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to: , Team Manager, LMSB:HMT:

from: Christopher J. Bello, Assistant to the Branch Chief, CC:INTL:6

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subject:

This Chief Counsel Advice responds to your request for advice dated September 27, 2004. This advice may not be used or cited as precedent.

LEGEND

USCorp =
FSC1 =
CountryZ =
Division1 =
Division2 =
Product1 =

Product2 =
Calendar Year1 =

ISSUE

Whether income from long-term sales entered into before October 1, 2000, that is taken into account under the section 460 percentage-of-completion method of accounting ("POC method") after September 30, 2000, may qualify for the extraterritorial income ("ETI") exclusion under section 114.

CONCLUSION

No. Income from sales entered into before October 1, 2000 – including income from long-term sales entered into before October 1, 2000, that is taken into account under the POC method after September 30, 2000 – does not qualify for the ETI exclusion. Thus, in the case of the section 460 long-term contracts entered into before October 1, 2000, at issue here, income from sales entered into pursuant to those contracts qualifies[1] for the ETI exclusion only if the sales were entered into after September 30, 2000. The determination of when a sale is entered into requires an analysis of the surrounding facts and circumstances on a case-by-case basis. Accordingly, as discussed in detail below, in this case, some sales were entered into at or around the time the underlying contract was signed and, therefore, were entered into before October 1, 2000, and do not qualify for ETI exclusion treatment. Other sales were entered into at or around the time a post-September 30, 2000, option under the contract was exercised and, therefore, were entered into after September 30, 2000, and qualify[2] for ETI exclusion treatment.

FACTS

I. Taxpayer's Business

USCorp and its U.S. subsidiaries (hereinafter "Taxpayer") is a domestic defense contractor engaged in providing products and services[3] under long-term contracts (within the meaning of section 460) with the United States government ("U.S. government") and with foreign governments. Taxpayer entered into a significant number of such long-term contracts prior to, and during, taxable year 2000. At all relevant times, Taxpayer wholly owned FSC1, a foreign corporation organized in CountryZ that elected under sections 922(a)(2) and 927(f) to be treated as a FSC for federal income tax purposes.

Of the contracts mentioned above, those that generate over 90% of the income at issue in this case are attributable to Taxpayer's Division1 and Division2 business segments. Division1 is engaged in the design, development, and production of Product1. Division2 is engaged in the design, development, and integration of Product2.

II. Taxpayer's Long-Term Contracts

The long-term contracts under consideration relate to sales of military property as defined in sections 923(a)(5) and 995(b)(3)(B) that also constitute section 927(a) export

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[1] Solely for purposes of addressing the narrow legal issue regarding the ETI effective date discussed in detail below, we assume that Taxpayer's sales satisfied all of the FSC or ETI exclusion requirements, as the case may be.

[2] See footnote 1, above.

[3] This memorandum assumes, solely for the purpose of addressing the narrow legal issue, that all of the income at issue is sales income. Therefore, the memorandum does not address whether any of such income is properly characterized as services income and, if so, whether such services income constitutes income from related and subsidiary services as defined in section 924(a)(3)(A) or 942(a)(1(C)(i).

property (under the FSC provisions) or section 943(a) qualifying foreign trade property (under the ETI exclusion provisions). They are generally fixed-price contracts with fixed payment schedules, such that both Taxpayer and its customer know the final price, or at least the formula to derive the final price, at the time of contract signature. Because the particular configuration of military property for a sale is specified in the contract and varies from contract to contract, Taxpayer does not manufacture products in anticipation of contracts and generally does not maintain a product inventory. We understand that this is standard practice among similarly situated defense contractors.

In the case of some of its sales to foreign governments, Taxpayer sells directly to those governments. But in the case of most of Taxpayer's sales to foreign governments, the U.S. government acts as an intermediary between Taxpayer and the foreign government. Consequently, most of Taxpayer's sales to foreign governments involve a two-step process in which the foreign government first enters into an agreement with the U.S. government, which in turn contracts with Taxpayer. In such cases, the foreign government enters into a letter of offer and acceptance ("LOA") with the U.S. government, and the U.S. government later finalizes the purchase order reflected in the LOA by making a contract with Taxpayer that typically mirrors the LOA.

Pursuant to the contract provisions, the customer generally takes title to, or a security interest in, products as the customer makes advance or progress payments. The U.S. government issues a DD Form 250 with respect to a sale when the seller has satisfied the contractual specifications and is entitled to retain the purchase price. Thus, Taxpayer asserts that delivery and acceptance of Products1 and 2 is generally evidenced by the U.S. government's issuance of a DD Form 250.

