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Taxpayer's Name: Taxpayer's Address:

Taxpayer's Identification No.: Years Involved: Date of Conference:

#### LEGEND:

USCorp	=
USCorp-FSC	=
CountryX	=
Date1	=
IndustryA	=

## **ISSUE 1**

In determining the foreign sales corporation ("FSC") commission payable by USCorp to USCorp-FSC, whether the taxpayer may compute the overall profit percentage ("OPP") under Temp. Treas. Reg. § 1.925(b)-1T(c)(2) of the marginal costing rules for a product by using the OPP for the product or product line grouping in which the product is included if, with respect to other products in the same product line, the taxpayer uses an OPP determined at a different, overlapping level of the product line hierarchy.

# **ISSUE 2**

In determining the extraterritorial income ("ETI") exclusion under section 114, whether USCorp may compute the OPP under the section 941(a)(4) marginal costing rules for a product by using the OPP for the product or product line grouping in which the product is included if, with respect to other products in the same product line, USCorp uses an OPP determined at a different, overlapping level of the product line hierarchy.

# **CONCLUSION 1**

No. In determining the FSC commission payable by USCorp to USCorp-FSC, the taxpayer may not compute the OPP under Temp. Treas. Reg. § 1.925(b)-1T(c)(2) of the marginal costing rules for a product by using the OPP for the product or product line grouping in which the product is included if, with respect to other products in the same product line, the taxpayer uses an OPP determined at a different, overlapping level of the product line hierarchy. This method of computing the OPP is not permissible because it involves inclusion of a product in more than one product group in violation of the second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii).

# **CONCLUSION 2**

No. In determining the ETI exclusion under section 114, USCorp may not compute the OPP under the section 941(a)(4) marginal costing rules for a product by using the OPP for the product or product line grouping in which the product is included if, with respect to other products in the same product line, USCorp uses an OPP determined at a different, overlapping level of the product line hierarchy. This method of computing the OPP is not permissible because it involves inclusion of a product in more than one product group in violation of the second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii).

# FACTS:

USCorp is a domestic corporation that files a consolidated Federal income tax return with various wholly-owned domestic subsidiaries. USCorp-FSC is a wholly-owned subsidiary of USCorp, incorporated in CountryX on Date 1. For taxable years through , USCorp-FSC had in place a valid election to be treated as a FSC pursuant to sections 922(a)(2) and 927(f)(1) and in all other respects continuously maintained its status as a FSC as defined in section 922(a). USCorp and certain of its domestic subsidiaries are engaged in the manufacture and worldwide sale of products in IndustryA and are related suppliers with respect to USCorp-FSC within the meaning of Temp. Treas. Reg. § 1.927(d)-2T(a). For purposes of this memorandum, we refer to USCorp and the other related suppliers collectively as USCorp.

For taxable years through , USCorp-FSC acted as commission agent with respect to sales of section 927(a) export property by USCorp, which paid USCorp-FSC a commission determined using the combined taxable income ("CTI") method of section 925(a)(2). For taxable year , USCorp also sold section 943(a) qualifying foreign trade property. The gross receipts derived from USCorp's sales of export property and qualifying foreign trade property (hereinafter "Product Sales") are foreign trading gross receipts within the meaning of sections 924(a)(1) and 942(a)(1)(A), respectively.

In amended returns timely filed pursuant to Temp. Treas. Reg. § 1.925(a)-1T(e)(4) and (c)(8)(i) (as amended by T.D. 8764, 1998-1 C.B. 844) for taxable years and , USCorp and USCorp-FSC (collectively "Taxpayer")<sup>1</sup> elected to group some of the Product Sales for purposes of applying the CTI method. Taxpayer used the full costing rules to redetermine some CTI amounts and used the marginal costing rules to redetermine other CTI amounts. With respect to Product Sales for which Taxpayer chose to apply the marginal costing rules, Taxpayer grouped transactions for purposes of computing the OPP.

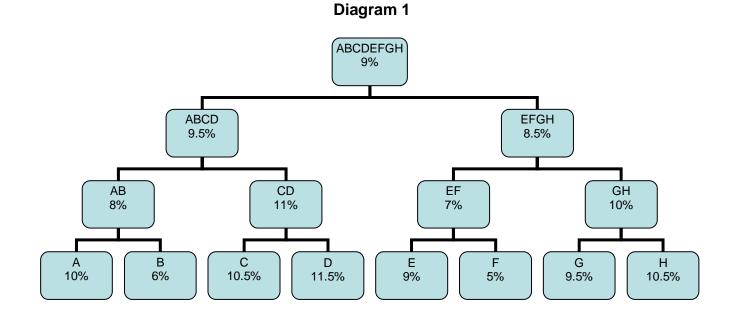
In the original income tax returns filed for taxable years through , Taxpayer elected to group some of its Product Sales for purposes of applying the CTI method. Taxpayer used the full costing rules to compute some CTI amounts and used the marginal costing rules to compute other CTI amounts. With respect to Product Sales for which Taxpayer chose to apply the marginal costing rules, Taxpayer grouped transactions for purposes of computing the OPP.

In its original income tax return filed for taxable year , USCorp elected to group some of its Product Sales in applying the foreign trade income method of section 941(a)(1)(C) to determine its ETI exclusion under section 114.<sup>2</sup> USCorp used the full costing rules with respect to some transactions and groups of transactions and used the marginal costing rules with respect to other transactions and groups of transactions. With respect to Product Sales for which USCorp chose to apply the marginal costing rules, USCorp grouped transactions for purposes of computing the OPP.

<sup>&</sup>lt;sup>1</sup> Although USCorp and USCorp-FSC are separate and distinct tax entities, for simplicity, we use the collective term "Taxpayer" where we address the FSC context separately and where we address both the FSC and ETI exclusion contexts simultaneously. Where we address the ETI exclusion context separately, we refer to USCorp (rather than Taxpayer). Where the discussion applies to USCorp or USCorp-FSC (but not to both), we use the name of the corporation (rather than Taxpayer).

<sup>&</sup>lt;sup>2</sup> Effective October 1, 2000, the FSC provisions were replaced (with limited transition relief) by the ETI exclusion provisions. <u>See</u> FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423, § 5 (Nov. 15, 2000).

At issue is the methodology that Taxpayer used to group transactions for OPP purposes.<sup>3</sup> USCorp's Product Sales typically are categorized into a multi-tiered "tree" or "hierarchy" of products and product lines as shown in Diagram 1 below.



This product hierarchy was based on distinctions among the "product families" that USCorp used for business and recordkeeping purposes and in marketing and selling its products.<sup>4</sup> The broadest product line, ABCDEFGH, comprises two narrower product lines, ABCD and EFGH. Product line ABCD, in turn, comprises two narrower product lines, AB and CD, while product line EFGH comprises product lines EF and GH. Each of these narrower product lines comprise the various products. For example, product line AB includes products A and B. A product constitutes the narrowest level at which transactions are grouped.

