INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

January 31, 2007

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200721018**
Release Date: 5/25/2007
Index (UIL) No.: 941.04-00
CASE-MIS No.: TAM-106199-06

Director
LMSB:CTO:

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference: July 28, 2006

LEGEND:

Taxpayer =
Taxpayer-FSC =
Distribution Agreement =

Taxable Year1 =
Taxable Year2 =
AmountA =
AmountB =
AmountC =
AmountD =
AmountE =

ISSUES:

1. Whether a portion of Taxpayer's income from its sales of products to foreign distribution subsidiaries is properly allocable (within the meaning of section 941(c)(1)(A)) to foreign economic processes ("FEP") performed by the subsidiaries with respect to their resales of the same products to unrelated customers.

2. Whether section 941(c)(1)(A)(i) refers only to the FEP specified in section 942(b)(2)(A)(i) and (3) or refers generally to all distribution activities.

3. When determining foreign sale and leasing income ("FSLI") as a subset of foreign trade income ("FTI") pursuant to section 941(c)(1)(A), whether directly allocable expenses are deducted from foreign trading gross receipts ("FTGR") under section 941(c)(3)(B) in the calculation of the FTI of which such FSLI is a subset or whether section 941(c)(3)(B) is otherwise taken into account in the calculation of the FSLI subset itself.

4. Whether the methodology under the section 861 regulations should be applied when determining the scope of the term "directly allocable expense" under section 941(c)(3)(B).

5. Whether the amount of FSLI determined under section 941(c)(1)(A) can be greater than the amount of FTI of which the FSLI is a subset.

6. Whether FSLI may be computed based on groups of products or product lines within the meaning of Treas. Reg. § 1.925(a)-1(c)(8)(i).

CONCLUSIONS:

1. Based on the facts of this case, a portion of Taxpayer's income from its sales of products to its foreign distribution subsidiaries may be properly allocable (within the meaning of section 941(c)(1)(A)) to FEP performed by the subsidiaries with respect to their resales of the same products to unrelated customers.

2. Section 941(c)(1)(A)(i) refers only to the FEP specified in section 942(b)(2)(A)(i) and (3). Factual determinations may be necessary to determine whether certain activities at issue are specified in section 942(b)(2)(A)(i) and (3) and the regulations thereunder.

3. When determining FSLI as a subset of FTI pursuant to section 941(c)(1)(A), directly allocable expenses are first deducted from FTGR under section 941(c)(3)(B) in the calculation of the FTI before determining what portion of such computed FTI is FSLI. In addition, adjusting the FSLI subset of such FTI consistently with the principles of section 941(c)(3)(B) may be appropriate depending on the method used to determine the subset and the facts of the case.

Such adjustment must be consistent with the determination in Conclusion 4 below.

4. For purposes of determining FTI and FSLI under section 941(c)(3)(B), the term "directly allocable expense" encompasses all expenses that are generally factually related to the relevant class or grouping of income under the section 861 regulations.

5. No. The amount of FSLI determined under section 941(c)(1)(A) cannot be greater than the amount of FTI of which the FSLI is a subset.

6. We believe that, if Taxpayer properly follows any (and especially any combination) of Conclusions 2 through 5 in calculating FSLI, Taxpayer will conclude that FSLI is not the best basis, in this case, for computing ETI exclusions. Resolution of the grouping issue raised in Issue 6 in Taxpayer's favor (assuming arguendo that Taxpayer can produce FSLI computations on a transaction-by-transaction basis) would have no impact on that outcome. Therefore, we do not reach the grouping issue.

FACTS:

A. Background

Taxpayer is the domestic parent corporation of foreign and domestic subsidiaries. Prior to the repeal of the foreign sales corporation ("FSC") provisions, Taxpayer paid commissions to its wholly-owned FSC, Taxpayer-FSC, with respect to Taxpayer's sales of export property (as defined in section 927) and claimed corresponding FSC commission expense deductions. A "Commission Agreement" governed that arrangement.

Under the Commission Agreement, Taxpayer-FSC was responsible for performing the FEP required under section 924 with respect to Taxpayer's sales of export property. Taxpayer and Taxpayer-FSC also entered into a "Subagency Agreement" under which Taxpayer agreed to perform all the FEP for which Taxpayer-FSC was otherwise responsible under the Commission Agreement. Pursuant to the Subagency Agreement, Taxpayer-FSC was required to compensate Taxpayer for its performance of FEP in accordance with Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(ii). To summarize, Taxpayer-FSC agreed to perform FEP with respect to Taxpayer's sales, and Taxpayer simultaneously agreed to perform such FEP in Taxpayer-FSC's stead.[1]

[1] After initially participating in the submission of the request for technical advice ("Technical Advice Memorandum ("TAM")), Taxpayer formally withdrew from the TAM process. Taxpayer subsequently chose to resume its participation and ultimately participated in every aspect of this TAM. Taxpayer's arguments as represented in this TAM were provided in documents submitted by Taxpayer's representatives in connection with conferences held with Taxpayer and its representatives as well as through statements made by Taxpayer and its representatives during those conferences.

B. Taxpayer's Sales Structure under the ETI Exclusion Provisions

After the extraterritorial income ("ETI") exclusion provisions were enacted in 2000, Taxpayer ceased paying commissions to Taxpayer-FSC. Instead, Taxpayer began claiming ETI exclusions with respect to sales of qualifying foreign trade property (as defined in section 943). Those sales are the subject of this memorandum.[2]

Taxpayer manufactured qualifying foreign trade property ("Products"), which it sold to certain of its foreign subsidiaries ("Distributors"),[3] pursuant to a "Distribution Agreement."[4] Pursuant to the Distribution Agreement,[5] the Distributors were required to resell, distribute, service, and support Products in foreign countries. To this end, the Distribution Agreement includes the following passages:

. . .

. . .

. . .

. . .

[2] For Taxable Year1, Taxpayer-FSC originally filed a Form 1120-FSC, which reported FSC commissions paid by Taxpayer, and Taxpayer originally filed a Form 1120 claiming deductions for such commissions. Subsequently, Taxpayer amended its return to remove the FSC commission deductions, and claimed ETI exclusions computed with respect to FSLI. Taxpayer-FSC correspondingly amended its return.

[3] Some Distributors bought and sold Products while others performed warehousing, marketing, and other activities with respect to such Products. For simplicity, we refer to all such entities collectively as Distributors in this memorandum.

[4] Taxpayer also sold Products directly to unrelated foreign customers (instead of to Distributors for resale). The request for technical advice does not mention (and this memorandum does not address) those sales.

[5] Taxpayer provided a number of sample distribution agreements. Though they contain some variation, all are generally consistent. We simplify the issue here by treating all such agreements as containing identical language based on the Distribution Agreement.

. . .

[6]. . ---.

.

Thus, the Distribution Agreement provides that the purchase price payable by a Distributor to Taxpayer for a Product must be the unit price established by Taxpayer, reduced by an applicable discount rate adjusted by Taxpayer from time to time. For example, if the unit price for a particular Product was $100 and the discount rate was 2%, the Distributor was required to pay Taxpayer $98 to buy the Product that it would then resell for $100. We understand the discount is intended to yield a AmountA% return on the Distributor's value added costs of reselling Products.

The parties' joint submission agrees, at least for purposes of addressing this narrow legal question, that Taxpayer bore most or all of the economic risks with respect to the FEP performed by the de-risked Distributors. Although the Distributors have some discretion in the resale of Taxpayer's products, Taxpayer makes the critical strategic decisions on trade, product research, design and development, quality control, pricing, cost budgets, manufacturing, and marketing strategies. Therefore, Taxpayer bears most or all of the economic risks and responsibilities for the overall success of the sales to unrelated foreign customers. The AmountA% return on value added costs of reselling that the Distributors earn on resales of Products reflects a non-risky return for the Distributors' risk-free activities.

C. Taxpayer's ETI Exclusion Calculations

For Taxable Years1 and 2, Taxpayer had net losses from sales of Products (i.e., negative FTI) in the amounts of $AmountB million and $AmountC million, respectively. During those years, Taxpayer claimed ETI exclusions with respect to its gross income from sales of Products to Distributors. Taxpayer computed ETI exclusions using the FSLI method under section 941(a)(1)(A). The amounts of positive FSLI that Taxpayer computed corresponding to the $AmountsB and C losses were $AmountD and $AmountE, respectively. For this purpose, Taxpayer elected to group its Product sales under section 943(d)(1)(B) and Treas. Reg. § 1.925(a)-1(c)(8)(i) (rather than computing

[6] We requested but never obtained a copy of this table. Therefore, we were unable to review the table.

