DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

August 20, 2001

Number: **200147037**
Release Date: 11/23/2001
CC:INTL:Br6/WTA-N-111819-01
UILC: 924.03-00; 925.01-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Elizabeth G. Beck
Chief, CC:INTL:BR6

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated January 30, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Amount A

Amount B

Country A

Date A

FSalesCorp

Owners

Products A

Taxable Year

Trade Name

USDistribCo

USIntlSalesCorp

USMfgCo

ISSUES

1. Whether the foreign economic process requirements of section 924(d) were met for intercompany product sale transactions recorded by the taxpayer's commonly-owned U.S. companies simultaneously with the taxpayer's sale of the product to unrelated foreign customers in a transaction in which a foreign sales corporation (FSC) acted as the taxpayer's commission agent.

2. Whether the taxpayer's method of computing a FSC commission met the requirements of the administrative pricing method of section 925(a)(2).

CONCLUSIONS

1. The taxpayer has not shown, on the facts presented, that the foreign economic process requirements were met with respect to the intercompany sales transactions.

2. Each related supplier must compute its own combined taxable income from a transaction separately, taking into account its cost of goods sold and the total other costs (excluding commission) of it and the FSC related to such transaction. We have insufficient facts to show that the method of computing a FSC commission used by the taxpayer in this case complied with the requirements of the administrative pricing method of section 925(a)(2).

FACTS

I. Corporate Structure

USMfgCo is a U.S. subchapter S corporation that manufactures Products A. It is a member of a group of domestic companies ("Trade Name Group"), all of which are owned, directly or indirectly, by Owners. The Trade Name Group includes five other U.S. subchapter S companies that manufacture Products A. These manufacturing company members of the Trade Name Group, including USMfgCo, are referred to collectively as "USMfgCos."

USDistribCo, a U.S. subchapter S corporation engaged in the distribution of Products A, is also a member of the Trade Name Group. USDistribCo purchases Products A from USMfgCos for resale to two sales company members of the Trade Name Group. One of these sales companies is a U.S. subchapter S corporation that purchases Products A from USDistribCo for resale within the United States.

USIntlSalesCorp, a U.S. subchapter C corporation, is the other sales company member of the Trade Name Group.[1] USIntlSalesCorp purchases Products A from USDistribCo for resale outside of the United States. USIntlSalesCorp is wholly owned by USMfgCo. USIntlSalesCorp is the sole owner of nine controlled foreign corporations and of FSalesCorp, a FSC.[2]

II. FSC Agreements

FSalesCorp and USIntlSalesCorp entered into an agreement titled "Sales Representation and Assumption of Credit Risk Agreement" ("Commission Agent Agreement"), effective as of Date A, remaining in force for the year following this effective date, and automatically renewed for successive one-year periods thereafter, unless terminated by either party. We understand that this agreement was in effect for the Taxable Year at issue here. This Commission Agent Agreement provides as follows:

> Supplier [USIntlSalesCorp] grants FSC [FSalesCorp] a non-exclusive sales representation with respect to the sale . . . of all property produced in or exported from the United States by Supplier . . . , provided such transactions will generate qualified foreign trading gross receipts as defined in section 924(a) of the Code (hereinafter called "Qualified Transactions").

Commission Agent Agreement, ¶ 2.

In return,

> Supplier [USIntlSalesCorp] agrees to pay commissions to FSC [FSalesCorp] only with respect to Qualified Transactions. The amount of commissions shall be equal to the maximum amount permitted to be received by FSC [FSalesCorp] as commission income under the transfer pricing rules of Section 925 of the Code.

Commission Agent Agreement, ¶ 3.

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[1] In total, the Trade Name Group consists of nine subchapter S corporations, four partnerships, and one subchapter C corporation. In addition to the members of the Trade Name Group referred to above, other members of the Trade Name Group are engaged in support or investment activities.

[2] FSalesCorp is a Country A corporation. For purposes of this analysis, we assume that FSalesCorp had in place for the Taxable Year at issue here a valid election to be treated as a FSC, pursuant to sections 922(a) and 927(f)(1), and in all other respects continuously maintained its status as a FSC, as defined in section 922(a).