Taxpayer represents that all products and product lines are properly determined in accordance with recognized trade or industry usage within the meaning of Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii). Taxpayer also represents that it determines FSC CTI and ETI exclusion foreign trade income for each product at either the transaction level or the product level of the hierarchy. For example, Taxpayer determined CTI for

<sup>&</sup>lt;sup>3</sup> The sole issue addressed by this memorandum is the permissibility of the OPP grouping methodology described. No opinion is expressed on any other issue, including whether any specific product or product line conforms with the requirements of Temp. Treas. Reg. § 1.925(a)-1T(c)(8) or 1.925(b)-1T(b)(3) or whether any grouping redetermination was timely filed or otherwise conformed with the procedural requirements of Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i) or (e)(4).

<sup>&</sup>lt;sup>4</sup> The term "product families" was used in the Joint Fact Statement submitted as part of the TEAM request. It is not a defined term for FSC or ETI exclusion purposes.

product E either on a transaction-by-transaction basis or by grouping all product E transactions together at the product E level, but Taxpayer did not determine CTI for product E by grouping the product E transactions with other transactions at the EF, EFGH, or ABCDEFGH product line level.

In grouping for OPP purposes,<sup>5</sup> Taxpayer first computes an OPP for each product and product line. A typical example is shown in Diagram 1. Taxpayer computes an OPP of 10% for product A by grouping all transactions in that product. Taxpayer also computes an OPP of 8% for product line AB, grouping all transactions in all products in that product line, including products A and B. The OPP for product line AB is less than the OPP for product A because the profitability of product B, which has a lesser individual OPP of 6%, is averaged with the profitability of product A to arrive at the OPP for product line AB. Similarly, working up the product line tree, Taxpayer computes an OPP of 9.5% for the broader product line ABCD, grouping all product lines under that product line, including product lines AB and CD. Finally, Taxpayer computes an OPP of 9% for the broadest product line, ABCDEFGH, grouping all product lines under it, including ABCD and EFGH.

Taxpayer then selects the OPP grouping to be used in the determination of its OPP limitation ("OPPL") with respect to each CTI amount determined at the transaction or product level as the case may be. In making this selection for a product, Taxpayer chooses the greatest of the OPPs for all the levels of the product lines that comprise that product. For example, for product A, Taxpayer chooses the OPP computed separately for that product, because that OPP (10%) is greater than the OPP computed for product line AB (8%), product line ABCD (9.5%), or product line ABCDEFGH (9%). By contrast, in the case of product B, the OPP computed for the ABCD product line (9.5%) is greater than that computed for product B separately (6%) or at the level of product line AB (8%) or product line ABCDEFGH (9%). Therefore, Taxpayer uses the 9.5% OPP computed for the entire product line ABCD grouping as the operative OPP to be used in determining the OPPL with respect to product B CTI, notwithstanding that such grouping overlaps the product A grouping used for OPP purposes to limit product A CTI.

# LAW AND ANALYSIS

# I. The FSC and ETI Exclusion Provisions

A foreign corporation that properly elects FSC treatment pursuant to sections 922(a)(2) and 927(f)(1) may, under section 921(a), exclude from its taxable income portions of its foreign trade income derived from foreign trading gross receipts. Under section 924(a)(1) and Temp. Treas. Reg. § 1.924(a)-1T(b), foreign trading gross receipts of a FSC generally include gross receipts from the sale of export property (as

<sup>&</sup>lt;sup>5</sup> In the Law and Analysis section of this memorandum, we refer to these as "OPP groupings" in contrast to "method groupings" which, in this case, are groupings for the purpose of computing FSC CTI and ETI exclusion foreign trade income under both the full costing and marginal costing rules.

defined in section 927(a)) either by the FSC or by any principal for whom the FSC acts as a commission agent. The commission payable to the FSC by a related supplier may be determined under the administrative pricing rules of section 925, which include the CTI method under section 925(a)(2). Under this method, the FSC commission is computed by reference to full costing CTI under Temp. Treas. Reg. § 1.925(a)-1T(c)(6), or in the alternative, marginal costing CTI pursuant to section 925(b)(2) and Temp. Treas. Reg. § 1.925(b)-1T.

Although the ETI exclusion provisions do not involve the concepts of the separate FSC entity or commission payments, they contain qualification requirements and computation methods that are analogous to those in the predecessor FSC provisions summarized above. For this purpose, the foreign trade income method for determining the ETI exclusion under section 941(a)(1)(C) is analogous to the FSC CTI method. For simplicity, the "Discussion" section of this memorandum addresses the issues using FSC terminology only, but similar principles, analyses, and conclusions apply in the ETI exclusion context.

# A. The Grouping Rules

Section 927(d)(2)(B) provides the FSC grouping rule:

(B) GROUPING OF TRANSACTIONS. – To the extent provided in regulations, any provision of this subpart which, but for this subparagraph, would be applied on a transaction-by-transaction basis may be applied by the taxpayer on the basis of groups of transactions based on product lines or recognized industry or trade usage. Such regulations may permit different groupings for different purposes.

Temp. Treas. Reg. § 1.925(a)-1T(c)(8)<sup>6</sup> provides, in pertinent part:

(8) <u>Grouping transactions</u>. (i) The determinations under this section are to be made on a transaction-bytransaction basis. However, at the annual choice made by the related supplier if the administrative pricing methods are used, some or all of these determinations may be made on the basis of groups consisting of products or product lines....

(ii) A determination by the related supplier as to a product or a product line will be accepted by a district

 $<sup>^{6}</sup>$  References in this memorandum to Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i) include its successor Treas. Reg. § 1.925(a)-1(c)(8)(i) where applicable. See T.D. 8944, 2001-1 C.B. 1067.

director if such determination conforms to either of the following standards: Recognized trade or industry usage, or the two-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President. <u>A product shall</u> <u>be included in only one product line if a product otherwise</u> falls within more than one product line classification.

(iii) A choice by the related supplier to group transactions for a taxable year on a product or product line basis shall apply to all transactions with respect to that product or product line consummated during the taxable year. However, the choice of a product or product line grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are to be made on a transaction-by-transaction basis. For example, the related supplier may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year. . . . (Emphasis added.)

Section 941(b)(1)(B) provides a grouping rule for the ETI exclusion that is analogous to the FSC grouping rule in section 927(d)(2)(B). Pending the issuance of detailed administrative guidance, the FSC grouping regulations cited above apply for purposes of the ETI exclusion. <u>See</u> Staff of the Joint Committee on Taxation, "Technical Explanation of the Senate Amendment to H.R. 4986, the FSC Repeal and Extraterritorial Income Exclusion Act of 2000," JCX-111-00, p.20 (Nov. 1, 2000) (hereinafter cited as "JCX-111-00").