ETI exclusions on a transaction-by-transaction basis). See also S. Rep. No. 106-416, at 18 (2000) ("Senate Report") (pending the issuance of detailed administrative guidance, the cited FSC regulations – including the grouping regulations – apply for purposes of the ETI exclusion).[7] Taxpayer used an economic analysis to determine FSLI based on a hypothetical transfer price charged by a hypothetical full-risk distributor. This memorandum does not address whether Taxpayer's economic analysis is valid. The request for technical advice specifically reserved that issue for resolution at the Examination level.

Under Taxpayer's approach, if Taxpayer determined a net loss of <$100> in a taxable year, its economic analysis might enable it to determine positive FSLI for that year as follows: FSLI (i.e., selling profit) of $50 and manufacturing loss of <$150>. Similarly, if Taxpayer determined a net profit of $100 in a taxable year, its economic analysis might enable it to determine positive FSLI for that year as follows: FSLI (i.e., selling profit) of $150 and manufacturing loss of <$50>. The purported FSLI amount in both scenarios results from the deconstruction of a single economic profit or loss from a single transaction such that Taxpayer earns a purported profit on the transaction greater than the actual profit, if any.

LAW:

Section 114 provides the ETI exclusion under which qualifying FTI ("QFTI") is excluded from gross income. Section 941(a)(1) provides, in relevant part, that QFTI from a transaction is

> the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to the greatest of—
>
> (A) 30 percent of the foreign sale and leasing income derived by the taxpayer from such transaction,
> (B) 1.2 percent of the foreign trading gross receipts derived by the taxpayer from the transaction, or
> (C) 15 percent of the foreign trade income derived by the taxpayer from the transaction.

The methods contained in section 941(a)(1)(B) and (C) are materially similar to the administrative pricing methods under the FSC provisions. See I.R.C. §§ 925(a)(1) and (2), 923(a)(3), and 291(a)(4). The FSLI method in section 941(a)(1)(A) replaced the non-

[7] When Congress enacted the ETI exclusion provisions, it recognized that there would be a gap in time between such enactment and the issuance of detailed administrative guidance and intended that, during such gap period, the administrative guidance provided under the FSC provisions should be applied to analogous concepts under the ETI exclusion provisions. Senate Report, at 18.

administrative pricing method under the FSC provisions. See I.R.C. §§ 925(a)(3), 923(a)(2), and 291(a)(4).

Section 941(b)(1) provides that FTI is the taxable income attributable to FTGR. Section 941(c)(1)(A) defines FSLI, in relevant part, with respect to a transaction as

> foreign trade income properly allocable to activities which—
>
> (i) are described in paragraph (2)(A)(i) or (3) of section 942(b) and
>
> (ii) are performed by the taxpayer (or any person acting under contract with such taxpayer) outside the United States.

The activities listed in section 942(b)(2)(A)(i) and (3) are commonly known as FEP. Section 942(b)(2)(A)(i) and (3) provide, in relevant part, that FEP comprise the following eight foreign activities: (1) through (3) solicitation (other than advertising), negotiation, and making of a contract; (4) advertising and sales promotion; (5) processing of customer orders and arranging for delivery; (6) transportation outside the United States in connection with delivery to the customer; (7) the determination and transmittal of a final invoice or statement of account or the receipt of payment; and (8) assumption of credit risk.[8]

Under the ETI exclusion provisions, FTI generally is determined by reducing FTGR by: (1) cost of goods sold; (2) expenses definitely related to such gross receipts; and (3) a ratable portion of expenses that are not definitely related to any class of gross income. See Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(i) and (iii)(C) and (D) (describing the calculation of combined taxable income – the materially similar predecessor of FTI under the FSC provisions); see also Senate Report, at 18. But in the case of FSLI, a different rule applies. Section 941(c)(3)(B) provides:

> (B) ONLY DIRECT EXPENSES TAKEN INTO ACCOUNT.— For purposes of this subsection, any expense other than a directly allocable expense shall not be taken into account in computing foreign trade income.

[8] See Treas. Reg. §§ 1.924(d)-1 and 1.924(e)-1 for additional details and guidance regarding FEP. Also, we note that the determination of FSLI with respect to FEP under section 941(c)(1)(A) is a concept that is separate and distinct from the threshold FEP requirement set forth in section 942(b)(1), which generally denies the ETI exclusion if the taxpayer fails to perform a specified amount of FEP activities. The only connection between section 941(c)(1)(A) and the FEP requirement in section 942(b)(1) is that both provisions involve concepts that reference the activities listed as FEP in section 942(b)(2). The FEP requirement in section 942(b)(1) is not at issue.

ANALYSIS:

Issue 1: Whether a portion of Taxpayer's income from its sales of Products to Distributors is properly allocable (within the meaning of section 941(c)(1)(A)(i)) to FEP performed by the Distributors with respect to their resales of the same Products to unrelated customers.

Section 941(c)(1)(A), in relevant part, defines FSLI with respect to a transaction as the FTI properly allocable to FEP "performed by the taxpayer (or any person acting under a contract with such taxpayer) outside the United States." This language mirrors the language "taxpayer (or any person acting under a contract with such taxpayer)" in section 942(b)(2)(A)(i) and (C)(i) and the materially similar predecessor FSC language "corporation (or any person acting under a contract with such corporation)" in section 924(d)(1)(A) and (3)(A). Regarding section 924(d), Treas. Reg. § 1.924(d)-1(b)(1) provides, in part, that the FEP activity must be

> performed pursuant to a contract for the performance of that activity on behalf of the FSC.

Treas. Reg. § 1.924(d)-1(b)(1) further provides that such contract may be an oral or written legal agreement. The legislative history to the ETI exclusion provisions provides:

> It is intended that the principles of present-law regulations apply during the gap period for purposes of the foreign economic processes requirement . . . .

Senate Report, at 20. Taxpayer and Examination agree that the principles of Treas. Reg. § 1.924(d)-1(b)(1) summarized above apply to the "acting under a contract" language of section 942(b)(2)(A)(i) and (C)(i) and by analogy, therefore, to section 941(c)(1)(A). We agree also.

Taxpayer's position is that a portion of its FTI is properly allocable (within the meaning of section 941(c)(1)(A)) to FEP[9] performed by itself[10] and the Distributors. In support of its position, Taxpayer argues that it bore the economic risks of the FEP performed by the Distributors. Thus, Taxpayer claims that the FEP were performed for Taxpayer's economic benefit and, therefore, should be considered to have been performed on Taxpayer's behalf. Taxpayer also argues that it contracted with the

[9] We note that, as discussed in Issue 2 below, we believe section 941(c)(1)(A) refers only to the eight specified FEP activities whereas Taxpayer argues that section 941(c)(1)(A) refers to all distribution activities whether or not specified. For simplicity and brevity, we refer only to "FEP" in the discussion of Issue 1.

[10] As we understand it, Taxpayer performs little or no FEP itself with respect to the Distributors' resales.

Distributors to perform the FEP on its behalf in accordance with section 941(c)(1)(A)(ii) and Treas. Reg. § 1.924(d)-1(b)(1).

In this case, Taxpayer and Examination agree that Taxpayer bore most or all of the economic risks with respect to the FEP performed by the de-risked Distributors and that Taxpayer bears most or all of the economic risks and responsibilities for the overall profitability of the resales by Distributors. Thus, Taxpayer indirectly benefited economically from the FEP performed by Distributors. We agree with Taxpayer that some of Taxpayer's FTI may be considered economically attributable to the Distributors' selling activities. Accordingly, we determine that the Distributors performed FEP (as well as non-FEP activities) on Taxpayer's behalf in the sense that Taxpayer bore the risks and, therefore, would have received the benefit of risky returns, if any. The pricing agreement prevented the Distributors from receiving the economic benefits attributable to the economic risks borne by Taxpayer.

For any FSLI to be present, however, Taxpayer must show not only that the Distributors performed FEP on its behalf, but also that such performance of FEP was pursuant to an oral or written contract. Taxpayer presented a number of contracts in support of its claim that it had one or more written contracts that meet the requirements of section 941(c)(1)(A)(ii) and Treas. Reg. § 1.924(d)-1(b)(1). We consider some of those contracts irrelevant to the issue at hand and, therefore, we do not discuss them in this memorandum.[11] But the Distribution Agreement, although it does not directly or explicitly provide that the Distributors performed FEP on behalf of Taxpayer for purposes of section 941(c)(1)(A), may be read, in combination with other facts such as the pricing agreement and the de-risking of the Distributors, as describing the "on behalf of" relationship.

For example, the Distribution Agreement provides that the Distributors will perform all manner of distribution activities with respect to the Products resold by Distributors. That broad range of distribution activities logically includes those activities known as FEP. The Distribution Agreement also provides that the Distributors will be compensated by Taxpayer on a discount basis. We know from the submitted facts that the discounts reflect an agreement between Taxpayer and the Distributors that Distributors are guaranteed only a non-risky return on their activities (including sales of Products) reflecting the fact that Taxpayer bears the economic risks. Taken together, we believe the facts, including language in the Distribution Agreement, constitute the required written or oral contract between Taxpayer and the Distributors whereby the Distributors agreed to, among other things, perform FEP for Taxpayer's economic benefit and, therefore, on Taxpayer's behalf.

