

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Director of Field Operations East
LMSB:CTM

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
Taxpayer-FSC =

Subsidiary 1 =
Subsidiary 2 =
Subsidiary 3 =
Subsidiary 4 =
Subsidiary 5 =
Subsidiary 6 =
Subsidiary 7 =
Subsidiary 8 =

Product Line =
Products =

Tax Year 0 =
Tax Year 1 =
Tax Year 2 =

TAM-123196-03

Year 1 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Percentage A =

Amount A =

Amount B =

Amount C =

Amount D =

Amount E =

Amount F =

Amount G =

Amount H =

Amount I =

Amount J =

Amount K =

Amount L =

Amount M =

Amount N =

Amount O =

Amount P =

Amount Q =

Amount R =

Amount S =

Amount T =

Amount U =

Amount V =

Amount W =

Amount X =

Amount Y =

Amount Z =

Amount AA =

Amount BB =

Amount CC =

Amount DD =

Amount EE =

TAM-123196-03

Amount FF =
 Amount GG =
 Amount HH =
 Amount II =

ISSUES:

1. Whether taxpayer's method of accounting for the Advance Payment Transactions results in a material distortion of income under I.R.C. § 925(a) and Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(B).
2. Whether the reimbursement payment claimed by taxpayer is a correct application of the "no loss" rule under Temp. Treas. Reg. § 1.925(a)-1T(e)(1)(i).

CONCLUSION(S):

1. Taxpayer's method of accounting for the Advance Payment Transactions results in a material distortion of income under I.R.C. § 925(a) and Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(B).
2. The reimbursement payment claimed by Taxpayer is not a correct application of the "no loss" rule under Temp. Treas. Reg. § 1.925(a)-1T(e)(1)(i).

FACTS:

Taxpayer is a publicly traded company incorporated in the state of Delaware. It is the parent for a consolidated group (the Taxpayer Group); Taxpayer and its consolidated group have a taxable year ending on December 31st. The Taxpayer Group is a global leader in production and distribution of Product Line. Taxpayer's Products are used by a wide range of customers.

Taxpayer directly owns 100 percent of Taxpayer-FSC, a foreign sales corporation (FSC) which is a company incorporated in Year 1 under the laws of Barbados. Taxpayer-FSC is a foreign sales corporation under I.R.C. §§ 922 and 925 and their pertinent regulations. Taxpayer-FSC is the Taxpayer Group's agent and/or distributor for foreign sales of its products, including sales to Taxpayer's foreign subsidiaries listed in the next paragraph and other of Taxpayer's foreign subsidiaries. Taxpayer-FSC may serve as either commission agent or seller on the Taxpayer Group's sales to its foreign subsidiaries. Taxpayer-FSC operates as the distributor on the Taxpayer Group's buy-sell transaction to the foreign subsidiaries listed in the next paragraph under the advance payment transaction that is the subject of this Technical Advice Memorandum (the Advance Payment Transaction).

TAM-123196-03

In addition, Taxpayer directly owns 100 percent of each of the following entities: (1) Subsidiary 1, a corporation organized under the laws of Australia; (2) Subsidiary 2, a corporation organized under the laws of France; (3) Subsidiary 3, a corporation organized under the laws of Germany; (4) Subsidiary 4, a corporation organized under the laws of Japan; (5) Subsidiary 5, a corporation organized under the laws of the United Kingdom; (6) Subsidiary 6, a corporation organized under the laws of Canada; and (7) Subsidiary 7, a corporation organized under the laws of the Netherlands. This group of wholly owned subsidiaries will be collectively referred to as the "FSubs." Taxpayer sells its products worldwide through the FSubs and other foreign subsidiaries. Taxpayer acquired Subsidiary 8 in Tax Year 1.

The Advance Payment Transaction, Tax Year 1

The eight contracts detailed below were entered into as part of the Advance Payment Transaction.

1. On Date 1, Taxpayer-FSC entered into a contract with each of the FSubs (collectively, the FSubs advance payment contracts), a total of seven contracts, to sell an unspecified amount of specified products to the FSubs for a fixed price per unit.

a. Under these contracts, Taxpayer-FSC agreed to defer delivery of the quantities of products specified by the FSubs until Tax Year 2.

b. The advance payments specified in the FSubs advance payment contracts were payable on or before Date 2.

c. The purchase prices due under the FSubs advance payment contracts were based upon Taxpayer-FSC's expected standard transfer prices for sales to the FSubs for the period beginning Date 3, less a Percentage A discount to compensate the FSubs for the period between the payment date (no later than Date 2) and the expected Tax Year 2 delivery dates.

d. The unit purchase prices under the FSubs advance payment contracts as of Date 3 were determined by Taxpayer-FSC using the same transfer pricing methodology that Taxpayer and FSubs used in past taxable years to determine unit prices for sales of product by Taxpayer through Taxpayer-FSC to the FSubs.

