Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SER:KYT:NAS:TL-N-8364-98
AMPapadakis

VIA: Federal Express

date: JUL 12 1999

to: Chief, Examination Division, Kentucky-Tennessee District
Attn: Branch Chief Billy W. Shannon

from: District Counsel, Kentucky-Tennessee District, Nashville

subject: [redacted]
FSC Amended Returns [redacted] and Form 1120 Claims
Review of Grouping Practices in Determining the OPP

This is in reply to your memorandum dated December 7, 1998 requesting advice on the issue below. Although this office was preparing the below advice for Field Service Advice, it is our understanding that you have reached a basis of settlement and do not want this request to go forward. Thus, we are forwarding you our tentative legal conclusions with respect to the issue below. Although we believe our determinations to be legally sound, we suggest that if settlement negotiations deteriorate that Field Service Advice be sought through this office.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

FACTS

Corporation A is a manufacturer of [redacted] and related products. Corporation A owns all the stock of a Foreign Sales Corporation (FSC B hereafter) which earns its income as a commission agent for Corporation A through sales of [redacted] and allied products to foreign entities. Export sales are made to Corporation A's Controlled Foreign Corporations and to other third parties.

Corporation A and FSC B for full costing purposes accounts for its sales in the form of [redacted] Product Groups. Each of the [redacted] Product Groups is divided into varying numbers of Product Lines. Each Product Line is also divided into different Products. Finally, each Product is further be divided into varying Grades. Although it has not been determined, it is believed that grouping a product/product line at any level of this hierarchy would conform to trade or industry usage.

For the tax years at issue, amended returns (1120FSC) have been filed by FSC B reflecting an increase in gross commissions due to a change from product line groupings (at the grade level) to a grade level transaction by transaction method for purposes of determining the transfer price of the exported property pursuant to Treas. Reg. §§ 1.925(a)-1T(c)(8)(i) & 1.925(b)-1T(b)(3). Corporation A, as the supplier of the [redacted] products, correspondingly amended its returns to reflect the increase to its commissions expense. The net effect of this transaction is that FSC B is paying tax on approximately [redacted]% of the increase in gross commissions and Corporation A is receiving a [redacted]% refund of the tax with respect to the corresponding deduction. This tax maximizing transaction was recommended by [redacted] CPA Firm.

The audit scope of the amended returns was limited to the [redacted] and [redacted] tax years. If no errors were found in such years, then the Internal Revenue Service intends to accept the other years and allow the claims as filed. From such years, one of the larger FSC product lines was examined for the accuracy of its costing methodology. Specifically, Product Group #[redacted] ([redacted])/ Product Line #[redacted] ([redacted]) was examined. *See* Product Grouping Summary attached hereto as Exhibit A.

Based on the review of FSC B's workpapers used to compute the commissions after the transaction by transaction election was made, the taxpayer was alternating between the larger of a Grade overall profit percentage limitation (hereafter OPP) and a Product Line OPP for marginal costing purposes with respect to the sales of the varying grades within a line.[1] Thus, in many cases the indirect costs of selling a particular grade of a product was included in two OPP groupings, once in its own grade grouping and again in a product line group for costing purposes on a transaction by transaction at the grade level during the tax years at issue.

The above costing methodology is demonstrated in the following table:

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[1] *See* the color coded columns within the table on page three of this memorandum.

TAX YEAR [redacted]

Product Group	Product Line	Product	Grade	Description	Group OPP	Line OPP	Product OPP	Grade OPP	Selected OPP For Costing	Exhibit Reference
[redacted]				[redacted]	14.99%					Exhibit B
	[redacted]			[redacted]	14.99%	**24.94%**				Exhibit B
		[redacted]		[redacted]	14.99%	**24.94%**	26.10%			Exhibit B
			[redacted]	[redacted]	14.99%	**24.94%**	26.10%	**14.77%**	24.94%	Exhibit C
			[redacted]	[redacted]	14.99%	**24.94%**	26.10%	**15.56%**	24.94%	Exhibit C
			[redacted]	[redacted]	14.99%	**24.94%**	26.10%	**34.80%**	34.80%	Exhibit C
			[redacted]	[redacted]	14.99%	**24.94%**	26.10%	**37.57%**	37.57%	Exhibit C
			[redacted]	[redacted]	14.99%	**24.94%**	26.10%	**33.44%**	33.44%	Exhibit C