FSalesCorp and USIntlSalesCorp also entered into an agreement titled "Management and Economic Processes Services Agreement" ("Services Agreement"), effective as of Date A, remaining in force for the year following this effective date, and automatically renewed for successive one-year periods thereafter, unless terminated by either party. We understand that this agreement was in effect for the Taxable Year at issue here. Under the Services Agreement, USIntlSalesCorp agreed to perform or assist in the performance of, on behalf of FSalesCorp, certain of the management, record keeping, sales and economic processes required to be performed outside the United States by a FSC (or a person acting under a contract with the FSC) in order to allow the FSC to have foreign trading gross receipts under section 924(b) and to qualify for the use of the administrative pricing rules of section 925(c). FSalesCorp agreed to reimburse certain expenses incurred by USIntlSalesCorp in this regard. We assume for purposes of this analysis that FSalesCorp satisfied the foreign management requirements of sections 924(b)(1)(A) and 924(c) and the foreign economic process requirements of sections 924(b)(1)(B) and 924(d) with respect to the export sale transactions of USIntlSalesCorp.

FSalesCorp did not have any written agreements with any of USMfgCos or with USDistribCo.

III. Sales Transactions

USIntlSalesCorp records, under its accounting system, a sale for export to an unrelated party abroad at the time the product is shipped from a warehouse to the foreign destination. At that time, also, one of the USMfgCos records a sale of the product to USDistribCo and USDistribCo, in turn, records a sale of the product to USIntlSalesCorp (the "intercompany sales").

The prices at which Products A are sold are based on discounts from the "list prices," which are the prices at which Products A are expected to be sold by the unrelated parties abroad to ultimate consumers. Sales by USMfgCos to USDistribCo are made at the largest discount. Sales by USDistribCo to USIntlSalesCorp are made at a smaller discount. And sales by USIntlSalesCorp to unrelated purchasers abroad are made at a still smaller discount from the list price.

IV. Taxpayer's Calculation of FSC Commission

USIntlSalesCorp claims to have used the administrative pricing method provided for by section 925(a)(2) to determine the commissions paid to FSalesCorp. Section 925(a)(2) allows a FSC to derive taxable income from a sale of export property in an amount that does not exceed 23 percent of the combined taxable income of the FSC and its related supplier attributable to the sale. For this purpose, the combined taxable income of a commission FSC and its related supplier is equal to the related supplier's gross receipts from the transaction that would have been foreign trading gross receipts had the sale been made by the FSC

directly, less the related supplier's total costs (including its cost of goods sold and its noninventoriable costs, but excluding the FSC commission) and less the FSC's total costs. Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(iii). The maximum commission a FSC may charge under this method is 23 percent of this combined taxable income of a commission FSC and its related supplier, plus the FSC's total costs for the transaction. Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(iv).

In determining the combined taxable income of the FSC and its related supplier for purposes of this method, USIntlSalesCorp reduced its cost of goods sold (the transfer price paid to USDistribCo) by the gross margins (sales price less cost of sales) that were earned by USMfgCos and USDistribCo on the intercompany sales they recorded at the time of USIntlSalesCorp's export sale. Thus, the commission paid to FSalesCorp in this case was based, in effect, on the combined taxable income of USMfgCos, USDistribCo, USIntlSalesCorp and FSalesCorp.

USIntlSalesCorp apportioned the responsibility for payment of the commission among these members of the Trade Name Group by using each member's gross margin on each of its intercompany sales as if that margin had been, in itself, the combined taxable income of that member of the Trade Name Group and of FSalesCorp in connection with an export sale. No selling expenses or allocable general and administrative expenses were deducted from the gross margins of these members of the Trade Name Group.

To determine the portion of the commission payable by USIntlSalesCorp, the gross margin of USIntlSalesCorp was reduced by all of the selling expenses with respect to the export sales, including those incurred by FSalesCorp, and by all of the allocable G&A expenses with respect to the export sales.