2. On the same day, Date 1, Taxpayer and Taxpayer-FSC entered into an advance payment contract (the Taxpayer advance payment contract) under which Taxpayer agreed to sell an unspecified quantity of specified products to Taxpayer-FSC for a fixed price per unit.

TAM-123196-03

a. Taxpayer-FSC agreed to delay delivery of product it paid for in the Tax Year 1 until Tax Year 2 or later.

b. The product purchase price due under this contract was payable on or before Date 2.

c. According to Taxpayer, the total advance purchase price under the Taxpayer advance payment contract was based on Taxpayer's cost to manufacture the product for resale through Taxpayer-FSC to the FSUBs. That is, the advance purchase price was based on Taxpayer's expected standard transfer price to the FSUBs from Taxpayer-FSC for the period beginning Date 3 less a discount as stated in the FSUBs advance payment contracts (Amount A \times 77% = Amount B).¹

3. Taxpayer's treatment of the Advance Payment Transaction on its Form 1120 for Tax Year 1 and for book purposes was as follows:

a. Taxpayer reported the entire amount of the advance payment received from Taxpayer-FSC, Amount B, as gross income on its Form 1120 for Tax Year 1.

b. Taxpayer did not record Amount B as income for book purposes. Accordingly, a Schedule M-1 item was required and added to line 7 of Schedule M-1 on the Form 1120.

c. The Schedule M amount on Taxpayer's Form 1120 was shown net of the deferred revenue reported as income on its return for Tax Year 0.

Beginning Balance: Deferred Revenues Reported in Tax Year 0	(Amount C)
Ending Balance: Advance Payment Income for Tax Year 1	Amount D
Net Schedule M for Tax Year 1 (Change in Balance)	<u>(Amount E)</u>

4. Taxpayer-FSC's treatment of the Advance Payment Transaction on its form 1120FSC for Tax Year 1 was as follows:

a. Taxpayer-FSC reported the full amount of the advance payments from the FSUBs as taxable income.

¹ This computation is based on Taxpayer-FSC retaining 23% of the combined taxable income of Taxpayer and Taxpayer-FSC.

TAM-123196-03

b. Taxpayer-FSC paid tax on Amount F (foreign trading gross receipts of Amount A, less Amount G, expenses allocable to foreign trading gross receipts) rather than on its profit of Amount H.

5. Neither Taxpayer nor Taxpayer-FSC were subject to any restrictions on the use of the advance payments that they received respectively prior to or on Date 2.

The Advance Payment Transaction, Tax Year 2

1. Taxpayer produced and delivered the specified products subject to the FSubs advance payment contracts and the Taxpayer advance payment contract.

2. Taxpayer-FSC sold the products pursuant to the FSubs advance payment contracts.

3. Title to all goods shipped by Taxpayer to Taxpayer-FSC under this contract passed to Taxpayer-FSC in the United States.

4. Taxpayer deducted the costs of producing the products delivered under the Taxpayer advance payment contract on its tax return for Tax Year 2.

5. Taxpayer also deducted on the return for Tax Year 2 an amount as reimbursement to Taxpayer-FSC for Taxpayer-FSC's loss on the Advance Payment Transaction.

6. Taxpayer-FSC deducted its cost to purchase the products delivered under the FSubs advance payment contracts in Tax Year 2.

7. Taxpayer-FSC reported as gross income the amount of reimbursement received from Taxpayer in Tax Year 2.

Taxpayer has not established a tax accounting method to defer recognizing the income from the advance payments. Further, the FSubs and Taxpayer-FSC have not elected under Treas. Reg. § 1.461-4(d)(6)(ii) to treat services or property reasonably expected to be provided within 3.5 months after the date of payment as having been provided when payment has been made.

Taxpayer's Purpose for Entering into the Advance Payment Transaction

According to Taxpayer, and as stated in the individual FSubs advance payment contracts and/or the Taxpayer advance payment contract, the Advance Payment Transaction was entered into to secure supply and fix the cost for the products under

TAM-123196-03

the contracts, as well as to hedge against currency fluctuations and mitigate commercial risks of doing business in the markets of Taxpayer and the FSubs. In addition, the Advance Payment Transaction was entered into to assist Taxpayer in its cash management and financing its restructuring after the acquisition of Subsidiary 8.