B. The Marginal Costing Rules

Section 925(b)(2) provides the FSC marginal costing rule:

(b) RULES FOR . . . MARGINAL COSTING. – The Secretary shall prescribe regulations setting forth --

\* \* \*

(2) 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.

Temp. Treas. Reg. § 1.925(b)-1T provides, in pertinent part:

(a) <u>In general</u>. This section prescribes the marginal costing rules authorized by section 925(b)(2). If under paragraph (c)(1) of this section a FSC is treated for its taxable year as seeking to establish or maintain a foreign market for sales of an item, product, or product line of export property . . . from which foreign trading gross receipts . . . are derived, the marginal costing rules prescribed in paragraph (b) of this section may be applied at the related supplier's election to compute combined taxable income of the FSC and related supplier derived from those sales. . . .

(b) Marginal costing rules -- (1) <u>In general</u>. Marginal costing is a method under which 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)....

(2) <u>Overall profit percentage limitation</u>. Under marginal costing, the combined taxable income of the FSC and its related supplier 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.

(3) <u>Grouping of transactions</u>. (i) In general, for purposes of this section, an item, product, or product line is the item or group consisting of the product or product line pursuant to § 1.925(a)-1T(c)(8) used by the taxpayer for purposes of applying the full costing combined taxable income method of § 1.925(a)-1T(c)(3)and (6)...

(ii) However, for purposes of determining the overall profit percentage under paragraph (c)(2) of this section, any product or product line grouping permissible under 1.925(a)-1T(c)(8) may be used at the annual choice of the FSC even though it may not be the same

item or grouping referred to in the above subdivision (i) of this paragraph as long as the grouping chosen for determining the overall profit percentage is at least as broad as the grouping referred to in the above subdivision (i) of this paragraph. <u>A product may be</u> included for this purpose, however, in only one product group even though under the grouping rules it would otherwise fall in more than one group. Thus, the marginal costing rules will not apply with respect to any regrouping if the regrouping does not include any product (or products) that was included in the group for purposes of the full costing method.

\* \* \*

(c) <u>Definitions</u>. -- (1) <u>Establishing or maintaining</u> <u>a foreign market</u>. 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 paragraph (b) of this section is greater than the full costing combined taxable income....

(2) <u>Overall profit percentage</u>. (i) For purposes of this section, the overall profit percentage 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 other 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 . . . of the FSC and related supplier from all sales of the product or product line.

(ii) At the annual option of the related supplier, the overall profit percentage for the FSC's taxable year for all products and product lines may be determined by aggregating the amounts described in subdivision (i)(A) and (B) of this paragraph of the FSC, and all domestic members of the controlled group (as defined in section 927(d)(4) and § 1.924(a)-1T(h)) of which the FSC is a member, for the FSC's taxable year and for taxable years of the members ending with or within the FSC's taxable year. (Emphasis added.)

Section 941(a)(4) provides a marginal costing rule for the ETI exclusion that is analogous to the FSC marginal costing rule in section 925(b)(2). Pending the issuance of detailed administrative guidance, the FSC marginal costing regulations cited above apply for purposes of the ETI exclusion. <u>See</u> JCX-111-00, p.20.

## C. Historical Background of the Grouping and Marginal Costing Rules

Prior to the enactment of the FSC provisions, certain transactions were subject to the domestic international sales corporation ("DISC") provisions (sections 991 through 997), which contained administrative pricing rules similar to the FSC administrative pricing rules. The legislative history of the FSC provisions states:

In general, where the provisions of the bill are identical or substantially similar to the DISC provisions under present law, the committee intends that rules comparable to the rules in regulations issued under those provisions will be applied to the FSC.

S. Prt. No. 169, 98th Cong., 2d Sess. (Vol. I) 636 (1984).

With respect to grouping transactions of a DISC for full costing CTI purposes, the first three paragraphs of Treas. Reg. § 1.994-1(c)(7) provide:

(7) <u>Grouping transactions</u>. (i) Generally, the determinations under this section are to be made on a transaction-by-transaction basis. However, at the annual choice of the taxpayer some or all of these determinations may be made on the basis of groups consisting of products or product lines.

(ii) A determination by a taxpayer as to a product or a product line will be accepted by a district director if such determination conforms to any one of the following standards: (a) a recognized industry or trade usage, or (b) the two-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President.

(iii) A choice by the related supplier to group transactions for a taxable year on a product or product line basis shall apply to all transactions with respect to that product or product line consummated during the taxable year. However, the choice of a product or product line grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are made on a transaction-by-transaction basis. For example, the taxpayer may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year.

With respect to grouping transactions of a DISC for marginal costing CTI purposes, Treas. Reg. § 1.994-2(c)(3) provides:

(3) <u>Grouping of transactions</u>. (i) In general, for purposes of this section, an item, product, or product line is the item or group consisting of the product or product line pursuant to \$ 1.994-1(c)(7) used by the taxpayer for purposes of applying the intercompany pricing rules of \$ 1.994-1.

(ii) However, for purposes of determining the overall profit percentage under subparagraph (2) of this paragraph, any product or product line grouping permissible under § 1.994-1(c)(7) may be used at the annual choice of the taxpayer, even though it may not be the same item or grouping referred to in subdivision (i) of this paragraph, as long as the grouping chosen for determining the overall profit percentage is at least as broad as the grouping referred to in subdivision (i).

The Technical Memorandum accompanying the Treasury Decision issuing the DISC administrative pricing regulations states, in pertinent part:

§ 1.994-2(c)(3)

Paragraph (c)(3) provides the rules with respect to grouping of transactions for purposes of marginal costing. The groups consisting of products or product lines adopted by the related supplier under 1.994-1(c)(7) for purposes of applying the intercompany pricing rules of § 1.994-1 must also be used for purposes of applying the marginal costing rules. Items not grouped under § 1.994-1(c)(7) should not be grouped for marginal costing purposes. However, for purposes of determining the overall profit percentage under paragraph (c)(2), the option is given to adopt broader groups of products and product lines than were adopted under § 1.994-1(c)(7). This liberalization of the grouping rule is intended to make simpler and easier the computation of the overall profit percentage limitation. Also, if broader groups may be adopted, marginal costing may be permitted with respect to some items, products, or product lines for which marginal costing would not otherwise be available. This approach is consistent with the theory of 1.994-1(c)(7) which is to give taxpayers maximum flexibility in determining groups of products and product lines in order to obtain maximum benefit from the intercompany pricing rules and to simplify computations.

Tech. Mem., T.D. 7364, 1974 TM Lexis 30, at 68-69 (Oct. 29, 1974).