III. Income Tax Reporting for Taxpayer's Long-Term Contracts

With respect to the long-term contracts at issue, Taxpayer uses the POC method to report income and loss. Under the POC method, a percentage of the total contract revenue is included in taxable income during each year of the contract. Taxpayer elected to apply the 10-percent method pursuant to section 460(b)(5) under which no income is included until the first taxable year as of the close of which 10 percent of the estimated total contract costs have been incurred.

Beginning in Calendar Year1, Taxpayer paid commissions to FSC1 with respect to sales of section 927(a) export property, including some or all of the sales of military property at issue here. Each FSC commission corresponded to an inclusion of income by Taxpayer under the POC method. After the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423 (2000) ("ETI Act") was enacted, Taxpayer ceased paying FSC commissions on income from such sales and, instead, claimed ETI exclusions with respect to sales of section 943(a) qualified foreign trade property. Each ETI exclusion corresponded to an inclusion of income by Taxpayer under the POC method.[4]

[4] See footnote 1, above.

Beginning with its 2000 taxable year, Taxpayer prepared Forms 8873 (Extraterritorial Income Exclusion) and purportedly elected to apply the ETI exclusion provisions in lieu of the FSC provisions under section 5(c)(2) of the ETI Act for the sales at issue.[5] In each instance, Taxpayer made the election by checking the box on line 2 of each Form 8873 in the first year (but in no case before September 30, 2000) that Taxpayer claimed an ETI exclusion with respect to the sale or a later year if the 10-percent method delayed recognition until such year.

IV. Contract Sample

Taxpayer asserts that all income it reported pursuant to long-term contracts entered into before October 1, 2000, qualifies for ETI exclusions. To evaluate Taxpayer's claims, the Examination team reviewed a representative group of such long-term contracts. Below, we provide a generic example, ContractX, of Taxpayer's contracts that reflects the terms of the sample of contracts reviewed by Examination. We use ContractX later in this memorandum for illustrative purposes.

ContractX

In April 1998, the government of CountryX signed an LOA with the U.S. Department of Defense ("DoD") to purchase a specified number of ProductX ("Original Sale") with an option to purchase an additional specified number of ProductX ("Second Sale"). The option met the requirements of section 5(c)(1) of the ETI Act. In July 1998, Taxpayer executed ContractX with the DoD whereby the DoD would purchase ProductX in accordance with the LOA on behalf of CountryX.

Actual deliveries of ProductX purchased in the Original Sale occurred during 2002, 2003, and 2004. Taxpayer recognized income under the POC method from 1999[6] through 2004. In 2004, the DoD issued a DD Form 250 evidencing delivery and acceptance with respect to the Original Sale.

In 2001, CountryX exercised its option to purchase additional ProductX under the contract. Deliveries of the additional ProductX began in 2004 and will continue for several more years. Taxpayer recognized income under the POC method in 2004 and will continue to do so for several more years. The DoD has not issued a DD Form 250 with respect to the Second Sale.

With respect to its income from the two sales, Taxpayer claimed: (1) FSC benefits for income recognized during 1999; (2) FSC benefits for income recognized during the first nine months of 2000 and ETI exclusions for income recognized during

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[5] As discussed in more detail below, we believe the elections are invalid because such elections cannot be made with respect to sales entered into before the ETI effective date.

[6] Taxpayer did not recognize income during 1998 because of the 10-percent method.

the last three months of 2000; and (3) ETI exclusions for income recognized during 2001 through 2004.

LAW

Both the FSC and ETI exclusion provisions provide tax benefits with respect to foreign trading gross receipts. See generally I.R.C. §§ 921-927; 941-943; and 114. A major difference between the FSC and ETI exclusion provisions is with respect to military property. Under the FSC provisions, only 50% of the partial exemption from U.S. income tax provided by sections 923(a)(1) and 921(a) applies to the sale of military property. I.R.C. § 923(a)(5). In other words, sales of export property that constitutes military property usually generate only one-half of the FSC benefit generated by sales of export property that does not constitute military property. This rule, commonly known as the military property "haircut," is not present in the ETI exclusion provisions. Consequently, reporting its military property sales under the ETI exclusion provisions generally would double a taxpayer's tax benefit in comparison with the benefit available under the FSC provisions.[7]

The ETI Act repealed the FSC provisions and enacted the ETI exclusion provisions. See §§ 2 and 3, ETI Act. Section 5(a) of the ETI Act provides that the ETI exclusion provisions generally apply to "transactions after September 30, 2000" (the "ETI effective date"). The legislative history further clarifies that the ETI exclusion provisions are "effective for transactions entered into after September 30, 2000." (emphasis added). S. Rep. No. 104-416 (2000), p. 20 ("ETI Report"); see also Rev. Proc. 2001-37, 2001-1 C.B. 1327, §§ 2.02 and 6.03. For purposes of the ETI exclusion provisions, "transaction" means any sale, exchange, or other disposition; lease or rental; and furnishing of services. I.R.C. § 943(b)(1).