Based on these calculations, USIntlSalesCorp had a negative FSC commission payable, while the other members of the Trade Name Group had, collectively, a positive FSC commission payable. These other members of the Trade Name Group paid all of FSalesCorp's commission for the Taxable Year at issue ($Amount A) and paid, as well, the negative FSC commission determined with respect to USIntlSalesCorp ($Amount B). The members of the Trade Name Group that made these payments deducted them from taxable income, as FSC commission payments, on their respective Forms 1120S. USIntlSalesCorp reported the amount of its "negative FSC commission," received from the other members of the Trade Name Group, as "other income" on its Form 1120.

LAW AND ANALYSIS

I. The FSC Provisions

A. FSC Benefits

Under the FSC provisions, sections 921 through 927 of the Internal Revenue Code and the related Treasury Regulations, a FSC is allowed a partial exclusion from Federal income tax of income attributable to "foreign trading gross receipts." I.R.C. §§ 921(a); 923(a)(1) & (b).

B. Foreign Trading Gross Receipts

Section 924 provides generally that the gross receipts of a FSC with respect to a sale of export property will be foreign trading gross receipts only if the management of the FSC takes place outside the United States during the relevant taxable year (the foreign management requirement) and only if economic processes with respect to such transaction take place outside the United States (the foreign economic process requirements). I.R.C. §§ 924(a)(1) and (b)(1). Foreign trading gross receipts of a FSC include gross receipts from the sale of export property by any principal for whom the FSC acts as a commission agent (whether or not the principal is a related supplier). Temp. Treas. Reg. § 1.924(a)-1T(b).

C. Foreign Economic Processes

Section 924(d) describes the foreign economic processes that must be performed with respect to a transaction in order for the gross receipts of a FSC derived from the transaction to be considered foreign trading gross receipts. Two tests must be met, one relating to participation outside of the United States in the sales portion of the transaction and the other to incurring foreign direct costs attributable to the transaction. The activities comprising these economic processes may be performed by the FSC or by any other person acting under contract with the FSC and, for purposes of the economic processes requirements, references to a FSC include, if applicable, the person performing the relevant activity under contract on behalf of the FSC. Treas. Reg. § 1.924(d)-1(a).

Section 924(d)(1)(A) contains the "sales test" with respect to the gross receipts of a FSC derived from a transaction. To meet this sales test, the FSC (or a person under contract with the FSC) must participate outside the United States in the solicitation (other than advertising), the negotiation, or the making of the contract relating to such transaction. Treas Reg. § 1.924(d)-1(c) provides guidance on the manner in which this test may be met.

Section 924(d)(1)(B) contains a "50-percent foreign direct cost test" with respect to the gross receipts of a FSC derived from a transaction. To meet this test, the foreign direct costs incurred by the FSC attributable to the transaction must equal or exceed 50 percent of the total direct costs attributable to the transaction.

Section 924(d)(2) provides an alternative "85-percent foreign direct cost test." The 50-percent foreign direct cost test is treated as satisfied under this alternative 85-percent test with respect to a transaction if a corporation incurs foreign direct

costs equal to 85 percent or more of the total direct costs attributable to the activities described in at least two of the following five paragraphs of section 924(e):

> (1) advertising and sales promotion,
>
> (2) the processing of customer orders and the arranging for delivery of the export property,
>
> (3) transportation from the time of acquisition by the FSC (or, in the case of a commission relationship, from the beginning of such relationship for such transaction) to the delivery to the customer,
>
> (4) the determination and transmittal of a final invoice or statement of account and the receipt of payment, and
>
> (5) the assumption of credit risk.

Treas. Reg. § 1.924(e)-1 defines these section 924(e) activities relating to disposition of export property that give rise to "foreign direct costs" for purposes of section 924(d). The key factor is generally whether a "foreign" cost is incurred. Each activity is described in the regulation, as is the basis for determining the location in which the activity takes place. Transactions in which the customer is a domestic company may fail to meet this location factor, even where the transaction involves the use of a FSC.