# **II. Discussion**

The CTI method is a FSC administrative pricing method that may be applied by a taxpayer using either the full costing rules of Temp. Treas. Reg. § 1.925(a)-1T(c)(6) or the marginal costing rules of Temp. Treas. Reg. § 1.925(b)-1T. Temp. Treas. Reg. § 1.925(b)-1T(a)(second sentence) and (c)(1) limits the marginal costing rules to sales where marginal costing CTI is greater than full costing CTI ("threshold requirement"). Even if the threshold requirement is met, CTI determined under the marginal costing rules may not exceed the OPPL, which is the product of the foreign trading gross receipts that gave rise to such CTI and the OPP.<sup>7</sup> Temp. Treas. Reg. § 1.925(b)-1T(b)(2). Thus, for each CTI amount determined under the marginal costing rules, an OPP must also be determined.

Generally, the CTI method applies on a transaction-by-transaction basis. Section 927(d)(2)(B) provides that, to the extent provided in regulations, FSC provisions that would otherwise apply on a transaction-by-transaction basis may be applied by taxpayers "on the basis of groups of transactions based on product lines or recognized industry or trade usage." Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i) allows taxpayers to elect to group transactions for administrative transfer pricing purposes under the full costing rules. Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) through (vii) contains guidelines for such groupings. Temp. Treas. Reg. § 1.925(b)-1T(a) allows taxpayers to elect to apply the marginal costing rules instead of the full costing rules to transactions or

<sup>&</sup>lt;sup>7</sup> OPP is defined below.

groups of transactions. For clarity in the following discussion, we refer to these groupings elected for administrative transfer pricing purposes under both the full costing and marginal costing rules as "method groupings."

Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i) provides that, in general, the grouping rules of Temp. Treas. Reg. § 1.925(a)-1T(c)(8) apply for purposes of the marginal costing rules. Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) provides that, for purposes of determining the OPP with respect to marginal costing CTI, taxpayers may elect groupings that are different from the underlying method groupings provided that: (1) they adhere to the grouping rules of Temp. Treas. Reg. § 1.925(a)-1T(c)(8); (2) they are at least as broad as the method groupings; and (3) no product is included in more than one grouping. Thus, a special grouping is used to determine OPP and may be broader than the method grouping used to determine the marginal costing CTI to which such OPP relates. For clarity in the following discussion, we refer to this special grouping as the "OPP grouping." The OPP is a fraction the numerator of which is the worldwide taxable income from sales of products in the OPP grouping determined on a full costing basis and the denominator of which is the gross receipts from such sales. Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(i).

In a case involving the marginal costing regulations under the DISC regime,<sup>8</sup> 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).

<u>Brown-Forman Corp. v. Commissioner</u>, 94 T.C. 919, 929 (1990), <u>aff'd</u>, 955 F.2d 1037 (6<sup>th</sup> Cir. 1992), <u>cert. denied</u>, 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. <u>Id.</u> at 947. <u>See also Dow Corning Corp. v. United States</u>, 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 CTI 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 determined on a full costing basis. Both the Tax Court (affirmed by the Sixth Circuit) and the Federal Circuit have held that the OPPL regulation is a valid regulation. <u>See Brown-Forman</u>, 94 T.C. at 943 and <u>Dow Corning</u>, 984 F.2d at 422.<sup>9</sup>

<sup>&</sup>lt;sup>8</sup> Treas. Reg. § 1.994-2 was the direct predecessor of the FSC marginal costing regulations.

<sup>&</sup>lt;sup>9</sup> We note that the earlier version of the OPPL regulation at issue in <u>Brown-Forman</u> and <u>Dow Corning</u> differed from the FSC OPPL regulation in at least one material respect. The double-inclusion prohibition

At issue is whether the OPP grouping methodology adopted by Taxpayer -- the selection of overlapping OPP groupings at different levels of the product hierarchy for different products -- complies with the restriction stated in the second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii):

A product may be included for this purpose, however, in only one product group even though under the grouping rules it would otherwise fall in more than one group.

This restriction prohibits a product from being counted more than once in a taxpayer's OPP computations. Thus, we refer to the restriction as a prohibition against double inclusion, or the "double-inclusion prohibition." In Diagram 1, for example, assuming Taxpayer elects the benefit of product A's own relatively large product-level OPP (10%) with respect to product A CTI, we must determine whether Taxpayer's election of the OPP for product line ABCD (9.5%) with respect to product B CTI constitutes a double counting of product A for OPP purposes in violation of the double-inclusion prohibition.

For maximum clarity throughout the remainder of this discussion, we must emphasize the distinction between method groupings and OPP groupings.<sup>10</sup> We reiterate that method groupings are the groupings elected to determine (in this case) CTI, both under the full costing rules (Temp. Treas. Reg. § 1.925(a)-1T(c)(8)) and the marginal costing rules (Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i)). The method groupings must be the same for both full costing and marginal costing purposes. Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i). Taxpayer elected method groupings at the lowest product level (A, B, C, etc.).

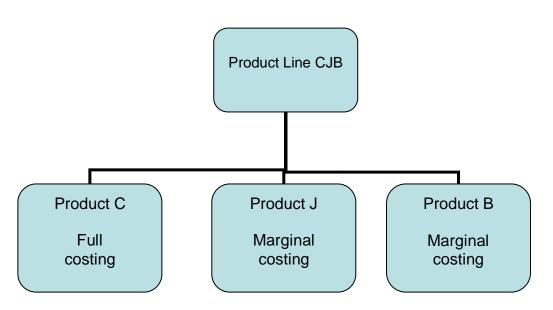
An OPP grouping may be broader than the method grouping to which it relates. Such OPP grouping applies for the purpose of determining the OPP applicable to the CTI amount determined for the method grouping. For example, if Taxpayer determined marginal costing CTI for product G transactions using the product G grouping and applied the OPP for product line GH to product G, the method grouping for product G is product G and the OPP grouping for product G is product line GH. In addition to the rule that allows an OPP grouping to be broader than its corresponding method grouping, the OPP grouping must comply with all other grouping rules including the double-inclusion prohibition, which is stated in both the method grouping portion of the FSC regulations (<u>i.e.</u>, Temp. Treas. Reg. § 1.925(a)-1T(c)(8) and Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i)) and the OPP grouping portion of the FSC regulations (<u>i.e.</u>, Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii)).

(discussed in detail below) was not present in the earlier version and was added to the FSC regulation to prevent, among other things, the kind of grouping methodology at issue in this case.

<sup>&</sup>lt;sup>10</sup> We recognize that "method grouping" and "OPP grouping" are not defined terms set forth in the FSC or ETI exclusion provisions. We use these terms only to distinguish between the two types of groupings that are described in the FSC transfer pricing regulations.

We present the following example to illustrate the FSC transfer pricing principles described above:

Assume that TaxpayerZ has FSC sale transactions involving three different products. The product hierarchy of products and product lines, each of which could be a valid grouping individually<sup>11</sup> under the FSC grouping rules, is as follows:





As Diagram 2 shows, TaxpayerZ applies the full costing rules to determine the CTI from sales of Product C and elects to apply the marginal costing rules to determine the CTI from sales of Products J and B. Because TaxpayerZ applied the full costing rules to Product C, Taxpayer may not group Product J and B sales at a level higher than the product level (i.e., J and B) for CTI purposes.