Section 5(c)(1) of the ETI Act contains transition rules that delay the application of the ETI exclusion provisions to certain transactions notwithstanding the ETI effective date. Section 5(c)(1) of the ETI Act provides:

> In the case of a FSC (as so defined) in existence on September 30, 2000, and at all times thereafter, the amendments made by this Act shall not apply to any transaction in the ordinary course of trade or business involving a FSC which occurs—
>
> (A) before January 1, 2002; or
> (B) after December 31, 2001, pursuant to a binding contract—

[7] Aside from certain discrete deviations such as the military property "haircut," the FSC and ETI exclusion provisions generally provide quantitatively similar tax benefits.

> (i) which is between the FSC (or any related person) and any person which is not a related person; and
> (ii) which is in effect on September 30, 2000, and all times thereafter.
>
> For purposes of this paragraph, a binding contract shall include a purchase option, renewal option, or replacement option which is included in such contract and which is enforceable against the seller or lessor.

We refer to the section 5(c)(1)(B) transition rule involving binding contracts as the "binding contract rule." The FSC provisions, rather than the ETI exclusion provisions, apply to transactions to which the binding contract rule applies. However, under section 5(c)(2) of the ETI Act, a taxpayer may elect out of the binding contract rule.

Section 5(c)(2) allows a taxpayer to elect to apply the ETI exclusion provisions to any transaction that would have been subject to the FSC provisions by reason of section 5(c)(1) of the ETI Act. The section 5(c)(2) election applies on a transaction-by-transaction basis and is "effective for the taxable year for which made and all subsequent taxable years. . . ." See also Rev. Proc. 2001-37 at § 6.04.

ANALYSIS

I. Interpreting the ETI Effective Date

This case involves a disagreement between the Service and Taxpayer regarding whether the ETI exclusion provisions apply to the income from certain long-term sales of military property by Taxpayer pursuant to certain long-term contracts under the POC method. Resolution of this dispute turns on the interpretation and application of the ETI effective date provision in section 5(a) of the ETI Act.

A. Service Position

The Service interprets the ETI effective date to encompass transactions entered into after September 30, 2000. This "entered into" interpretation is explicitly supported by the legislative history to the ETI Act. ETI Report, p. 20. The determination of when a sale is entered into within the meaning of section 5(a) of the ETI Act requires an analysis of the surrounding facts and circumstances on a case-by-case basis. For example, in a particular case, a sale might be entered into: (1) when the underlying contract is signed; (2) when the purchaser and seller make an LOA or memorandum of understanding; (3) when an export license[8] for military property is obtained from the Department of State; or (4) when an option is exercised pursuant to the underlying

[8] See, for example, the rules under the Arms Export Control Act. 22 U.S.C. §§ 2751 et seq., Pub. L. No. 90-629, 82 Stat. 1321 (1968); 22 C.F.R. §§ 121.1 et seq.

contract.

Under the Service’s interpretation of the ETI effective date and as determined under the facts and circumstances, ContractX gives rise to two sales – the Original Sale of ProductX entered into in 1998 and the Second Sale of ProductX entered into in 2001 upon the exercise of the purchase option. The income arising from the Original Sale would not qualify for the ETI exclusion provisions because such sale was entered into before October 1, 2000. However, the income arising from the Second Sale could qualify for the ETI exclusion provisions because the sale was entered into after September 30, 2000. Accordingly, the Discussion section below addresses sales entered into before the ETI effective date (such as the Original Sale), not sales entered into after the ETI effective date (such as the Second Sale).

B. Taxpayer Position

Taxpayer originally asserted that each inclusion of income under its POC method corresponds to a separate transaction entered into at the time of such inclusion. Taxpayer now agrees with the Service that its original POC method theory is without merit. Thus, Taxpayer has abandoned that position in favor of a new position described below.

Taxpayer now interprets the ETI effective date to encompass transactions completed after September 30, 2000. More specifically, Taxpayer believes that a transaction is “after September 30, 2000,” within the meaning of section 5(a) of the ETI Act if delivery and acceptance occur after that date. Taxpayer asserts that such time of delivery and acceptance is evidenced by the issuance of DD Forms 250 by the DoD.