Summary of the Tax Consequences of the Advance Payment Transaction

1. Taxpayer's treatment of the Advance Payment Transaction, including all deductions, was as follows:

Sales revenues	Amount A
Cost of sales	(Amount I)
Allocated expenses	<u>(Amount G)</u>
Combined taxable income	<u>Amount J</u>

Tax Year 1

	<u>Taxpayer</u>	<u>Taxpayer-FSC</u>
Sales revenues	Amount B	Amount A
Cost of sales	Amount L	Amount L
Allocated expenses	Amount G	(Amount G)
Reimbursement	<u>N/A</u>	<u>N/A</u>
Subtotal	Amount K	Amount F
FSC exemption	N/A	(Amount M)
Taxable income	<u>Amount K</u>	<u>Amount N</u>
Tax rate	<u>35%</u>	<u>35%</u>
Tax payable/benefit	<u>Amount O</u>	<u>Amount P</u>

Tax Year 2

	<u>Taxpayer</u>	<u>Taxpayer-FSC</u>
Sales revenues	Amount L	Amount L
Cost of sales	(Amount I)	(Amount B)
Allocated expenses	Amount L	Amount L
Reimbursement	<u>(Amount B)</u>	<u>Amount B</u>
Subtotal	(Amount Q)	Amount L

TAM-123196-03

FSC exemption	<u>N/A</u>	<u>Amount L</u>
Taxable income	(Amount Q)	Amount L
Tax rate	<u>35%</u>	<u>35%</u>
Tax payable/benefit	<u>(Amount R)</u>	<u>Amount L</u>

2. Ignoring the Advance Payment Transaction (no advance payment, all income and deductions within taxable Tax Year 2), tax due would be calculated as follows:

Gross receipts	Amount A
Cost of sales	(Amount I)
Allocated expenses	<u>(Amount G)</u>
Combined taxable income	<u>Amount J</u>
FSC foreign trade income (23% of CTI Method)	<u>Amount S</u>
FSC foreign trading gross receipts	Amount A
Foreign trade income	(Amount S)
Expenses	<u>(Amount G)</u>
Transfer price	<u>Amount T</u>
<u>Taxpayer-FSC</u>	
Foreign trading gross receipts	Amount A
Cost of sales	(Amount T)
Expenses	<u>(Amount G)</u>
Subtotal	Amount S
FSC exemption	<u>Amount U</u>
Taxable income	Amount V
Tax rate	<u>35%</u>
Tax payable	<u>Amount W</u>
<u>Taxpayer</u>	
Sales to FSC	Amount T
Cost of sales	(Amount I)
FSC expenses	<u>Amount G</u>
Taxable income	Amount X

TAM-123196-03

Tax rate	<u>35%</u>
Tax payable	<u>Amount Y</u>
Total Tax Payable	<u>Amount Z</u>

3. Net Tax Benefit

<u>Taxpayer's position</u>	
Taxpayer tax paid Tax Year 1	Amount O
Taxpayer-FSC tax paid Tax Year 1	Amount P
Taxpayer tax refund Tax Year 2	<u>(Amount R)</u>
Net refund	<u>Amount AA</u>

<u>Ignoring Advance Payment Transaction</u>	
Taxpayer tax payable	Amount Y
Taxpayer-FSC tax payable	<u>Amount W</u>
Total tax payable	<u>Amount Z</u>

<u>Net Benefit of Advance Payment Transaction</u>	
Net refund with transaction	Amount AA
Tax payable without transaction	<u>Amount Z</u>
Net benefit	<u>Amount BB</u>

4. Additional Observations

Taxpayer agrees with the Service regarding the above calculation of the tax due, in the event that the Advance Payment Transaction is ignored. Taxpayer does not agree that the Advance Payment Transaction should be ignored.

LAW:

FSC Provisions²

Where a foreign corporation qualifies as a FSC, its "exempt foreign trade income" is treated as foreign source income that is not effectively connected with the conduct of a trade or business within the United States and thus is not subject to U.S.

² The FSC Repeal and Extraterritorial Income Exclusion Act of 2000 repealed the FSC provisions (I.R.C. §§ 921 through 927) and replaced them with the extraterritorial income exclusion provisions (I.R.C. §§ 114 and 941 through 943) for transactions entered into after September 30, 2000. Pub. L. No. 106-519, 114 Stat. 2423 (Nov. 15, 2000).

