INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-158403-05

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

**LEGEND:**

USCorp =
USCorp-FSC =
Taxable Year 1 =
Taxable Year 2 =
Taxable Year 3 =
Taxable Year 4 =
Taxable Year 5 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
AmountA =

AmountB =
AmountC =
AmountD =
StateA =
PossessionB =
Market Segments1 through X =

Market SegmentY =

**ISSUES:**

1) Whether the time limits for changing a grouping basis set forth in Treas. Reg. § 1.925(a)-1(c)(8)(i) ("grouping deadlines") apply to groupings for purposes of determining the overall profit percentage ("OPP groupings") under Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii).

2) If the grouping deadlines apply to OPP groupings, whether Taxpayer's changes to its OPP groupings for Taxable Years 1, 2, and 3 were timely.

3) Whether Taxpayer may use a "market segment approach" for its OPP groupings.

**CONCLUSIONS:**

1) Yes. The grouping deadlines apply to OPP groupings.

2) No. Taxpayer's changes to its OPP groupings for Taxable Years 1, 2, and 3 were not timely.

3) No. Taxpayer may not use a "market segment approach" for its OPP groupings.

**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 foreign subsidiary of USCorp. For Taxable Years 1 through 4, USCorp-FSC had in place a valid election to be treated as a foreign sales corporation ("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 is engaged in the manufacture and sale of a wide variety of products and is a related supplier with respect to USCorp-FSC within the meaning of Temp. Treas. Reg. § 1.927(d)-2T(a).

USCorp timely filed (including extensions) its original tax returns for Taxable Years 1 through 5. Examination issued the first information document request ("IDR") for the audit of USCorp's returns for Taxable Years 1 through 3 sixty-eight days prior to Date 1, and issued a letter formally notifying USCorp of the start of that audit on Date 1. Examination issued the first IDR for the audit of USCorp's returns for Taxable Years 4 and 5 seventy days prior to Date 2, and issued a letter formally notifying USCorp of the start of that audit on Date 2.

USCorp-FSC timely filed (including extensions) its tax returns for Taxable Years 1 through 4. The audit of USCorp-FSC's returns for Taxable Years 1 and 2 began by a letter dated Date 3, and ended with only minor changes. Examination did not audit USCorp-FSC's return for Taxable Year 3. All relevant statutes of limitation are open.

At a meeting held with Examination on Date 4, Taxpayer made a presentation regarding its FSC benefits[1] for Taxable Years 1 through 5. Solely for purposes of addressing Issue 2 in this memorandum, the Service and Taxpayer agree that the presentation constitutes an informal grouping redetermination for Taxable Years 1 through 4. On Date 5, USCorp filed amended returns for Taxable Years 1 through 5, and USCorp-FSC filed amended returns for Taxable Years 1 through 4.

On its original tax returns, Taxpayer computed combined taxable income ("CTI") on a transaction-by-transaction basis using the marginal costing rules and, for that purpose, elected approximately AmountA OPP groupings based generally on the Standard Industrial Classification ("SIC") codes applicable to the underlying products.[2] Examination accepted those product groupings as based on recognized trade or industry usage within the meaning of Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii).

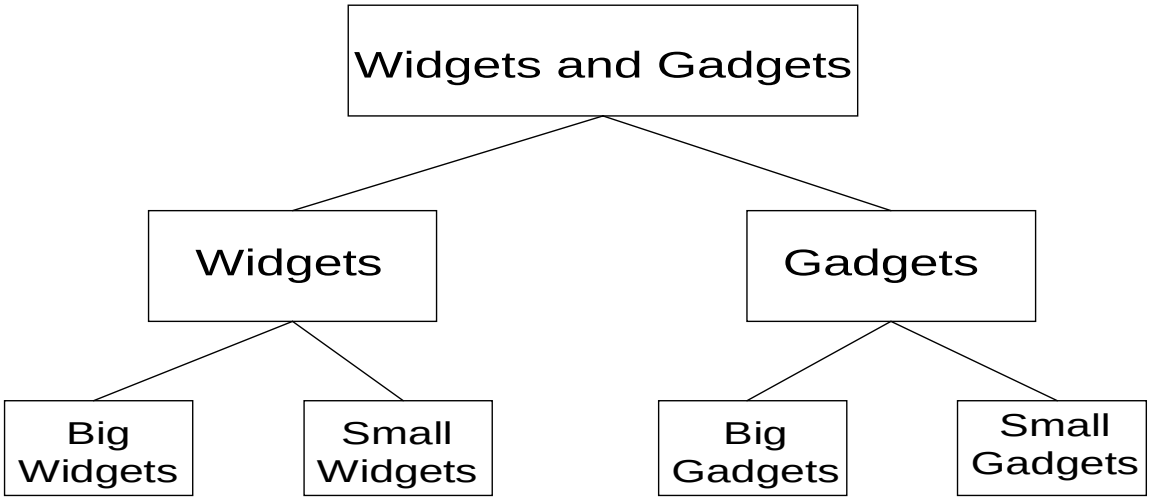
The products within each original OPP grouping were related to other products in the same grouping through product similarities such as physical characteristics, use, and manufacturing facilities and processes. Taxpayer's original OPP groupings are

[1] Some years involve both FSC benefits and extraterritorial income ("ETI") exclusions. We believe the FSC and ETI exclusion provisions are materially similar for purposes of the TAM issues. For convenience and brevity, we generally refer only to the FSC provisions throughout the remainder of this memorandum, but occasionally make reference to the ETI exclusions as well. The conclusions in this memorandum apply similarly whether the FSC provisions or the ETI exclusion provisions apply.

[2] Taxpayer used its own system of classification codes as the basis for its OPP groupings; those codes were very similar, but not identical, to the SIC codes.

illustrated in Diagram 1 below. Diagram 1 shows that Taxpayer grouped sales of similar products together – such as widgets with widgets and gadgets with gadgets.