[11] For example, much of the contractual language relied upon by Taxpayer addresses compliance with the FEP requirement of section 942(b)(1) on sales between Taxpayer and the Distributors. Such FEP requirement (and such FEP) has no relevance to the present issue.

Our conclusion that the Distributors performed FEP on behalf of Taxpayer (in part because Taxpayer bore the economic risks[12] of the FEP performed by the Distributors) does not mean that Taxpayer has FSLI for the taxable years at issue and does not go to the determination of the amount of such FSLI, if any.

Issue 2: Whether section 941(c)(1)(A)(i) refers only to the FEP specified in section 942(b)(2)(A)(i) and (3) or refers to all distribution activities.

Section 941(c)(1)(A) provides, in part, that FSLI includes:

> foreign trade income properly allocable to activities which—
> (i) are described in paragraph (2)(A)(i) or (3) of section 942(b), and
> (ii) are performed . . . outside the United States . . . .

We interpret this provision to mean that FSLI is the FTI economically attributable only to the FEP activities named in section 942(b). The list of FEP in section 942(b) is specific and finite. FSLI is the FTI economically attributable to the FEP activities specified in section 942(b)(2)(A)(i) and (3) and further defined in Treas. Reg. §§ 1.924(d)-1 and 1.924(e)-1. It may be necessary to determine whether certain activities at issue are specified in section 942(b)(2)(A)(i) and (3).

Taxpayer asserts that the reference to FEP activities in section 941(c)(1)(A)(i) refers generally to all distribution activities similar to the specified FEP regardless of whether they are specifically mentioned in the statute. Taxpayer asserts that the phrases "described in" (as used in section 941(c)(1)(A)) and "such as" (as used in the corresponding legislative history[13]) prove that the reference to FEP activities in section 941(c)(1)(A)(i) is intended merely to provide examples of distribution activities and, therefore, refers to all distribution activities. Taxpayer argues further that, had the drafters of the ETI exclusion provisions intended to limit the activities to the FEP activities specified in section 942(b)(2)(A)(i) and (3), the statute would have more explicitly referenced only those activities.

We disagree with Taxpayer's assertions. Taxpayer assumes that the phrase "described in," in section 941(c)(1)(A), must mean "similar to." This assumption is

[12] We state no opinion as to whether economic attribution of the return to FEP is relevant for purposes of interpreting and applying sections 942(b)(2)(A)(i) and (C)(i) and 924(d)(1)(A) and (3)(A).

[13] When defining foreign sale and leasing income, the Senate Report provides:

> For example, a distribution company's profit from the sale of qualifying foreign trade property that is associated with sales activities, such as solicitation or negotiation of the sale, advertising, processing customer orders and arranging for delivery, transportation outside of the United States, and other enumerated activities, would constitute foreign sale and leasing income.

Senate Report, at 10 (emphasis added).

unfounded. The word "described" is used elsewhere in the ETI exclusion provisions to mean "named" or "listed" or "specified." For example, section 942(b)(2)(C)(i) provides:

> The term 'total direct costs' means, with respect to any transaction, the total direct costs incurred by the taxpayer attributable to activities described in paragraph (3) performed at any location by the taxpayer or any person acting under a contract with such taxpayer. (Emphasis added.)

In turn, section 942(b)(3) provides:

> The activities described in this paragraph [(3)] are any of the following with respect to qualifying foreign trade property . . . . (Emphasis added.)

That section then lists five FEP activities. In other words, the FEP provisions internally use the phrase "described in" to mean "listed below." This mirrors the materially similar predecessor language in section 924(d)(3)(A) and (e) of the FSC provisions and the regulations thereunder, which interpret section 924(d) and (e) as referring only to the eight identified FEP activities rather than all distribution activities.

Taxpayer is also incorrect when it asserts that the legislative history supports its interpretation of section 941(c)(1)(A)(i). The Senate Report provides that:

> 'foreign sale and leasing income' is the amount of the taxpayer's foreign trade income (with respect to a transaction) that is properly allocable to activities that constitute foreign economic processes (as described above).

Senate Report, at 10 (emphasis added). The Senate Report identifies FEP activities as including only those activities specified in the statute:

> The foreign economic processes requirement is satisfied if the taxpayer (or any person acting under a contract with the taxpayer) participates outside of the United States in the solicitation (other than advertising), negotiation, or making of the contract relating to such transaction and incurs a specified amount of foreign direct costs attributable to the transaction. For this purpose, foreign direct costs include only those costs incurred in the following categories of activities: (1) advertising and sales promotion; (2) the processing of customer orders and the arranging for delivery; (3) transportation outside of the United States in connection with delivery to the customer; (4) the

> determination and transmittal of a final invoice or statement of account or the receipt of payment; and (5) the assumption of credit risk.

Id. at 8-9 (footnote omitted).

The Senate Report contains other language that supports our interpretation. An example that illustrates the computation of FSLI under section 941(c)(1)(A) provides:

> Foreign sale and leasing income is defined as an amount of foreign trade income . . . that is properly allocable to certain specified foreign activities. Assume for purposes of this example that . . . $35 is properly allocable to such foreign activities (e.g., solicitation, negotiation, advertising, foreign transportation, and other enumerated sales-like activities) and, therefore, is considered to be foreign sale and leasing income.

Id. at 12 (emphasis added). In short, far from supporting Taxpayer's position, the Senate Report defines the relevant activities as FEP and then defines FEP as the eight activities "enumerated" in section 942(b)(2)(A)(i) and (3).

Taxpayer also argues that the FSLI method is the analogous successor to the FSC non-administrative pricing method and that, accordingly, section 941(c)(1)(A)(i) must be interpreted as referring to all conceivable foreign distribution activities because the FSC non-administrative pricing method does not limit FSC profit to particular distribution activities. Specifically, Taxpayer argues that, because the FSC non-administrative pricing method was used by foreign distributors and because the FSLI method is an analogous method, the full range of foreign distribution activities must be taken into account under the FSLI method.

We do not know with any reasonable level of certainty exactly what Congress intended section 941(c)(1)(A)(i) to achieve with regard to distributors or any other category of taxpayers. We do know that the FSLI method bears at least one statutory similarity to the FSC non-administrative pricing method mentioned by Taxpayer. Both methods provide a benefit by applying a 30% fraction to some base of income. See I.R.C. § 941(a)(1)(A) (ETI exclusion based on 30% of FSLI) and I.R.C. §§ 923(a)(2) and 291(a)(4) (providing that 30% of FSC foreign trade income is exempt if all of the FSC's shareholders are corporations). We also believe that, as Taxpayer points out, some taxpayers that used the FSC non-administrative pricing method were taxpayers that bought and resold property as distributors. So we acknowledge similarities -- even a historical relationship -- between the two methods.

But Taxpayer fails to recognize the significant differences between the two methods. For example, the FSC non-administrative pricing method applied section 482

to actual sales where appropriate. In contrast, the FSLI method is presumed to apply an economic analysis to a sale that in some cases (such as Taxpayer's) is a hypothetical sale involving a hypothetical taxpayer.[14] As another example, whereas the FSC non-administrative pricing method did not have special rules for taking into account fewer than all expenses, the FSLI method requires that only directly allocable expenses be taken into account. Yet another material difference between the two methods is that the FSC non-administrative pricing method did not focus only on the portion of a manufacturer's profit attributable to FEP, as the FSLI method does.

In short, although the FSC non-administrative pricing and FSLI methods seem to be related historically, they are materially different methods and are not analogous within the meaning of the Senate Report. Senate Report, at 18. The FSLI method is perhaps best described as a hybrid of the FSC combined taxable income method and non-administrative pricing method of section 925(a)(2) and (3), respectively, modified by entirely new elements such as the special rule in section 941(c)(3)(B) requiring that only directly allocable expenses be taken into account. We deduce from this fact that the intent of the drafters was not to precisely re-create the FSC non-administrative pricing method in the form of the FSLI method. As demonstrated above, the FSLI method is materially different from the FSC non-administrative pricing method, especially as applied by Taxpayer (e.g., to a hypothetical sale by a hypothetical taxpayer determined using economic principles but not section 482 itself). Therefore, it would be inappropriate for us to disregard the plain language of section 941(c)(1)(A)(i) and interpret the provision as referring to all distribution activities. We have no reason to believe section 941(c)(1)(A)(i) fails to reflect the intent of the drafters, and Taxpayer has presented no evidence to that effect.