TAM-123196-03

income tax. I.R.C. § 921(a). Nor is this category of income subject to U.S. tax when repatriated as dividends from the FSC. I.R.C. § 245(c). A FSC's "foreign trade income" is its gross income attributable to foreign trading gross receipts (FTGR) and includes gross income from the sale, exchange, or other disposition of export property, and from the lease or rental of export property for use by the lessee outside the United States, less the transfer price determined under the transfer pricing methods of I.R.C. § 925(a). I.R.C. §§ 923(b), 924(a)(1); Temp Treas. Reg. § 1.923-1T(a). "Exempt" foreign trade income (as defined in I.R.C. § 923(a)(1)) is a specific portion of overall foreign trade income, determined with reference to: (1) the pricing method used to compute the FSC's income from the export transaction or group of export transactions and (2) ownership of FSC stock. I.R.C. §§ 291(a)(4), 923(a)(1), 923(a)(6); Temp Treas. Reg. § 1.923-1T(b).

For purposes of the FSC provisions, the term "related supplier" means a related party that directly supplies to a FSC any property or services which the FSC disposes of in a transaction producing foreign trading gross receipts, or a related party that uses the FSC as a commission agent in the disposition of any property or services producing foreign trading gross receipts. Temp. Treas. Reg. § 1.927(d)-2T(a).

Where a FSC determines its income using the administrative pricing rules under I.R.C. § 925(a)(1) or (2), either 15/23 or 16/23 of its foreign trade income may be treated as exempt. I.R.C. § 291(a)(4), 923(a)(1) and (3), 923(a)(6); Temp. Treas. Reg. § 1.923-1T(b)(1)(i).³

The transfer pricing rules under Temp. Treas. Reg. § 1.925(a)-1T(c) provide, in pertinent part:

(c) Transfer price for sales of export property –

(1) In general. Under this paragraph, rules are prescribed for computing the allowable price for a transfer from a related supplier to a FSC in the case of a sale, described in paragraph (b)(2)(iii)(A) of this section, of export property.

(2) The "1.83 percent" gross receipts method – Under the gross receipts method of pricing, described in section 925(a)(1), the transfer

³ A similar rule applies where a FSC does not use the administrative pricing rules. See Temp. Treas. Reg. § 1.923-1T(b)(1)(ii) (where a FSC does not use the administrative pricing rules, 30% of its foreign trade income will be exempt foreign trade income; if such a FSC has a non-corporate shareholder (shareholders), 32% of its foreign trade income attributable to the non-corporate shareholder's (shareholders') proportionate interest in the FSC will be exempt foreign trade income).

TAM-123196-03

price for a sale by the related supplier to the FSC is the price as a result of which the profit derived by the FSC from the sale will not exceed 1.83 percent of the foreign trading gross receipts of the FSC derived from the sale of the export property. Pursuant to section 925(d), the amount of profit derived by the FSC under this method may not exceed twice the amount of profit determined under, at the related supplier's election, either the combined taxable income method of § 1.925(a)-1T(c)(3) or the marginal costing rules of § 1.925(b)-1T. For FSC taxable years beginning after December 31, 1986, if the related supplier elects to determine twice the profit determined under the combined taxable income method using the marginal costing rules, because of the no-loss rule of § 1.925(a)-1T(e)(1)(i), the profit that may be earned by the FSC is limited to 100% of the full costing combined taxable income as determined under § 1.925(a)-1T(c)(3) and (6). Interest or carrying charges with respect to the sale are not foreign trading gross receipts.

(3) The "23 percent" combined taxable income method. Under the combined taxable income method of pricing, described in section 925(a)(2), the transfer price for a sale by the related supplier to the FSC is the price as a result of which the profit derived by the FSC from the sale will not exceed 23 percent of the full costing combined taxable income (as defined in paragraph (c)(6) of this section) of the FSC and the related supplier attributable to the foreign trading gross receipts from such sale.

(4) Section 482 method. If the methods of paragraph (c)(2) and (3) of this section are inapplicable to a sale or if the related supplier does not choose to use them, the transfer price for a sale by the related supplier to the FSC is to be determined on the basis of the sales price actually charged but subject to the rules provided by section 482 and the regulations for that section and by § 1.925(a)-1T(a)(3)(ii).

