OFFICE OF
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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: JACOB FELDMAN
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OFFICE OF ASSOCIATE CHIEF COUNSEL
(INTERNATIONAL) CC:INTL

SUBJECT:

This Field Service Advice responds to your memorandum dated August 31, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Agency A =

Corp A =
Corp A-FSC =

Country A =

Country Group A =

Date 1 =

Date 2 =

Product A =

Product Type A =

Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =

x =
y =
z =

ISSUE:

Whether, on the facts presented, sales of Product A to the United States Government by Corp A through Corp A-FSC generated foreign trading gross receipts within the meaning of I.R.C. § 924.

CONCLUSION:

Sales of Product A by Corp A to the United States Government for its own use do not generate foreign trading gross receipts within the meaning of I.R.C. § 924 because the Government was required by law or regulation to purchase products manufactured in the United States within the meaning of I.R.C. § 924(f)(1)(A)(ii) and Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i).

FACTS:

In Year 1 the United States Government entered into a Memorandum of Understanding (MOU) with the governments of Country Group A regarding establishment of a program to develop Product A. The MOU contemplated purchases of Product A by Agency A and by the other signatory countries from Corp A and one other prime contractor.

As to Product A production for Agency A, the MOU called for industry in Country Group A to be granted subcontracts for a small portion (x percent) of the procurement value, with final assembly in the United States. Higher percentages of foreign industrial participation were provided with respect to Product A production for the Country Group A signatories, with final assembly to be abroad. The MOU provided that procurement of equipment and services for the Product A program shall be consistent with Department of Defense regulations, but that with respect to

the non-domestic x percent industrial participation called for in the MOU, "[o]ffers shall be evaluated without applying price differentials such as those required by 'Buy American' and 'Balance of Payment' laws and regulations."

We further understand that Agency A over the years has entered into y procurement contracts with Corp A for Product A. Each of these contracts appears to incorporate the "buy American" clause required by Department of Defense regulations (DFARs or FARs). The most recent of these contracts, dating from Year 2, indicates in a footnote that a "FAR waiver has been granted from this clause."

Corp A-FSC is a wholly-owned subsidiary of Corp A, incorporated in Country A on Date 1. Corp A-FSC timely elected foreign sales corporation (FSC) treatment pursuant to sections 922(a)(2) and 927(f)(1) for Year 3 and all subsequent tax years, and in all other respects has continuously maintained its status as a FSC as defined in section 922(a). Pursuant to a Foreign Sales Commission Agreement dated Date 2, Corp A-FSC provides consultation and representation to Corp A with respect to Corp A's export sales, and Corp A pays Corp A-FSC a commission equal to the maximum amount permitted under the transfer pricing provisions of section 925.

At issue are Corp A's export sales of Product A to Agency A during the taxable years Years 4 through 5. In claims for refund, Corp A now maintains that such Product A sales were export transactions entitled to FSC benefits.

LAW AND ANALYSIS

Under Code section 921 et seq., portions of the foreign trade income of a FSC are exempt from tax. Foreign trade income is the gross income of a FSC attributable to foreign trading gross receipts. Section 923(b). Foreign trading gross receipts of a FSC generally include gross receipts from the sale of export property by either the FSC or any principal for whom the FSC acts as a commission agent. Section 924(a)(1); Temp. Treas. Reg. § 1.924(a)-1T(b). Export property is defined, in pertinent part, as property manufactured in the United States by a person other than a FSC, held primarily for sale in the ordinary course of business by a FSC for direct use outside of the United States, and no more than 50 percent of the value of which is attributable to articles imported into the United States. Section 927(a)(1); Temp. Treas. Reg. § 1.927(a)-1T. Accordingly, in order for a sale transaction to be entitled to FSC benefits, it must involve export property, and the receipts from the sale must qualify as foreign trading gross receipts.

You have advised our office that there is no dispute regarding the qualification of Product A as export property as defined. The sole dispute involves whether the sales of Product A generated foreign trading gross receipts within the meaning of section 924. More specifically, the issue is whether the "buy American" provision of

section 924(f)(1)(A)(ii) operates to disqualify the receipts from such sales as foreign trading gross receipts.