Treas. Reg. § 1.924(e)-1(a) relates to "advertising and sales promotion."

"Advertising" is defined generally to mean the announcement or description of export property in a medium of mass communications as an inducement for multiple potential customers to buy the property from the FSC or related supplier, not including advertising primarily directed at customers in the United States. Treas. Reg. §1.924(e)-1(a)(1)(i)(A). A special rule allows a FSC to incur direct advertising costs to a foreign end consumer even though the FSC sells to a U.S. distributor, provided certain conditions are met. Treas. Reg. § 1.924(e)-1(a)(1)(i)(B). The location of advertising is generally the place to which the advertising is conveyed to potential customers or, in the case of the special rule for sales to a distributor's customers, to the distributor's customers or ultimate users. Treas. Reg. § 1.924(e)-1(a)(1)(iii).

"Sales promotion" is defined generally to mean an appeal made in person to a potential export customer for the sale of export property in the context of a trade show or customer meeting, excluding such appeals made in the context of any meeting, show or event primarily aimed at U.S. customers. Treas. Reg. § 1.924(e)-1(a)(2)(i). The location of a sales promotion activity is the place where the trade show or customer meeting is held. Treas. Reg. § 1.924(e)-1(a)(2)(iii).

Treas. Reg. § 1.924(e)-1(b) relates to "processing of customer orders and arranging for delivery of the export property."

"Processing of customer orders" is defined generally to mean notification by the FSC to the related supplier of the order and of the requirements for delivery. This does not include subsequent or prior communications with respect to an order and the related supplier may have independent knowledge of the order and of the requirements for delivery. Treas. Reg. § 1.924(e)-1(b)(1)(i). The location of the processing of customer orders is the place where the communication is initiated by the FSC. Treas. Reg. § 1.924(e)-1(b)(1)(iii).

"Arranging for delivery" is defined generally to mean taking the necessary steps to have the export property delivered to the customer according to the requirements of the order. It does not include preparing shipping documents or preparing the export property for shipment, but does include communications with the provider of transportation for the export property and with the customer to provide notice of the time and place of delivery. Prior or subsequent communications to either are not included in this definition. Treas. Reg. § 1.924(e)-1(b)(2)(i). The location of arranging for delivery is the place where the activity is initiated by the FSC. Treas. Reg. § 1.924(e)-1(b)(2)(iii).

Treas. Reg. § 1.924(e)-1(c) relates to "transportation."

"Transportation" is defined generally as moving or shipping the export property during the period when the FSC owns or is responsible for the property or, for a commission FSC, during the period the related supplier owns or is responsible for the property and after the commission relationship for purposes of the transportation has begun. A commission FSC is treated as responsible for the property if the related supplier has either title, bears the risk of loss, or insures the property during shipment. Treas. Reg. § 1.924(e)-1(c)(1). The location of transportation is the area over which the property is transported, so that foreign direct costs are those that relate to the portion of the transportation mileage that is outside the U.S. customs territory. Treas. Reg. § 1.924(e)-1(c)(3).

Treas. Reg. § 1.924(e)-1(d) relates to "determination and transmittal of a final invoice or statement of account and receipt of payment."

"Determination and transmittal of a final invoice or statement of account" is defined generally to mean the assembly of a final invoice or statement of account and the forwarding of that document to the customer. Treas. Reg. § 1.924(e)-1(d)(1)(i)(A). The location of the determination and transmittal of a final invoice or statement of account is the place where the final invoice or statement of account is both assembled and forwarded to the customer. Treas. Reg. § 1.924(e)-1(d)(1)(iii).

"Receipt of payment" is defined generally to mean crediting of the FSC's bank account by an amount that is not less than 1.83 percent of the gross receipts

associated with the transaction. Treas. Reg. § 1.924(e)-1(d)(2)(i). The location of the receipt of payment is the office of the banking institution at which the account is maintained. Treas. Reg. § 1.924(e)-1(d)(2)(iii).

Treas. Reg. § 1.924(e)-1(e) relates to "assumption of credit risk."