The so-called administrative pricing rules, which consist of the gross receipts and combined taxable income (CTI) methods described above, are only available if the FSC (or another person acting under contract with the FSC) meets certain foreign economic process requirements. See I.R.C. § 925(a), (c) and Temp. Treas. Reg. § 1.925(a)-1T(b)(2)(ii). The legislative history of the administrative pricing provisions and their predecessor provisions under the Domestic International Sales Corporation (DISC) regime indicate that Congress intended that the administrative pricing rules would in all events be applied in a manner that would "prevent pricing at a loss to the related supplier." Report of the Senate Committee on Finance, Deficit Reduction Act of 1984, S. Prt. No. 98-169, 98th Cong., 2d Sess., Vol. I, 1, 649 (1984). See also H.R. Rep. No. 92-533, 92d Cong., 1st Sess. 1, 58 (1971), 1972-1 C.B. 498, 537 (similar

TAM-123196-03

intent re administrative pricing rules for DISCs); S. Rep. No. 92-437, 92d Cong., 1st Sess. 1, 90 (1971), 1972-1 C.B. 559, 618 (same).

FTGR includes the gross receipts of a FSC derived from the sale, exchange or other disposition of export property. I.R.C. § 924(a). Combined taxable income is the excess of the FTGR of the FSC from the sale over the total costs of the FSC and related supplier, including the related supplier's cost of goods sold and its and the FSC's noninventoriable costs which are related to the foreign trading gross receipts. Temp. Treas. Reg. 1.925(a)-1T(c)(6)(i).

For purposes of determining gross receipts and total costs of the FSC, Treas. Reg. 1.925(a)-1T(c)(6)(iii) provides, in pertinent part:

(iii) Rules for determination of gross receipts and total costs.

* * *

(A) Subject to the provisions of subdivision (iii)(B) through (E) of this paragraph, the methods of accounting used by the FSC and related supplier to compute their taxable incomes will be accepted for purposes of determining the amounts of items of income and expense (including depreciation) and the taxable year for which those items are taken into account.

(B) A FSC may, generally, choose any method of accounting permissible under section 446(c) and the regulations under that section. However, if a FSC is a member of a controlled group (as defined in section 927(d)(4) and § 1.924(a)-1T(h)), the FSC may not choose a method of accounting which, when applied to transactions between the FSC and other members of the controlled group, will result in a material distortion of the income of the FSC or of any other member of the controlled group. Changes in the method of accounting of a FSC are subject to the requirements of section 446(e) and the regulations under that section.

Temp. Treas. Reg. 1.925(a)-1T(e) provides, in pertinent part:

(e) Special rules for applying paragraphs (c) and (d) of this section – (1) Limitation on FSC income (“no loss” rules). (i) If there is a combined loss on a transaction or group of transactions, a FSC may not earn a profit under either the combined taxable income method or the gross receipts method. Also, for FSC

TAM-123196-03

taxable years beginning after December 31, 1986, in applying the gross receipts method, the FSC's profit may not exceed 100% of full costing combined taxable income determined under the full costing method of § 1.925(a)-1T(c)(3) and (6). This rule prevents pricing at a loss to the related supplier. The related supplier may in all situations set a transfer price or rental payment or pay a commission in an amount that will allow the FSC to recover an amount not in excess of its costs, if any, even if to do so would create, or increase, a loss in the related supplier.

Income Tax Accounting Methods Provisions

Section 446(b) of the Code provides that “if the method of accounting used [by the taxpayer] does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.”

Treas. Reg. § 1.451-1(a) provides that, under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. See also Treas. Reg. § 1.446-1(c)(1)(ii)(A). All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is received, whichever happens earliest. See Schlude v. Commissioner, 372 U.S. 128, 133 (1963); Rev. Rul. 84-31, 1984-1 C.B. 127.

Treas. Reg. § 1.451-5(b)(1) provides:

(1) In general. Advance payments must be included in income either –

(i) In the taxable year of receipt; or

(ii) Except as provided in paragraph (c) of this section.

(a) In the taxable year in which properly accruable under the taxpayer's method of accounting for tax purposes if such method results in including advance payments in gross receipts no later than the time such advance payments are included in gross receipts for purposes of all of his reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes, or

(b) If the taxpayer's method of accounting for purposes of such reports results in advance payments (or any portion of such

TAM-123196-03

payments) being included in gross receipts earlier than for tax purposes, in the taxable year in which includible in gross receipts pursuant to his method of accounting for purposes of such reports.

The exception in paragraph (c) does not apply in this case.