In light of the usage of the phrase "described in" with respect to FEP activities in the ETI exclusion provisions to mean "specified;" in light of similar corresponding prior usage in the FSC provisions; considering the overall context of the provision; considering analysis of the language in the Senate Report; and considering analysis of the non-administrative pricing method under the FSC provisions, we believe the phrase "described in" as used in section 941(c)(1)(A)(i) refers only to the eight FEP activities listed in section 942(b)(2)(A)(i) and (3).[15]

We conclude that FSLI includes FTI properly allocable only to the specific activities listed in section 942(b)(2)(A)(i) and (3). Because FSLI is the part of FTI that is properly allocable to the FEP activities listed in section 942(b)(2)(A)(i) and (3), FSLI is a subset of FTI. Taxpayer's economic analysis in support of its FSLI computation

[14] As we understand it, Taxpayer acknowledges that it does not apply section 482, only some of the principles under section 482.

[15] We also note that Taxpayer's strained logic regarding the relevance of the choice of the word "described" by the drafters proves too much. Under Taxpayer's reasoning, its own interpretation of section 941(c)(1)(A)(i) would be supported only if the drafters had used a construction such as "all distribution activities" rather than the "activities described in" construction actually adopted.

inappropriately takes into account activities that do not constitute FEP. Therefore, Taxpayer incorrectly calculated FSLI to the extent it took into account such non-FEP activities.

Issue 3: When determining FSLI as a subset of FTI pursuant to section 941(c)(1)(A), whether directly allocable expenses are deducted from FTGR under section 941(c)(3)(B) in the calculation of the FTI of which such FSLI is a subset or whether section 941(c)(3)(B) is otherwise taken into account in the calculation of the FSLI subset itself.

This issue involves two disputed calculations – the calculation of FTI under section 941(b)(1) subject to section 941(c)(3)(B) and the calculation of the FSLI subset of such FTI under section 941(c)(1)(A). We discuss the two calculations separately and in sequence.

Section 941(c)(1)(A) provides that the FSLI of a transaction is the FTI from the transaction that is properly allocable to FEP. Section 941(c)(3)(B) provides that, for purposes of determining FSLI, only directly allocable expenses are taken into account in calculating FTI:

> For purposes of this subsection, any expense other than a directly allocable expense shall not be taken into account in computing foreign trade income.

We conclude based on the plain language of section 941(c) that, to properly calculate FSLI under subsection 941(c)(1)(A), FTI must first be computed without regard to expenses that are not directly allocable expenses within the meaning of section 941(c)(3)(B). In other words, directly allocable expenses, but not other expenses, are deducted from FTGR when computing FTI under section 941(c). To read this provision differently would ignore the language of the statute as well as other straightforward descriptions of the rule in the Senate Report. See, e.g., Senate Report, at 12 (example illustrating the computation of FTI before the computation of FSLI for purposes of section 941(c)(1)(A)).

Taxpayer asserts that footnote 25 in the Senate Report supports its position that expenses other than directly allocable expenses are disregarded in the FSLI calculation, but not in the FTI calculation. The footnote provides:

> Because foreign sale and leasing income only takes into account direct expenses, it is appropriate to take into account only such expenses for purposes of this calculation.

Id. at 13. Taxpayer's interpretation of the footnote is inconsistent with the plain language of the statute. In contrast, we see the footnote as perfectly consistent with the plain language of the statute. That is, because only directly allocable expenses are

regarded when computing FTI, and because FSLI is a subset of FTI, the footnote correctly describes FSLI as taking into account only directly allocable expenses. Finally, though it is consistent with the plain language of the statute and our position, we observe that the footnote is nonetheless inapposite to the present issue because the purpose of the footnote is to explain the gross-up for disallowed expenses only after FTI and FSLI have been computed. The footnote does not address the mechanics of computing the FSLI and FTI that underlie the gross-up, but Taxpayer incorrectly cites it for that purpose.

We agree with Taxpayer that an economic analysis may be used to determine the portion of FTI of a transaction that is properly allocable to FEP in order to determine FSLI.[16] In this case, Taxpayer apparently determined FSLI by determining returns for purportedly comparable, full-risk distributors. Taxpayer claims that, to compute FSLI based on its economic analysis while remaining consistent with section 941(b)(1) and (c)(3)(B), Taxpayer must gross up the amount determined under its analysis by expenses not directly allocable or must reduce the amount by directly allocable expenses depending on the particular method. In contrast, Examination suggests that the expense rules under section 941(c)(3)(B) apply only when determining FTI, not the FSLI subset of that FTI.

We agree with Examination that under a literal reading of section 941(b)(1) and 941(c), the special rule for expenses applies only to the initial calculation of FTI. However, such interpretation could result in a mathematical mismatch of FTI and the FSLI subset, depending on the facts of the case. If a taxpayer's economic analysis determines the FSLI subset based on comparables that take into account all expenses or no expenses instead of only directly allocable expenses, it could be appropriate to adjust the result to reflect the rule of section 941(c)(3)(B) that only directly allocable expenses must be taken into account. Because we have not had the opportunity to review Taxpayer's economic analysis and expense adjustment, we cannot opine on whether Taxpayer's approach is acceptable. But we acknowledge the possibility of a situation where an adjustment to reflect the rule of section 941(c)(3)(B) in the calculation of the FSLI subset is necessary in order to align (mathematically and conceptually) the FSLI amount with the FTI amount of which it is a subset and which also must reflect the rule of section 941(c)(3)(B) in accordance with our determination above.

Consider the following example. Taxpayer computes FTI of $100 by properly taking into account only directly allocable expenses. Using an economic analysis and comparables, Taxpayer determines a gross return to its FEP activities of $20. Such gross amount takes into account no expenses other than the cost of goods sold. It would be inappropriate for Taxpayer to claim the entire $20 as FSLI because that amount is artificially inflated by the failure to account for directly allocable expenses. Conversely, assume that the $20 return takes into account all expenses rather than only directly allocable expenses. It would be inappropriate for Taxpayer to claim only the

[16] As mentioned above, we do not opine on whether Taxpayer's particular economic analysis is valid.

$20 as FSLI. In both scenarios (assuming the economic analysis is acceptable), an adjustment to the $20 amount would be necessary to determine the actual FSLI subset of FTI and avoid the use of an incorrect FSLI amount in light of the status of FSLI as a subset of the FTI profit amount computed with regard to section 941(c)(3)(B).

To summarize, section 941(c)(3)(B) always applies when computing FTI for purposes of section 941(c). When computing the FSLI subset of that FTI under section 941(c)(1)(A), if the taxpayer uses an economic analysis that is inconsistent with section 941(c)(3)(B), an adjustment to that FSLI consistent with section 941(c)(3)(B) would be appropriate. Such adjustment must be consistent with our determination regarding Issue 4.

Issue 4: Whether the methodology under the section 861 regulations should be applied when determining the scope of the term “directly allocable expense” under section 941(c)(3)(B).

A. Background

The issue here is the meaning of the term "directly allocable expense" in section 941(c)(3)(B), which provides:

> (B) ONLY DIRECT EXPENSES TAKEN INTO ACCOUNT.— For purposes of this subsection, any expense other than a directly allocable expense shall not be taken into account in computing foreign trade income.

Neither sections 941 through 943 nor the Senate Report provides a definition of the phrase "directly allocable." A primary source of guidance is an example illustrating the FSLI provisions that was included in the Senate Report. The example is set forth in relevant part as follows:

> XYZ Corporation, a U.S. corporation, manufactures property that is sold to unrelated customers for use outside of the United States. XYZ Corporation satisfies the foreign economic processes requirement through conducting activities such as solicitation, negotiation, transportation, and other sales-related activities outside of the United States with respect to its transactions. During the year, qualifying foreign trade property was sold for gross proceeds totaling $1,000. The cost of this qualifying foreign trade property was $600. XYZ Corporation incurred $275 of costs that are directly related to the sale and distribution of qualifying foreign trade property.

Senate Report, at 11. Although the example does not explain what is meant by the phrase "costs that are directly related to," it later refers to these costs as "direct expense." The example continues as follows:

> XYZ Corporation paid $40 of income tax to a foreign jurisdiction related to the sale and distribution of the qualifying foreign trade property. XYZ Corporation also generated gross income of $7,600 (gross receipts of $24,000 and cost of goods sold of $16,400) and direct expenses of $4,225 that relate to the manufacture and sale of products other than qualifying foreign trade property.

