INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-152995-06

Director

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

USCorp =
USCorp-FSC =
Year1 =
Year2 =
Year3 =
Date1 =

ISSUES:

1. Whether the foreign sales corporation ("FSC") marginal costing rules under section 925(b)(2) and Temp. Treas. Reg. § 1.925(b)-1T apply to licenses of property.

2. With respect to the FSC marginal costing rules, whether the numerator and denominator of the overall profit percentage ("OPP") (defined in Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(i)) computed for sales of a product or product line include income from licenses of such product or product line.

3. Whether the Conclusion for Issue 1 or 2 is different under the extraterritorial income (“ETI”) exclusion marginal costing rules under section 941(a)(4)).

CONCLUSIONS:

1. The FSC marginal costing rules under section 925(b)(2) and Temp. Treas. Reg. § 1.925(b)-1T do not apply to licenses of property.

2. With respect to the FSC marginal costing rules, the numerator and denominator of the OPP (defined in Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(i)) computed for sales of a product or product line do not include income from licenses of such product or product line.

3. The Conclusions for Issues 1 and 2 are the same under the ETI exclusion marginal costing rules under section 941(a)(4)) as under the FSC marginal costing rules.

FACTS:

I. The Taxpayer

USCorp is a domestic corporation in the business of developing, marketing, and distributing computer software products (“Products”) and providing services in connection with Products. Products are copyrighted articles as defined in Treas. Reg. § 1.861-18(c)(3). To this end, USCorp owns rights in computer software (“Property”), which it licenses to its controlled foreign corporations (“CFCs”) (as defined in section 957(a)) and unrelated third parties. Property is copyright rights as defined in Treas. Reg. § 1.861-18(c)(2). USCorp wholly-owns USCorp-FSC, a foreign corporation that had an election in effect under sections 922(a)(2) and 927(f)(1) to be treated as a FSC during Year1. We assume, solely for purposes of analyzing the issues presented, that USCorp-FSC satisfied the foreign management and economic process requirements under section 924(b), that USCorp’s Property constitutes export property within the meaning of section 927(a), and that all other requirements for qualification under the FSC provisions in sections 921 through 927 were met with respect to the transactions at issue here.

Prior to Date1, USCorp paid commissions to USCorp-FSC, with respect to income it received for licensing Property. USCorp purportedly elected on behalf of USCorp-FSC to use the marginal costing combined taxable income (“CTI”) method under section 925(a)(2) and (b)(2) and Temp. Treas. Reg. § 1.925(b)-1T(a) for determining some or all of these FSC commissions. In addition, USCorp included such licensing income in computing the OPP that was applied to limit such marginal costing CTI from sales of Products and licenses of Property.

After Date1, USCorp ceased paying commissions to USCorp-FSC. Instead, USCorp claimed ETI exclusions with respect to income it received when it licensed Property. We assume, solely for purposes of analyzing the issues presented, that USCorp satisfied the foreign economic process requirements under section 942(b), that USCorp's Property constitutes qualifying foreign trade property within the meaning of section 943(a), and that all other requirements for qualification under the ETI exclusion provisions in sections 941 through 943 were met with respect to the transactions at issue here. USCorp purportedly elected to use the marginal costing foreign trade income ("FTI") method under section 941(a)(1)(C) and (4) for determining some or all of its ETI exclusions. In addition, USCorp included such licensing income in computing the OPP that was applied to limit such marginal costing FTI from sales of Products and licenses of Property.

We note that, because some or all of the licenses at issue are long-term licenses that generate income during more than one taxable year, it is likely that Taxpayer has identified income from some or all of the licenses incorrectly as subject to the ETI exclusion provisions when such income is, in fact, subject to the FSC provisions that were in effect when the licenses were entered into before October 1, 2000. See FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423, §§ 2, 3, and 5(a) (2000); S. Rep. No. 104-416, p.20 (2000) (repealing the FSC provisions and enacting the ETI exclusion provisions); and Rev. Proc. 2001-37, 2001-1 C.B. 1327, §§ 2.02 and 6.03. Taxpayer's possibly incorrect treatment of some licensing income as subject to the ETI exclusion provisions may be immaterial for two reasons. First, as explained in the discussion of Issue 3 below, the marginal costing rules do not apply to licenses regardless of whether the FSC or ETI exclusion provisions apply. Second, Taxpayer used the materially similar CTI method and FTI method under the FSC and ETI exclusion provisions, respectively. In addition, during the pre-submission conference, the parties agreed that this issue would not be the subject of this memorandum. With these considerations in mind, we assume solely for purposes of addressing the narrow legal issues of this memorandum that Taxpayer correctly determined which licensing income is governed by the FSC provisions and which is governed by the ETI exclusion provisions.

II. The Distribution Channels

During Years1 through 3, USCorp did business generally using four distribution channels.