Under the marginal costing rules, Taxpayer must determine an OPP for Product J CTI and an OPP for Product B CTI. Each OPP must be determined with respect to a grouping that is at least as broad as the method grouping (J or B) to which it relates. Because of the double-inclusion prohibition, TaxpayerZ has two OPP grouping options: (1) Product J OPP and Product B OPP limiting Product J CTI and Product B CTI, respectively, or (2) Product Line CJB OPP limiting both Product J CTI and Product B CTI. These are the only two OPP grouping permutations that do not result in a prohibited double inclusion and do comply with all other grouping requirements. If TaxpayerZ elects to apply the Product Line CJB OPP grouping to Products J and B,

<sup>&</sup>lt;sup>11</sup> However, as the example demonstrates, because of the double-inclusion prohibition, the validity of any particular claimed grouping must be determined in the context of the other claimed groupings.

TaxpayerZ may (and in fact must) include the Product C sales in the OPP computation even though Product C CTI was computed using full costing. Inclusion of the Product C sales does not violate the double-inclusion prohibition because, as with Products J and B, Product C is included in only one OPP grouping (product Line CJB) and such inclusion is necessary in order for the grouping to be complete and valid.

## A. Service Position

Temp. Treas. Reg. § 1.925(b)-1T(b)(3) governs grouping for marginal costing purposes. Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i) sets forth a general rule that the marginal costing groupings must be the same as the full costing groupings. Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) provides an exception to the required congruence with the full costing groupings for purposes of determining the OPP. The first sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) provides that the OPP grouping need not be the same as the method grouping, with three qualifications. First, it must be a "product or product line grouping permissible under" the grouping rules in Temp. Treas. Reg. § 1.925(a)-1T(c)(8). Second, the OPP grouping must be "at least as broad as" the method grouping. Third, the double-inclusion prohibition applies. In summary, Temp. Treas. Reg. § 1.925(b)-1T(b)(3) provides that method groupings must be the same for both full costing and marginal costing purposes, but OPP groupings may be broader than the method groupings to which they relate, provided that no product is included in more than one OPP grouping.

Taxpayer's OPP grouping methodology violates the double-inclusion prohibition in the second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) insofar as it involves overlapping groupings. The use of OPPs selected from different levels in the product hierarchy necessarily results in the inclusion of a product in more than one grouping whenever the levels are within the same product line and, thus, overlap. An example of overlapping groupings in Diagram 1 is product A and product line ABCD. Product A falls within both of these levels of the product hierarchy and could be grouped in either one of them. For example, the individual product-level OPPs could be used for OPP grouping with respect to each of products A, B, C and D, or the OPP determined at the level of product line ABCD could be used with respect to each of the four products. In the latter case, none of the products would violate the double-inclusion prohibition because each product would be used in only one OPP grouping -- ABCD. However, the double-inclusion prohibition prevents any one of the products from being grouped at both levels because then it would be used in more than one OPP computation in determining the FSC commission for the taxable year. Thus, if Taxpayer uses the 10% OPP determined at the product A level with respect to product A CTI, Taxpayer is prohibited from using the 9.5% OPP determined at the product line ABCD level with respect to product B CTI. Otherwise, product A would be used in a second OPP grouping, that of product line ABCD.

#### B. Taxpayer Arguments

Taxpayer asserts (and we agree) that its OPP grouping methodology is substantively similar to the methodology that was analyzed and rejected in TAM 200121018, 2001 PRL LEXIS 280 (Feb. 15, 2001). Taxpayer asserts new arguments in support of that methodology and also invites the Service to rethink its rejection of the arguments raised by the TAM 200121018 taxpayer.<sup>12</sup> The new arguments, some of which bear similarities to the arguments addressed in TAM 200121018, are analyzed below.

#### Argument #1 – Threshold Requirement and Double-Inclusion Prohibition are Inconsistent

Taxpayer claims that the Service's application of the double-inclusion prohibition violates the threshold requirement in Temp. Treas. Reg. § 1.925(b)-1T(a) and (c)(1) that the marginal costing rules apply only if marginal costing CTI exceeds full costing CTI. As illustrated in the discussion above, the Service position is that Taxpayer's use of the 10% OPP for product A – in combination with the double-inclusion prohibition -- obligates Taxpayer to use the 6% OPP for product B. Application of one of the other potential OPPs to product B CTI (based on the AB, ABCD, and ABCDEFGH product lines), would constitute a prohibited double inclusion of product A in two OPP groupings. Taxpayer argues that requiring Taxpayer to use the 6% OPP for product B when greater OPPs are available (for instance, the product line ABCD 9.5% OPP) violates the threshold requirement.

Taxpayer fails to recognize that CTI and OPP are separate and distinct concepts. CTI is a taxable income amount specific to FSC transactions. OPP is a ratio the numerator of which is worldwide taxable income from a product or product line determined on a full costing basis and the denominator of which is the worldwide gross receipts from the same product or product line. The threshold requirement prescribes a comparison of CTI amounts computed under the full costing and marginal costing rules. Under the threshold requirement, if marginal costing CTI is greater than full costing CTI, a taxpayer <u>may</u> elect to apply the marginal costing rules to compute its FSC transfer price or commission. For this purpose, marginal costing CTI is limited by the OPPL, which is determined using a formula that includes an OPP.

Therefore, the OPP is irrelevant to the application of the threshold requirement and becomes relevant in the FSC context <u>only if</u> the threshold requirement has been satisfied. Taxpayer's obligation to use the 6% OPP for product B rather than a greater OPP has nothing to do with determining whether marginal costing CTI is greater than full costing CTI. Because the double-inclusion prohibition in Temp. Treas. Reg.

 $<sup>^{12}</sup>$  We note that technical advice memoranda ("TAM") may not be used or cited as precedent. I.R.C. § 6110(k)(3). We refer to TAM 200121018 solely for the purpose of acknowledging Taxpayer's assertion that its OPP grouping methodology is materially similar to the one described in that TAM and for the purpose of responding to Taxpayer's specific request that we rethink the reasoning and conclusions contained in the TAM.

§ 1.925(b)-1T(b)(3)(ii) has no connection to the computation of CTI, Taxpayer's assertion -- that the Service's position conflicts with the threshold requirement -- is incorrect.