"Assumption of credit risk" is defined generally to mean bearing the economic risk of nonpayment with respect to a transaction. This risk is borne by a commission FSC if the commission contract transfers the costs of this risk with respect to the transaction from the related supplier to the FSC. A FSC may elect to bear this risk for transactions during a taxable year by assuming the risk of a bad debt, obtaining insurance to cover nonpayment, investigating credit of a customer, factoring trade receivables, or selling by means of letters of credit or banker's acceptances. Only the alternative elected to be performed by the FSC is relevant. Treas. Reg. § 1.924(e)-1(e)(1). The location of the assumption of credit risk is the location of the customer or obligor whose payment is at risk, except that the location of investigating credit is the location of the credit agency or association performing the investigation. Treas. Reg. § 1.924(e)-1(e)(3).

D. Use of the Section 925(a)(2) Administrative Pricing Method

If a sale of export property gives rise to foreign trading gross receipts, the section 925(a)(2) administrative pricing method allows a FSC to earn 23 percent of the combined taxable income of the FSC and of the related supplier of the export property that is attributable to such foreign trading gross receipts. Temp. Treas. Reg. § 1.925(a)-1T(d)(2) describes how to calculate the commission that will allow a FSC to earn this amount of income. Thus, Temp. Treas. Reg. § 1.925(a)-1T(d)(2) provides:

> *Commissions*. If any transaction to which section 925 applies is handled on a commission basis for a related supplier by a FSC and if commissions paid to the FSC give rise to gross receipts to the related supplier which would have been foreign trading gross receipts under section 924(a) had the FSC made the sale directly then –
>
> . . . . .
>
> (iii) The combined taxable income of a FSC and the related supplier from the transaction is the excess of the related supplier's gross receipts from the transaction which would have been foreign trading gross receipts had the sale been made by the FSC directly over the related supplier's and the FSC's total costs, excluding the commission paid or payable to the FSC, but including the related supplier's cost of goods sold and its and the FSC's noninventoriable costs . . . .

> (iv) The maximum commission the FSC may charge the related supplier is the amount of income determined under subdivisions (ii) [23 percent of combined taxable income] and (iii) [how to determine combined taxable income] of this paragraph plus the FSC's total costs for the transaction as determined under paragraph (c)(6) of this section.

For FSC purposes, including application of the rules for determining the combined taxable income of a FSC and the "related supplier" from a transaction, Temp. Treas. Reg. § 1.927(d)-2T(a) defines "related supplier" with respect to a commission FSC to mean "a related party which uses the FSC as a commission agent in the disposition of any property or services producing foreign trading gross receipts."

II. Analysis

A. Foreign Trading Gross Receipts

The method used by USIntlSalesCorp to calculate FSalesCorp's commission resulted in the payment of commissions by USMfgCos and USDistribCo for their intercompany sales transactions. The amounts of these commissions were determined by reference to the gross margins of USMfgCos and USDistribCo on those transactions. Payment of these commissions therefore resulted in a FSC benefit with respect to those transactions because the commissions increased the amount of FSalesCorp's income, of which a portion was exempt from U.S. income tax. Also, such commissions were deducted from the income of USMfgCos and USDistribCo.

As noted above, in order to have exempt foreign trade income, a FSC must have foreign trading gross receipts. As also noted above, foreign trading gross receipts can exist only if the required foreign economic processes have been performed with respect to a transaction.

We have not been given any information to suggest that the foreign economic processes, which are required by section 924(b) to be performed with respect to a transaction in order to generate FSC foreign trading gross receipts, were performed with respect to the intercompany sales transactions of USMfgCos or of USDistribCo. We note, however, that there does not appear to be any reason that the intercompany sales transactions of USMfgCos and USDistribCo could not have been structured to use a FSC as a commission agent or that the required foreign economic processes could not have been performed with respect to these transactions, even though they were entirely domestic transactions.

