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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

DATE: June 11, 2002

MEMORANDUM FOR: Joseph Maselli
Area Counsel (Area 2), CC:LM:HMT

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

SUBJECT: FSC Marginal Costing – Overall Profit Percentage

This Chief Counsel Advice responds to your memorandum dated March 13, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

USCorp =
USCorp-FSC =
Industry =

Products =
Taxable Year1 =
Taxable Year2 =
AmountA =
AmountB =

ISSUE

With respect to the FSC marginal costing rules, whether the numerator and denominator of the overall profit percentage (defined in Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(i)) computed for sales of a product or product line include licensing royalties received in connection with such sales.

CONCLUSION

No. Neither the numerator nor denominator of the overall profit percentage (defined in Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(i)) computed for sales of a product or product line include licensing royalties received in connection with such sales.

FACTS

I. The Taxpayer

USCorp is a domestic corporation in the business of Industry. USCorp manufactures – and licenses the manufacture of – Products. USCorp wholly-owns USCorp-FSC, a foreign corporation that had an election in effect under sections 922(a)(2) and 927(f)(1) to be treated as a foreign sales corporation ("FSC") during Taxable Years1 through 2. We assume, solely for purposes of analyzing the question presented, that USCorp-FSC satisfied the foreign management and economic process requirements under section 924(b), that USCorp's Products constitute export property within the meaning of section 927(a), and that all other requirements for qualification under the FSC provisions in sections 921 through 927 were met with respect to Products at issue here.

USCorp paid commissions to USCorp-FSC when it sold Products to its controlled foreign corporations ("CFCs") (as defined in section 957(a)). Pursuant to Temp. Treas. Reg. § 1.925(b)-1T(a), USCorp elected on behalf of USCorp-FSC to use the marginal costing combined taxable income method for determining some, or all, of these FSC commissions.

II. The Transactions

During Taxable Years1 through 2, USCorp engaged in transactions with its CFCs using two different trading patterns. Both trading patterns involve USCorp and a series of CFCs wholly-owned, either directly or indirectly, by USCorp.[1]

A. Trading Pattern 1 – Sale of Products Accompanied by License of Manufacturing Know-how

Under Trading Pattern 1, USCorp manufactured Products which it sold to manufacturing CFC1. After performing further manufacturing on Products, manufacturing CFC1 sold the resulting products to manufacturing CFC2 for still further manufacturing and packaging. Manufacturing CFC2 then sold the final

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[1] In the case of one foreign subsidiary, USCorp owned only a majority interest in the company.

products to a marketing CFC for distribution to the general public. In Trading Pattern 1, manufacturing CFC1 paid USCorp both a purchase price for the Products and royalties for the license of manufacturing know-how necessary for the further manufacture of Products performed by manufacturing CFCs 1 and 2. USCorp paid a commission to USCorp-FSC with respect to the sale of Products but not with respect to the royalties.

B. Trading Pattern 2 – License of Know-How Only

Under Trading Pattern 2, USCorp did not sell Products. Rather, USCorp licensed to manufacturing CFC3 all of the know-how necessary to manufacture Products. Manufacturing CFC3 performed all of the manufacturing activities performed by both USCorp and manufacturing CFC1 in Trading Pattern 1. Manufacturing CFC3 then sold the product to manufacturing CFC4 which, after still further manufacturing and packaging, sold the final product to a marketing CFC for distribution to the general public. In Trading Pattern 2, manufacturing CFC3 paid USCorp royalties for the license of manufacturing know-how necessary for the further manufacture of the Products by manufacturing CFCs 3 and 4; USCorp paid no commissions to USCorp-FSC.

The royalties earned by USCorp under both trading patterns accounted for approximately AmountA% to AmountB% of Taxpayer's total gross receipts from all sales of the Products' product line, as computed under Taxpayer's interpretation of the overall profit percentage under Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(i). For purposes of applying the marginal costing combined taxable income method to its sales of Products to manufacturing CFC1, Taxpayer computed the overall profit percentage by including the royalties described above in the numerator and denominator of the percentage.