Nevertheless, Taxpayer asserts that the threshold requirement represents a guarantee, where marginal costing CTI is greater than full costing CTI, that FSC benefits determined under the marginal costing rules will be greater than under the full costing rules. Taxpayer further asserts that the double-inclusion prohibition contradicts such purported guarantee. We illustrate Taxpayer's argument with the following hypothetical based on Diagram 1:

Assume that, with respect to product B, full costing CTI is 90x, marginal costing CTI is 100x, and the OPPL is 80x (based on the 6% OPP for product B). If Taxpayer applies the product A OPP (10%) to the product A CTI, and the Service requires Taxpayer to apply the product B OPP (6%) to the product B CTI in accordance with the double-inclusion prohibition, then with respect to product B, Taxpayer receives FSC benefits on only 80x, which is less than the 90x full costing CTI amount. Taxpayer would receive FSC benefits that are less than (based on 80x) the benefits it would have received under the full costing rules (based on 90x) even though the marginal costing rules do not apply unless marginal costing CTI is greater than full costing CTI. Thus, Taxpayer argues, the Service's application of the double-inclusion prohibition is inconsistent with the threshold requirement.

Contrary to Taxpayer's assertions, the hypothetical taxpayer is not "stuck" with a worse result under the marginal costing rules than under the full costing rules as a result of the Service's enforcement of the double-inclusion prohibition. For instance, a taxpayer in such position may use the full costing rules to obtain the benefit of the result based on 90x. In the alternative, a taxpayer also has the option of using a broader OPP grouping (AB, ABCD, or ABCDEFGH) for both product A and product B.

Taxpayer appears to be operating under the misapprehension that, where marginal costing CTI is greater than full costing CTI, the marginal costing rules guarantee a better tax result. The threshold requirement only opens the door to the marginal costing rules; it does not ensure a better tax result. The purpose of the OPPL is to limit marginal costing CTI to worldwide profitability determined on a full costing basis. In the hypothetical set forth above, Taxpayer's OPP with respect to product B was lower than its FSC marginal costing profit percentage. As a result, Taxpayer's FSC benefits under the marginal costing rules with respect to product B are limited to the 80x amount <u>if</u> Taxpayer elects to use product A as the OPP grouping for product A CTI. However, the hypothetical taxpayer presumably will <u>either</u> use the full costing rules for product B <u>or</u> use a broader OPP grouping for both product A and product B.

The phenomenon demonstrated in the hypothetical – that the marginal costing rules can result in a lower FSC benefit than the full costing rules even if marginal costing CTI exceeds full costing CTI – is not limited to situations that involve the

application of the double-inclusion prohibition. For example, assume that TaxpayerQ's <u>only</u> product is product B, which has an OPP of 6%. Assume further that TaxpayerQ's full costing CTI, marginal costing CTI, and OPPL with respect to product B are 90x, 100x, and 80x, respectively. These are the same figures as in the hypothetical above. The only difference between the two scenarios is that, in this hypothetical, TaxpayerQ has no other products, which renders the double-inclusion prohibition irrelevant. That is, TaxpayerQ's only OPP grouping option is the product B grouping (6%); no broader OPP groupings are available because there are no other products.

Because TaxpayerQ's marginal costing CTI of 100x is greater than the full costing CTI of 90x, TaxpayerQ may apply the marginal costing rules to product B. However, the OPPL limits FSC benefits for product B under the marginal costing rules to 80x. Presumably, TaxpayerQ will choose to use the full costing rules (rather than elect the marginal costing rules) and claim FSC benefits on the 90x amount. In short, the OPPL can (and does) deny marginal costing benefits in situations where the double-inclusion prohibition is not involved. Taxpayer's argument suggests that double counting of some products should be permitted in spite of the double-inclusion prohibition. This view is in direct contradiction to the double-inclusion prohibition, which is intended to prevent such circumvention of the OPPL. Moreover, we note that the validity of the OPPL as an appropriate limitation was upheld in <u>Brown-Forman</u> and <u>Dow</u> <u>Corning</u>.

#### Argument #2 – Taxpayer's Method Groupings and OPP Groupings are the Same

Taxpayer asserts that the double-inclusion prohibition in Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) does not apply in Taxpayer's situation because Taxpayer's method groupings were the same as its OPP groupings. Put another way, Taxpayer argues that the double-inclusion prohibition applies only if OPP groupings are different from method groupings and that no such regrouping occurred in this case. Although it is a clear and unambiguous fact that Taxpayer regrouped for OPP purposes, we explain our reasoning here to dispel any lingering confusion.

While Taxpayer is correct that the Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) double-inclusion prohibition applies only in the case of OPP regroupings (<u>i.e.</u>, where OPP groupings differ from the valid method groupings to which they relate), Taxpayer is incorrect when it claims that it did not regroup in this case. For purposes of discussing this argument, we focus only on products A and B in Diagram 1. Taxpayer asserts that its method groupings with respect to products A and B are A, B, AB, ABCD, and ABCDEFGH. In other words, Taxpayer believes that its method groupings are all of the potential groupings contained in its product hierarchy. For similar reasons, Taxpayer asserts that its OPP groupings with respect to products A and B are A, B, AB, ABCD, and ABCDEFGH. As a result of this reasoning, Taxpayer concludes that its method groupings and OPP groupings are the same and, therefore, there was no regrouping to trigger the double-inclusion prohibition of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii).

Taxpayer's argument confuses two concepts – groupings and the product hierarchy. Method groupings and OPP groupings are elected by taxpayers on an annual basis. <u>See</u> Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(i) and 1.925(b)-1T(b)(3)(i). To repeat, a taxpayer's groupings are <u>elected</u>. The elected groupings, both method and OPP, generate the particular computations that are reflected on the taxpayer's return. In contrast, the product hierarchy is merely a conceptual construct (or schematic representation) used by taxpayers to facilitate consideration of their grouping options. A product or product line reflected in a taxpayer's product hierarchy constitutes a method grouping or OPP grouping <u>only if</u> the taxpayer elects to use such grouping in its FSC computations. Products and product lines that are not elected are not method groupings or OPP groupings; they are not groupings at all for FSC transfer pricing purposes. Taxpayer's assertions to the contrary are contradicted by the grouping elections reflected on Taxpayer's returns and Taxpayer's representations in connection with this memorandum.

Of Taxpayer's five purported method groupings with respect to products A and B (A, B, AB, ABCD, and ABCDEFGH), only two of them -- products A and B -- are actual groupings. We know this because Taxpayer elected to compute CTI for its product A and product B transactions on the basis of the groupings product A and product B, respectively. By its own admission, and as reflected on its returns, Taxpayer did not compute CTI and determine FSC commissions for product line AB, ABCD, or ABCDEFGH.

For similar reasons, Taxpayer's OPP groupings for products A and B are not A, B, AB, ABCD, and ABCDEFGH, as Taxpayer asserts but, rather, product A and product line ABCD, respectively. The method groupings product A and product B are different from the OPP groupings product A and product line ABCD. Therefore, Taxpayer regrouped for OPP purposes, and the double-inclusion prohibition applies to invalidate the combination of the product A and product line ABCD OPP groupings because product A is double-counted.