Although we do not have specific information regarding the foreign economic processes, if any, attributable to the intercompany sales, you should note the following. First, the sales test of section 924(d)(1)(A) can be satisfied by mailing a

brochure or catalog from abroad to a domestic corporation. For the "foreign direct costs" test of section 924(d)(1)(B), although section 924(d)(2) requires that the 85 percent test be satisfied with respect to two of the five direct cost tests listed under section 924(e), the taxpayer may in fact be able to satisfy four of the direct cost tests with respect to sales to a domestic corporation. Only the transportation test of Treas. Reg. § 1.924(e)-1(c) would clearly not be satisfied, since this test requires transportation abroad, which would not occur in a purely domestic sale. For the advertising test, if Products A were advertised abroad, FSalesCorp, had it been acting as a commission agent with respect to the intercompany sales, could have incurred direct advertising costs to a foreign end consumer even though the transaction involved a sale to a U.S. distributor, under the special rule for sales to distributors contained in Treas. Reg. § 1.924(e)-1(a)(i)(B). The processing of customer orders and arranging for delivery of the export property could have been done by FSalesCorp from a foreign location as required by Treas. Reg. § 1.924(e)-1(b). The determination and transmittal of a final invoice or statement of account and receipt of payment are also activities with respect to which the foreign economic processes requirements could have been met with respect to the intercompany transactions. Under Treas. Reg. § 1. 924(e)-1(d), this requirement is generally satisfied if the final invoice or statement of account is assembled and transmitted by the FSC outside the United States and if the FSC's bank account is credited by a certain amount in connection with a transaction. Finally, under Treas. Reg. § 1. 924(e)-1(e), the assumption of credit risk may be considered as having been a foreign economic process if the credit agency or association performing a credit investigation is located outside the United States even though a U.S. customer/obligor is involved.

Accordingly, on the basis of the facts that have been presented, we conclude that the taxpayer has failed to demonstrate that the required foreign economic processes were performed with respect to the intercompany sales of USMfgCos and USDistribCo. It has not been established, therefore, that the gross receipts from such sales constitute foreign trading gross receipts. Thus, under the section 925(a)(2) administrative pricing method, no FSC commissions are payable by USMfgCos or by USDistribCo to FSalesCorp in this case and the commissions that were paid are therefore not properly deductible by USMfgCos or by USDistribCo and are not includible in income by FSalesCorp. Moreover, as discussed below in part D of this analysis, it does not appear that the FSC commissions were properly computed with respect to the intercompany sales transactions, even assuming they gave rise to foreign trading gross receipts.

B. Use of a Commission FSC

Even if the required foreign economic processes had been performed with respect to the intercompany sales transactions of USMfgCos and USDistribCo, commissions would not be payable to FSalesCorp with respect to those transactions unless USMfgCos and USDistribCo had used FSalesCorp as their commission agent in connection with the transactions. See, e.g., Temp. Treas.

Reg. § 1.925(a)-1T(b)(2)(iii)(A) (when the required activities have been performed, the administrative pricing methods may be applied to a transaction if, among other circumstances, the FSC acted as commission agent for the related supplier on sales by the related supplier of export property to third parties, whether or not related parties).

As noted above, USIntlSalesCorp had written agreements with FSalesCorp for the performance by FSalesCorp of agency services and the payment by USIntlSalesCorp of commissions for such services, and for the performance by USIntlSalesCorp of foreign economic processes by USIntlSalesCorp on behalf of FSalesCorp with respect to USIntlSalesCorp's export sale transactions. There were no written agreements between any of USMfgCos and FSalesCorp or between USDistribCo and FSalesCorp for similar agency services with respect to the intercompany sales of exported Products A. Although there is no requirement that such agreements be in writing, in light of the written agreements between USIntlSalesCorp and FSalesCorp, we believe the lack of such agreements strongly indicates that no arrangement existed for the use of FSalesCorp as a commission agent with respect to the intercompany sales transactions. We note that if the taxpayer provides facts to show that the required economic processes were performed by FSalesCorp (or by USIntlSalesCorp acting on its behalf) with respect to the intercompany sales transactions, such facts might support a claim that there was an informal arrangement for FSalesCorp to act as a commission agent with respect to the intercompany sales transactions.