Under Taxpayer’s interpretation of the ETI effective date, the ETI exclusion provisions would apply both to the Original Sale of ProductX and the Second Sale of ProductX pursuant to ContractX because the relevant point in time is the issuance of the DD Form 250 with respect to Product X. Because both DD Forms 250 will have been issued after September 30, 2000, all income attributable to the sales of ProductX (both the Original Sale and the Second Sale), including income that was recognized before the ETI effective date, would qualify for the ETI exclusion provisions. Taxpayer also claims that its delivery and acceptance position is supported by general tax principles and the language of section 5(c)(1) and (2) of the ETI Act.

II. Discussion

The distinction between completion of a sale and entering into a sale may be irrelevant (even non-existent) in many contexts. For example, if all events associated with a sale – from negotiations, to agreement, to delivery and acceptance – occur within a single day, then the distinction may be immaterial. Nonetheless, in other situations this distinction may be quite relevant. This is true in the case of the long-term sales at issue in Taxpayer’s case because prices are fixed at the outset, products are made-to-order over a span of years, and income is taken into account under the POC method throughout that span of years. In the defense contractor context, generally, and the Taxpayer context, specifically, the Service's "entered into" interpretation of the ETI effective date appropriately reflects the critical significance of exactly when a sales agreement is reached. In contrast, Taxpayer's position would result in the inappropriate situation in which ETI exclusions – keyed off delivery and acceptance – are available years before an ETI exclusion regime was even contemplated. This approach simply is not a realistic outcome of the statutory scheme.

In short, we believe the proper interpretation should ensure similar treatment/tax benefits both to a taxpayer that is able to complete a sale immediately because the taxpayer has available inventory and to a taxpayer that must make the product to order over a period of time.

A. Taxpayer's Delivery and Acceptance Theory of the ETI Effective Date is Not Persuasive

Taxpayer's position is based on the concept of completing or consummating a sale. To this end, Taxpayer argues that completion of a sale is equivalent to final delivery and acceptance of the finished products evidenced by the issuance of a DD Form 250. To our knowledge, neither case law nor general tax principles support Taxpayer's position. Even under rules that embody a completion of sale concept, neither delivery nor acceptance, by itself, is dispositive. Moreover, Taxpayer's approach is particularly unsatisfactory in the context of long-term sales completed pursuant to contracts entered into before an ETI regime was even created.

Nonetheless, Taxpayer argues that traditional benefits and burdens analyses embodied in case law and regulations support its delivery and acceptance interpretation of the ETI effective date. In support of this position, Taxpayer cites Treas. Reg. § 1.861-7(c), Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981), and Guardian Industries v. Commissioner, 97 T.C. 308 (1991), aff'd, 21 F.3d 427 (6th Cir. 1994). The authorities cited by Taxpayer involve facts and legal questions that are materially different from the facts of the present case. For example, Grodt & McKay involved a determination as to whether, for federal income tax purposes, a sale has even occurred in the first place – clearly not a question here. In a different area of tax law, Treas. Reg. § 1.861-7(c) involves a determination of the source of inventory sales income – again, not an issue here.

Taxpayer seems to rely primarily on Guardian, which involved a determination of whether a by-product from a chemical process constitutes a capital asset in the hands of the processor. 97 T.C. 308. To make that determination, the Tax Court considered, among other issues, whether sales of the by-product were frequent and regular. Id. at 317-318. The taxpayer argued that the underlying contract gave rise to a single aggregate sale of the by-product spread over time. The Commissioner argued that the contract was merely an executory contract that gave rise to many individual sales over time as the by-product was regularly collected and sold. In holding that multiple sales occurred, the Tax Court relied both on a Grodt & McKay-style benefits and burdens analysis and on commercial sales law principles. Id. at 318. The court observed that, because most or all of the by-product was not identified, or even in existence, at the time the contract was signed, the contract did not correspond to a single, aggregate sale. The court also noted that, under the contract, purchasers of the by-product were not obligated to pay for the by-product until shipment and the taxpayer was permitted to (and, in fact, did) sell by-product purportedly covered by the contract to other customers. The Sixth Circuit Court of Appeals affirmed the Tax Court's decision without discussing the sale/contract issue. 21 F.3d 427.

Aside from the most superficial similarities between the two cases – the presence of contracts and sales – we do not see the relevance of Guardian to the present case. Guardian involves a situation where the parties do not agree on the number of sales that arose from non-binding executory contracts. The number of sales is not at issue in this case now that Taxpayer has abandoned its original POC method position described above. Moreover, this case involves binding contracts.