## DIAGRAM 1
### Taxpayer's OPP Groupings per Original Returns

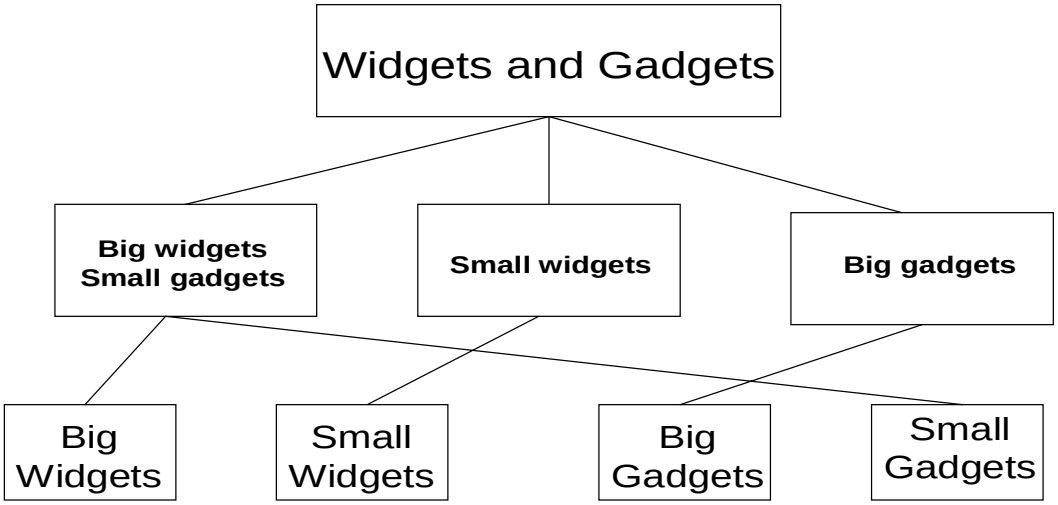



On Date 5, Taxpayer filed amended returns claiming refunds in connection with its FSC and ETI exclusion positions. The claimed refunds are attributable solely to redeterminations of its OPP groupings. Taxpayer claims that the redetermined OPP groupings are based on Taxpayer's AmountB market segments – which are Market Segments1 through X.[3] Taxpayer's annual report reflects these market segments; its website reflects AmountC markets and AmountD product categories. During discussions, Taxpayer asserted that the identified market segments reflect the aggregation of many smaller market segments and that such aggregation is based on similarity of profit margins among those smaller segments.

[3] Taxpayer used the AmountB listed market segments as the basis for its redetermined OPP groupings for Taxable Years 1, 2, 3, and 5. For Taxable Year 4, Taxpayer also used another market segment-based grouping – Market SegmentY – that was present for that year because of the acquisition of another company.

Where Taxpayer's sales of a product potentially fell within multiple market segments, Taxpayer optimized such product's placement among those market segments by excluding it from every market segment except the one that (in combination with simultaneous decisions for the market segment placement of every other product) would maximize the FSC benefit or ETI exclusion for the taxable year. Taxpayer applied the Temp. Treas. Reg. § 1.925(b)-1T(c)(2) overall profit percentage ("OPP") for each resulting market segment-based grouping to every product remaining in the group. Taxpayer's market segment-based OPP groupings are illustrated in Diagram 2 below. Diagram 2 shows that, by using the market segment approach to grouping its sales, Taxpayer separated groups of similar products and recombined them into groups of dissimilar products. This results in groupings that are materially different than the groupings of similar products depicted in Diagram 1.

## DIAGRAM 2
### Taxpayer's OPP Groupings per Amended Returns




**LAW AND ANALYSIS:**

**I. FSC Grouping Rules**

A FSC may determine its income under the administrative pricing rules of section

925, which include the CTI method under section 925(a)(2). 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."

A. The Full Costing Rules

Temp. Treas. Reg. § 1.925(a)-1T contains rules for determining CTI on a full costing basis. For that purpose, Temp. Treas. Reg. § 1.925(a)-1T(c)(8) provides grouping rules. Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i) provides: "[Reserved] For further guidance, see § 1.925(a)-1(c)(8)(i)."[4] Treas. Reg. § 1.925(a)-1(c)(8)(i) provides, in pertinent part:

> (8) Grouping transactions. (i) The determinations under this section are to be made on a transaction-by-transaction 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. The election to group transactions shall be evidenced on Schedule P of the FSC's U.S. income tax return for the taxable year. No untimely or amended returns filed later than one year after the due date of the FSC's timely filed (including extensions) U.S. income tax return will be allowed to elect to group, to change a grouping basis, or to change from a grouping basis to a transaction-by-transaction basis (collectively "grouping redeterminations"). The rule of the previous sentence is applicable to taxable years beginning after December 31, 1999. For any taxable year beginning before January 1, 2000, a grouping redetermination may be made no later than the due date of the FSC's timely filed (including extensions) U.S. income tax return for the FSC's first taxable year beginning on or after January 1, 2000. Notwithstanding the time limits for filing grouping redeterminations otherwise specified in the previous three sentences, a grouping redetermination may be

[4] Treas. Reg. § 1.925(a)-1(c)(8)(i) replaced Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i) effective March 2, 2001. See T.D. 8944, 2001-1 C.B. 1067.

> made at any time during the one-year period commencing upon notification of the related supplier by the Internal Revenue Service of an examination, provided that both the FSC and the related supplier agree to extend their respective statutes of limitations for assessment by one year. In addition, any grouping redeterminations made under this paragraph must meet the requirements under § 1.925(a)-1T(e)(4) with respect to redeterminations other than grouping. . . . See also § 1.925(b)-1T(b)(3)(i).

Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) through (viii) contain guidelines for groupings. Of particular relevance to this case are Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) and (iii), which provide, in part:

> (ii) A determination by the related supplier as to a product or a product line will be accepted by a district 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. A product shall be included in only one product line if a product otherwise 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. . . .

B. <u>The Marginal Costing Rules</u>

Section 925(b)(2) provides the statutory predicate for the FSC marginal costing rules. 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 certain transactions or groups

of transactions.[5] Regarding grouping of transactions for marginal costing purposes, Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i) and (ii) provide:

> (3) Grouping of transactions. (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. 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. 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.

## II. Discussion

Treas. Reg. § 1.925(a)-1(c)(8)(i) allows taxpayers annually to choose to group transactions based on products or product lines for purposes of determining CTI under the full costing rules. Treas. Reg. § 1.925(a)-1(c)(8)(i) also provides time limits (i.e., grouping deadlines) for when taxpayers may make grouping redeterminations. Such groupings must also follow the guidelines set forth in Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) through (vii). Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i) provides that, in general, the same groupings determined under Temp. Treas. Reg. § 1.925(a)-1T(c)(8) for full costing purposes must also be used for marginal costing purposes. Logically, the rules for groupings under Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i) are, therefore,

[5] See Temp. Treas. Reg. § 1.925(b)-1T(a)(second sentence) and (c)(1) for rules explaining when the marginal costing rules may be applied to sales.

identical to the rules for grouping under Temp. Treas. Reg. § 1.925(a)-1T(c)(8). For clarity in the following discussion, we refer to the groupings elected for CTI purposes under both the full costing and marginal costing rules as "method groupings."

Temp. Treas. Reg. § 1.925(b)-1T(b)(2) provides that CTI determined under the marginal costing rules may not exceed the OPP limitation, which is the product of the foreign trading gross receipts that gave rise to such CTI and the OPP. Thus, for each CTI amount determined under the marginal costing rules, an OPP must also be determined.

Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) provides that, for purposes of determining the OPP, taxpayers may elect groupings that are different from the underlying method groupings, provided that each such different grouping: (1) is "permissible" under Temp. Treas. Reg. § 1.925(a)-1T(c)(8); (2) is at least as broad as the underlying method grouping (or transaction if a method grouping was not elected); and (3) does not include a product in more than one grouping. Thus, a special grouping is used to determine an OPP, and that grouping may be broader than the underlying method grouping. For clarity in the following discussion, we refer to these special groupings as "OPP groupings."