Treas. Reg. § 1.461-1(a)(2) provides that under an accrual method of accounting, a liability is incurred and generally taken into account for Federal income tax purposes in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 461(h)(2)(B) of the Code provides that with respect to liabilities that require the taxpayer to provide property or services, economic performance occurs as the taxpayer provides such property or services.

ANALYSIS:

Issue 1 Taxpayer's Method of Accounting for its Advance Payment Transaction Results in a Material Distortion of Income

As a threshold matter, the method of accounting used by a FSC and its related supplier must be valid under general income tax principles. See Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii). A FSC and its related supplier may “generally” use any method of accounting that accords with I.R.C. § 446(c) and the regulations under that section. Taxpayer’s method of accounting for the Advance Payment Transaction qualifies as a valid method under I.R.C. § 446(b). Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(B). See also Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(ii). A method of accounting that otherwise constitutes a valid method of accounting for general Federal income tax purposes may nonetheless, in some cases, be subject to adjustment by the Service pursuant to Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii), if it materially distorts the income of the FSC, or if it fails to clearly reflect the income of the FSC and the related-supplier.

A buy-sell FSC or a commission FSC, which may lack a distinct method of accounting for items of expense or income that are necessary to compute CTI, is in effect bound by the method of accounting used by the related supplier for purposes of computing the transfer price or the FSC commission, respectively. In the present case, the method of accounting applied by Taxpayer (the related supplier) to the Advance Payment Transaction constitutes a “method of accounting of the FSC” within the meaning of Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(B) and that method is therefore subject to the “clear reflection of income” standard of I.R.C. § 446(b), as well as the prohibition against “material distortion” of the income of the FSC and the related

TAM-123196-03

supplier in Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(B). Thus, the related supplier's method of accounting must clearly reflect the income of both the related supplier and the FSC from export transactions. In other words, the related supplier's method of accounting must provide an accurate measure of the profit generated from the FSC's transactions, by reasonably matching the revenue from such transactions against the related costs.

Taxpayer uses a permissible accrual method of accounting. Taxpayer's inclusion in income of the advance payments when they were received in Tax Year 1 follows the general rule under Treas. Reg. §§ 1.451-1(a) and 1.451-5(b)(1) that advance payments should be included in gross income in the year of receipt. Similarly, Taxpayer's deduction in Year 2 of costs associated with producing and providing the products covered by the advance payment contracts follows the general rule under I.R.C. § 461 that a liability is not incurred until economic performance has occurred. In the Advance Payment Transaction, economic performance occurred in Year 2, when the products were delivered.

Although Taxpayer's method of accounting for the Advance Payment Transaction otherwise qualifies as a valid method under general Federal income tax accounting principles, it nonetheless violates the additional requirement under Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(B) that it not result in a material distortion of the income of Taxpayer-FSC or any other member of the Taxpayer Group. Because Taxpayer's method of accounting for the Advance Payment Transaction separates the income and deductions over two years, CTI cannot be accurately reflected in either Tax Year 1 or Tax Year 2. As a result, the income of both Taxpayer and Taxpayer-FSC with respect to the Advance Payment Transaction is materially distorted.

CTI is defined as the FTGR less the total costs of the FSC and related supplier that are related to the FTGR. Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(i). Viewing the Advance Payment Transaction as an integrated transaction, the FTGR with respect to the overall transaction should be calculated as Amount A and the CTI should be Amount J (FTGR less total costs). After application of the administrative pricing rules under Temp. Treas. Reg. § 1.925(a)-1T(c), the foreign trade income of Taxpayer-FSC, 15/23 of which is exempt income pursuant to I.R.C. § 923(a), should be limited to Amount S (the greater of: (1) 1.83% of FTGR (but not more than 46% of CTI) or (2) 23% of CTI; in this case 23% of CTI).

In Tax Year 1, Taxpayer's calculation overstates CTI because it does not take into account the total costs related to the FTGR. In particular, Taxpayer's cost of goods sold is not taken into account because it is deferred until Tax Year 2. Applying the administrative pricing rules to this overstated CTI alone would cause a distortion by overstating FSC foreign trade income, but Taxpayer's method of accounting also

TAM-123196-03

causes an additional distortion in the calculation of Taxpayer-FSC's foreign trade income. Following the administrative pricing rules, Taxpayer calculated a transfer price (Amount B) that when deducted from CTI should result in foreign trade income of Taxpayer-FSC in Tax Year 1 equal to 23% of the CTI as calculated by Taxpayer. However, because Taxpayer-FSC deferred its deduction of the transfer price until Tax Year 2, the foreign trade income reported by Taxpayer-FSC in Tax Year 1 consisted not of 23%, but rather 100%, of CTI. The result of these distortions in Tax Year 1 is that the amount of foreign trade income reported by Taxpayer-FSC, which should be equal to 23% of the combined taxable income of Taxpayer and Taxpayer-FSC, is instead 100% of an amount that correlates approximately to the gross receipts from the transaction. Taxpayer-FSC's foreign trade income in Tax Year 1 is therefore overstated by a total of Amount CC (Amount F, as reported by Taxpayer-FSC, less Amount S, the correct FSC foreign trade income, as calculated above).