Id. The example does not state what costs are included in direct expenses. The example continues as follows:

> XYZ Corporation also incurred $500 of overhead expenses. XYZ Corporation's financial information for the year is summarized as follows:

	Total	Other Property	QFTP
Gross receipts	$25,000.00	$24,000.00	$1,000.00
Cost of goods sold	17,000.00	16,400.00	600.00
Gross income	8,000.00	7,600.00	400.00
Direct expenses	4,500.00	4,225.00	275.00
Overhead expenses	500.00		
Net income	3,000.00		

Id. at 11-12. The example does not explain what expenses are included in "overhead expenses." The example continues as follows:

> Illustrated below is the computation of the amount of qualifying foreign trade income that is excluded from XYZ Corporation's gross income and the amount of related expenses that are disallowed. In order to calculate qualifying foreign trade income, the amount of foreign trade income first must be determined. Foreign trade income is the taxable income (determined without regard to the exclusion of qualifying foreign trade income) attributable to foreign trading gross receipts. In this example, XYZ Corporation's foreign trading gross receipts equal $1,000. This amount of gross receipts is reduced by the related cost of goods sold, the related direct expenses, and a portion of the overhead expenses [the example assumes that

> apportioning overhead on the basis of gross income is reasonable] in order to arrive at the related taxable income. Thus, XYZ Corporation's foreign trade income equals $100, calculated as follows:
>
> | | |
> |---|---|
> | Foreign trading gross receipts | $1,000.00 |
> | Cost of goods sold | 600.00 |
> | Gross income | 400.00 |
> | Direct expenses | 275.00 |
> | Apportioned overhead expenses | 25.00 |
> | Foreign trade income | 100.00 |

Id. at 12 (emphasis added.). Here the example illustrates that XYZ Corporation's FTI is determined by taking into account all of the expenses attributable to FTGR that it labels "direct expenses" and "overhead expenses," which are apportioned on the basis of gross income. The example takes into account all expenses because FTI is defined in section 941(b)(1) as "taxable income attributable to" FTGR. The example continues as follows:

> Foreign sale and leasing income is defined as an amount of foreign trade income (calculated taking into account only directly-related expenses) that is properly allocable to certain specified foreign activities. Assume for purposes of this example that of the $125 of foreign trade income ($400 of gross income from the sale of qualifying foreign trade property less only the direct expenses of $275), $35 is properly allocable to such foreign activities (e.g., solicitation, negotiation, advertising, foreign transportation, and other enumerated sales-like activities) and, therefore, is considered to be foreign sale and leasing income.

Id. (emphasis added). In this part, the example calculates FTI for purposes of FSLI by subtracting from all of its gross income from the sale of qualifying foreign trade property only those expenses that are "directly-related expenses," which the example previously, and in the next sentence, refers to as "direct expenses." XYZ does not subtract its "overhead expenses." However, any costs capitalized under section 263A, including such items as capitalized interest, are taken into account in determining gross income. The example assumes that a part of this net amount is “properly allocable” to FSLI but does not explain how that part was determined. The example goes on to determine XYZ's taxable income, which requires a gross-up of the amount excluded from gross income by the expenses that are allocable to this income. This gross-up is necessary because those expenses are not deductible for U.S. Federal income tax purposes. The example points out that if QFTI was determined using the FSLI method

of section 941(a)(1)(A), the disallowed expenses would include only the appropriate portion of the direct expenses.

B. Applicability of the Section 861 Regulations under Section 941(c)(3)(B)

In light of the overall background and context of section 941(c)(3)(B), we agree with Examination and Field Counsel that Congress intended the regulations under section 861 (Treas. Reg. §§ 1.861-8 through 1.861-17 and Temp. Treas. Reg. §§ 1.861-8T through 1.861-14T)("the section 861 regulations") to apply for determining the directly allocable expenses under section 941(c)(3)(B) that should be subtracted from gross income in determining FTI for FSLI purposes. Accordingly, only directly allocable expenses as determined under the section 861 regulations should be taken into account for purposes of section 941(c)(3)(B). We reach this conclusion primarily because FTI is a taxable income concept; section 114(c)(2) provides that any deduction of the taxpayer properly apportioned and allocated to the ETI derived by the taxpayer from any transaction is to be allocated between the excluded and nonexcluded parts of gross income; and Congress intended that the FSC regulations (and, by extension, the section 861 regulations), are to be used in determining FTI for purposes of the ETI exclusion, prior to the issuance of regulations under the ETI exclusion when analogous concepts were present. The Senate Report states that:

> The Committee recognize that there may be a gap in time between the enactment of the bill and the issuance of detailed administrative guidance. It is intended that during this gap period before administrative guidance is issued, taxpayers and the Internal Revenue Service may apply the principles of present-law regulations and other administrative guidance under sections 921 through 927 to analogous concepts under the bill.

Senate Report, at 18. Because administrative guidance has not been issued, the FSC regulations at Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(C), which provide that expenses will be allocated and apportioned under Treas. Reg. § 1.861-8 (including the other section 861 regulations referred to above) for the purpose of computing combined taxable income are applicable for purposes of determining FTI under the ETI exclusion provisions. See also Temp. Treas. Reg. § 1.921-3T(b) (regarding the allocation and apportionment of expenses to foreign trade income and non-foreign trade income and between exempt foreign trade income and non-exempt foreign trade income for FSC purposes).[17]

C. Applicability of the Section 861 Regulations to other Code Sections

[17] Note that "foreign trade income" in the FSC context is a gross income concept whereas "FTI" in the ETI exclusion context is a taxable income concept. See I.R.C. §§ 923(b) and 941(b)(1), respectively.

The phrase "directly allocable" is used in several other Code sections. The phrase is not defined in those sections either. The legislative history of some, but not all, of those sections supports our opinion that the phrase requires application of the section 861 regulations. The clearest example of their applicability is found in section 864(e)(6) and (7) which provide, in part, as follows:

> (6) ALLOCATION AND APPORTIONMENT OF OTHER EXPENSES.— Expenses other than interest which are not directly allocable or apportioned to any specific income producing activity shall be allocated and apportioned as if all members of the affiliated group were a single corporation.
>
> (7) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations providing— . . .
>
> (B) for direct allocation of interest expense incurred to carry out an integrated financial transaction to any interest (or interest-type income) derived from such transaction, . . .
>
> (D) for direct allocation of interest expense in the case of indebtedness resulting in a disallowance under section 246A, . . .

Section 864(e)(6) and (7) were enacted as part of the Tax Reform Act of 1986 (P.L. 99-514, § 1215(a)), and was slightly revised in 1988 (P.L. 100-647, § 1012(h)(5), Technical and Miscellaneous Revenue Act of 1988) by the substitution of the word "or" for "and" in paragraph (e)(6). In S. Rep. No. 99-313, at 3498 (1986), the Senate Finance Committee clarified that the phrase "direct allocation" in section 864(e)(7)(B) and (D), and by implication the phrase "directly allocable" in section 864(e)(6), require that a factual relationship must be established between the expense and the income, by stating as follows:

> The committee believes that in cases where interest expense is directly allocable against a certain type of income, that expense should reduce that kind of income. Therefore, a rule like that now embodied in Treas. Reg. sec. 1.861-8(e)(2)(iv) [see Temp. Treas. Reg. § 1.861-10T(b)], that allows taxpayers to trace interest expense on certain nonrecourse debt to related assets, will continue to be warranted.

In the American Jobs Creation Act of 2004 (P.L. 108-357, § 102(a)) ("AJCA"), Congress enacted section 199, which provides for a deduction for income attributable to domestic production activities. Under section 199(a)(1) and (d)(2), the deduction is limited to a percentage of the lesser of (a) the qualified production activities income

("QPAI") of the taxpayer for the taxable year; or (b) taxable income (determined without regard to section 199) for the taxable year (or, in the case of an individual, adjusted gross income).

As originally enacted in the AJCA, section 199(c)(1)(B) provided that QPAI meant domestic production gross receipts ("DPGR") reduced by

> (i) the cost of goods sold that are allocable to such receipts,
>
> (ii) other deductions, expenses, or losses directly allocable to such receipts, and
>
> (iii) a ratable portion of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income. (Emphasis added.)

The Gulf Opportunity Zone Act of 2005 (P.L. 109-135, § 403(a)(3)) ("GOZA"), replaced paragraphs (ii) and (iii) with the following paragraph (ii) (retroactive to the effective date of the AJCA):

> (ii) other expenses, losses, or deductions (other than deductions allowed under this section) which are properly allocable to such receipts. (Emphasis added.)

The AJCA provides in section 199(c)(2) that the Secretary should prescribe rules for the proper allocation of the cost of goods sold, expenses, losses, or deductions for purposes of determining QPAI. GOZA added the following sentence to section 199(c)(2):

> Such rules [rules prescribed by the Secretary] shall provide for the proper allocation of items whether or not such items are directly allocable to domestic production gross receipts.

H. R. Conf. Rep. No. 108-755, at 259, n. 24 (2004) issued for the AJCA provided as follows:

> The Secretary shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining income attributable to domestic production activities. Where appropriate, such rules shall be similar to and consistent with relevant present-law rules (e.g., sec. 263A, in determining the cost of goods sold, and sec. 861, in determining the source of such items). Other deductions, expenses, or losses that are directly allocable to such receipts include, for example, selling and marketing expenses. A proper

> share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income include, for example, general and administrative expenses allocable to selling and marketing expenses. (Emphasis added.)