LAW AND ANALYSIS

I. FSCs Generally

A FSC receives certain tax benefits under sections 921 through 927 of the Code. These benefits are determined with respect to foreign trading gross receipts ("FTGR"). I.R.C. §§ 923 and 925(a). Generally, the more FTGR a FSC earns, the greater its FSC benefits will be. Section 924(a) provides that FTGR

> means the gross receipts of any FSC which are–
>
> (1) from the sale, exchange, or other disposition of export property,
> (2) from the lease or rental of export property for use by the lessee outside the United States,
> (3) for services which are related and subsidiary to [(1) and (2) above]

> (4) [other services not relevant here]. (Emphasis added).

FTGR is similarly defined where a FSC acts as a commission agent with respect to such sale, lease, or service. Temp. Treas. Reg. § 1.924(a)-1T(b) through (f). For purposes of applying the FSC provisions, a license of export property is treated as a lease of export property. Temp. Treas. Reg. § 1.924(a)-1T(a)(2).

Section 927(a)(1) defines export property. Property that otherwise satisfies the definition of export property under section 927(a)(1) generally does not constitute export property if such property is, among other things, "patents, inventions, models, designs, formulas, or processes whether or not patented, . . . or other like property." I.R.C. § 927(a)(2)(B); Temp. Treas. Reg. § 1.927(a)-1T(f)(3). In other words, the intangible property described in section 927(a)(2)(B) generally may not generate FTGR.

II. Full Costing Combined Taxable Income Method

Section 925(a) provides three alternative methods for determining transfer prices on sales of export property to a FSC. Section 925(a)(2) describes the full costing combined taxable income method:

> In the case of a sale of export property to a FSC by a person described in section 482, the taxable income of such FSC and such person shall be based upon a transfer price which would allow such FSC to derive taxable income, attributable to such sale (regardless of the sales price actually charged) in an amount which does not exceed . . . 23 percent of the combined taxable income of such FSC and such person which is attributable to the foreign trading gross receipts derived from the sale of such property by such FSC. . . .

If a FSC is the principal on a sale, rather than a commission FSC, the full costing combined taxable income of the FSC and its related supplier[2] from a sale of export property is

> the excess of the foreign trading gross receipts 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 (see § 1.471-11(c)(2)(ii)) which relate to the foreign trading gross receipts.

[2] See Temp. Treas. Reg. § 1.927(d)-2T for the definition of "related supplier."

Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(i). The full costing combined taxable income method for determining FSC transfer prices in section 925(a)(2) applies similarly to the determination of the FSC commissions (except that the FSC commissions paid or payable are excluded from total costs) on sales and leases of export property as well as related and subsidiary services. I.R.C. § 925(b)(1) and Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(iii). For transfer pricing purposes, sale transactions may not be grouped on a product or product line basis with lease transactions. Temp. Treas. Reg. § 1.925(a)-1T(d)(1).

III. Marginal Costing Combined Taxable Income Method

A. Generally

Section 925(b)(2) authorizes the Secretary of the Treasury "to prescribe rules for the allocation of expenditures in computing combined taxable income under subsection (a)(2) in those cases where a FSC is seeking to establish or maintain a market for export property." Accordingly, Temp. Treas. Reg. § 1.925(b)-1T(a) provides that taxpayers may apply the combined taxable income method under section 925(a)(2) on a marginal, rather than full, costing basis "where a FSC is seeking to establish or maintain a market for export property." Temp. Treas. Reg. § 1.925(b)-1T(c)(1) states:

> A FSC shall be treated for its taxable year as seeking to establish or maintain a foreign market with respect to sales of an item, product, or product line of export property from which foreign trading gross receipts are derived if the combined taxable income computed under [the marginal costing combined taxable income method] is greater than the full costing combined taxable income computed under the full costing combined taxable income method of § 1.925(a)-1T(c)(3) and (6).