Section 924(f)(1) provides certain exclusions from the general definition of foreign trading gross receipts in section 924(a)(1) noted above. Section 924(f)(1)(A)(ii) provides that foreign trading gross receipts "shall not include receipts of a FSC from a transaction" involving export property that is "for use by the United States or any instrumentality thereof and such use of export property ... is required by law or regulation." Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i) elaborates:

> Foreign trading gross receipts of a FSC do not include [otherwise qualifying] gross receipts ... if a sale ... of export property ... is for use by the United States or an instrumentality thereof in any case in which any law or regulation requires in any manner the purchase ... of property manufactured, produced, grown, or extracted in the United States.... For example, a sale by a FSC of export property to the Department of Defense for use outside the United States would not produce foreign trading gross receipts for the FSC if the Department of Defense purchased the property from appropriated funds subject to either any provision of the Department of Defense Federal Acquisition Regulations Supplement (48 CFR Chapter 2) or any appropriations act for the Department of Defense for the applicable year if the regulations or appropriations act requires that the items purchased must have been grown, reprocessed, reused, or produced in the United States.

Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(iii) recognizes certain exceptions to this exclusion where the purchase of export property is pursuant to a program for resale to a foreign government or a program involving international competitive bidding.

Summarizing these provisions, receipts from sales of export property to the United States Government for its own use are generally excluded from the definition of foreign trading gross receipts where the Government was required in any manner by law or regulation to purchase only items produced in the United States, i.e., was required to "buy American".

By letter dated March 29, 1999, the Office of General Counsel of Agency A has confirmed to us, and Corp A and Corp A-FSC do not dispute, that the Product A sales were potentially subject to "buy American" laws and regulations. The Defense Department acquisition regulations ("DFARs") referenced in Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i) quoted above implement the Buy American Act of 1988, 41 U.S.C. § 10a et seq., and require that procurement contracts include clauses implementing such legislation. See 48 C.F.R. § 252.225.7001. Each of the Product A contracts between Corp A and Agency A expressly incorporates the clauses required by 48 C.F.R. § 252.225.7001 or some version of its predecessors, ASPR 7-104.3 and DAR 7-104.3. Moreover, Corp A and Corp A-FSC do not

maintain that any of the exceptions under Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(iii) are applicable.

However, it is the position of Corp A and Corp A-FSC that the "buy American" restrictions were waived as to Product A because foreign subcontractors supplied some of the components of Product A under the MOU among the United States and Country Group A. Corp A and Corp A-FSC maintain that such a waiver removed Corp A's sales of Product A from the scope of the "buy American" exclusion of section 924(f)(1)(A)(ii) and Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i), with the result that the receipts from such sales constituted foreign trading gross receipts. For several reasons, we find this conclusion fundamentally flawed.

First, the plain language of the MOU among the United States and Country Group A did not purport to waive the central "buy American" requirement, namely, that the end product at issue be manufactured in the United States. Indeed, the MOU expressly provided that the Product A produced for Agency A be assembled in the United States with American components representing almost all (z percent) of the procurement value. Such assembly is a key indicator of a manufacturing process within the meaning of the FSC provisions. See Temp Treas. Reg. § 1.927(a)-1T(c)(2); Treas. Reg. § 1.954-3(a)(4). The only reference in the MOU to non-application of "buy American" restrictions was with respect to offers from subcontractors within the permitted non-domestic x-percent industrial participation.

Subcontracting arrangements are irrelevant to the application of "buy American" restrictions to the contract between Corp A and Agency A for the purchase and sale of Product A. What Corp A sold to Agency A was completed Product A, not the components purchased by Corp A from others and incorporated into the final export product. From a FSC standpoint, Corp A's receipts at issue were from sales of the end product. The "buy American" restrictions as implemented in the DFARs, by their terms, also apply to the end product. See 48 C.F.R. § 252.225-7001(b) ("This clause implements the Buy American Act in a manner that will encourage a favorable international balance of payments by providing a preference to domestic end products over other end products...." [Emphasis added])

For DFAR purposes, a domestic end product is defined as "an end product manufactured in the United States, if the cost of its components mined, produced, or manufactured in the United States exceeds 50 percent of the cost of all its components." 48 C.F.R. § 252.225-7001(a)(2)(ii). This definition reinforces that the product subject to the "buy American" restriction is the end product. Foreign components are relevant only as they may affect qualification of the end product as domestic. Similarly, for FSC purposes, the presence of foreign components is taken into account in determining the threshold issue of qualification of the end product as "export property" under section 927(a)(1), discussed above, but is irrelevant to the operation of the "buy American" exclusion under section 924(f)(1)(A)(ii).

Second, we asked the Department of Defense to review the history of the Product A program, including the reference to a "FAR waiver" in the Year 2 contract, to determine whether there was any waiver of "buy American" restrictions with respect to the sales of Product A by Corp A to Agency A during the taxable years at issue. By letter dated March 29, 1999, the Office of General Counsel of Agency A advised us that there was never any such waiver and that the reference to a "FAR waiver" in the Year 2 contract could only have been referring to the permitted participation of foreign subcontractors to the extent of x percent of the procurement value. As discussed above, these subcontracting transactions are not the Product A sale transactions for which FSC benefits are claimed.