It is not clear what was intended by the emphasized language, but the rest of the quoted language clearly indicates that the phrases "directly allocable" and ”properly allocable" rely on the concepts of regulations under section 861 (or section 263A with respect to cost of goods sold). As stated, no official committee reports were issued for GOZA. Also, the Technical Explanation of the Revenue Provisions of H.R. 4440 (JCX-88-05) did not discuss the change, made by GOZA, from "directly allocable" to "properly allocable."

Also as part of the AJCA (§848(a)), Congress enacted section 470, which provides that a tax-exempt loss will not be allowed. A tax-exempt loss is the amount by which

> (A) the sum of—
>
> (i) the aggregate deductions (other than interest) directly allocable to a tax-exempt use property, plus
>
> (ii) the aggregate deductions for interest properly allocable to such property, exceed
>
> (B) the aggregate income from such property.

I.R.C. § 470(c)(1). Tax-exempt use property is, generally, tangible property leased to a tax-exempt entity. See I.R.C. § 470(c)(2). Section 470 does not define the phrases "directly allocable" or "properly allocable." However, with respect to the required allocation of deductions, the H. R. Conf. Rep. No. 108-755, at 644 (2004), states:

> This provision [enacted section 470] applies to deductions or losses related to a lease to a tax-exempt entity and the leased property.[608] . . .
>
> [608] Deductions related to a lease of tax-exempt use property include depreciation or amortization expense, maintenance expense, taxes or the cost of acquiring an interest in, or lease of, property. In addition, this provision applies to interest that is properly allocable to tax-exempt use property, including interest on any borrowing by a related person, the proceeds of which were used to acquire an interest in the property, whether or not the borrowing is secured by the leased property or any other property.

In this report, the Committee appears to equate the phrase "directly allocable" to the phrase "related to" which implies a factual relationship analysis as is required in the regulations under section 861. In addition, the Committee indicates that interest will be taken into account, or properly allocated to tax-exempt use property, if the proceeds are used to acquire the property irrespective of "whether the borrowing is secured by the leased property." This rule, which requires a tracing of the borrowed funds to the acquisition of the property, is similar to the rule in Temp. Treas. Reg. § 1.861-10T(b) that provides a special rule for interest that is directly allocable to income generated by property acquired by the borrowed funds. However, the rule in Temp. Treas. Reg. § 1.861-10T(b) is limited, generally, to those situations where the debt is nonrecourse.

D. Taxpayer's Assertions

Taxpayer asserts that simply applying the section 861 regulations, without modification, will render meaningless the statutory mandate that for purposes of determining FSLI, only directly allocable expenses should be taken into account in determining FTI. Taxpayer also asserts that applying the section 861 regulations will require taking into account inappropriate expenses. We do not agree with Taxpayer's assertion that applying the section 861 regulations means that non-directly allocable expenses are necessarily taken into account. As support for its position, Taxpayer points to the fact that, in the Senate Report's example, in determining FTI, XYZ Corporation's gross income is reduced by overhead expense that is allocated and apportioned under the section 861 regulations to that gross income. Taxpayer asserts that the example illustrates how the section 861 regulations require that non-directly allocable expenses must be taken into account because in its opinion, overhead expenses are clearly non-allocable expenses. However, that part of the example only illustrates the FTI calculation in the non-FSLI context and does not illustrate how the section 861 regulations would be applied to determine a taxpayer's FTI in the FSLI context, which takes into account only directly allocable expenses pursuant to section 941(c)(3)(B). That concept is reflected in the next sentence of the example, which provides:

> Foreign sale and leasing income is defined as an amount of foreign trade income (calculated taking into account only directly-related expenses) that is properly allocable to certain specified foreign activities.

Senate Report, at 12. It is in this separate calculation that only directly allocable expenses as identified under the section 861 regulations are to be taken into account.

Taxpayer asserts that the standard established by the Service for identifying "directly allocable expenses" for purposes of section 965(d)(2) in Notice 2005-64, 2005-36 I.R.B. 471, should also be applied for identifying directly allocable expenses for purposes of section 941(c)(3)(B). We do not think that standard is appropriate. Its concept of directly allocable expenses is irrelevant for determining directly allocable expenses for

purposes of the FTI under section 941(c)(3)(B) because section 965 was enacted for entirely different purposes. In this regard, the Conference Committee stated that "[t]he conferees emphasize that [section 965] is a temporary economic stimulus measure." H.R. Conf. Rep. No. 108-755, at 302 (2004). Accordingly, in our opinion, the concept of directly allocable expenses under section 965 should be interpreted more narrowly than should that concept under section 941..

As part of the AJCA (§ 422(a)), Congress enacted section 965, which provides that a corporation that is a U.S. shareholder of a controlled foreign corporation may elect, for one year, an 85 percent dividend received deduction with respect to certain cash dividends it receives from that controlled foreign corporation. When enacted, section 965(d)(2) provided that a taxpayer was not allowed to deduct expenses "properly allocated and apportioned" to the 85 percent portion of the dividend deductible under section 965. Congress revised section 965(d)(2) in GOZA (§ 403(q)(5)) by replacing the phrase "properly allocated and apportioned" with the phrase "directly allocable."

No committee reports were issued for GOZA. However, the Technical Explanation of the Revenue Provisions of H.R. 4440 (JCX-88-05) provided as follows with respect to disallowed directly allocable expenses under section 965(d)(2):

> The provision also clarifies that the expense disallowance rule of Code section 965(d)(2) applies only to deductions for expenses that are directly allocable to the deductible portion of the dividend. For these purposes, an expense is 'directly allocable' if it relates directly to generating the dividend income in question. Thus, deductions for direct expenses such as legal and accounting fees and stewardship costs are disallowed under this provision. Deductions for indirect expenses such as interest, research and experimentation costs, sales and marketing costs, state and local taxes, general and administrative costs, and depreciation and amortization are not disallowed under this provision.

On December 19, 2005, Chairman Grassley submitted for the record the Technical Explanation, which he asserts was submitted to the Senate at the time the bill was passed to be printed in the Congressional Record but was not printed because of a clerical error. See 151 Cong. Rec. S14028. Apparently, Senator Grassley intended that, by making this statement and having the Technical Explanation printed in the Congressional Record, it would have more precedential value. That language in the Technical Explanation followed a colloquy between Senators Smith and Grassley in the Senate on October 9, 2004 (151 Cong. Rec. S10976), regarding the AJCA, as follows:

> Senator Smith: Would it be reasonable to say that properly allocated and apportioned expenses would not include general

> and administrative costs not directly related to generating the income being repatriated and such indirect expenses as research and experimentation costs, interest, state and local taxes, sales and marketing costs, depreciation, and amortization.
>
> Senator Grassley: Yes, your understanding is correct. I would add that directly related expenses would include, but is not limited to, stewardship costs and directly related legal and accounting fees.

No explanation is given, however, why the phrase "properly allocated and apportioned" in the AJCA was changed to "directly allocable" in GOZA. Nonetheless, it is clear that under section 965(d)(2) an expense will be "directly allocable" only if the expense was incurred because the qualifying dividend from the controlled foreign corporation was paid. As was the case in the Senate Report, the Technical Explanation and the Senators in their colloquy are inexact in their use of terminology, in that the terms "direct expenses" and "directly related" appear to be used to mean the same thing as "directly allocable."

In light of the legislative history of section 965(d)(2), the Service provided as follows in section 5.01(d) of Notice 2005-64:

> The disallowance of deductions under section 965(d)(2) does not extend to expenses that, while treated as definitely related to the production of income in a category that includes qualifying dividends, do not relate directly to generating qualifying dividends. Expenses described in the preceding sentence include interest expense, research and experimental expenses, general and administrative expenses, depreciation and amortization, sales and marketing expenses, state and local taxes . . . .

Taxpayer asserts that the standard for determining expenses that "relate directly to generating" income should be applied to determining "directly allocable" expenses under section 941(c)(3)(B) so that expenses that are definitely related to Taxpayer's FTI would not be directly allocable unless they "relate directly to generating" FSLI. In our opinion, the standard proposed by Taxpayer is inappropriate and inconsistent with the example in the Senate Report that, when determining FTI, takes into account all directly allocated expenses, and not only the directly allocated expenses that related to the generation of FSLI.