This result conflicts with the purpose and structure of the administrative pricing rules provided for in I.R.C. § 925 and the regulations under that provision. The administrative pricing rules, including rules not directly relevant here that under certain circumstances permit CTI to be calculated by reference to marginal costs, are intended to prevent an excessive amount of profit from being allocated to a FSC. Generally speaking, the appropriate amount of profit that can be allocated to the FSC is capped at the higher of 1.83% of FTGR (not to exceed 46% of CTI), or 23% of CTI. I.R.C. § 925(a), (d). Taxpayer's accounting method, in contrast, allocates nearly 100% of FTGR to the FSC as profit.

In Tax Year 2, Taxpayer's calculation understates CTI. As stated above, CTI is equal to FTGR less total related costs. Whereas in Tax Year 1, CTI is overstated because the calculation failed to include the total costs, in Tax Year 2, a loss is created because the calculation takes into account the costs but includes no FTGR. Although it is clear that, viewed on an integrated basis, the Advance Payment Transaction generates income, Taxpayer's method of accounting in effect treats the Advance Payment Transaction as two distinct transactions: a gain transaction in Tax Year 1 and a loss transaction in Tax Year 2. Taxpayer then asserts that the "no loss" rule of Temp. Treas. Reg. § 1.925(a)-1T(e)(1)(i) permits it to set a transfer price in Year 2 that will permit Taxpayer-FSC to recover its costs in that year. Taxpayer in effect establishes a "negative" transfer price, whereby it makes a payment to Taxpayer-FSC to reimburse it for its deduction in Year 2 of costs of goods sold, of Amount B. As a result, Taxpayer - FSC's deduction for costs of goods sold in Tax Year 2, which should properly have offset FSC foreign trade income in Tax Year 1, subject to a reduced rate of tax on account of the 15/23 exemption, instead generates a tax benefit in Tax Year 2 for Taxpayer at the full 35% tax rate applicable to domestic corporations.

TAM-123196-03

In light of the distortions of income in both Tax Year 1 and Tax Year 2 described above, although Taxpayer's method of accounting otherwise qualifies as a valid method under I.R.C. § 446 for general Federal income tax accounting purposes, Taxpayer's method of accounting is impermissible for purposes of calculating CTI and FSC foreign trade income under Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii).

Issue 2 Taxpayer's Reimbursement Payment is not a Correct Application of the "No Loss" Rule

In the unlikely event that Taxpayer's method of accounting for the Advance Payment Transaction satisfies the "material distortion of income" standard under Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(B), Taxpayer's interpretation of the "no loss" rule under Temp. Treas. Reg. § 1.925(a)-1T(e)(1)(i) is unsupported and accordingly the reimbursement payment by Taxpayer to Taxpayer-FSC in Tax Year 2 should be disallowed.

In accordance with congressional intent, the "no loss" rule is intended to prevent pricing at a loss to the related supplier in most circumstances. Temp. Treas. Reg. § 1.925(a)-1T(e)(1) and Report of the Senate Committee on Finance, Deficit Reduction Act of 1984, S. Prt. No. 98-169, 98th Cong., 2d Sess. Vol. I, 1, 649 (1984). The rule provides that where a particular transaction or grouping of transactions yields a combined loss (as opposed to combined taxable income), the administrative pricing rules may not be used to create a profit in the FSC. The "no loss" rule is intended to prevent use of the administrative pricing rules to allocate income to a FSC inappropriately, at the expense of its related supplier. A limited exception to the "no loss" rule applies. The related supplier may set a transfer price in an amount that will allow the FSC to recover its costs associated with the sale, even if doing so would create or increase a loss in the related supplier. Temp. Treas. Reg. § 1.925(a)-1T(e)(1)(i).