Third, Corp A's and Corp A-FSC's claims are inconsistent with the purpose and policy underlying both the FSC regime in general and the "buy American" exclusion in particular. Analysis of the FSC regime is rooted in examination of the earlier domestic international sales corporation (DISC) regime from which the FSC provisions were largely drawn.

The legislative history of the DISC provisions makes explicit Congress' overall purpose "to provide tax incentives for U.S. firms to increase their exports." H.R. Rep. No. 533, 92d Cong., 1st Sess., reprinted in 1972-1 C.B. 498, 529; S. Rep. No. 437, 92d Cong., 1st Sess., reprinted in 1972-1 C.B. 559, 609. The DISC statutory "buy American" exclusion at section 993(a)(2)(C) provides that the Secretary may by regulations exclude from qualified export receipts (analogous to FSC foreign trading gross receipts) those receipts from sales and other transactions in domestic products for use by the United States that are found to be required by law or regulations.

By excluding certain receipts from the general definition of DISC qualified export receipts, Congress sought to "limit the application of the tax-[favored] treatment to situations which, in fact, involve export transactions" and to deny such treatment to receipts from enumerated types of transactions (including those compelled or preferred by "buy American" constraints) that were "not really export transactions." H. Rep. No. 533, supra, at 1972-1 C.B. 533; S. Rep. No. 437, supra, at 1972-1 C.B. 614. Thus Congress determined to carve out of the FSC regime transactions subject to "buy American" constraints because such transactions would not advance the stated legislative purpose.

Treasury further implemented and refined this carve-out throughout the process of developing the DISC regulations. The 1972 proposed regulations gave an example of the "buy American" exclusion whereby purchases of domestic goods for resale at military commissaries abroad would be ineligible for DISC benefits (subject to the exclusion) because such purchases were found subject to Department of Defense procurement regulations, while purchases of goods for resale at military post or base exchanges would be eligible for DISC benefits (not subject to the exclusion) because they were believed not subject to procurement regulations. Prop. Treas.

Reg. § 1.993-1(j)(4)(i), 37 Fed. Reg. 20853, 20857 (Oct. 4, 1972). During the ensuing several years, further research and numerous comments received on the proposed regulation revealed that in fact commissary purchases were excepted from the "buy American" provisions of procurement regulations. Accordingly, the final regulation dropped the commissary/PX example and clarified that only those purchases in fact subject to restrictions would be subject to the DISC exclusion. T.D. 7514, 1977-2 C.B. 266 (1977). The eligibility of commissary purchases for DISC benefits was later confirmed by Rev. Rul. 88-11, 1988-1 C.B. 296.

When Congress replaced DISC with the FSC regime, the legislative history clarified that the purpose of FSC was "to afford U.S. exporters treatment comparable to what exporters customarily obtain in territorial systems of taxation" and that Congress generally "intends excluded receipts to be the same as excluded receipts under the ... DISC rules...." S. Rep. No. 169 (Vol. 1), 98th Cong., 2d Sess. 635, 645 (1984). Moreover, the preamble to the FSC regulations provides: "The detailed definitions of foreign trading gross receipts of a FSC are taken in all important respects from the definition of qualified export receipts of a DISC at § 1.993-1." T.D. 8126, 1987-1 C.B. 184, 186. Specifically, the FSC "buy American" exclusion at section 924(f)(1)(A)(ii), quoted above and here at issue, is substantially similar to its DISC counterpart. Congress and Treasury thus have continued in the FSC regime to carve out "buy American" transactions as inconsistent with the legislative purpose.

Product Type A is in its nature and scale wholly unlike the commissary/PX merchandise treated as eligible for FSC benefits. As confirmed by Agency A and not disputed by Corp A, Product A was subject to "buy American" restrictions and was consistently treated by Agency A as subject to those restrictions in awarding the procurement contracts to Corp A without any consideration of foreign competition at the end product level. The only permitted foreign participation was with respect to components provided by subcontractors, and then only to the extent of x percent of procurement value.

Accordingly, the receipts from sales of Product A to Agency A should be excluded from foreign trading gross receipts of Corp A-FSC under section 924(f)(1)(A)(ii) and Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i).

If you have any further questions, please call Elizabeth Beck, Senior Technical Reviewer, Branch 6, Office of Associate Chief Counsel (International), at (202) 874-1490.

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