Taxpayer also cites Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26 (1988) (involving income inclusion under the all events test) and Segall v. Commissioner, 114 F.2d 706 (6th Cir. 1940), cert. denied, 313 U.S. 561 (1941) (determining when sales are consummated), as supporting its delivery and acceptance position. Taxpayer's reliance on Hallmark and Segall is similarly misplaced.

The authorities cited and relied upon by Taxpayer are inapposite. The authorities address issues such as: (1) whether a sale occurred in the first place (Grodt & McKay); (2) whether an activity comprises a single sale or multiple sales (Guardian); (3) when a sale is consummated (Treas. Reg. § 1.861-7(c) and Segall); and (4) income inclusion under the all events test (Hallmark). In other words, the authorities cited by Taxpayer do not address the issue at hand – determining when long-term sales are entered into for purposes of a statutory transaction-based effective date.

Furthermore, none of those authorities support Taxpayer's claim that a sale is entered into at the time delivery and acceptance are completed. The authorities involve determinations based on traditional benefits and burdens analyses, commercial sales law principles, and the all events test. Thus, those authorities are focused on concepts such as legal title, beneficial ownership, risk of loss, right to receive payment, and right of withdrawal. None of those authorities stand for the proposition that a sale is either entered into or completed at the time of delivery and acceptance as evidenced by a DD Form 250.

B. Taxpayer's Position Would Render the ETI Act Inadministrable

Taxpayer's theory amounts to a "wait-and-see" approach. That is, Taxpayer typically would not know if the FSC provisions, the ETI exclusion provisions, or a successor regime applies to income until long after the income has been recognized – i.e., when the DD Form 250 is eventually issued. Then, once delivery and acceptance occur, Taxpayer would have to amend its returns for open taxable years and claim the appropriate tax benefits depending on what tax regime ultimately is in effect at the time of delivery and acceptance.

In some instances, Taxpayer presumably would have to file protective claims for refund for taxable years that close before delivery and acceptance occur. In other instances, Taxpayer would be able to claim ETI exclusions on income that it recognized even before the ETI effective date because the product was delivered and accepted after the ETI effective date. In short, if followed to its logical conclusion, Taxpayer's interpretation of the ETI effective date would in some instances delay or deny ETI exclusion benefits where, we believe, Congress intended they be available. In other instances, Taxpayer's interpretation would permit ETI exclusion benefits retroactively (i.e., before the ETI effective date). In fact, this interpretation could permit ETI exclusion benefits even for income recognized before the ETI regime was contemplated.

For example, under Taxpayer's delivery and acceptance interpretation, a taxpayer that entered into a long-term sale in 1982 with delivery and acceptance in 2002 could qualify for ETI exclusions for the income earned from such sale beginning in 1982 (i.e., even before the predecessor FSC provisions were in effect). Conversely, under Taxpayer's theory, the same taxpayer would be unable to claim domestic international sales corporation ("DISC")[9] or FSC benefits for such income. We are not aware of any Congressional intent favoring such unusual results.[10]

For the reasons discussed above, Taxpayer's interpretation of the ETI effective date is inherently inadministrable. That inadministrability is further exacerbated by the fact that neither Taxpayer nor any other taxpayer of which we are aware has ever applied the "wait-and-see" approach dictated by Taxpayer's interpretation. In short, Taxpayer's long-standing return position dating back, we believe, at least until Calendar Year1, belies its current interpretation of the ETI effective date. Presumably, Congress was aware that taxpayers may claim FSC and ETI tax benefits with respect to inclusions of income under the POC method long before the sale is fully completed. Thus, the ETI Report used the "entered into" formulation in restating the ETI effective date.

Long-standing business practices, including those of Taxpayer, confirm the administrability of the Service interpretation and underscore the inadministrability of Taxpayer's position. We believe that, when a taxpayer bids on a contract or otherwise negotiates a sales agreement while the FSC or ETI exclusion provisions are in effect, the taxpayer relies on the anticipated benefit under such provisions, whichever are in effect at the time. Such reliance can occur in the long-term sale context only if the

[9] The DISC provisions were the materially similar predecessor of the FSC provisions.

[10] Taxpayer's interpretation places it in an awkward position, especially considering the retroactivity aspect. According to Taxpayer's Vice President of Tax, Taxpayer does not intend to claim ETI exclusions before the ETI effective date even though Taxpayer claims it is permitted to do so under its interpretation of the ETI effective date. We believe Taxpayer's reluctance to follow its own argument to its logical conclusion and claim ETI exclusions in pre-ETI effective date years reveals Taxpayer's awareness that its position leads to absurd results.

Service's "entered into" interpretation is followed.