We conclude, on the basis of the facts that have been presented, that the taxpayer has failed to demonstrate that USMfgCos and USDistribCo used FSalesCorp as their commission agent with respect to their intercompany sales transactions.

C. Related Supplier

To meet the definition of "related supplier" for FSC purposes, a related party must "use[ ] the FSC as a commission agent in the disposition of . . . property . . . producing foreign trading gross receipts." Temp. Treas. Reg. § 1.927(d)-2T(a). Based on the facts that have been presented in this case, taxpayer has failed to establish that USMfgCos and USDistribCo used FSalesCorp as their commission agent with respect to their intercompany sales transactions or that the foreign economic processes necessary for the transactions to produce foreign trading gross receipts had been performed. Accordingly, we cannot conclude that USMfgCos and USDistribCo were related suppliers of FSalesCorp with respect to their intercompany sales transactions.

D. Calculation of FSC Commission

Even if FSalesCorp had acted as a commission agent with respect to the intercompany sales transactions of USMfgCos and USDistribCo and the required

foreign economic processes had been performed with respect to those transactions, so that USMfgCos and USDistribCo would have qualified as related suppliers on such sales, one would still need to determine whether the commissions paid to FSalesCorp by each member of the Trade Name Group are correctly computed under the section 925(a)(2) administrative pricing method. Temp. Treas. Reg. § 1.925(a)-1T(d)(2) applies "[i]f any transaction to which section 925 applies is handled on a commission basis for a related supplier by a FSC." Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(iv) provides the means of determining "the maximum commission the FSC may charge the related supplier" with respect to such a transaction. This regulation does not provide for multiple related suppliers to determine a single commission with respect to multiple transactions and nothing in the regulation suggests that a single amount of combined taxable income can properly be computed for a single FSC and its multiple related suppliers.

USIntlSalesCorp maintains that the method it has used to compute a single commission payable to FSalesCorp and to apportion that commission among the separate members of the Trade Name Group reaches the same result as if a separate commission had been computed with respect to the sales transactions of each of the separate USMfgCos and USDistribCo. However, assuming the USMfgCos and USDistribCo were related suppliers, USIntlSalesCorp's use of the gross margin earned by each of these companies on its intercompany sales transactions as the equivalent of the combined taxable income of the FSC and a related supplier with respect to such transactions does not comply with the requirements of Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(iii) for calculating the combined taxable income of a FSC and a related supplier from a transaction. Specifically, Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(iii) provides that the combined taxable income of a FSC and the related supplier from a transaction is the foreign trading gross receipts from the transaction, reduced by "the related supplier's and the FSC's total costs, excluding the commission paid or payable to the FSC, but including the related supplier's cost of goods sold and its and the FSC's noninventoriable costs . . . which relate to the transaction." Thus, in computing its (the related supplier's) cost of goods sold, USIntlSalesCorp improperly reduced this figure by the gross margins of USMfgCos and USDistribCo with respect to Products A. See also Temp. Treas. Reg. § 1.925(a)-1T(e)(2). Also, in the calculations of USIntlSalesCorp, the gross receipts of USMfgCos and USDistribCo do not appear to have been reduced by anything other than their cost of goods sold. Thus, for example, no FSC expenses associated with the intercompany sales were subtracted to determine the combined taxable income with respect to such sales. Rather, all of the other reductions provided for by this regulation appear to have been made exclusively with respect to determining the combined taxable income of the FSC and USIntlSalesCorp, resulting in a negative FSC commission payable by USIntlSalesCorp.

USIntlSalesCorp's method of computing FSC commissions therefore appears to shift expenses which would reduce the combined taxable income of the FSC and each of the members of the Trade Name Group that had intercompany sales

transactions from those members of the Trade Name Group to USIntlSalesCorp. If this is the case, then USIntlSalesCorp has improperly computed not only its commission expenses but also those of the other members of the Trade Name Group.

If you have any further questions, please call (202) 874-1490.

ELIZABETH G. BECK
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