A simple example of the application of the "no loss" rule is as follows: assume FTGR of \$1000, related supplier's cost of goods sold of \$900 and FSC expenses of \$150. The general "no loss" rule provides that because there is an overall loss of \$50 on the transaction (\$1000, gross receipts, less \$900 of related-supplier costs, less \$150 of FSC expenses), the FSC may not earn a profit through application of the administrative pricing rules. However, the exception to the rule permits the related supplier to set a transfer price of \$850, which when subtracted from the gross receipts of \$1000 allows the FSC net proceeds of \$150, which is sufficient to cover its expenses. This result is permitted even though it "creates" a loss to the related supplier of \$50 (\$850, amount received from FSC, less \$900, costs of goods sold). See generally Temp. Treas. Reg. § 1.925(a)-1T(f), Example 9.

TAM-123196-03

Taxpayer's application of the "no loss" rule to the Advance Payment Transaction conflicts with the general rule as well as the exception. First, the sale of products from Taxpayer to Taxpayer-FSC and from Taxpayer-FSC to FSubs constitutes a single FSC transaction that generates gain of Amount J. The "no loss" rule does not apply to gain transactions. Taxpayer generates a loss by bifurcating the transaction into a gain transaction in Tax Year 1 and a separate loss transaction in Tax Year 2. In the unlikely event that the bifurcation of the transaction clearly reflects income (see Issue 1, above), it does not change the fact that the transaction generated an economic gain, thus rendering the no-loss rule inapplicable.

Second, by setting one transfer price in Tax Year 1 of Amount B and then setting a second transfer price in Tax Year 2 in the form of a reimbursement of Amount B, Taxpayer in effect calculated two distinct transfer prices for a single transfer of products between Taxpayer and Taxpayer-FSC. In addition, when these two transfer prices are combined they fully offset one another. As a result the Taxpayer-FSC pays nothing for the products it receives from Taxpayer, even though it realizes a profit of Amount F on the overall transaction.

Third, the reimbursement to Taxpayer-FSC in Tax Year 2 pertains to costs that are not properly subject to the "no loss" rule. Pursuant to the "no loss" rule, a related supplier may set a transfer price that allows the FSC to recover its costs. Such costs do not include the cost of paying the transfer price itself. Setting a transfer price that allocates income from a related supplier to a FSC in order to cover the cost of FSC's payment of the transfer price to the related supplier would be a meaningless circular flow of cash. The only Taxpayer-FSC's "cost" in Tax Year 2 that is covered by the negative transfer price, or reimbursement payment, consists of its payment of the transfer price that was set in Tax Year 1. The net result is a circular flow of cash: Taxpayer-FSC pays Taxpayer a transfer price in Tax Year 1 and an equal amount is paid back by Taxpayer in Tax Year 2.

The reimbursement payment in Tax Year 2 is based on an incorrect application of the "no loss" rule. The allocation of excessive income to Taxpayer-FSC and the corresponding creation of a loss for Taxpayer is in fact the result the "no loss" rule was designed to prevent. Therefore, even if Taxpayer's accounting method for the Advance Payment Transaction were otherwise permissible, i.e., if that method did not materially distort income, the Tax Year 2 reimbursement payment should be disallowed and the Federal income tax consequences would be as follows:

Tax Year 1

Taxpayer

Taxpayer-FSC

TAM-123196-03

Sales revenues	Amount B	Amount A
Cost of sales	Amount L	Amount L
Allocated expenses	Amount G	(Amount G)
Reimbursement	<u>N/A</u>	<u>N/A</u>
Subtotal	Amount K	Amount F
FSC exemption	N/A	Amount M
Taxable income	<u>Amount K</u>	<u>Amount N</u>
Tax rate	<u>35%</u>	<u>35%</u>
Tax payable/benefit	<u>Amount O</u>	<u>Amount P</u>

Tax Year 2

	<u>Taxpayer</u>	<u>Taxpayer-FSC</u>
Sales revenues	Amount L	Amount L
Cost of sales	(Amount I)	(Amount B)
Allocated expenses	<u>Amount L</u>	<u>Amount L</u>
Subtotal	(Amount I)	(Amount B)
FSC exemption	<u>N/A</u>	<u>Amount DD</u>
Taxable income	(Amount I)	(Amount EE)
Tax rate	<u>35%</u>	<u>35%</u>
Tax payable/benefit	<u>(Amount FF)</u>	<u>(Amount GG)</u>
Net Tax Payable Tax Years 1 & 2	<u>Amount HH</u>	

Note that even without the reimbursement payment, the net tax payable is still less than the net taxable payable without the Advance Payment Transaction by Amount II (i.e., Amount Z – Amount HH).

CAVEAT(S):

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.