Thus, Taxpayer's interpretation of the ETI effective date would have at least two unintended effects with respect to the long-standing business practices described above. First, a taxpayer situated similarly as Taxpayer would not be able to rely on an anticipated FSC or ETI benefit when bidding on a contract or otherwise negotiating the terms of long-term sales because the taxpayer would not know if the benefit would still be available at the time delivery and acceptance occur years later. Second, in some circumstances, such taxpayer might be able to claim a greater tax benefit than it had anticipated at the time it entered into the sale. That is, in fact, what Taxpayer is attempting to do here. Taxpayer negotiated long-term sales anticipating FSC benefits and is now trying to avail itself of a twice-as-great benefit under the ETI exclusion provisions. The ETI exclusion benefit, if permitted, would constitute a windfall to Taxpayer that, we believe, was not intended by Congress.

C. Taxpayer Misconstrues Section 5(c)(1) and (2) of the ETI Act

Taxpayer asserts that, because section 5(c)(2) of the ETI Act allows taxpayers to elect to apply the ETI exclusion provisions (instead of the FSC provisions) where a binding contract is involved, the Service's denial of ETI exclusions in this case is contrary to the purpose of the ETI transition rules. More specifically, Taxpayer seems to believe that all income from a binding contract described in section 5(c)(1)(B) of the ETI Act automatically qualifies for ETI exclusion treatment. We discern no merit in this argument, which seems to reflect Taxpayer's fundamental misunderstanding of the transition rules, in particular the binding contract rule. In addition, Taxpayer does not appreciate that its interpretation of the ETI effective date is inconsistent with the election provision under section 5(c)(2) of the ETI Act. The binding contract rule and related election are discussed below.

1. <u>The Binding Contract Rule</u>

The purpose of section 5(c)(1) of the ETI Act is to allow FSCs to continue to benefit from the FSC provisions for certain transactions entered into after the general repeal of the FSC provisions, thus easing the transition from FSC to ETI. The purpose of section 5(c)(2) of the ETI Act is to allow FSCs to choose between ETI exclusions or FSC benefits for transactions described in section 5(c)(1). This rule may be particularly helpful, for example, to a buy-sell FSC that entered into a binding contract before the ETI effective date for sales of military property with purchase options exercisable after the ETI effective date. Section 5(c)(1) would force such buy-sell FSC to remain under the FSC provisions subject to the military property "haircut" (unless the contracts are novated). But section 5(c)(2) would allow the FSC to claim the greater benefits under the ETI exclusion provisions for the sales pursuant to the purchase options while leaving the contracts intact. However, these rules are not without limitations. The section 5(c)(2) election applies only to transactions involving a FSC that were entered into <u>after</u> the ETI effective date. <u>See</u> § 5(a), (c)(1), and (c)(2), ETI Act. The binding contract rule logically does not lead to the conclusion that Taxpayer may claim ETI exclusions on sales entered into before the ETI effective date.

To summarize, the ETI effective date is the general rule (i.e., the ETI exclusion provisions apply to transactions entered into after September 30, 2000). The binding contract rule is an exception to the general rule (i.e., the FSC provisions apply to certain transactions entered into after September 30, 2000, involving a FSC and a binding contract). The section 5(c)(2) election is the exception to the exception (i.e., the general rule is reinstated). In no case can the ETI exclusion provisions apply to a transaction entered into before October 1, 2000.

2. The Section 5(c)(2) Election

Taxpayer's interpretation of the ETI effective date is inconsistent with the section 5(c)(2) election in at least two respects. A section 5(c)(2) election is "effective for the taxable year for which made and all subsequent taxable years. . . ." ("election effective date"). The election effective date is premised on the notion that income recognition from some transactions will span more than one taxable year. Moreover, the election effective date provides that the election will apply to all such years on a prospective basis. Thus, the election effective date imposes a multi-year discipline – if a taxpayer earns income from a transaction during more than one taxable year and makes a section 5(c)(2) election with respect to such transaction, all the income (including the income recognized in subsequent years) must be subject to the election.[11] This multi-year discipline regarding the election effective date is consistent with the Service's interpretation of the ETI effective date.

In contrast, Taxpayer's interpretation of the ETI effective date would render the election effective date meaningless and, thus, is inconsistent with section 5(c)(2) of the ETI Act. Because Taxpayer considers a sale not to occur until ultimate delivery and acceptance, Taxpayer most likely will have recognized all the income from the sale by the time Taxpayer is permitted to make the election. Consequently, there would be no "subsequent taxable years" with respect to which a multi-year discipline could apply.