The above costing methodology demonstrates that in many cases the indirect costs of selling a particular grade of a product were included in more than one product grouping for OPP purposes. For example, the Grades [redacted] through [redacted] were included in their respective Grade groupings and in the Line groupings of Grades [redacted] and [redacted]. Exhibit D is a comprehensive summary of the OPP selection of the varying grades of [redacted]. As demonstrated in Exhibit E, these alternating OPP's were used in computing the allowable FSC profit (FSC Commission). The sales on a transaction by transaction basis of the varying grades of this product are illustrated in Exhibit F.

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[2] Although there are approximately [redacted] grades of [redacted], the methodology used can be demonstrated by examining the above [redacted] grades.

ISSUE

Whether a product may be included in multiple groupings for purposes of determining the overall profit percentage under the marginal costing rules of Treas. Reg. § 1.925(b)-1T?

BRIEF ANSWER

Grouping for marginal costing, including definitions for 'product' and 'product line', are identical to nonmarginal costing rules. Treas. Reg. §§ 1.925(b)-1T(c)(3) & 1.925(a)-1T(c)(6). Any product or product line grouping that is permissible under the grouping rules of Treas. Reg. § 1.925(a)-1T(c)(8) may be used for OPP purposes. Treas. Reg. § 1.925(b)-1T(b)(3)(ii). Grouping designations are chosen on annual basis. Id. Further, a FSC can include a product in only one product group, even if it would otherwise fall into more than one group. Treas. Reg. § 1.925(b)-1T(b)(3)(ii).

During the tax years at issue, FSC B was alternating between the larger of a Grade OPP and a Product Line OPP for marginal costing purposes on a transaction by transaction basis. Such a methodology artificially inflated the allowable commission expenses of the FSC by improperly inflating the overall profit percentage limitation (hereafter OPPL). The methodology used is improper for a number of reasons. First, the overall profit percentage limitation by definition is the product of the overall profit percentage times the FSC's foreign trading gross receipts from export property. Treas. Reg. § 1.925(b)-1T(b)(2). Although the regulations permit aggregation of the overall profit percentage and foreign trading gross receipts (hereafter FTGR) on the basis of products or lines for purposes of determining the overall profit percentage limitation, they do not permit aggregation of the OPP without aggregating the FTGR and CTI. Treas. Reg. §§ 1.925(b)-1T(c)(2)(i) & (ii). Further, by alternating between the larger of the grade and line overall profit percentage ratios, this methodology is in direct contravention of the requirements of Treas. Reg. § 1.925(b)-1T(c)(2)(ii) which restricts redetermination of a FSC's grouping strategy to an annual election. Finally, this methodology violates Treas. Reg. § 1.925(b)-1T(b)(3)(ii) by including products in more than one grouping during the relevant taxable years which has the direct result of artificially inflating the allowable commission expenses of the FSC.

Discussion

Marginal costing (hereafter MC) is a method under which only the direct costs of producing an item are taken into account for purposes of computing combined taxable income (CTI). Essentially, MC enables a FSC to increase income from export sales. Robert Feinschrieber, Transfer Pricing Handbook 304 (1993). This methodology limits costs when determining CTI of a FSC and its related supplier. Treas. Reg. § 1.925(b)-1T(b)(1).

The theoretical standard for MC is that the FSC must be seeking to establish or maintain a market for export property. Treas. Reg. § 1.925(b)-1T(c)(1). Neither the Internal Revenue Code nor the regulations define establishing or maintaining a market. The overall profit percentage limitation (hereafter OPPL) serves as the "establish or maintain" test. Treas. Reg. § 1.925(b)-1T(b)(1). Under the OPPL, FSC sales provide MC benefits only when export sales are less profitable than domestic sales in the relevant grouping.

