

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Team Coordinator, LM:NRC:1452

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

Corp A =

Corp B =

Corp A-FSC =

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 product lines that are determined by a selective grouping of "inferior classifications" using the SIC code standard under Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii).

TAM-131365-02

CONCLUSION:

The taxpayer may not group transactions for purposes of FSC administrative pricing determinations on the basis of product lines that are determined by a selective combination of “inferior classifications,” using the SIC code standard under Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii), where such combination is not itself a SIC code classification.

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 the _____ industry 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).

TAM-131365-02

On examination, Taxpayer proposes to redetermine its FSC commissions by grouping its export transactions by product or product line (as determined using the Standard Industrial Classification (SIC) codes) for both full costing and marginal costing purposes.¹ At issue is the methodology used for such grouping.

The SIC code structure, as established and published by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President, is a four-tiered hierarchy for classifying establishments by type of business activity. The classification is by:

- (1) Division - i.e., "Manufacturing"
- (2) Major Group - 2 digit
- (3) Industry Group - 3 digit
- (4) Industry Code - 4 digit

The products in an Industry roll up into a specific Industry Group, which in turn roll up into a Major Group. The most recent manual of SIC codes was published in 1987.

An example of the SIC code system would be as follows:

<u>SIC Classification</u>	<u>SIC Code #</u>	<u>Description</u>
Division		
Major Group		
Industry Group		
Industry Code		

There are Industry Groups within the Major Group , each containing from one to five Industry Code classifications. Each Industry Code classification has numerous specific products in it.

The Taxpayer's export products fall within several two-digit classifications, the largest being SIC code . Within this SIC code there are approximately four-digit groups of products, which fall within several specific three-digit classifications. The Taxpayer has selectively combined certain four-

¹ We assume for these purposes that the Taxpayer's proposed redetermination is timely under the rules set forth in Treas. Reg. § 1.925(a)-1(c)(8)(i).

TAM-131365-02

digit groups in computing combined taxable income for full costing and marginal costing purposes.

The Taxpayer illustrates its grouping methodology through the following hypothetical example:

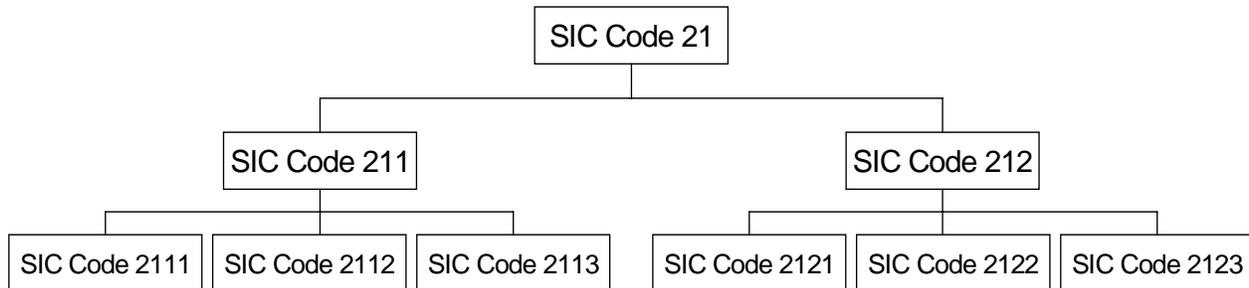


DIAGRAM 1

In the first scenario,

Groups 2112 and 2113 are combined

Group 2111 is treated separately

Groups 2121, 2122, 2123 are treated separately or combined as Group 212

In the second scenario

Groups 2111 and 2123 are combined

Groups 2112, 2113, 2121, 2122 are treated separately

Taxpayer claims these groupings satisfy the FSC rules for full and marginal costing purposes.

LAW:

For Tax Years 1, 2 and 3, a foreign corporation that properly elects FSC treatment pursuant to section 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

TAM-131365-02

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.*

* * *

(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) ("Example 11") illustrates, inter alia, the rule stated in Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) that a product may

TAM-131365-02

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

TAM-131365-02

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.

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 determining product lines for grouping purposes under the SIC code standard by selectively combining inferior classifications that come within the same two-digit classification, but which combinations are not themselves SIC code classifications, e.g., combining two four-digit groups that do not come within the same three-digit group or combining some but not all of the four-digit groups that come within the same three-digit group.

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 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.

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) (ii). Second, the grouping must include all transactions that fall within 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).