A. Issue 1

The first issue in this case is whether the grouping deadlines apply to OPP groupings. If we determine that the grouping deadlines do apply to OPP groupings, then we must determine under Issue 2 whether Taxpayer's informal OPP grouping redeterminations for Taxable Years 1, 2 and 3 were timely with respect to the grouping deadlines.

Taxpayer claims that the grouping deadlines do not apply to OPP groupings, and consequently, Taxpayer is allowed to change its OPP groupings at any time, provided the relevant statute(s)[6] of limitations for the underlying taxable year are open.

1. Service Position

a. Cross-references import the grouping deadlines (along with the other method grouping rules) into the OPP grouping rules

The grouping deadlines apply to OPP groupings because a series of cross-references link the OPP grouping rules to the grouping deadlines. Our reasoning is straightforward. First, the rules for OPP groupings in Temp. Treas. Reg. § 1.925(b)-

[6] In the FSC context, see Temp. Treas. Reg. § 1.925(a)-1T(e)(4); in the ETI exclusion context, see S. Rep. No. 106-416, at 8 (2000).

1T(b)(3)(ii)(first sentence) cross references the method grouping rules in Temp. Treas. Reg. § 1.925(a)-1T(c)(8):

> 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. (Emphasis added.)

Second, the method grouping rules in Temp. Treas. Reg. § 1.925(a)-1T(c)(8) cross reference the rules in Treas. Reg. § 1.925(a)-1(c)(8)(i) as follows:

> (i) [Reserved] For further guidance, see §1.925(a)-1(c)(8)(i).

Third, the rules in Treas. Reg. § 1.925(a)-1(c)(8)(i) include specific deadlines for grouping redeterminations:

> . . . No untimely or amended returns filed later than one year after the due date of the FSC's timely filed (including extensions) U.S. income tax return will be allowed to elect to group, to change a grouping basis, or to change from a grouping basis to a transaction-by-transaction basis (collectively “grouping redeterminations”). The rule of the previous sentence is applicable to taxable years beginning after December 31, 1999. For any taxable year beginning before January 1, 2000, a grouping redetermination may be made no later than the due date of the FSC’s timely filed (including extensions) U.S. income tax return for the FSC's first taxable year beginning on or after January 1, 2000. Notwithstanding the time limits for filing grouping redeterminations otherwise specified in the previous three sentences, a grouping redetermination may be made at any time during the one-year period commencing upon notification of the related supplier by the Internal Revenue Service of

> an examination, provided that both the FSC and the related supplier agree to extend their respective statutes of limitations for assessment by one year. . . .

Thus, the grouping deadlines apply to OPP groupings.

b. Timely election is a prerequisite for OPP groupings

Even absent the cross-references discussed above, other language in the OPP grouping rules logically leads to the conclusion that the grouping deadlines apply to OPP groupings. The OPP grouping rules require "permissible" product or product line groupings. A permissible grouping may be present only if a grouping is present. A grouping may be present only if a valid "determination" or "choice" is made as described in Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) and (iii), respectively. A valid determination or choice may be made only if a valid election is made as described in Treas. Reg. § 1.925(a)-1(c)(8)(i). An election is valid only if, among other requirements, it is timely with respect to the grouping deadlines. In other words, a grouping election described in Treas. Reg. § 1.925(a)-1(c)(8)(i) is a prerequisite for an OPP grouping; a grouping election is not valid if it is not timely; and timeliness is determined under the grouping deadlines.

2. Taxpayer Position

Taxpayer maintains that the grouping deadlines in Treas. Reg. § 1.925(a)-1(c)(8)(i) apply only to method groupings.[7] The following discussion summarizes and addresses Taxpayer's arguments which, though numerous, are not persuasive.

a. Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) does not reference Treas. Reg. § 1.925(a)-1(c)(8)(i)

Taxpayer argues that the cross-reference in Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) does not extend to Treas. Reg. § 1.925(a)-1(c)(8)(i) and, therefore, does not incorporate the grouping deadlines. Taxpayer's reasoning seems to be that because Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) refers to Temp. Treas. Reg. § 1.925(a)-1T(c)(8), it cannot incorporate Treas. Reg. § 1.925(a)-1(c)(8).

We do not follow Taxpayer's reasoning. We are unaware of a rule of statutory or regulatory construction whereby one cross-reference may not lead to another cross-

[7] In its written submission, Taxpayer stated its belief that the grouping deadlines apply to both full costing and marginal costing method groupings. USCorp's TEAM Presubmission Rebuttal, p.4. We agree. The language of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i) can lead to no other conclusion.

reference thereby incorporating the rule of the second cross-reference. Indeed, such a rule would be contrary to the purpose and common usage of cross-references in the Code and regulations. Cross-references enable drafters to "reuse" provisions efficiently that are already promulgated instead of inefficiently republishing such provisions. The approach the Government took in promulgating the grouping deadlines was, in fact, a model of efficiency. The Government finalized the grouping deadlines in Treas. Reg. § 1.925(a)-1(c)(8)(i) and left the cross-reference in Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) unchanged knowing that such cross-reference would refer practitioners to Treas. Reg. § 1.925(a)-1(c)(8)(i) by way of the cross-reference in Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i).

Implicit in Taxpayer's argument is the notion that the language in Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) – "any product or product line permissible under §1.925(a)-1T(c)(8)" – does not refer to the grouping deadlines. In other words, Taxpayer implicitly argues that the word "permissible" in Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) refers to all of the full costing rules for groupings except the grouping deadlines.

We see no support for Taxpayer's selective reading of that language. As discussed above, a number of considerations are relevant to whether a grouping is permissible. Timeliness is one of those considerations – indeed, a consideration significant enough to inspire the grouping deadlines now contained in Treas. Reg. § 1.925(a)-1(c)(8)(i).

b. The "See also" reference

The cross-reference in Treas. Reg. § 1.925(a)-1(c)(8)(i) provides: "See also § 1.925(b)-1T(b)(3)(i)." We call this the "See also" reference. Taxpayer argues that the presence of the "See also" reference proves that the grouping deadlines apply only to method groupings.

Taxpayer's argument is flawed in several respects. First, nothing in the "See also" reference limits the application of the grouping deadlines to method groupings. "See also" is not limiting language. The "See also" reference to Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i) reminds the reader that the marginal costing rules potentially apply in which case the method groupings for marginal costing purposes must be identical to the method groupings for full costing purposes. Once the reader is within the framework of the marginal costing regulations, Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) instructs that broader groupings may be used for OPP purposes. But for the purpose of determining such broader groupings, Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) incorporates by reference the grouping deadlines along with all the other full costing method grouping rules.

Second, Taxpayer's argument is premised on the view that the "See also" reference is the operative provision that makes the grouping deadlines applicable to marginal costing method groupings. This is an incorrect premise. As explained above, the "See also" reference contains no substantive rule in itself. Rather, it helps make a reader aware that identical method groupings must be used for both full costing and marginal costing purposes (and that marginal costing rules may be available). The operative rule providing that the grouping deadlines apply to marginal costing method groupings is located in Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i) itself, not in the "See also" reference.