Temp. Treas. Reg. § 1.925(b)-1T(a) provides that the marginal costing method "may be applied at the related supplier's election" with respect to a taxable year. In addition, "[t]he marginal costing rules do not apply to leases of property or to the performances of any services even if they are related and subsidiary services (as defined in § 1.924(a)-1T(d) and § 1.925(a)-1T(b)(2)(iii)(C))." Temp. Treas. Reg. § 1.925(b)-1T(a).

Under the marginal costing method,

> only direct production costs of producing a particular item, product, or product line are taken into account for purposes of computing the combined taxable income of the FSC and its

> related supplier under section 925(a)(2). The costs to be taken into account are the related supplier's direct material and labor costs (as defined in § 1.471-11(b)(2)(i)).

Temp. Treas. Reg. § 1.925(b)-1T(b)(1). The amount of combined taxable income determined under the marginal costing method

> 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.

Temp. Treas. Reg. § 1.925(b)-1T(b)(2). This limitation on the amount of combined taxable income computed under the marginal costing combined taxable income method is known as the overall profit percentage limitation ("OPPL").

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

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

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

In other words, the OPPL reduces a taxpayer's combined taxable income under the marginal costing method to the amount that would result if the taxpayer's profit percentage on sales of export property were equal to its worldwide profit percentage on all sales of the same product or product line. Thus, the marginal costing method may not yield a higher profit percentage for sales of export property than the taxpayer would otherwise realize on its aggregate worldwide sales of the same product or product line.

B. The Overall Profit Percentage

Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(i) provides that the overall profit percentage ("OPP") for a taxable year of the FSC for a product or product line

> is the percentage which–
>
> (A) The combined taxable income of the FSC and its related supplier from the sale of export property plus all taxable income of its related supplier from all sales (domestic and foreign) of such product or product line during the FSC's taxable year, computed under the full costing method, is of
>
> (B) The total gross receipts (determined under § 1.927(b)-1T) of the FSC and related supplier from all sales of the product or product line. (Emphasis added).

The preamble to T.D. 8126, which contains Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(i), describes the OPP fraction as follows:

> the numerator . . . is the FSC's and related supplier's combined taxable income on all sales, foreign and domestic, of the export product or product line determined under the full costing method and the denominator . . . is the total gross receipts from those sales.

1987-1 C.B. 184, 190 (emphasis added). Temp. Treas. Reg. § 1.927(b)-1T(a) defines "gross receipts" for FSC purposes as follows:

> (1) Business income. The total amounts received or accrued by the person from the sale or lease of property held primarily for sale or lease in the ordinary course of a trade or business, and
>
> (2) Other income. Gross income recognized from whatever source derived, such as, for example, from–
>
> > (i) The furnishing of services (whether or not related to the sale or lease of property described in subdivision (1) of this paragraph),
> >
> > (ii) Dividends and interest (including tax exempt interest),
> >
> > (iii) The sale at a gain of any property not described in paragraph (1) of this paragraph, and

> (iv) Commission transactions to the extent described in paragraph (e) of this section.[3]

Thus, as applied to the present case, the OPP may be stated as the following fraction:

$$\frac{\text{worldwide taxable income from sales of the Products' product line}}{\text{worldwide gross receipts from sales of the Products' product line}}$$

IV. Taxpayer's Argument

The dispute in this case centers on the meaning of the phrase "from all sales," which appears in both the numerator and the denominator of the OPP fraction. Taxpayer argues that although the marginal costing rules do not apply to licensing royalties, the OPP that is applied to limit Taxpayer's marginal costing combined taxable income from sales of Products reflects royalty payments earned by Taxpayer on licenses of manufacturing know-how connected with sales of Products. Citing Webster's New Collegiate Dictionary (1977) ("Webster's"), Taxpayer defines "from" as it is used in the OPP context as follows: "used as a function word to indicate the source, cause, agent, or basis." Taxpayer has also described the nexus necessary for non-sale income to be included in the OPP fraction as a "sufficient connection." Taxpayer argues that its taxable income and gross receipts "from all sales" of the Products' product line include taxable income and gross receipts attributable to its licensing royalties because sales of the Products' product line were the "source, cause, agent, or basis" for the royalty receipts ("Taxpayer's Interpretation").