As we noted above, Taxpayer claims to have elected ETI exclusion treatment under section 5(c)(2) of the ETI Act with respect to some or all of the sales at issue. Taxpayer's purported elections are premised on the notion that Taxpayer entered into each sale prior to delivery and acceptance. That is the only way that Taxpayer could know, in the first year of a long-term sale (or later year if the 10-percent method delays recognition) that Taxpayer should make the election at that time. Under Taxpayer's own theory, however, such elections could not have been possible until many years later when delivery and acceptance were completed.

For example, assume that the ETI exclusion provisions are in effect during Year1. If Taxpayer properly takes income into account in Year1 under the POC method

[11] We note that a taxpayer that made an election under section 5(c)(2) of the ETI Act may revoke such election only with the consent of the Secretary of the Treasury. Such revocations apply on a prospective basis. Rev. Proc. 2001-37 at § 6.06.

with respect to a sale that will not be completed until Year5, Taxpayer does not know in Year1 if the Year1 income qualifies for the ETI exclusion. By Year5, it is possible that the ETI exclusion provisions would no longer be in effect. In that case, none of the income from the sale would qualify for the ETI exclusion. Therefore, under Taxpayer's own theory, Taxpayer cannot know if its Year1 income qualifies for ETI exclusion treatment until delivery and acceptance occur in Year5, and Taxpayer determines whether the ETI exclusion provisions are still in effect at that time. Thus, Taxpayer's attempt to make a section 5(c)(2) election upon entering into each sale is inconsistent with Taxpayer's position and aligns with the Service position.

To summarize, Taxpayer's purported section 5(c)(2) elections reflect an internal inconsistency of Taxpayer's argument. On the one hand, the sales are deemed to exist for the purpose of making the section 5(c)(2) election. On the other hand, the sales are deemed not to exist for purposes of the ETI effective date. Taxpayer, therefore, directly contradicts its interpretation of the ETI effective date by purportedly making section 5(c)(2) elections at the time it "enters into" each sale. As a result, Taxpayer's position actually underscores the practicality and functionality of the Service position.

3. <u>The AJCA Footnote</u>

Taxpayer also argues that a footnote in recent legislative history supports its reading of the ETI Act. Section 101(c) of the American Jobs Creation Act of 2004, Pub. L. No. 108-357 ("AJCA") generally repealed the ETI exclusion provisions for "transactions after December 31, 2004," subject to certain transition rules.[12] The legislative history to the AJCA provides in a footnote:

> Transition rules delayed the repeal of the FSC rules and the effective date of ETI for transactions before January 1, 2002. An election was provided, however, under which taxpayers could adopt ETI at an earlier date for transactions after September 30, 2000. This election allowed the ETI rules to apply to <u>transactions after September 30, 2000</u>, including transactions occurring pursuant to pre-existing binding contracts.

H.R. Conf. Rept. No. 108-755, n.1 (2004) (emphasis added) ("AJCA footnote"). Taxpayer asserts that the AJCA footnote supports Taxpayer's interpretation of the ETI effective date and transition rules.

The quoted language is a somewhat accurate paraphrasing of the rules in section 5(c)(1) and (2) of the ETI Act. However, the language lends no support to Taxpayer's position. To the extent that one may consider the language of the ETI effective date or of section 5(c)(1) or (2) of the ETI Act to be ambiguous (as evidenced

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[12] To the extent that the AJCA contains provisions/concepts that are analogous to the ETI Act provisions/concepts addressed in this memorandum, such ETI Act and AJCA provisions/concepts should be interpreted consistently.

by the competing interpretations in this case), a similar ambiguity is present in the AJCA footnote, which merely repeats the disputed phrase “transactions after” without adding any clarification. We see no basis for Taxpayer’s reliance on the AJCA footnote as supporting its position in this case.

D. Transaction-based Effective Dates

The Service’s “entered into” reading of the ETI effective date is not novel. The Service’s interpretation draws support from the DISC and FSC legislative precursors to the ETI Act. The Tax Reform Act of 1984, which enacted the FSC provisions and repealed the DISC provisions, applied generally to “transactions after December 31, 1984.” Pub. L. No. 98-369, 98 Stat. 985, § 805(a)(1) (1984). This transaction-based effective date for the FSC provisions would have denied FSC benefits to taxpayers that entered into long-term sales before 1985 but reported income from such sales after 1984 because the sales were entered into before the effective date. In addition, taxpayers could no longer claim DISC benefits after 1984. See Temp. Treas. Reg. § 1.921T-(a)(1) (providing that the DISC election of every DISC was deemed to be revoked on December 31, 1984). This is an important distinction between the DISC/FSC transition and the FSC/ETI transition. In the DISC/FSC context, denial of FSC benefits (because the transaction was entered into under the DISC provisions) meant denial of all DISC/FSC tax benefits after 1984 for long-term sales because DISC benefits were no longer available after 1984. In contrast, in the FSC/ETI context, denial of the ETI exclusion (because the transaction was entered into under the FSC provisions) usually means that the taxpayer will qualify for a FSC benefit instead.