Third, because Taxpayer incorrectly views the "See also" reference as an operative rule, Taxpayer is similarly wrong that the absence of a parallel reference to the OPP grouping rules "proves" that the grouping deadlines do not apply to OPP groupings. In short, the "See also" reference in no way overrides the cross-reference in Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) or otherwise supports the conclusion that the grouping deadlines do not apply to OPP groupings.

c. The "Starting Point" Theory

Taxpayer also focuses on the notion that method groupings are a "starting point" for OPP groupings. Taxpayer's logic is as follows: (1) the grouping deadlines do apply to method groupings; (2) OPP groupings may be broader than the underlying method groupings; (3) broader means different; (4) therefore, the grouping deadlines do not apply to OPP groupings.

We agree with Taxpayer that method groupings provide a starting point for OPP groupings in the sense that an OPP grouping must be the same as or broader than the underlying method grouping. We also agree that an OPP grouping is not the same as the underlying method grouping if it is broader than the method grouping. But we otherwise cannot follow the logic of Taxpayer's argument. The fact that an OPP grouping is broader/different than the underlying method grouping is not relevant to whether the grouping deadlines apply to the OPP grouping. As explained above, the regulations provide that the grouping deadlines do apply to OPP groupings. This makes sense because, if compliance with the grouping deadlines is a prerequisite for the starting point (i.e., for the method grouping), as Taxpayer concedes, then it should also be a prerequisite for the ending point (i.e., for the OPP grouping based on the method grouping).

d. Taxpayer's Hypothetical

In support of its position, Taxpayer poses a hypothetical situation in which a taxpayer's sales of its only product generate a net operating loss for a particular taxable

year. Based on the facts, the most beneficial approach is for taxpayer to compute CTI on a full costing, transaction-by-transaction basis for its profitable sales. The taxpayer did not use the marginal costing rules and, therefore, did not elect the OPP grouping on its original, timely-filed return.

In the hypothetical, the Service audits the taxpayer and makes an adjustment such that the net operating loss becomes net taxable income. The hypothetical then assumes that the applicable grouping deadlines have expired by the time the taxpayer becomes aware that marginal costing (and the attendant OPP grouping redetermination) for that taxable year would be beneficial. Based on this fact pattern, Taxpayer argues that, because the Service's position could have the effect of preventing OPP grouping redeterminations in such situations (and, therefore, use of the marginal costing rules), the Service's interpretation of the regulations in the present case must be wrong.

This argument misses the point in several respects. First, time limitations, by their nature, are limiting. The FSC grouping deadlines are no different. In fact, the grouping deadlines were imposed in temporary form in 1998 and in final form in 2001 for purposes of limiting the ability of taxpayers to make grouping redeterminations. Second, the grouping deadlines provide some relief for taxpayers in the situation hypothesized by Taxpayer. For example, reflecting that an examination might motivate or enable a taxpayer to make a grouping redetermination, the grouping deadlines contain a deadline triggered by the notification of an examination. In other words, the grouping deadlines anticipate the hypothetical posed by Taxpayer and provide some degree of relief. But this relief is narrow lest the grouping deadlines be meaningless.

Third, we note that the concern raised by Taxpayer with respect to OPP grouping redeterminations is equally applicable in the method grouping context. That is, the grouping deadlines also limit the ability of taxpayers to make method grouping redeterminations. Taxpayer fails to provide an explanation for why it finds the limitations imposed on OPP grouping redeterminations unacceptable but apparently does not object to the imposition of identical limitations on method grouping redeterminations.

e. Intent

Taxpayer also argues that the intent of the drafters of the grouping deadlines was to limit method grouping redeterminations but not OPP grouping redeterminations. For example, Taxpayer claims that public comments made by Government employees on June 24, 1998, and other such comments reported on May 4, 1999, prove that the Service was concerned with potential abuses relating to method groupings, not OPP groupings. Taxpayer's claim is based on comments reported in the tax press that do

not include specific mention of OPP concepts.[8] Taxpayer then concludes from these omissions that the purpose of the grouping deadlines is to limit method grouping redeterminations, not OPP grouping redeterminations. Taxpayer also asserts that the drafters' intent to apply the grouping deadlines only to method groupings was reflected in public statements made by another Government employee at a conference on March 24, 1998, as well as in a slide used in a presentation at that conference.

The Service amended Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i) in 1998 to impose special time limits on grouping redeterminations in addition to the time limits already imposed by the relevant statutes of limitation. T.D. 8764, 1998-1 C.B. 844. Under the 1998 rules, the grouping deadlines applied to both method and OPP groupings because: (1) the relevant cross-references at that time (as they still are now) were to Temp. Treas. Reg. § 1.925(a)-1T(c)(8); and (2) the grouping deadlines were contained in Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i). Id. at 845. Thus, the amendments resulted in grouping deadlines that applied to both method and OPP groupings.

Three years later, the Service finalized the grouping deadlines. Instead of adding cross-references to "Treas. Reg. § 1.925(a)-1(c)(8)" alongside already-existing cross-references to Temp. Treas. Reg. § 1.925(a)-1T(c)(8), the Service simply added the "further guidance" cross-reference in Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i). As a result, all existing cross-references to Temp. Treas. Reg. § 1.925(a)-1T(c)(8) automatically incorporate the grouping deadlines in Treas. Reg. § 1.925(a)-1(c)(8)(i). We see no indication in the regulations and are aware of no intent that either the 1998 temporary rules or the 2001 final rules apply grouping deadlines to method groupings, but not OPP groupings.

Moreover, in our experience, most disputes involving the validity of FSC groupings have involved OPP groupings. The notion that the Service intended that the grouping deadlines not apply to OPP groupings is unsupported. The fact that Government employees were not quoted as specifically mentioning OPP concepts (not to mention marginal costing concepts) in a public meeting or spoke on a panel where views inconsistent with the plain language of the regulations were expressed and/or misperceived does not mean we should disregard the plain language of the regulations. Moreover, Taxpayer's reliance on alleged omissions from public comments of some Government employees and an alleged statement of another underscores the dearth of evidence in support of Taxpayer's intent argument. In short, Taxpayer's intent argument has no factual basis and is inconsistent with the language of both the 1998

[8] We note that these comments also fail to mention the marginal costing rules in general, though Taxpayer concedes that the grouping deadlines apply for marginal costing grouping method purposes. We also note that the comments are in no way limited to method groupings; rather, they address grouping generally.

and final regulations that incorporate the grouping deadlines into the OPP grouping rules by reference.