Thus, Taxpayer argues that taxable income or gross receipts "from all sales" referenced in the OPP fraction are not strictly "sales income" or "sales receipts." Rather, taxable income and gross receipts "from all sales" include all income that ultimately results from sales of the product or product line to which the marginal costing method is applied. In Taxpayer's view, where licensing income results from a sale, that licensing income must be said to be "from all sales." Thus, Taxpayer

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[3] Temp. Treas. Reg. § 1.927(b)-1T(e)(1)(i) provides that a commission

> FSC's gross receipts for purposes of computing its profit under the administrative pricing methods of section 925(a)(1) and (2) shall be the gross receipts (other than gross receipts which would not be foreign trading gross receipts had they been received by the FSC) derived by the related supplier from the sale or lease of the property or from the furnishing of services with respect to which the commissions are derived.

rewrites the OPP fraction applicable to Products as the following ratio:

$$\frac{\text{worldwide taxable income ultimately resulting from sales of the Products' product line}}{\text{worldwide gross receipts ultimately resulting from sales of the Products' product line}}$$

Taxpayer's Interpretation enables Taxpayer to include in the OPP non-sales income for the purpose of increasing its profit percentage on sales income.

V. Summary of Conclusions

We believe that Taxpayer's Interpretation of the OPP fraction is wrong. It disregards the plain language of the marginal costing rules and the purpose of those rules as confirmed by the only two courts that have discussed the OPPL provisions. Within the context of the marginal costing regulations, Taxpayer's Interpretation is premised on a definition of the word "from" that, we believe, is contrary to the plain language of the OPP fraction, would yield clearly incorrect results if applied in other areas of the FSC provisions, and ignores the crucial sales-only scope of the marginal costing rules. Taxpayer's Interpretation is also internally contradictory; by its own terms, licensing royalties could not logically be included in the OPP for Products because sales of the Products' product line were not the "source, cause, agent, or basis" of the licenses of manufacturing know-how. We conclude that licensing royalties are not included in the OPP fraction because they are not sales receipts.

VI. Analysis

We start our analysis by identifying areas of common agreement. We agree with Taxpayer that the term "gross receipts" that appears in the denominator of the OPP fraction, considered alone, may include licensing royalties. Temp. Treas. Reg. § 1.927(b)-1T(a)(2), which expands on the section 927(b)(1)(B) definition of gross receipts, provides that gross receipts are "[g]ross income recognized from whatever source derived. . . ." We also agree with Taxpayer that licensing royalties constitute "gross income . . . from whatever source derived."[4]

[4] We note, however, that the term "gross receipts" referenced in the OPP fraction is modified by the phrase "from all sales." The discussion below will illustrate that, whereas Taxpayer considers "from all sales" to refer to gross receipts merely resulting from sale transactions, we consider "from all sales" to refer strictly to sales receipts. Therefore, although we agree with Taxpayer that the general definition of "gross receipts" includes licensing royalties of the related supplier, we do not agree with

Further, we agree with Taxpayer that the word "from" – as used in the OPP context – indicates a "source, cause, agent, or basis" and may, in certain contexts, convey a more attenuated causal connection than that supported by the Service in this case. We also agree with Taxpayer that the numerator of the OPP fraction encompasses the same class of gross receipts as the denominator of the OPP fraction reduced by the total costs of the FSC and related supplier as defined in Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(C) and (D). Finally, Taxpayer is correct that inclusion in the OPP of transactions involving property other than export property is not, in itself, inappropriate because the OPP fraction, by its own terms, requires the inclusion of income "from all sales" regardless of whether the sales involved export property.[5]

From these areas of common agreement we make the following analysis.