#### <u>Argument #3 – The Broadness Requirement Is Premised on Double Inclusion</u>

Taxpayer argues, based on the "at least as broad as" language of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii), that the product line ABCD <u>OPP grouping</u> that Taxpayer elected for product B CTI must include product A, notwithstanding the double-inclusion prohibition. Otherwise, such grouping would not be at least as broad as the purported ABCD <u>method grouping</u>.

This argument is premised, in part, on Taxpayer's incorrect assumption that its product hierarchy constitutes its product groupings for FSC purposes. As we indicated in our analysis of Argument #2, Taxpayer incorrectly claims that product line ABCD was a method grouping. Taxpayer admits (and Taxpayer's returns reflect) that Taxpayer elected method groupings no higher than the product level of the product hierarchy. In addition, Taxpayer's proposed interpretation of the "at least as broad as language"

disregards the accompanying double-inclusion prohibition. That is, Taxpayer suggests that we interpret the marginal costing rules in a manner that disregards the double-inclusion prohibition and, thus, permits double counting of products for OPP purposes. Under Taxpayer's approach, the double-inclusion prohibition would have no effect on OPP groupings. The second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) is an integral part of the OPPL rules and may not be disregarded.

## Argument #4 – Horizontal vs. Vertical Grouping Relationships

Taxpayer claims that the double-inclusion prohibition applies "horizontally" but not "vertically." For example, Taxpayer believes that the double-inclusion prohibition is intended to prevent Taxpayer from including a single product in more than one product grouping that are at the <u>same level</u> of the product hierarchy – for example, ABC<u>D</u> and <u>D</u>EFGH (<u>i.e.</u>, horizontal relationship). Conversely, Taxpayer does not believe that the double-inclusion prohibition is intended to prevent Taxpayer from including a single product in <u>more than one level</u> of the product hierarchy – for example, product <u>A</u> and product line <u>ABCD (i.e.</u>, vertical relationship).

We find no support for Taxpayer's position in the FSC regulations, which do not distinguish between horizontal and vertical relationships among groupings. The double-inclusion prohibition is a blanket restriction against double inclusion. The horizontal and vertical grouping relationships posited by Taxpayer have the same characteristic of overlapping which results in a similarly distortive mathematical effect in both cases. That is, a high-profit product (A in the example) is double-counted as both the source of a large OPP (10%) with respect to its own transactions and an enhancement to the OPP of a product with lower profitability (B in the example). This kind of distortion is targeted by the plain language of the second sentence of Temp. Treas. Reg.  $\S$  1.925(b)-1T(b)(3)(ii), which by its terms abides no double counting. In short, we perceive no relevance in a distinction between horizontal and vertical grouping relationships in connection with the double-inclusion prohibition.<sup>13</sup>

# Argument #5 – The Double-Inclusion Prohibition Hinders Maximization of FSC Benefits

Taxpayer suggests that the Service's application of the double-inclusion prohibition complicates Taxpayer's task of electing the most beneficial OPP groupings and, thereby, frustrates Taxpayers' ability to determine and claim the maximum FSC benefits allowable. For example, under Taxpayer's OPP grouping methodology, Taxpayer determines the OPP for each product and product line in the product hierarchy and then applies to each transaction or product the greatest OPP that includes such transaction or product without regard for the double-inclusion prohibition.

<sup>&</sup>lt;sup>13</sup> Moreover, we reject Taxpayer's premise that its OPP grouping methodology is based on vertical relationships rather than horizontal relationships. When Taxpayer applied the product A OPP to product A CTI and applied the product line ABCD OPP to product B CTI, Taxpayer double counted product A for OPP purposes with respect to products A and B, which are – according to Taxpayer's unsupported theory -- horizontally related within the grouping hierarchy.

In contrast, the additional step of abiding by the double-inclusion prohibition would require Taxpayer to perform a greater number of computations to determine which OPP grouping permutation in the aggregate yields the greatest FSC benefit while also complying with the double-inclusion prohibition.

Taxpayer is correct that taxpayers have the right to maximize their FSC benefits in applying the grouping and marginal costing rules. If Taxpayer has more than one OPP grouping option, Taxpayer may elect the grouping with the greatest OPP, provided that the grouping meets the requirements of Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8) and 1.925(b)-1T(b)(3). These requirements state the double inclusion prohibition twice – first in Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) and again in Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) – emphasizing that the fundamental grouping rules are the same for both method grouping and OPP grouping purposes and that the double-inclusion prohibition applies in both contexts.

Although Taxpayer may maximize its FSC benefits when it elects its OPP groupings, such maximization must occur within the guidelines for OPP grouping, which include the double-inclusion prohibition. The double-inclusion prohibition contributes to the determination of what amount of FSC benefits is the maximum allowable amount. Without rules such as the double-inclusion prohibition, taxpayers would not know what the maximum allowable benefit is.

#### <u>Argument #6 – Goal of Flexibility Justifies Disregard of the Double-Inclusion Prohibition</u>

Taxpayer asserts that the FSC provisions should be construed in a manner that permits Taxpayer the flexibility to use double counting in its OPP grouping methodology notwithstanding the double-inclusion prohibition. Taxpayer correctly observes that the administrative pricing rules in general, and the marginal costing and OPP grouping rules in particular, afford taxpayers certain choices and flexibility in determining FSC treatment. See Tech. Mem., T.D. 7364, 1974 TM Lexis 30, at 68-69. However, Taxpayer erroneously extrapolates from these general statements of policy to a position that the FSC provisions must be construed to permit unrestricted flexibility. The flexibility afforded in the administrative pricing rules is not unbridled. The OPPL itself is a significant restriction on the marginal costing rules.

Taxpayer's argument ignores well-established principles of statutory construction. The FSC provisions in general, and in particular the marginal costing and grouping rules enabled by sections 925(b)(2) and 927(d)(2)(B), effectively confer a partial exemption of income. The Tax Court has held that grouping issues under the DISC regime are subject to the doctrine of narrow construction of tax exemption provisions.<sup>14</sup> In <u>Napp</u>

<sup>&</sup>lt;sup>14</sup> This doctrine has been consistently applied in a variety of tax cases by the Supreme Court and Circuit Courts of Appeal. <u>See United States v. Burke</u>, 504 U.S. 229, 248 (1992) (Title VII back-pay award held not within scope of section 104 exclusion of damages for personal injury; "exclusions from income must be narrowly construed"); <u>Commissioner v. Clark</u>, 489 U.S. 726, 739 (1989) ("In construing provisions such

<u>Systems, Inc. v. Commissioner</u>, T.C. Memo. 1993-196, the court held invalid a country-by-country basis of grouping, finding that "since the regulation results in a tax deduction, we are ... required to construe it narrowly."