Taxpayer also suggests that the intent of the grouping deadlines was to prevent "last minute" grouping redeterminations.[9] Because the grouping redeterminations at issue in the present case were not "last minute," Taxpayer argues the grouping deadlines should not apply. Though the concerns of the Service regarding grouping redeterminations arose in part in response to so-called "last minute" cases, the resulting grouping deadlines contain no such limiting language. We cannot read such a limitation into the regulations. The relevant consideration is not what the drafters intended the grouping deadlines to do, but what the grouping deadlines actually do. As discussed in detail above, the language of the FSC grouping regulations provides that the grouping deadlines apply to all OPP groupings, not just "last minute" OPP groupings.

f. Tax forms argument

Taxpayer cites to the following sentence from Treas. Reg. § 1.925(a)-1(c)(8)(i): "The election to group transactions shall be evidenced on Schedule P of the FSC's U.S. income tax return for the taxable year." Taxpayer also observes that the Schedule P and the Form 8873 (the forms for computing FSC benefits and ETI exclusions, respectively) have special lines for electing method groupings, but not OPP groupings.[10] Taxpayer then concludes that the grouping deadlines do not apply to OPP groupings because neither Schedule P nor Form 8873 provides a way for taxpayers to evidence OPP grouping elections.

Taxpayer's argument assigns undue weight to tax forms and is, therefore, irrelevant. The tax rules are contained in statutes, regulations, and other published guidance. The formatting of tax reporting forms does not alter those rules. In addition, Taxpayer's argument disregards the mechanics of the forms. We disagree with Taxpayer's assumption that the Schedule P and Form 8873 do not provide a way for a taxpayer to evidence its election to make OPP groupings. Or, stated another way, unlike method groupings (the presence of which may not be evident unless indicated on the specified line of the form), the election of OPP groupings is evidenced by the taxpayer's use of the marginal costing portion of the form. That is because the marginal costing rules require the calculation of OPP, which involves the use of groupings. See generally Temp. Treas. Reg. § 1.925(b)-1T(b) and (c). In contrast to the situation involving method groupings, it is not necessary for the forms to require an indication that OPP groupings were elected, because such information is already reflected in the taxpayer's use or non-use of the marginal costing rules. The fact that the forms contain

[9] Taxpayer cites certain language in Notice 99-24, 1999-1 C.B. 1069, to support this view.

[10] Taxpayer cites certain language in Notice 99-23, 1999-1 C.B. 1068, to support this view.

a more robust mechanism for reporting method groupings than OPP groupings does not change the meaning of the regulations.

g. Internal inconsistency

Moreover, we note that Taxpayer's position is internally inconsistent. If Taxpayer were to follow its reasoning to its logical conclusion, Taxpayer would have to conclude that the grouping deadlines apply only for purposes of full costing method groupings, not marginal costing method groupings. This conclusion must result under Taxpayer's reasoning because Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(i) refers to Temp. Treas. Reg. § 1.925(a)-1T(c)(8), not Treas. Reg. § 1.925(a)-1(c)(8). To put it another way, Taxpayer's position rests on the distinction between Temp. Treas. Reg. § 1.925(a)-1T(c)(8), which is explicitly cross-referenced by the OPP grouping rules, and Treas. Reg. § 1.925(a)-1(c)(8), which is not. But the same distinction must be drawn in the context of the marginal costing method grouping rules if Taxpayer is to apply its reasoning consistently. Despite this, Taxpayer concedes that grouping deadlines apply for purposes of marginal costing method groupings.

To summarize, we see no textual support for Taxpayer's position. Treas. Reg. § 1.925(a)-1(c)(8) and Temp. Treas. Reg. § 1.925(a)-1T(c)(8) do not limit the grouping deadlines to method groupings. On the contrary, the OPP grouping rules contain a cross-reference to the method grouping rules in Temp. Treas. Reg. § 1.925(a)-1T(c)(8), which in turn contain a cross-reference to the grouping deadlines in Treas. Reg. § 1.925(a)-1(c)(8)(i). Within the framework of the grouping regulations, timeliness is a logical prerequisite for a valid grouping election. Taxpayer's claims to the contrary notwithstanding, the intent of the grouping deadlines was to limit grouping redeterminations which, as a practical matter, often are redeterminations of OPP groupings. Regardless of the intent, the grouping regulations speak for themselves.

A. Issue 2

Because the grouping deadlines apply to the OPP grouping rules, we must determine whether Taxpayer's informal grouping redeterminations for Taxable Years 1, 2, and 3 were timely in accordance with the grouping deadlines.

1. Service Position

Treas. Reg. § 1.925(a)-1(c)(8)(i) contains three distinct grouping deadlines. One grouping deadline applies to taxable years beginning before January 1, 2000 (the "pre-2000 deadline"). The pre-2000 deadline provides that the taxpayer may make a grouping redetermination no later than the due date of the FSC's timely filed (including

extensions) U.S. income tax return for the FSC's first taxable year beginning on or after January 1, 2000.

Another grouping deadline applies to taxable years beginning after December 31, 1999 (the "post-1999 deadline"). The post-1999 deadline provides that the taxpayer may make grouping redeterminations no later than one year after the due date of the FSC's timely filed (including extensions) U.S. income tax return.

In addition to the pre-2000 deadline or post-1999 deadline that applies to a grouping redetermination as the case may be, an alternate grouping deadline may also apply to provide a later time limit for making the grouping redetermination than the other grouping deadline. This alternate deadline ends with

> the one-year period commencing upon notification of the related supplier by the Internal Revenue Service of an examination, provided that both the FSC and the related supplier agree to extend their respective statutes of limitations for assessment by one year.

Treas. Reg. § 1.925(a)-1(c)(8)(i) (the "notification deadline"). If a taxpayer satisfies any of the three grouping deadlines, its grouping redetermination is considered timely under Treas. Reg. § 1.925(a)-1(c)(8)(i).

In the present case, the notification deadline provides for a due date (one year after Date 1) that is later than both the pre-2000 and post-1999 deadlines for every grouping determination at issue. Therefore, our analysis of the timeliness of Taxpayer's grouping redeterminations focuses only on the notification deadline.[11] For Taxable Years 1 through 3, the Service formally notified Taxpayer of examinations in a letter dated Date 1. Thus, the resulting notification deadline for all three years was one year after Date 1. Taxpayer filed its elections to make grouping redeterminations with respect to Taxable Years 1 through 3 on Date 4. Because Date 4 is later than one year after Date 1 (as well as later than the earlier pre-2000 or post-1999 deadline as the case may be), the grouping redeterminations for Taxable Years 1 through 3 were not timely.

A. Taxpayer Position

Taxpayer claims the notification deadline of Treas. Reg. § 1.925(a)-1(c)(8)(i)

[11] On the one hand, if Taxpayer failed to meet the notification deadline, it necessarily also failed the earlier pre-2000 and post-1999 deadlines. On the other hand, if Taxpayer did meet the notification deadline, the other deadlines are irrelevant. Thus, in either scenario, the other two deadlines are irrelevant.

provides that, if the Service notifies the related supplier or FSC of any examination, Taxpayer is allowed an additional year to make grouping redeterminations. As noted above, the deadline keys off:

> the one-year period commencing upon notification of the related supplier by the Internal Revenue Service of an examination, provided that both the FSC and the related supplier agree to extend their respective statutes of limitations for assessment by one year. (Emphasis added.)

