contract solicitation was cancelled ("lost, abandoned, or cancelled contracts") in the year of award, abandonment, or cancellation. Taxpayer did not classify any of the B&P costs as research and experimental expenses under Treas. Reg. §§1.861-8(e)(3) and 1.861-17.²

For book purposes, Taxpayer expensed its B&P costs as part of its general and administrative expenses in the year the costs were incurred. On its tax return for each taxable year at issue, Taxpayer made a Schedule M adjustment for B&P costs. The net adjustment reflected a positive amount for accrued B&P costs on pending contracts and a negative amount for B&P costs on contracts awarded, proposals abandoned, or solicitations cancelled during the year.

²This advice assumes that this classification of the B&P costs is correct.

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We understand that Taxpayer was also awarded short-term contracts for the sale of Product A and that some portion of those contracts were for the sale of spare parts. We understand that some portion of the short-term contracts also produced foreign trading gross receipts.

With respect to its sales that Taxpayer asserts resulted in foreign trading gross receipts,³ Taxpayer used the combined taxable income administrative pricing method of section 925(a)(2) of the Code to determine the amount of commission payable to its FSC subsidiary. Taxpayer allocated and apportioned B&P costs on the awarded contracts to FSC sales on a transaction-by-transaction basis; each contract for the sale of product A was treated by Taxpayer as a transaction.⁴

Taxpayer did not allocate any of the B&P costs incurred for lost, abandoned, or cancelled long-term contracts to awarded contracts. It did not allocate or apportion any of those B&P costs to FSC sales.

LAW AND ANALYSIS

Under the combined taxable income administrative pricing method described in section 925(a)(2) of the Code, the taxable income that a commission FSC, such as Taxpayer's FSC subsidiary, may earn with respect to a sale of export property that results in foreign trading gross receipts may not exceed 23 percent of the full costing combined taxable income of the related supplier and the FSC attributable to the foreign trading gross receipts. Section 925(b)(1); Temp. Treas. Reg. §1.925(a)-1T(c)(3) and (d)(2). The determination of full costing combined taxable income under Temp. Treas. Reg. §1.925(a)-1T is made on a transaction-by-transaction basis unless the FSC's related supplier elects to group the transactions on a product or product-line basis. Temp. Treas. Reg. §1.925(a)-1(c)(8)(i). Here, Taxpayer is the related supplier of its FSC subsidiary. Taxpayer made these determinations on a transaction-by-transaction basis and treated each contract for the sale of product A as a separate transaction.

In general, full costing combined taxable income of a related supplier and its FSC subsidiary on a transaction is the excess of the foreign trading gross receipts from

³We have not been asked and have not considered whether Taxpayer correctly determined that a given sale resulted in foreign trading gross receipts.

⁴We understand that, in certain cases, Taxpayer makes multiple sales pursuant to a single contract. We have not been asked and we express no opinion on whether Taxpayer's treatment of each contract as a "transaction" is appropriate. In addition, we express no opinion on whether multiple sales pursuant to a single contract would constitute a permissible "group" under Treas. Reg. §1.925(a)-1(c)(8)(i).

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the transaction over the total costs of the related supplier and the FSC, including cost of goods sold, which relate to those foreign trading gross receipts. Temp. Treas. Reg. §1.925(a)-1T(c)(6)(i); see also Temp. Treas. Reg. §1.925(a)-1T(d)(2)(iii).

Temp. Treas. Reg. §1.925(a)-1T(c)(6)(iii)(D) provides that costs (other than cost of goods sold) which are treated as relating to gross receipts from sales of export property are the expenses, losses, and deductions definitely related, and therefore allocated and apportioned thereto, and a ratable part of any other expenses, losses, or deductions which are not definitely related to any class of gross income, determined in a manner consistent with the rules set forth in Treas. Reg. §1.861-8. See also Treas. Reg. §1.861-8(f)(1)(iii).