To prevent the denial of benefits for post-1984 income from long-term sales entered into under the DISC provisions (because taxpayers had relied on the expectation of DISC benefits when entering into the sales), Congress provided a special rule to allow certain long-term contracts to qualify for FSC benefits by deeming certain FSC requirements satisfied and by authorizing regulations. Id. at § 805(a)(2); see Temp. Treas. Reg. § 1.921-1T(b)(8). Congress further indicated its intent to provide a special effective date for certain long-term contract taxpayers by stating in the legislative history that, for such taxpayers,

> the income from the long-term contract will be treated as FSC income when recognized, provided the general FSC requirements are satisfied after December 31, 1984.

S. Rep. No. 98-169, 98th Cong., 2d Sess. 636 (April 2, 1984). In the case of the long-term contract taxpayers that had post-1984 income from sales entered into before 1985, this special effective date (essentially a taxable year-based effective date) trumped the general transaction-based effective date. Thus, Congress enabled taxpayers that had relied on an anticipated DISC benefit to claim a comparable FSC benefit instead.

Congress provided another special taxable year-based effective date with respect to computer software. In amending section 927(a)(2)(B) to include computer software in the definition of FSC export property, Congress allowed "gross receipts attributable to periods after December 31, 1997, in taxable years ending after such date" to qualify for FSC benefits. Pub. L. No. 105-34, 111 Stat. 788, § 1171(b) (1997). The legislative history explained that:

> In the case of a multi-year license, the provision applies to gross receipts attributable to the period of such license that is after December 31, 1997.

H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 636 (July 30, 1997), reprinted in 1997-4 C.B. (vol. 2) 1457, 2106. Thus, as with long-term contract sales that straddled the DISC and FSC provisions, Congress provided a special taxable year-based effective date for software licenses that straddled pre- and post-amendment versions of section 927(a)(2)(B), thereby trumping the general transaction-based effective date, which would have denied FSC benefits.

Neither the ETI exclusion provisions nor the accompanying legislative history provide a similar special rule indicating that income from a sale entered into before the ETI effective date should qualify for ETI exclusions (rather than FSC benefits). On the contrary, the ETI exclusion legislative history adopts an "entered into" formulation of the ETI effective date consistent with the general transaction-based effective date of the FSC provisions. As demonstrated above, if Congress wanted to grant ETI benefits with respect to sales entered into before the ETI effective date, Congress knew how to do so. Congress could have written a taxable year-based effective date for POC method taxpayers, but it chose not to.

E. "Transaction" and "Contract" are Separate and Distinct Concepts

Taxpayer claims that the Service's position incorrectly treats "transaction" and "contract" as synonymous. Taxpayer's claim is unwarranted. We agree that "transaction" and "contract" have separate and distinct meanings, at least in the context of the ETI Act. See § 5(c)(1), ETI Act ("any transaction in the ordinary course of trade or business involving a FSC which occurs after December 31, 2001, pursuant to a binding contract. . . .") (emphasis added). Our differentiation between transactions and contracts is illustrated by our analysis of ContractX described above.

ContractX gave rise to two sales. As determined under the facts and circumstances, Taxpayer entered into the Original Sale before the ETI effective date and entered into the Second Sale after the ETI effective date. Therefore, income from the Original Sale does not qualify for an ETI exclusion, but income from the Second Sale could qualify for ETI exclusion treatment assuming all other ETI exclusion requirements are satisfied. Our reading of the ETI Act clearly distinguishes between contracts and the sales to which such contracts give rise.

In summary, we find Taxpayer's arguments unpersuasive and consider the better reading of section 5(a) of the ETI Act to be consistent with the Service position described herein. Accordingly, we conclude that income from Taxpayer's sales entered into before October 1, 2000 – including income from long-term sales entered into before October 1, 2000, that is taken into account under the POC method after September 30, 2000 – does not qualify for the ETI exclusion. Thus, in the case of a long-term contract that Taxpayer entered into before October 1, 2000, income from a sale entered into pursuant to such contract may qualify for the ETI exclusion only if Taxpayer entered into the sale after September 30, 2000 (as in the case of the Second Sale pursuant to ContractX).

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