A. Distribution Channel 1 – Property Licensed to Unrelated Third Parties

Under distribution channel 1, USCorp licensed (within the meaning of Treas. Reg. § 1.861-18(f)(1)) Property to unrelated third parties. Such third parties either (1) installed Products into equipment that they manufactured and sold such equipment to consumers, or (2) sublicensed the Property to other third parties that installed Products into equipment that such other parties manufactured and sold to consumers.

B. Distribution Channel 2 – Property Licensed to CFCs

Under distribution channel 2, USCorp licensed (within the meaning of Treas. Reg. § 1.861-18(f)(1)) Property to its CFCs. Under the licensing agreements, each CFC received the right to either reproduce and distribute Products or sublicense such rights in a certain territory.[1]

C. Distribution Channel 3 – Products Sold to Unrelated Third Parties

Under distribution channel 3, USCorp sold (within the meaning of Treas. Reg. § 1.861-18(f)(2)) Products to unrelated third party distributors.

D. Distribution Channel 4 – Products Leased to Unrelated Third Parties

Under distribution channel 4, USCorp leased (within the meaning of Treas. Reg. § 1.861-18(f)(2)) Products to unrelated third parties. Under the lease agreements, a customer acquires the right to use the current version of the Product and the future versions that are made available to the public during the term of the arrangement. USCorp does not use the marginal costing rules for this leasing income and does not include such income in the OPP for any income.

Because Examination agrees that distribution channel 3 involves sales of copyrighted articles to which the marginal costing rules apply, and because Taxpayer concedes that distribution channel 4 involves leases of copyrighted articles to which the marginal costing rules do not apply (and which are not taken into account for purposes of the OPP), this memorandum analyzes only licensing income that results from distribution channels 1 and 2 (except as explained in footnote 1 of this memorandum).

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[1] Taxpayer asserts that some of the licensing income included within distribution channel 2 comprises cost sharing buy-in payments under Treas. Reg. § 1.482-7(g). We note that purported buy-in payments often comprise a combination of both actual buy-in payments (subject to Treas. Reg. § 1.482-7(g)) and other payments (subject only to Treas. Reg. §§ 1.482-4 though -6). In other cases, purported buy-in payments may consist entirely of other payments subject only to Treas. Reg. §§ 1.482-4 though -6. In other words, purported buy-in payments may be determined upon examination to consist partially or entirely of payments that are not, in fact, buy-in payments. We have determined in other cases that true buy-in payments cannot, logically, qualify for FSC benefits or ETI exclusions. Such payments are pursuant to licensing agreements that, unlike the other licenses at issue here, convey the right to use software in research and development. We likely would reach a similar conclusion in this case but have not been asked by the parties to address that issue. Assuming that such similar conclusion is appropriate in this case, the purported buy-in income at issue to the extent attributable to a buy-in would not generate FSC benefits or ETI exclusions and, therefore, the marginal costing issues addressed herein would be irrelevant to that income.

LAW AND ANALYSIS:

I. The FSC Provisions

A. FSCs Generally

A FSC receives certain tax benefits under sections 921 through 927. Section 921(a) provides that exempt FTI[2] of a FSC is treated as foreign source income (and, as a result, is excluded from gross income). Section 923(a)(1) provides that, for purposes of the FSC provisions, exempt FTI is the aggregate amount of certain FTI of a FSC for the taxable year, including a percentage of FTI computed with respect to CTI. Section 923(b) defines FTI as the gross income of a FSC attributable to foreign trading gross receipts ("FTGR"). Section 941(a) of the ETI exclusion provisions defines "qualifying foreign trade income" as gross income from FTGR – in other words, qualifying foreign trade income is a gross income concept materially similar to the FTI concept under the FSC provisions.

Section 924(a) provides that, for purposes of sections 921 through 927, FTGR

> means the gross receipts of any FSC which are—
>
> (1) from the sale, exchange, or other disposition of export property,
> (2) from the lease or rental of export property for use by the lessee outside the United States,
> (3) for services which are related and subsidiary to [(1) or (2) above]
> (4) [other services not relevant here] . . . .

Section 942(a) provides a materially similar definition of FTGR for ETI exclusion purposes. FTGR is similarly defined where a FSC acts as a commission agent with respect to such sale, lease, or service. I.R.C. § 925(b)(1); Temp. Treas. Reg. § 1.924(a)-1T(b) through (f). In addition, for purposes of section 924(a), Temp. Treas. Reg. § 1.924(a)-1T(a)(2) provides:

> The term 'sale' includes an exchange or other disposition and the term 'lease' includes a rental or a sublease. The term 'license' includes a sublicense. All rules under this

[2] Note that "FTI" has different meanings under the FSC and ETI exclusion provisions. For FSC purposes, FTI is <u>gross</u> income from FTGR as discussed below (<u>see</u> section 923(b)). For ETI exclusion purposes, FTI is <u>taxable</u> income from FTGR (see section 941(b)(1)) and is the basis for the FTI method mentioned above.