In <u>Brown-Forman Corp. v. Commissioner</u>, 94 T.C. 919, 939-40 (1990), <u>aff'd</u>, 955 F.2d 1037, 1040 (6th Cir. 1992), the court rejected a taxpayer's argument that the OPP regulations must be interpreted in every case to maximize the benefit of marginal costing. The court held:

Petitioner's argument is essentially that, if its method produces a result in harmony with the [general regulatory] purpose . . . it is correct. . . . [S]uch "end justifies the means" argument . . . must fail where the "means" contravenes the plain language of [the regulations]. . . . [W]e are unwilling to rewrite the regulation. . . .

as § 356, in which a general statement of policy is qualified by an exception, we usually read the exception narrowly in order to preserve the primary operation of the provision"); Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 265 (1958) (rate exception for capital gain "has always been narrowly construed so as to protect the revenue against artful devices"); Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 52 (1956) ("Since [capital gain treatment] is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied...."); Commissioner v. Jacobson, 336 U.S. 28, 49 (1949) ("The income taxed is described in sweeping terms and should be broadly construed in accordance with an obvious purpose to tax income comprehensively. The exemptions, on the other hand, are specifically stated and should be construed with restraint in the light of the same policy"); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934) ("[O]nly in exceptional situations, clearly defined, has there been provision for an allowance for losses suffered in an earlier year"); Finley v. United States , 123 F.3d 1342, 1348 (10th Cir. 1997) ("[W]e must narrowly construe the 'reasonable cause' exception to § 6672 liability in order to ... further the basic purpose of § 6672 to protect government revenue"); Estate of Shelfer v. Commissioner, 86 F.3d 1045, 1050 (11th Cir. 1996) ("Because the terminable property rule is an exception to this general public policy, it should be narrowly construed"); Commissioner v. Miller, 914 F.2d 586, 590 (4<sup>th</sup> Cir, 1990) (defamation damages held not within scope of section 104 exclusion of damages for personal injury; "it is a well-recognized, even venerable, principle that exclusions to income are to be narrowly construed"); Commissioner v. Baertschi, 412 F.2d 494, 499 (6th Cir. 1969) (deferral of gain on residence denied; "income tax provisions which exempt taxpayers under given circumstances from paying taxes (or as here, postponing them) are strictly construed"); Kentucky Utilities Co. v. Glenn, 394 F.2d 631, 637 (6th Cir. 1968) (dividend credit denied; "[i]t is standard tax law that income deductions and tax credits are narrowly construed. And the taxpayer has the burden of showing he comes within the provision relied upon"); Holt v. Commissioner, 364 F.2d 38, 40, 42 (8<sup>th</sup> Cir, 1966) (income of Native American lessee of tribal land not entitled to statutory exemption relating to fee interests; "exemptions from taxation are matters of legislative grace" while here there was "no treaty or statute expressly or impliedly exempting such income"); United States v. Foster, 324 F.2d 702, 706 (5th Cir. 1963) ("This treatment is an exception to the general rule of taxing all net income as ordinary income, and, as an exception, it should be narrowly construed"); O'Gilvie v. United States, 92-2 USTC ¶ 50,344 (D. Kan. 1992), mot. for recons. granted, 92-2 USTC ¶ 50,567, rev'd, 66 F.3d 1550 (10<sup>th</sup> Cir. 1995), aff'd, 519 U.S. 79 (1996) (punitive damages held not within scope of section 104 exclusion; "[i]t is a cardinal rule of taxation that exclusions to income are to be narrowly construed").

The Sixth Circuit affirmed, stating: "Given the clarity of [the OPP regulation at issue], we are unmoved by [the taxpayer's] argument." 955 F.2d at 1040.

Applying the same principle to this case, the scope of permitted OPP grouping should be narrowly construed. As in <u>Brown-Forman</u>, the OPP regulation in this case is unambiguous. We decline to adopt Taxpayer's interpretation, which in effect would rewrite (or even delete) the second sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii). Had Treasury and the Service intended to narrow the scope of the double-inclusion prohibition in the very specific way that Taxpayer suggests, we would expect that explicit language limiting the scope of the prohibition would have been added to the provision. As adopted, the double-inclusion prohibition applies to the overlapping OPP groupings used by Taxpayer.

#### <u>Argument #7 – Inclusion of Full Costing Transactions in OPP Groupings</u>

In the TEAM request, Taxpayer asked that this memorandum address whether full costing transactions are included in the OPP groupings applied to marginal costing transactions. Taxpayer argues that, if full costing transactions are, in fact, properly included in OPP groupings, then this is inconsistent with the Service's application of the double-inclusion prohibition. The double-inclusion prohibition does not require the exclusion of full costing transactions from OPP considerations. On the contrary, the worldwide aspect of the OPP formula requires the inclusion of all transactions in the relevant OPP grouping regardless of whether the full costing or marginal costing rules are applied. In short, we agree with Taxpayer that full costing transactions are properly included in OPP groupings in some instances.<sup>15</sup>

But Taxpayer is incorrect that such treatment is inconsistent with the doubleinclusion prohibition. Although inclusion of full costing transactions in OPP groupings is required by Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(iii) and 1.925(b)-1T(b)(3)(ii) and (c)(2)(i), such transactions are still subject to the double-inclusion prohibition for OPP grouping purposes. That means that a full costing transaction may be included in no more than one OPP grouping (just like any marginal costing transaction). The inconsistency perceived by Taxpayer is non-existent. The double-inclusion prohibition applies to each full costing transaction that is properly included in an OPP grouping. As a result, such transaction (or product or product line as the case may be) is included in <u>one and only one method grouping</u> for the purpose of computing full costing CTI and <u>one and only one OPP grouping</u> for the purpose of determining the OPPL for a product grouping that includes such transaction. Therefore, if the double-inclusion prohibition and other grouping rules are applied correctly, double counting of full costing transactions occurs neither in the CTI context nor in the OPP context.

<sup>&</sup>lt;sup>15</sup> This issue was analyzed in detail in Technical Assistance 200231014, 2002 TM LEXIS 1 (June 27, 2002). We note that technical assistance memoranda may not be used or cited as precedent. I.R.C. § 6110(k)(3). We refer to TA 200231014 solely for the purpose of directing Taxpayer's attention to a detailed analysis of the question raised by Taxpayer.

#### C. Summary

As described above, Taxpayer presented several arguments in support of its double counting of products for OPP grouping purposes despite the plain meaning of the double-inclusion prohibition in Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii). After careful consideration, we conclude that Taxpayer's arguments are unfounded. Double inclusion of products for purposes of OPP computations results in a distortion of a taxpayer's worldwide profitability – a principal limitation on FSC benefits. In other words, Taxpayer's OPP grouping methodology computes an artificially inflated worldwide profit margin. Taxpayer's position disregards the purpose, policy, and plain language of the OPPL rules. Taxpayer also requested that we reconsider the arguments raised by a different taxpayer and rejected in TAM 200121018. We agree with the conclusions stated in TAM 200121018 and decline to review those arguments in detail in this memorandum.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.