Taxpayer emphasizes that the rule refers to "an examination," not "an examination of the related supplier." So Taxpayer argues that the letter sent by the Service to the FSC on Date 3, relating to the examination of the FSC constituted "notification . . . of an examination" for purposes of the notification deadline.

Taxpayer's position relies on a notification of the FSC despite the fact that the notification deadline is triggered by a notification of the related supplier. Taxpayer reasons that, because of the parent/subsidiary relationship between the related supplier and the FSC and in light of overlapping personnel (a common tax director), notification of the FSC is equivalent to notification of the related supplier. Thus, Taxpayer argues that the letter sent on Date 3 to the FSC constituted the notification necessary to trigger the notification deadline and give Taxpayer an additional year (i.e., until one year after Date 3) to make grouping redeterminations for Taxable Years 1 through 3. Taxpayer concludes that its informal grouping redeterminations filed on Date 4 were timely with respect to the purported notification deadline because Date 4 is less than one year after Date 3.

Taxpayer's argument is flawed in several respects. Treas. Reg. § 1.925(a)-1(c)(8)(i) requires notification of the related supplier. A letter sent to the FSC does not constitute notification of the related supplier. The related supplier and FSC are separate and distinct entities for tax purposes.[12] Because the regulation requires notification of the related supplier, and the related supplier and the FSC are separate and distinct legal entities, logic dictates that notification of a FSC does not trigger the notification deadline.

Furthermore, read in the broader context of Treas. Reg. § 1.925(a)-1(c)(8)(i), the phrase "notification of an examination" does not refer to all conceivable examinations.

[12] For example, USCorp is a domestic corporation (incorporated in StateA) that is required to file Form 1120 income tax returns whereas USCorp-FSC is a foreign corporation (incorporated in PossessionB) required to file Form 1120-FSC income tax returns.

Rather, the regulation refers only to an examination of the related supplier. The facts of this case are consistent with and support our interpretation of the notification deadline. The Service notified the related supplier of examinations by letters dated Date 1 and Date 2, but notified the FSC of an examination by a letter dated Date 3. The facts of this case – separate examinations and separate notifications of separate taxpayers (indeed, the regular audit practices of the Service) – belie Taxpayer's strained interpretation of the notification deadline. The examination referenced in the notification deadline language is the examination of the related supplier – that is, the notified taxpayer.

We find additional support for our position in the fact that Taxpayer's reasoning leads to absurd results. Under Taxpayer's reasoning, a notification of the related supplier or FSC (or perhaps another party that has some modicum of privity with the related supplier or FSC such as common ownership or sharing the same tax director) of an examination of a person that has no connection to a FSC claim or FSC grouping position would trigger the notification deadline.[13] We think the notification deadline cannot reasonably be read in the proper context to extend the deadline for making FSC grouping redeterminations any time that a person with ties to a related supplier or FSC is notified of an examination whether or not connected to a potential grouping redetermination.

Taxpayer also raises an argument based on a sentence in the preamble to the grouping deadlines. The sentence provides with regard to the notification deadline:

> The IRS and Treasury anticipate the IRS and taxpayers to plan and conduct examinations in a manner consistent with the foregoing provision so as to facilitate efficient and fair administration of the FSC grouping rules for transfer pricing.

T.D. 8944, 2001-1 C.B. 1067, 1068. Relying on this sentence, Taxpayer argues that the Service should interpret the notification deadline in Taxpayer's favor.

We disagree. The sentence on which Taxpayer relies refers to the final dependent clause of the sentence that sets forth the notification deadline. That clause modifies the preceding portion of the sentence as follows: "provided that both the FSC and the related supplier agree to extend their respective statutes of limitations for

[13] Taxpayer claimed during the adverse conference that it would not consider notifications of parties other than the related supplier and FSC relevant for this purpose. However, Taxpayer could not provide a principled basis for drawing such a line under its reasoning. Followed to its logical conclusion, Taxpayer's reading of the notification deadlines contemplates any conceivable notification of any conceivable examination.

assessment by one year." In other words, the sentence in the preamble encourages the Service and taxpayers to cooperate with respect to application of the notification deadline. The preamble does not, however, direct the Service to disregard the fundamental requirements of the notification deadline. To conclude that Taxpayer met the notification deadline in this case, we would have to disregard basic elements of the notification deadline. We do not believe that respecting the plain language of the notification deadline is at odds with the cited preamble language. On the contrary, we believe that Taxpayer's interpretation of the notification deadline is itself at odds with the above-quoted preamble language.

A. Issue 3

The final issue is whether Taxpayer may elect OPP groupings based on market segments. Because we determined under Issues 1 and 2 that Taxpayer's grouping redeterminations for Taxable Years 1 through 3 were not timely, Issue 3 applies only to the timely grouping redeterminations for Taxable Years 4 and 5.

Treas. Reg. § 1.925(a)-1(c)(8) and Temp. Treas. Reg. § 1.925(a)-1T(c)(8) provide rules for grouping transactions by product or by product line. Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) provides:

> A determination by the related supplier as to a product or product line will be accepted by a district 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. A product shall be included in only one product line for purposes of this section if a product otherwise falls within more than one product line classification.

Thus, transactions are grouped into products, and products are grouped into product lines. A FSC transfer pricing grouping is valid if, among other requirements, the product or product line is recognized in trade or industry usage (the "RTIU standard") or if all products included in the product line fall within the same two-digit SIC code or any inferior classification or combination thereof (the "SIC standard"). A product may be included in only one grouping even though it would otherwise fall into more than one grouping ("double inclusion prohibition"). Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(iii)

provides that a product or product line grouping elected by a taxpayer "shall apply to all transactions with respect to that product or product line. . . ." ("full inclusion rule").

The first sentence of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) provides that an OPP grouping must be a grouping that is "permissible" under the rules of Temp. Treas. Reg. § 1.925(a)-1T(c)(8), which includes the RTIU/SIC code requirement as well as the full inclusion rule and the double inclusion prohibition. In addition, the second and third sentences of Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) mirror the double exclusion prohibition and full inclusion rule, respectively. Thus, an OPP grouping must, among other requirements not discussed herein, comply with either the RTIU or SIC standard and also must comply with the full inclusion rule and the double inclusion prohibition. Taxpayer agrees.

1. Service Position

It is undisputed that Taxpayer's OPP groupings do not conform to the SIC standard. Thus, for its OPP groupings to be permissible, Taxpayer must show that its OPP groupings satisfy the RTIU standard. We believe that Taxpayer's market segment-based OPP groupings for Taxable Years 4 and 5 are invalid because they do not satisfy the requirements of Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(ii) and (iii) and 1.925(b)-1T(b)(3)(ii). In other words, the OPP groupings fail to satisfy the RTIU standard and also violate the full inclusion rule.