The issue here is whether, under the rules of Treas. Reg. §1.861-8, Taxpayer's B&P costs for the lost, abandoned, or cancelled long-term contracts should be allocated and apportioned to Taxpayer's gross income arising from awarded contracts for purposes of determining full costing combined taxable income.

Treas. Reg. §1.861-8(a)(2) provides that a taxpayer is required to allocate expenses, losses and other deductions to a class of gross income and, then, if necessary to make the determination required by the operative section of the Code, to apportion deductions within the class of gross income between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income. Allocations and apportionments are made on the basis of the factual relationship of deductions to gross income. Except for deductions, if any, which are not definitely related to gross income and which, therefore, are ratably apportioned to all gross income, all deductions of the taxpayer must be so allocated and apportioned.

Allocation is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to such class of gross income (without regard to the taxable year in which such gross income is received or accrued or is expected to be received or accrued). Treas. Reg. § 1.861-8(b)(1). Treas. Reg. §1.861-8(b)(2) provides that a deduction is definitely related to a class of gross income and therefore allocable to that class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. Where a deduction is incurred as a result of, or incident to, an activity or in connection with property, which activity or property generates, has generated, or could reasonably have been expected to generate gross income, such deduction shall be considered definitely related to such gross income as a class whether or not there is any item of gross income in such class which is received or accrued during the taxable year and whether or not the amount of deductions exceeds the amount of the gross income in such class. Id.

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Classes of gross income are not predetermined but must be determined on the basis of the deductions to be allocated. “Class of gross income” may consist of one or more items (or subdivisions of these items) of gross income enumerated in section 61 of the Code. Treas. Reg. §1.861-8(a)(3). Most deductions will be definitely related to some class of a taxpayer’s total gross income. However, some deductions are related to all gross income. In addition, if a deduction is not definitely related to any gross income, it must be apportioned ratably as provided in Treas. Reg. §1.861-8(c)(3) and (e)(9).

In this case, Taxpayer’s B&P costs for an awarded long-term contract are included in contract costs since those costs are allocated pursuant to section 460(c)(4)(B) of the Code to Taxpayer’s PCM contracts. Under the allocation rules discussed above, the class of gross income for those costs is the gross income from that individual awarded contract since they are definitely related to that contract. Unlike Taxpayer’s B&P costs for successful contracts, Taxpayer’s B&P costs for the lost, abandoned, or cancelled contracts are not included in contract costs since those costs are not allocated pursuant to section 460(c)(4)(B) of the Code to Taxpayer’s PCM contracts. Accordingly, Taxpayer’s B&P costs for the lost, abandoned, or cancelled contracts are not definitely related to the gross income from any particular contract and should therefore be allocated to the gross-income- from-sales class of gross income.⁵ Gross income from sales is a subdivision of the item “gross income from business” enumerated in section 61(a)(2) of the Code. Those B&P costs were definitely related to the gross income from sales class of income since Taxpayer incurred those costs with the expectation that they would result in awarded contracts. Those costs were incurred incident to an activity from which gross income from sales would reasonably have been expected to result had the bids and proposals been successful. See Treas. Reg. §1.861-8(b)(2).

Taxpayer’s position that B&P costs for lost, cancelled, or abandoned contracts should be allocated to those contracts would require that the class of gross income for those expenses be considered the gross income from individual contracts similar to the gross income from awarded contracts that is relevant for purposes of allocating B&P costs for awarded contracts. Treas. Reg. §1.861-8(b)(2) provides that a class of gross income may exist even though there is no gross income in the class. Here, each lost, cancelled, or abandoned contract could be viewed as giving rise to such a class of gross income. In our view, the better position is that the class of gross income to which the B&P costs are allocable is gross income from sales. First, although Treas. Reg. §1.861-8(b)(2) contemplates that a class may

⁵We note that a portion of Taxpayer’s awarded contracts were for the sale of spare parts. Although we believe that gross income from such contracts would fall within the class of gross income consisting of gross income from sales, we do not have sufficient facts to make this determination.