TAM-131365-02

In applying the product-line requirement, the recognized trade or industry usage standard is the more subjective rule and in general gives the taxpayer more flexibility in grouping its products. The SIC code standard, on the other hand, is more objective since the SIC code lists specific classifications by industry and product or product line. The SIC code standard was added to the regulations to provide taxpayers with a greater level of certainty to their grouping determinations than was available under the recognized trade or industry standard. T.D. 7364, 1975-2 C.B. 315. There is no indication that the adoption of the SIC code standard included a radical departure from the grouping options available under the recognized trade or industry standard.

The full-inclusion requirement applies to grouping under both the SIC code and recognized trade or industry usage. Taxpayer's interpretation of the SIC grouping rules would eviscerate the full-inclusion requirement by permitting taxpayers to selectively group products at broader levels in a manner clearly at odds with the principle of full inclusion. For example, referring to Diagram 1, Taxpayer maintains that Groups 2112 and 2113 may be combined as one product line and Group 2111 treated separately. All three groups fall under Group 211. Under the full-inclusion requirement, the three groups must either all be combined under Group 211 or each treated separately, but a combination of two of the three groups excluding the third would not be permitted.

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) of the SIC. Taxpayer maintains that the use of the parenthetical phrase "or combinations thereof" allows for the selective combination of any inferior classifications within a two-digit group to create product lines that are not themselves SIC code classifications. Taxpayer argues that this type of combination is the only sort of combination that gives rise to the necessity of using the word "combination" in the regulations. Otherwise, Taxpayer maintains, the regulations could have simply read "two-digit major groups (or any inferior classifications within a major group)."

Though we recognize Taxpayer's interpretation as one possible literal reading of the language, this interpretation ignores the context in which the rule was written and conflicts with the overarching policies of the regulations. A better literal construction of the language, one that is more logical within the broader context of the regulations and one that reaches the proper policy results, is to read the addition of the phrase "or combinations thereof" as a clarification that a taxpayer may use three-digit groups, four-digit groups or a combination of both. Without the phrase "or combinations thereof", one might have read the language above to mean that instead of two-digit major groups, a taxpayer may use either three-digit groups or four-digit groups, but not both at the same time.

TAM-131365-02

Taxpayer's interpretation would result in an inconsistent application of the full-inclusion requirement as between the recognized trade or industry usage standard and the SIC code standard. In the example described above, Taxpayer would argue that Group 2112 and Group 2113 could be combined to create Product Line 2112/2113 and that the full-inclusion requirement would apply to this newly created Product Line, not to Group 211, and therefore Group 2111 need not be included. If we assumed Diagram 1 was organized by recognized trade or industry usage rather than SIC codes, it would be clear that Groups 2112 and 2113 are separate product groups that could only be combined by looking to a higher-tier group, such as Group 211, in which case, pursuant to the full-inclusion rule, Group 2111 would also have to be included, not treated separately.

We believe the appropriate 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. For example, products in the four-digit groups 2111, 2112 and 2113 could be grouped together at the level of the three-digit group 211. At the same time, products in the four-digit Groups 2121, 2122 and 2123 could be grouped separately at the four-digit level. In this way, Taxpayer would make use of two different levels, *i.e.*, three-digit and four-digit groups, a "combination" of inferior classifications.

Since it is clear that the full-inclusion rule applies to both the SIC and recognized trade or industry usage methods of grouping, reading the parenthetical language in a manner which would consistently satisfy the full-inclusion limitation is the proper reading of the parenthetical language.

Finally, we note that Example 11 does not support Taxpayer's groupings. 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. If this principle applied to Taxpayer's groupings, one could argue, for example, that the full-inclusion requirement, while ordinarily requiring Group 211 to comprise all of Groups 2111, 2112 and 2113, is considered satisfied if Taxpayer chooses to treat Group 2113 as a separate grouping, because to include Group 2113 in both its own grouping and in Group 211 would violate the double-inclusion prohibition. However, Example 11 on its face addresses only cases in which a product falls within more than one of a taxpayer's product lines that otherwise are separate and distinct. Example 11 does not address the treatment of a subset of an operative product-line grouping as a separate product line. Given the rigid structure of the SIC codes, it is unlikely that product lines determined under a SIC standard would ever overlap in the way described by Example 11. Thus Taxpayer's violation of the full-inclusion requirement, as discussed above, may not be cured by compliance with the double-inclusion prohibition under the coordinating principle of

TAM-131365-02

Example 11.

Accordingly, we conclude that Taxpayer may not group transactions according to product lines determined by a selective combination of inferior SIC code classifications where such combination is not itself a SIC code classification.

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.