E. Analysis of Specific Expenses under the Section 861 Regulations

It is beyond the scope of this TAM to analyze each of Taxpayer's expenses to determine which expenses would be classified as expenses directly allocable to

Taxpayer's FTI. However, because of their relative significance, we will analyze in depth whether interest expense and research and experimentation ("R&E") expenditures are directly allocable to Taxpayer's gross income attributable to FTGR. Before discussing those two expenses, it appears, as Examination points out, Taxpayer incorrectly did not include as directly allocable expenses any depreciation or rents, overhead, or general and administrative expense attributable to Taxpayer's total gross income from sales qualifying for the ETI exclusion. In our opinion, the FSC and ETI provisions in connection with the FEP requirements of sections 924 and 942(b), respectively, provide guidance on whether those expenses are directly allocable to Taxpayer's gross income attributable to FTGR. Accordingly, costs or expenses that under Treas. Reg. § 1.924(d)-1(d)(2) are "incident to and necessary for" or "identified or associated directly with" the performance of an activity described in section 942(b) (as well as in section 924(e)) are directly allocable under section 941(c)(3)(B) because only those costs would be allocated and apportioned under the section 861 regulations to the class of income generated by the FEP activities. Although, as Treas. Reg. § 1.924(d)-1(d)(2)(i) states, such identified costs do not include all costs that are taken into account in determining combined taxable income, the regulation defines the costs that are so identified as follows:

> Direct costs include the costs of materials which are consumed in the performance of the activity, and the cost of labor which can be identified or associated directly with the performance of the activity (but only to the extent of wages, salaries, fees for professional services, and other amounts paid for personal services actually rendered, such as bonuses or compensation paid for services on the basis of a percentage of profits). Direct costs also include the allowable depreciation deduction for equipment or facilities (or the rental cost for use thereof) that can be specifically identified or associated with the activity, as well as the contract price of an activity performed on behalf of the FSC by the contractor. If costs of services or the use of facilities are only incidentally related to the performance of an activity described in section 924(e), only the incremental cost is considered to be identified directly with the activity. For example, supervisory, administrative, and general overhead expenses, such as telephone service, normally are not identified directly with particular activities in section 924(e). The cost of a long distance telephone call made to arrange for delivery of export property, however, is identified directly with the activities described in section 924(e)(2).

Accordingly, the part of Taxpayer's depreciation that is specifically identified under the section 924 standard is directly allocable to Taxpayer's gross income attributable to

FTGR for section 941(c) purposes. Likewise, the incremental cost of Taxpayer's overhead and administrative expenses that is specifically identified under the section 924 standard is directly allocable to Taxpayer's gross income attributable to FTGR for section 941(c) purposes. Also, Taxpayer incorrectly did not include any state or local income tax as directly allocated expenses. Under Treas. Reg. § 1.861-8(e)(6), such state income taxes are directly allocable to Taxpayer's gross income attributable to FTGR to the extent that they are directly allocable to the gross income with respect to which such state income taxes are imposed.

Most of Taxpayer's interest expense likely is not "directly allocable" to Taxpayer's gross income attributable to FTGR because most of the interest is treated under Temp. Treas. Reg. § 1.861-9T(a) as "attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid." However, section 864(e)(7) and Temp. Treas. Reg. § 1.861-10T recognize that certain interest expense must be directly allocated to income generated by certain assets. Under Temp. Treas. Reg. § 1.861-10T, interest expense is directly allocated to gross income generated by certain assets that are (1) subject to qualified nonrecourse indebtedness or (2) acquired in integrated financial transactions. Also under Temp. Treas. Reg. § 1.861-10T, third party interest of an affiliated group is directly allocated to such group's investment in related controlled foreign corporations in cases involving excess related person indebtedness. In addition, Treas. Reg. § 1.861-9T(b)(5) requires direct allocation of amortizable bond premium. Only these four types of interest would be directly allocable to Taxpayer's gross income attributable to FTGR because only that interest would be considered to have generated the specific item of FTI. It is not clear whether Taxpayer incurred these types of interest.

Taxpayer did not directly allocate any of its R&E to FTI because, in its opinion, the R&E was attributable solely to its gross income from manufacturing. We think Taxpayer's position is generally incorrect under Treas. Reg. § 1.861-17.

Treas. Reg. § 1.861-17 provides specific rules for the allocation and apportionment of R&E. Under that regulation, R&E is generally considered to definitely relate to income reasonably connected to a taxpayer's relevant product category (or categories) and, therefore, is allocable to all items of gross income as a class related to such product category (or categories). Treas. Reg. § 1.861-17(a)(2)(i) and (ii) provide that, ordinarily, a taxpayer's R&E may be divided between the relevant product categories, which are determined by reference to the three-digit classification ("SIC code") of the Standard Industrial Classification Manual ("SIC Manual"). Where R&E is conducted with respect to more than one product category, the taxpayer may aggregate the categories for purposes of allocation and apportionment; however, the regulations provide that the taxpayer may not subdivide the categories (below a three-digit category).

Consistent with the approach to allocating R&E to "all income reasonably connected" with SIC code categories, the wholesale trade rule of Treas. Reg. § 1.861-

17(a)(2)(iv) states that the two-digit SIC code category "wholesale trade" is not applicable with respect to sales by the taxpayer of goods and services from any other of the taxpayer's product categories. Thus, with respect to a single product, although the SIC Code Manual distinguishes between manufacturing activities on the one hand and wholesaling activities (wholesale and retail) on the other hand, R&E associated with manufacturing or R&E associated with marketing, must be allocated to gross income from both manufacturing and wholesale trade activities involving those goods. In other words, if a taxpayer incurs manufacturing R&E with respect to a product and sells that product, then the R&E should be allocated to all gross income attributable to that product, regardless of whether the gross income qualifies as manufacturing income or sales income for SIC code purposes. A taxpayer is required to aggregate its wholesaling SIC code gross income with its manufacturing SIC code gross income for purposes of allocating its manufacturing R&E because the R&E is considered to directly relate to generating all of the gross income, not just the manufacturing gross income. The wholesale trade rule of Treas. Reg. § 1.861-17(a)(2)(iv) provides that taxpayers that both manufacture and wholesale products may not separate the manufacturing gross income from the wholesale gross income and then allocate their R&E solely to the manufacturing gross income. Because of this rule, we believe that the use of the phrases "manufacture and sale" expenses and "sales and distribution" expenses in the Senate Report example is irrelevant for purposes of determining whether R&E is directly allocable.

Because Taxpayer both manufactures and sells goods in the same product category, the wholesale trade rule applies. Accordingly, under Treas. Reg. § 1.861-17, Taxpayer's R&E is directly allocable to all of Taxpayer's gross income reasonably connected with the applicable product category and not solely to Taxpayer's gross income from manufacturing as Taxpayer asserts. In our opinion, reasonable methods of determining the portion of Taxpayer's R&E reasonably connected with an applicable product category that is directly allocable to Taxpayer's gross income attributable to FTGR within that product category, could include, for example, apportioning on the basis of the ratio of Taxpayer's gross income attributable to FTGR within that product category to all of taxpayer's gross income in that product category. Because, as stated in Issue 3 above, FSLI is a subset of FTI, there may be situations where, because of the nature of the comparables used by Taxpayer, a similar gross-to-gross apportionment must be utilized to determine the portion of the Taxpayer's R&E that is directly allocable to FSLI within that product category.

The regulations provide an exception with respect to R&E that is not clearly identified with any product category (or categories) and that is, therefore, considered under Treas. Reg. § 1.861-17(a)(2) as conducted with respect to all the taxpayer's product categories. Taxpayer asserts that, even if R&E in general is an expense that is directly allocable to Taxpayer's gross income attributable to FTGR, R&E that is not clearly identified with any product category (or categories) is not directly allocable to gross income attributable to FTGR because that R&E is not considered to relate to generating FSLI. This R&E is like interest expense other than the interest that falls

within the four special categories described above. Although we agree with Taxpayer in principle, we point out that this special provision in Treas. Reg. § 1.861-17(a)(2) is intended to be a narrow exception to the general rule that most R&E will be identified with a specific product category (or categories). In order to apply this provision to its R&E, Taxpayer must refute the general underpinning of Treas. Reg. § 1.861-17 that R&E is generally attributable to product categories and establish that the R&E is not conducted with respect to any of its product categories.

Taxpayer also asserts that, even if R&E in general is an expenditure that is directly allocable to gross income attributable to FTGR, the exclusive geographic apportionment rule of Treas. Reg. § 1.861-17(b) should apply and would operate to remove R&E performed within the United States from the R&E that is directly allocable to gross income attributable to FTGR because FSLI, by definition, only includes gross income attributable to activities performed outside the United States. Treas. Reg. § 1.861-17(b) provides that "[a]n exclusive apportionment shall be made . . . where an apportionment based upon geographic sources of income of a deduction for research and experimentation is necessary." We do not think the exclusive geographic apportionment rule applies to determine expenses directly allocable to gross income attributable to FTGR because FSLI is a subset of FTI, the determination of which is not dependent upon sourcing of income.

Issue 5: Whether the amount of FSLI determined under section 941(c)(1)(A) can be greater than the amount of FTI of which the FSLI is a subset.