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have no gross income, it would be inconsistent with Treas. Reg. §1.861-8 to have a class of gross income that can never give rise to gross income like the class Taxpayer proposes in this case. Second, Taxpayer's position has the effect of allocating all B&P costs on lost, cancelled or abandoned contracts solely to its nonFSC income and, thus, of treating such B&P costs as definitely related to its nonFSC income. This result is unreasonable since it disregards the definite relationship described above that such B&P costs have to gross income from Taxpayer's sales, including its FSC sales.

In addition to Treas. Reg. §1.861-8(b)(2), Taxpayer also relies on the FSC regulations and on *St. Jude Medical, Inc. v. Commissioner*, 34 F.3d 1394 (8th Cir. 1994), *rev'g*, 97 T.C. 457 (1991), *nonacq.*, 1995-1 C.B. 1, to support its argument that B&P costs for lost, cancelled, or abandoned contracts should be allocated to those contracts. Taxpayer's reliance on the FSC regulations is misplaced since those regulations provide that the principles of Treas. Reg. §1.861-8 govern the allocation and apportionment of expenses in computing full costing combined taxable income. Temp. Treas. Reg. §1.925(a)-1T(c)(6)(iii)(D). Taxpayer's reliance on *St. Jude* is also misplaced. That case involved the validity of Treas. Reg. § 1.861-8(e)(3) in allocating R&D expenses for purposes of computing combined taxable income under the domestic international sales corporation (DISC) regime. This case involves B&P costs, not research and experimental expenses, and Treas. Reg. §1.861-8(e)(3), which governed the allocation and apportionment of research and experimental expenses, is not at issue here.⁶

Once the B&P costs for the lost, abandoned, or cancelled long-term contracts have been allocated to the gross income from sales class of gross income those expenses must be apportioned by attributing the deduction to gross income within that class which is in the statutory grouping (or groupings) and to gross income within the class which is in the residual grouping. In apportioning deductions, it may be that for the taxable year there is no gross income in the statutory grouping or that deductions will exceed the amount of gross income in the statutory grouping. Treas. Reg. §§1.861-8(a)(2) and 1.861-8T(c)(1). Under Treas. Reg. §1.861-8(a)(4), the term "statutory group" means the gross income from a specific source or activity which must first be determined in order to arrive at "taxable income" from a specific source or activity under an operative section. Section 925 of the Code is an operative section since, in order to determine the taxable income of Taxpayer's

⁶Moreover, to the extent that the Eighth Circuit's opinion could be read to support Taxpayer's argument, we note that the Internal Revenue Service nonacquiesced in that case and that the Ninth Circuit upheld the application of Treas. Reg. §1.861-8(e)(3) for purposes of computing combined taxable income for DISC and FSC purposes. *The Boeing Company v. U.S.*, 258 F.3d 958 (9th Cir. 2002), *cert. granted*, 122 S. Ct. 2288-89 (2002).

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FSC subsidiary, full costing combined taxable income must be determined. Treas. Reg. §1.861-8(f)(1)(iii). Here, the section 925 statutory group is subdivided into statutory groups for each transaction based upon awarded contracts.⁷

The attribution of the deduction for the B&P costs for the lost, abandoned, or cancelled contracts to the section 925 statutory groups based on transactions must be accomplished in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the statutory groups. Treas. Reg. §1.861-8T(c)(1). Here, Taxpayer's B&P costs for each lost, abandoned, or cancelled long-term contract are definitely related to the gross income from sales class of income and are not definitely related to the gross income from any particular contract. Therefore, the B&P costs should be apportioned on a pro rata basis among each of the statutory groups and the residual group within the class.

Please call (202) 622-3850 if you have any further questions.

ASSISTANT TO THE BRANCH CHIEF

⁷A lost, abandoned or cancelled contract is not a statutory grouping since no transaction has occurred and there will never be gross income with respect to which the taxpayer must determine full costing combined taxable income.