Section 924(a) and Temp. Treas. Reg. § 1.924(a)-1T specify that, for purposes of the FSC provisions, transactions are generally separated into three separate and distinct categories: sales, leases/licenses, and services.[6] The combined taxable income method under section 925(a)(2) determines FSC transfer prices and commissions for such sales, leases/licenses, and services on a full costing basis. Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(i). Sales and leasing/licensing income cannot be combined. Temp. Treas. Reg. § 1.925(a)-1T(d)(1). Where a taxpayer's marginal costing profit percentage on sales of export property is lower than its full costing profit percentage on sales of the same product or product line worldwide, the taxpayer may apply the combined taxable income method on a marginal costing basis. Temp. Treas. Reg. § 1.925(b)-1T(a) and (c)(1). Thus, the marginal costing rules allow a taxpayer to determine greater combined taxable income than would otherwise be permissible under section 925(a). I.R.C. § 925(b)(2).

Taxpayer that licensing royalties are "gross receipts . . . from all sales." In short, "gross receipts" include licensing royalties but "gross receipts . . . from all sales" do not.

[5] The discussion, below, illustrates our view that the OPP fraction does not reflect licensing transactions regardless of whether the licenses involved export property.

[6] Throughout this advice, we use the term "sale" to refer to the sales, exchanges, and other dispositions enumerated in section 927(d)(2)(A)(i), we use the term "lease/license" to refer to the leases, subleases, licenses, sublicenses, and rentals enumerated in section 927(d)(2)(A)(ii) and Temp. Treas. Reg. § 1.924(a)-1T(a)(2), and we use the term "services" to refer to the furnishing of services enumerated in section 927(d)(2)(A)(iii).

The marginal costing combined taxable income method is similar to the full costing combined taxable income method with two notable exceptions. First, the marginal costing method takes into account only direct costs of production whereas the full costing method takes into account all costs and expenses, both direct and direct. Temp. Treas. Reg. §§ 1.925(a)-1T(c)(6) and 1.925(b)-1T(b)(1). Second, the marginal costing method applies only to sale transactions whereas the full costing method applies to all three categories of transactions – sales, leases/licenses, and services. Temp. Treas. Reg. §§ 1.925(a)-1T(b)(2)(iii) and 1.925(b)-1T(a). Taxpayer's reading of "from all sales" as meaning "from licenses from all sales" renders meaningless the important distinction in the FSC provisions between sale transactions and licensing transactions and, thus, circumvents the restriction against combining sale and licensing income.

The notion that the marginal costing rules apply only to sales is not restricted to Temp. Treas. Reg. § 1.925(b)-1T(a). The sales-centered nature of the marginal costing rules is reflected in the basic operation of the marginal costing method. Because marginal costing requires the reduction of gross income by direct costs of production only (rather than by all costs and expenses, both direct and direct), marginal costing is relevant only in the product sales context where production costs are a factor. Marginal costing is inapplicable and irrelevant in the context of other sorts of transactions such as leases, licenses, and services.

The sales-only scope of the marginal costing rules is further reflected by the plain language of the OPP fraction. The numerator consists only of taxable income amounts "from all sales," and the denominator consists only of gross receipts "from all sales." Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(i). The sole reference to leases, services, or any other non-sale transactions in the marginal costing rules and the examples therein is the statement in Temp. Treas. Reg. § 1.925(b)-1T(a) which expressly prevents the marginal costing rules from applying to leases and services. In sum, the marginal costing rules set forth a sales-centered pricing method that boosts combined taxable income while limiting FSC-sales profitability to worldwide-sales profitability. Taxpayer's Interpretation is inconsistent with the clearly limited scope of the marginal costing rules.

Taxpayer's argument that non-sale receipts factor into the OPP fraction also runs contrary to the purpose of the OPPL as a limitation on a taxpayer's profit on sales of export property under the marginal costing rules. In upholding the validity of the OPPL, both the Tax Court and the Federal Circuit observed that the OPPL limits the profit on sales of export property to the average profit that the taxpayer realizes on its worldwide sales of the same product or product line. Brown-Forman, 94 T.C. at 929; Dow Corning, 984 F.2d at 421. However, according to Taxpayer's Interpretation, profit earned on sales of export property is limited not by worldwide profit on sales but by worldwide profit on transactions of any kind such as sales, leases, licenses, services, agency fees, etc., so long as the transactions ultimately

result from qualifying sale transactions.