The OPPL restricts MC benefits because the CTI of the FSC and its related supplier, using the MC rules, cannot exceed the OPPL. Treas. Reg. § 1.925(b)-1T(b)(2). For this purpose, CTI is gross receipts less direct material costs and direct labor costs, so that other costs and expenses are excluded. The OPPL is the product of the overall profit percentage (hereafter OPP)[3] times the FSC's foreign trading gross receipts (hereafter FTGR) from export property. This formula can be expressed as:

$$OPPL = FTGR * OPP$$

If the FSC operates as a commission agent, as in this case, the related supplier's gross receipts are used for this purpose. Treas. Reg. § 1.925(b)-1T(b)(2).

The OPP combines the domestic and export sales percentage, determined on a product or product line basis for each tax year of the FSC. Treas. Reg. § 1.925(c)(2)(i). This percentage is net income divided by gross receipts. The numerator includes two separate net income amounts:[4]

1. CTI of the FSC and its related supplier from the sale of the export property with respect to such product or grade; and

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[3] Treas. Reg. § 1.925(b)-1T(c)(2).

[4] Treas. Reg. § 1.925(b)-1T(c)(2)(i)(A).

2. All other taxable income of the related supplier from all sales, domestic and foreign, based on full costing CTI (hereafter FCCTI). Treas. Reg. § 1.925(b)-1T(c)(3).

The denominator is total gross receipts (hereafter TGR) of the FSC and its related supplier from all export and domestic sales. Treas. Reg. §§ 1.927(b)-1T & 1.925(b)-1T(c)(2)(i)(B). The computation can be expressed by the following formula:

$$OPP = \frac{CTI + FCCTI}{TGR}$$

At the annual option of the related supplier, the OPPL for the FSC's taxable year for all products and product lines may be determined by aggregating the OPP ***and*** FTGR of the FSC, and all domestic members of the controlled group of which the FSC is a member, for the FSC's taxable year. Treas. Reg. § 1.925(b)-1T(c)(2)(ii).

In this case, the taxpayer has artificially inflated the allowable commission expenses of the FSC by inflating the OPPL. The methodology used is improper for a number of reasons. First, OPPL by definition is the product of the OPP times the FSC's FTGR from export property. Treas. Reg. § 1.925(b)-1T(c)(2). Although the regulations permit aggregation of the OPP and FTGR on the basis of products or lines for purposes of determining the OPPL, they do not permit aggregation of the OPP without aggregating the FTGR. As illustrated in Exhibit E, the taxpayer in this case used Line OPP anytime it exceeded Grade OPP in calculating the FSC's OPPL while always using the Grade values for FTGR, CTI, and COGS. Such a costing methodology does not clearly reflect the income. I.R.C. § 446(b).

Further, by alternating between the larger of the grade and line OPP ratios, this methodology is in direct contravention of the requirements of Treas. Reg. § 1.925(b)-1T(c)(2)(ii) which restricts redetermination of a FSC's grouping strategy to an annual election. It is clear from Exhibit D, column *P*, that the taxpayer was regrouping on a transaction by transaction basis rather than on an annual basis.

Finally, this methodology violates Treas. Reg. § 1.925(b)-1T(b)(3)(ii) by including products in more than one grouping during the relevant taxable years which has the direct result of artificially inflating the allowable commission expenses of the FSC. To explain, by alternating between the larger of the grade and line OPP ratios the taxpayer has improperly included products in more than one product group for marginal costing purposes. For example, Group [redacted], Line [redacted], Product [redacted] consists of [redacted] Grades of [redacted]. Grade [redacted] is included in Group [redacted] (consisting of 9 transactions) and in every group where the Line OPP is elected.

Thus, the FSC commission redeterminations for the tax years [redacted] through [redacted] should be corrected to clearly reflect income and comply with the Marginal Costing Rules of Treas. Reg. § 1.925(a) & (b)-1T. Should you have any questions regarding this memo, please contact Andrew M. Papadakis at (615) 250-5520.

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District Counsel

By: /s/ Andrew M. Papadakis

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Attorney

Enclosures:
Examiner's Report
Exhibits A - G