The RTIU standard is an objective standard that provides safeguards against the use of all conceivable combinations of products. Under the RTIU standard, product lines may not be determined in a haphazard or random fashion but must be "recognized" as a product or product line by the relevant trade or industry. The Service's authority set out in Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii) to reject groupings demonstrates that some groupings are unacceptable. The addition of the SIC standard safe harbor[14] to the DISC predecessors of Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(ii) and 1.925(b)-1T(b)(3) (to provide certainty for grouping validity unavailable under the RTIU standard) further demonstrates that certain groupings are considered invalid under the RTIU standard. Thus, taxpayers do not have free rein when identifying products and product lines for purposes of method and OPP groupings.

[14] See Prop. Treas. Reg. § 1.994-1(c)(7), 37 Fed. Reg. 19625 (Sept. 20, 1972) (providing only the RTIU standard for DISC grouping purposes); T.D. 7364, 1975-2 C.B. 315 (providing that the addition of the SIC standard for DISC grouping purposes eliminates uncertainty with respect to the validity of groupings); Tech. Memo. T.D. 7364, 1974 TM Lexis 30, at *68-69 (Oct. 29, 1974) (explaining the addition of the SIC standard to the DISC regulations in response to taxpayer comments regarding the proposed regulations for grouping).

Because “product line” is not defined for purposes of the FSC provisions or regulations, we may look to the common meaning of the term. Webster’s New Collegiate Dictionary (“Webster’s”) defines “product” as “something produced.” Webster’s defines “produce” as “give being, form, or shape to: make: esp. manufacture.” Webster’s defines “line” as “merchandise or services of the same general class for sale or regularly available.” Webster’s defines “class” as “a group, set, or kind sharing common attributes.” Thus, the plain language meaning of “product line” is manufactured merchandise or services that belong to a group that shares common attributes. This commonality or similarity of attributes is the characteristic that distinguishes a product line from other collections of manufactured items or services for sale or regularly available.

We observe that, like the plain language meaning of “product line,” the SIC code structure reflects relationships among products and product lines on the basis of similarity. All products or product lines included within the same two-digit SIC code share some similarity that they do not share with other products or product lines. The SIC code offers one out of many possible categorizations of products and product lines on the basis of similarity for the purpose of providing a safe harbor method for determining valid groupings.

a. Measure of Similarity under the RTIU Standard

Taxpayer must apply the RTIU standard to determine whether the purported products and product lines share enough similarity to justify OPP groupings under Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(ii) and 1.925(b)-1T(b)(3). The measure of similarity required under the SIC standard is predetermined by the categorization of products and product lines under the two-digit SIC codes. No such predetermined measure of similarity under the RTIU standard is set forth in Temp. Treas. Reg. §§ 1.925(a)-1T(c)(8)(ii) and 1.925(b)-1T(b)(3). Therefore, this advice identifies not only factors that may indicate the degree of similarity that justifies grouping under the RTIU standard, but also factors that should not be taken into account for purposes of applying the RTIU standard.

i. Common Customer or Contract Not Equivalent to Similarity under RTIU Standard

As a preliminary matter, we reject the possibility of using customers or contracts as the sole basis for measuring similarity among products or product lines under the RTIU standard. Support for this conclusion is found in an analysis of the FSC regulatory scheme for grouping. The FSC regulations provide separate grouping rules for purposes of applying the foreign economic process tests. See Treas. Reg. § 1.924(d)-1(c)(5) and (e). These grouping rules provide three alternative methods for grouping: 1) on a product or product line basis using the SIC or RTIU standard, 2) on a customer basis, and 3) on a contract basis. Because each of these three alternative methods provides an independent basis for grouping under the foreign economic process regulations, we conclude that neither customers nor contracts may be, in themselves, measures of similarity for purposes of grouping by product or product line under Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii).

ii. Other Factors Irrelevant to the RTIU Standard

We can also reject other possible factors under the RTIU standard. In adopting the SIC standard, the Service and Treasury rejected suggested additional grouping practices based solely on business divisions, raw materials, product end use, accounting, manufacturing techniques, or Form 10-K filed with the SEC. See Tech. Memo. T.D. 7364, 1974 TM Lexis 30, above, at *22. Thus, standing alone, groupings on these bases do not constitute products or product lines under the RTIU standard. Packaging and trade dress also do not determine product or product line similarity for purposes of the RTIU standard because the tested item is the product, not the wrapper or container. Economic factors such as a product or product line's rate of profitability, risk, or opportunity for growth are irrelevant to the determination of similarity under the RTIU standard because they do not define the product or product line. Finally, the RTIU standard does not permit groupings on a geographical basis. See Napp Systems, Inc. v. Commissioner, T.C. Memo. 1993-196, 65 T.C.M. (CCH) 2567, 2570 (1993).

iii. Indicators of RTIU Standard Similarity

We believe the presence of any of the indicators described below with respect to two or more products or product lines may signal a degree of similarity between such products or product lines. Each factor should be carefully considered in light of all facts and circumstances. In one set of circumstances, a factor may accompany products that share a relatively high degree of similarity. Under different circumstances, the same factor may be present where overwhelming dissimilarity prevents grouping under the RTIU standard. The presence or absence of any indicator is irrelevant unless considered in the context of all other pertinent factors. Thus, the mere fact that any

indicator is present does not, by itself, prove that two products or product lines share the requisite similarity necessary for grouping under the RTIU standard. Conversely, the absence of any factor is not dispositive of the level of dissimilarity that would preclude a valid grouping.

*Product Form*

Some products are marketed in a manner that allows the consumer to choose from a variety of attributes available with respect to a core product or product line. For example, an automobile purchaser may be able to choose between the standard and automatic models or the six-cylinder and eight-cylinder models. In both cases, the core product is an automobile and the optional attributes serve not only to differentiate the otherwise identical core products but also to emphasize their fundamental similarity. To the extent that attributes are mere variations on a single core product or product line without changing the nature of the core product or product line, such attributes may indicate similarity under the RTIU standard. To the extent that attributes change the nature of the core product or product line so substantially that a distinct and dissimilar product or product line results, such attributes indicate dissimilarity for purposes of the RTIU standard.

*Product Function or Related Activity*

Multiple products often fulfill a similar function or purpose. For instance, screws and nails are both used to fasten objects together. In some cases, they are interchangeable and, thereby, share a similarity to be taken into account in determining whether the two products are similar enough to justify RTIU standard grouping. In short, products that serve a common function or fulfill a common purpose may share a degree of similarity.

Two products may be used with respect to related activities if both products are commonly associated with, or necessary to, similar activities, events, or practices. For example, although hammers and screwdrivers are different products, they are commonly associated together because both are hand-powered tools often used in construction, building, and assembly activities. The carpenter's tool belts and variety tool packs sold in hardware stores emphasize the special relationship between screwdrivers and hammers. Indeed, both products fall under the common label "tools." Thus, some products may share a similarity to the extent that they are used with respect to related activities.