Accordingly, Taxpayer's Interpretation of the OPP fraction contradicts the plain language and purpose of the marginal costing regulations as confirmed by the Brown-Forman and Dow Corning courts. It disregards the sales-only premise of the marginal costing rules and, thereby, bases the OPPL on transactions that share no apparent economic or accounting nexus with sales of export property. In our view, gross profits earned on licenses of intangible property do not constitute a reasonable measuring stick for a limitation on the sales profit under marginal costing and were not intended by the drafters of the marginal costing regulations ("the drafters") to figure in the OPPL.

Our view of the sales-only nature of the marginal costing rules is further buttressed by an analysis of the logical implications of Taxpayer's Interpretation for other FSC provisions. In particular, the use of the phrase "from all sales" in the OPP fraction mirrors the use of the phrase "from the sale" in the definition of FTGR under section 924(a)(1).[7] Section 924(a)(1) defines FTGR to include "gross receipts . . . from the sale . . . of export property." Applying Taxpayer's Interpretation, section 924(a) means that FTGR include all gross receipts that have a sale as their beginning, source, cause, or basis. Taxpayer's Interpretation would improperly enlarge the universe of gross receipts that may qualify as FTGR to include gross receipts from transactions that are not explicitly described in section 924(a). For example, under Taxpayer's Interpretation, a service fee earned by an unrelated third party (not pursuant to a contract with the FSC) that transports export property in connection with a sale of the property would qualify as FTGR even though section 924(a) does not list such fees as FTGR. See also Temp. Treas. Reg. § 1.924(a)-1T(d). We are unaware of any decision or other accepted authority supporting the view that such transportation fees or any other gross receipts not explicitly described in section 924(a) and Temp. Treas. Reg. § 1.924(a)-1T(b) through (f) may qualify as FTGR.

In addition, Taxpayer's Interpretation logically would allow Taxpayer to treat the licensing royalties for manufacturing know-how described above as FTGR because such royalties are, according to Taxpayer's Interpretation, gross receipts that emanate from the sale of Products. Such treatment directly contradicts the section 927(a)(2)(B) prohibition against FSC benefits for such intangible property. H. R. Rep. No. 92-533, 92d Congress, 1st Sess., 69 (1971). In other words,

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[7] The additional word "all" in the OPP fraction is necessitated by the fact that the OPP fraction reflects worldwide sales. Both the section 924(a)(1) phrase and the OPP phrase mean, in essence, "from sales" and differ only in the number of sales to which they refer. In addition, we note (1) that the construction "from the sale . . . of export property" in section 924(a)(1) mirrors the phrase "from the sale of export property" in the OPP numerator and (2) that "from the sale of export property" is a construction that parallels the phrase "from all sales" elsewhere in the OPP numerator.

applying Taxpayer's Interpretation would render the section 927(a)(2)(B) carve-out for intangible property meaningless and would greatly expand the definition of FTGR beyond the widely-accepted current definition. We note that, inconsistent with its position on marginal costing, Taxpayer did not apply its interpretation of "from sales" to section 924(a)(1) in this case and, thus, did not seek FSC exemptions for its royalties from licenses of manufacturing know-how related to its sales of Products.

Taxpayer's Interpretation of "from all sales" derives, at least in part, from its definition of "from." We agree with Taxpayer that, in the context of the OPP fraction, the word "from" indicates a source, cause, agent, or basis. In our view, the word "from" – as used in the OPP fraction – refers only to the specified "sales" whereas Taxpayer's Interpretation assumes that "from" refers also to non-sale transactions that arise from sales. We believe that the context of the OPP fraction and the marginal costing rules in general does not support the connotation of "from" espoused by Taxpayer. Taxpayer's Interpretation inappropriately stretches the meaning of "from" to require merely a "sufficient connection" between a cause (e.g., a sale) and an effect (e.g., licensing income).[8] We find no reasonable support in the language of the marginal costing rules or the FSC legislative history for Taxpayer's argument that non-sale receipts should be included in the OPP fraction simply because they have a cause-and-effect relationship, however tangential, to qualifying sales.