Section 941(c)(1)(A)(i) provides that FSLI is "with respect to any transaction – foreign trade income properly allocable to activities. . . ." Taxpayer agrees that this language means that FSLI is a subset of FTI. We believe the logical corollary[18] to the subset concept is that FSLI cannot exceed FTI. Taxpayer does not agree on this point.

Our position is that some portion of FTI (if any FTI is present in the first place) may constitute FSLI depending on the facts of the case. If no FTI is present, the question is moot because $0 has no subsets unless the Code or regulations say otherwise. If FTI is present, then the question is whether any of that FTI qualifies as FSLI. At most, 100% of FTI can also qualify as FSLI. But logically, FSLI cannot exceed FTI.

Taxpayer disagrees with our reasoning on a fundamental level. To determine whether FSLI was present, Taxpayer used an economic analysis that bifurcated the FTI (whether positive or negative) derived from its sales of qualifying foreign trade property into two components: (1) the portion of FTI allocable to foreign distribution activities and (2) the portion of FTI not allocable to foreign distribution activities.[19] Under Taxpayer's

[18] Or perhaps this is not a corollary so much as just another way of stating the identical concept.

[19] As explained in the discussion of Issue 2 above, Taxpayer's treatment of all foreign distribution activities as FEP is incorrect.

approach, FSLI results from the deconstruction of an economic profit or loss. For example, if Taxpayer determined a loss of <$100> on a sale, its economic analysis might enable it to determine phantom FSLI for that sale as follows: FSLI of $50 and a loss of <$150>. In the case of a profitable sale of $100, Taxpayer's economic analysis might enable it to determine artificially inflated FSLI for that sale as follows: FSLI of $150 and a loss of <$50>. Regardless of whether Taxpayer's FTI is positive or negative, Taxpayer believes the FSLI subset can be greater than the FTI set.

We disagree with Taxpayer's position because it disregards the plain language of section 941(c)(1)(A) and simultaneously reads language into the statute that is not there. The statute is particularly straightforward in this regard: (1) if FTI is present, then (2) a portion of that FTI may constitute FSLI. Nothing in the statutory language suggests that FSLI can or should exceed FTI.

We see no support in the ETI exclusion provisions for the notion that a single economic profit or loss can or should be bifurcated into larger or smaller profit and loss components. Taxpayer's interpretation allows Taxpayer to compute FSLI without computing FTI even though section 941(c)(1)(A) provides that FSLI is a subset of FTI. In fact, Taxpayer did not compute FTI in this case and claims it is not required to do so. Indeed, refusal to compute FTI appears to be a key element of Taxpayer's position because it enables Taxpayer to sidestep the logical limitation on FSLI imposed by the statute. This is directly at odds with the subset concept set out in the statute and as discussed above with respect to Issue 3. In order for the reference to FTI in section 941(c)(1)(A) to have any meaning, FTI must be computed and used as the starting point for determining FSLI. Because Taxpayer's approach treats FTI as irrelevant to the determination of FSLI, Taxpayer's approach disregards the plain language of section 941(c)(1)(A).

Taxpayer asks us to interpret section 941(c)(1)(A) as deconstructing FTI into notional profit and loss components. Thus, Taxpayer might treat $100 of FSLI as a valid subset of FTI where FTI is less than $100 or even a negative amount. But Taxpayer points to nothing as support for its position other than the economic nature of its approach to determining FSLI.[20] Taxpayer does not provide examples (and we are not aware) of other instances in the Federal income tax provisions where such economic bifurcations are permitted or required absent explicit provisions for such bifurcations to that end.

Our interpretation of section 941(c)(1)(A) gives meaning to the FTI starting point for FSLI but, unlike Taxpayer's interpretation, does not require a deconstruction of the

[20] Though we agree with Taxpayer's observation that one can conceptualize the economic profit or loss from a sale as comprising two or more profit or loss components that are economically attributable to two or more economic activities, we disagree that the FSLI provisions require or permit taxpayers to deconstruct FTI to find profits with respect to the sale that simply do not exist. Such an approach would require explicit approval in the statute or legislative history. We are aware of no such approval.

economic profit or loss from a transaction. For example, assume a taxpayer's FTI is $20. If the taxpayer determined under section 941(c)(1)(A) that profit attributable to FEP is $5, then we would conclude that the taxpayer's FSLI is $5 because $5 is the portion of $20 that is properly allocable to FEP performed by the taxpayer or on its behalf pursuant to a contract. Suppose in the alternative that the taxpayer determined that profit attributable to FEP is $20. We would conclude that the entire $20 is FSLI because that is the portion of $20 properly allocable to FEP performed by the taxpayer or on its behalf pursuant to a contract. Finally, suppose in the alternative that the taxpayer determined that profit attributable to FEP is $30. We would conclude that only $20 of the $30 is FSLI because that is the portion of $20 properly allocable to FEP performed by the taxpayer or on its behalf pursuant to a contract. The statute simply does not permit the taxpayer to use a profit amount to compute its ETI exclusion that is greater than the actual profit.

We also note that Taxpayer accuses the Service of treating Taxpayer differently under the ETI exclusion provisions as compared with the FSC provisions in contradiction to the Senate Report. See Senate Report, at 18. This accusation is unfounded. Under the FSC provisions, Taxpayer could not have claimed FSC benefits with respect to its FEP activities alone because none of the three FSC transfer pricing methods would have permitted Taxpayer to compute FSC benefits based only on its profit attributable to FEP activities. Thus, although Taxpayer claims that the Service's position unfairly limits its ETI exclusions in comparison with benefits previously permitted under the FSC provisions, the plain fact is that the Service position described herein permits Taxpayer potentially to compute ETI exclusions in a manner not even permitted previously under the FSC provisions. In other words, far from denying Taxpayer benefits that would have been available under the FSC provisions, the Service position regarding FSLI explained herein potentially allows a greater benefit to Taxpayer under the ETI exclusion provisions than would have been available under the FSC provisions.

Taxpayer claims that we are inappropriately applying the FSC "no loss" rule of Temp. Treas. Reg. § 1.925(a)-1T(e)(1) to this case. Taxpayer's attempt to challenge the Service's position by citing the inapplicability of the no loss rule in the FSC non-administrative pricing method context is misguided. First, we note again that the FSLI method is not analogous to the FSC non-administrative pricing method. So we do not agree with Taxpayer's assumption that the no loss rule cannot be applied in the FSLI method context. Second, we simply are not asserting the no loss rule here. Finally, and most importantly, we must emphasize that our position (contrary to Taxpayer's claims) is not that losses are not permitted when computing FTI for FSLI purposes. Rather, our position is that FSLI, as a matter of simple logic, cannot exceed FTI. Thus, our position is the same regardless of whether a loss is present and, therefore, is not an application of the FSC no loss rule as Taxpayer alleges.

Finally, Taxpayer's position disregards the fact that the ETI exclusion provisions apply on the basis of transactions or groups of transactions and define "transaction" for

this purpose as any sale, exchange, or other disposition; any lease or rental; and any furnishing of services. I.R.C. § 943(b)(1). "Transaction" is not defined to include economic components and subcomponents of actual sales. The FSLI provisions instruct taxpayers to (1) identify the transaction (in this case a sale); (2) compute the FTI for that transaction (if any); and if FTI is present, (3) determine the portion of that FTI that is allocable to certain FEP. Taxpayer complied with none of these three steps in computing its purported FSLI. Taxpayer's position requires us to disregard FTI completely even though, as Taxpayer concedes, the statutory language provides that FSLI is determined with respect to FTI. Taxpayer's position renders the statutory language referring to FTI in section 941(c)(1)(A) meaningless because Taxpayer does not need to know (and, in fact, does not know in this case) the amount of FTI in order to compute FSLI.

In short, Taxpayer asks us to read into the statute a rule that a subset of FTI can be greater than FTI itself. Without specific language in the statute or legislative history requiring or permitting the deconstruction of the economic profit or loss reflected in FTI into positive and negative components, we cannot adopt Taxpayer's interpretation. Based on the plain language of the FTI and FSLI provisions, we conclude that FSLI is a subset of FTI and, therefore, cannot be greater than FTI.

Issue 6: Whether FSLI may be computed based on groups of products or product lines within the meaning of Treas. Reg. § 1.925(a)-1(c)(8)(i).

We believe that, if Taxpayer properly follows any (and especially any combination) of Conclusions 2 through 5 in calculating FSLI, Taxpayer will conclude that FSLI is not the best basis, in this case, for computing ETI exclusions. A resolution of the grouping issue raised in Issue 6 in Taxpayer's favor (assuming arguendo that Taxpayer can produce FTI and FSLI computations on a transaction-by-transaction basis) would have no impact on that outcome. Therefore, we do not reach the grouping issue.

CAVEAT:

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.