*Common Labor*

Some businesses that market more than one product have separate or semi-

independent work forces for different products or product lines. The fact that a business uses the same employees with respect to more than one product or product line may suggest a similarity among such products because the skill level of laborers required to produce similar products is likely to be similar. For instance, if a company uses the same assembly line team to construct two products, such commonality may indicate the kind of similarity required to justify a product line grouping. However, the mere fact that two products share labor in common does not indicate similarity where such commonality is the only element of similarity between two products.

*Common Raw Materials*

Many manufacturers make more than one product using the same raw materials. For instance, a company might manufacture writing paper, gift wrap paper, and news print. The common use of the raw material wood as a major constituent of multiple products may signal a similarity among such products. However, this indicator should not be considered to be a similarity in itself. For instance, news print and mahogany furniture are dissimilar products despite the fact that they share their principal raw material in common. Thus, a differential in the extent of processing or manufacturing of raw materials may militate against a grouping on the basis of common raw materials.

*Common Customer*

As stated above, the fact that a taxpayer sells two products or product lines to the same customer does not justify grouping under the RTIU standard. However, a common customer may indicate that products or product lines share similarities.

We believe the market segment approach that Taxpayer used to determine its OPP groupings focuses on a single factor – a business construct[15] – and disregards any other similarity factor. This approach to grouping focuses on only one common attribute – the profit margin-based market segments constructed by Taxpayer for business purposes – to the exclusion of all relevant indicators of product similarity. The result of this market segment-based approach is purported product line groupings that, in fact, are aggregations of dissimilar products. Moreover, Taxpayer's OPP groupings, far from following recognized trade or industry usage, appear to be unique to Taxpayer.

Taxpayer's position – that its market segment approach complies with the RTIU standard – is an argument akin to another taxpayer's claim that its product line groupings could be geographically based. See Napp, T.C. Memo. 1993-196 (geographic grouping is not consistent with product line groupings permitted under the materially similar predecessor grouping rules in Treas. Reg. § 1.994-1(c)(7)(i)). We do not perceive a material difference between the substitution of geographic relationship for true product lines in the Napp case and the substitution of market segments for true

[15] Taxpayer's AmountB market segments actually reflect the aggregation of many smaller market segments and such aggregation is based solely on similarity of profit margins.

product lines in the present case. In both situations, the taxpayer turns the RTIU standard on its head by identifying a group and declaring it is a product line instead of identifying a product line and electing to treat it as a product line grouping. The result is irrational groupings of dissimilar products.

b. Full Inclusion Rule

Taxpayer's market segment approach not only fails to consider adequately the pertinent factors relating to similarity attributes among products, but also results in product lines that violate the full inclusion rule. The full inclusion rule provides that a product or product line grouping elected by a taxpayer "shall apply to all transactions with respect to that product or product line. . . ." Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii); see also Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii). Under the guise of purported market segment product lines, Taxpayer elected OPP groupings, but did not apply them consistently to all transactions with respect to that product or product line. In other words, Taxpayer's flawed approach to forming its OPP groupings amounts to forming product line groups, but failing to fully include all products properly includable in those groups.

To summarize, we believe Taxpayer developed its market-segment approach to justify mixing and matching for OPP grouping purposes the products that constituted its validly determined method groupings. The result is product line groupings that fail to satisfy the full inclusion rule and bear no resemblance to rational product or product line groupings.

2. Taxpayer Position

Taxpayer argues that whether the market segment-based OPP groupings are valid depends in large part upon the definition of "product line." The proper definition of product line, according to Taxpayer, is "a group of products of the same manufacturer having similar or related characteristics and intended for similar or related markets." Once Taxpayer used that definition to determine its market segments, Taxpayer was required by the double exclusion prohibition to eliminate products from the groupings based on those market segments until each product was included in only one grouping.

However, Taxpayer's concept of product line does not take into account the relevance of product similarity described above. If the SIC standard is a reasonable benchmark (especially in light of its role as a safe harbor with respect to the RTIU standard), Taxpayer's view falls short of this benchmark by failing to account for product similarity. Moreover, the absurd results of Taxpayer's position militate against Taxpayer's approach to OPP grouping. We believe a set of product lines that systematically separate widgets from widgets and gadgets from gadgets is fundamentally flawed under any reasonable understanding of the product line concept

expressed in Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii). Invocation of Taxpayer's market segments construction does not ameliorate or justify the absurd result.

In short, Taxpayer's approach substitutes market segment labels for product similarity. While we agree with Taxpayer that the OPP grouping rules provide taxpayers a measure of flexibility in choosing product or product line groupings (for example, a taxpayer may choose between a smaller number of broader groupings or a greater number of narrower groupings for a given set of products), taxpayers may not engineer groupings that consist of dissimilar products resulting from the deconstruction of valid product lines. Flexibility does not mean unfettered ability to group products in any manner so long as a justification can be articulated.

Finally, Taxpayer attempts to distinguish its situation from the situation addressed in Napp. First, Taxpayer argues that Napp is not informative with respect to the present case because it is not specifically about the RTIU standard. Taxpayer's argument is incorrect. As a matter of logic, Napp must have involved the RTIU standard as opposed to the SIC standard. If the Taxpayer's groupings had complied with the SIC standard, no issue would have existed for a court to address because the groupings would have been valid.

Taxpayer also argues that Napp is inapposite to the present case because it involved only a single product. We believe Taxpayer is incorrect that Napp involved only a single product, but Taxpayer's confusion is understandable considering contradictory language in the opinion. In particular, the Napp opinion contains the following two inconsistent statements of fact regarding Taxpayer's products and product lines:

> The products manufactured by petitioner and sold by the subsidiary consisted of photopolymer printing plates and related equipment and supplies. Such products constitute only one product line.
>
> Since petitioner sells only one product. . . .

T.C. Memo 1993-196 (emphasis added). According to the first quoted passage, the taxpayer in Napp had multiple products that rolled up into a single broad product line. According to the second quoted passage, Taxpayer had only one product. We believe that Taxpayer relies on the second quoted passage for its claim that Napp involved only a single product in contrast with the present case, which involves many products. We do not know the reason for the contradictory language in the opinion. However, we believe the better reading of the opinion is that the taxpayer had multiple products that rolled up into a single broad product line and, instead of forming its groupings on the basis of those products, chose to form groupings on the basis of the countries in which sales occurred.

Moreover, even if Napp involved only one product, that fact is not relevant here. Napp stands for the proposition that a country-by-country grouping is inconsistent with the concept of product or product lines groupings. That is why Napp is instructive in the present case. We see little distinction between the geographic groupings in Napp and the market segment-based groupings used by Taxpayer. In both cases, product similarity was disregarded in favor of a single, irrelevant consideration. We also note that such invalid groupings would have had the same effect as Taxpayer's redetermined OPP groupings in the present case – to deconstruct groupings of similar products and recombine them into groupings based on something other than product similarity.

CAVEAT(S):

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