Even under Taxpayer's Interpretation of the OPP fraction, the tax effect claimed by Taxpayer does not logically follow. Taxpayer describes a relationship in which sales of a product or product line are the source, cause, agent, or basis for non-sales receipts. In other words, the sales precede and give rise to other transactions that produce income that should be included as receipts "from sales." Therefore, according to Taxpayer's Interpretation, non-sale receipts are included in the OPP only if they ultimately result from an antecedent qualifying sale. After analyzing Taxpayer's trading patterns, we conclude that this prerequisite of an antecedent is not met.

In Trading Pattern 1, sales of Products are negotiated and contracted between Taxpayer and manufacturing CFCs in combination with licenses of the manufacturing know-how necessary to further manufacture the Products. On the one hand, a manufacturing CFC will not license know-how from Taxpayer unless the CFC also purchases Products because the know-how is useless without Products. On the other hand, a manufacturing CFC will not purchase Products from Taxpayer unless the CFC also licenses manufacturing know-how from

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[8] We note that, given Taxpayer's position that "from" indicates a causal or similar relationship, Taxpayer's characterization of the required nexus for non-sales receipts to be included in the OPP fraction as a "sufficient connection" must refer to a causal or similar relationship as opposed to a mere correlation.

Taxpayer because Products are useless to the CFC without the know-how necessary to further manufacture them.

The sale transaction is neither chronologically nor causally antecedent to the licensing transaction. Neither transaction necessarily precedes or may be said to give rise to the other. Taxpayer may not logically maintain that sales of Products gave rise to licenses of know-how when, but for the licenses of know-how, the sales of Products would not have occurred. Thus, even under Taxpayer's reading of the OPP fraction, licensing royalties earned by Taxpayer under Trading Pattern 1 could not be included in the OPP because the accompanying sales of Products were not antecedent to the licenses.

In Trading Pattern 2, Taxpayer's Interpretation is even less supportive of Taxpayer's argument because no sales of Products preceded or even accompanied the licenses of manufacturing know-how. There cannot be a "sufficient connection" between qualifying sales and royalty receipts because there were no sales of the Products' product line, much less any sales antecedent to licenses. Thus, even under Taxpayer's reading of the OPP fraction, royalties earned by Taxpayer under Trading Pattern 2 could not be included in the OPP calculation because the royalties do not have antecedent sales of the Products' product line as their "source, cause, agent, or basis." Moreover, Taxpayer's usage of Trading Pattern 2 confirms that the sales and licensing transactions involved in trading Pattern 1 are not necessarily connected and interdependent in the manner suggested by Taxpayer.

Finally, Taxpayer argues that, if the drafters intended the OPP fraction to include only sales receipts, then the drafters should have used unambiguous language to that effect. Specifically, Taxpayer suggests that the drafters could have clarified the OPP fraction by wording it to refer to "gross receipts <u>received for</u> a sale." We disagree that Taxpayer's suggested "received for" language can refer only to sales receipts. Webster's defines "for" to mean, among other things, "because of." Under that definition, one might interpret Taxpayer's suggested language to mean "received because of sales." We do not consider "received because of sales" to be more precise or specific than "from all sales." Therefore, we reject Taxpayer's assertion that the drafters could have more clearly specified the sales-only nature of the OPP fraction simply by substituting the phrase "received for a sale" for "from all sales."

Moreover, we believe that the phrase "from all sales," as used in the OPP fraction, enabled the drafters to convey the concepts of "combined taxable worldwide sales income" and "total worldwide sales gross receipts" in the most syntactically sound, technically accurate, and articulate manner. For instance, the phrase "combined taxable worldwide sales income," though undeniably descriptive,

would be unacceptable in the FSC context because the defined term “combined taxable income” would lose its specific meaning if its component words were separated. Furthermore, the phrase “from all sales” in the OPP fraction is consistent with other usage in the FSC provisions to convey a consistent meaning.

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

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