> section applicable to leases of export property apply in the same manner to licenses of export property.

Treas. Reg. § 1.861-18 provides special rules with respect to classifying transactions relating to computer programs and applies to, among other provisions, those contained in subchapter N of chapter 1 of the Internal Revenue Code. For example, Treas. Reg. § 1.861-18(f) distinguishes between, on the one hand, licenses of copyright rights in software and, on the other hand, sales of copyright rights in software and sales of copyrighted articles that incorporate software. The FSC provisions and sections 941 through 943 of the ETI exclusion provisions are located in subchapter N.

Finally, section 927(a)(1) defines export property. Section 943(a)(1) provides a materially similar definition of qualifying foreign trade property for ETI exclusion purposes. Section 927(a)(2)(B) provides that, for gross receipts attributable to periods after 1997, export property does not include:

> patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, and other than computer software (whether or not patented), for commercial or home use), goodwill, trademarks, trade brands, franchises, or other like property . . . .

Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, § 1171 ("TRA 1997"). Thus, section 927(a)(2)(B) describes two categories of intellectual property for FSC purposes. In general, all intellectual property is excluded from the definition of export property and, thus, is not eligible for FSC benefits. However, the longer parenthetical phrase in section 927(a)(2)(B) identifies copyrights on films, tapes, records, and computer software as intellectual property that is not excluded from the definition of export property. We refer to this limited category of copyright rights that potentially may qualify as export property as the "copyright carve-out." Section 943(a)(3)(B) provides a materially similar copyright carve-out for ETI exclusion purposes. To summarize the copyright carve-out concept: (1) section 927(a)(2)(B) contains a general rule that intellectual property cannot constitute export property; but (2) the copyright carve-out of section 927(a)(2)(B) provides that certain copyright rights (including copyright rights in computer software) may constitute export property and, thus, is an exception to the general rule of section 927(a)(2)(B).

Prior to an amendment made by TRA 1997, the copyright carve-out did not include the words "and other than computer software (whether or not patented)." Whether the pre-TRA 1997 version of the copyright carve-out included computer software (without specifically mentioning it) was the question considered by the Ninth Circuit Court of Appeals in Microsoft Corp. v. Commissioner, 311 F.3d 1178 (9^{th} Cir.

2002). The Ninth Circuit held that the copyright carve-out included copyrights on computer software prior to 1998.

B. Full Costing CTI Method

Section 925(a) provides three alternative methods for determining transfer prices on sales of export property from a related supplier[3] to a FSC. Section 925(a)(2) sets forth the CTI method:

> In the case of a sale of export property to a FSC by a person described in section 482, the taxable income of such FSC and such person shall be based upon a transfer price which would allow such FSC to derive taxable income, attributable to such sale (regardless of the sales price actually charged) in an amount which does not exceed . . . 23 percent of the combined taxable income of such FSC and such person which is attributable to the foreign trading gross receipts derived from the sale of such property by such FSC. . . .

The ETI exclusion FTI method set forth in section 941(a)(1)(C) is materially similar to the FSC CTI method of section 925(a)(2).

If a FSC is the principal on a sale, rather than a commission agent, the CTI of the FSC and its related supplier from a sale of export property under the full costing rules is

> the excess of the foreign trading gross receipts of the FSC from the sale over the total costs of the FSC and related supplier including the related supplier's cost of goods sold and its and the FSC's noninventoriable costs (see § 1.471-11(c)(2)(ii)) which relate to the foreign trading gross receipts.

Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(i). The full costing CTI method for determining FSC transfer prices in section 925(a)(2) applies similarly to the determination of the FSC commissions on sales and leases of export property as well as related and subsidiary services (except that the FSC commissions paid or payable are excluded from total costs). I.R.C. § 925(b)(1) and Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(iii). For this purpose, "costs" include the cost of goods sold and other expenses described in Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(C) and (D). Sale transactions may not be grouped on a product or product line basis with lease transactions. Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(iii)[4] and (d)(1).

[3] See Temp. Treas. Reg. § 1.927(d)-2T for the definition of "related supplier."

[4] The legislative history of the ETI exclusion provisions states:

C. Marginal Costing CTI Method

1. Generally

Section 925(b)(2) authorizes the Secretary of the Treasury to prescribe

> rules for the allocation of expenditures in computing combined taxable income under subsection (a)(2) in those cases where a FSC is seeking to establish or maintain a market for export property.

Section 941(a)(4) of the ETI exclusions is materially similar to the provision in section 925(b)(2). Temp. Treas. Reg. § 1.925(b)-1T prescribes the marginal costing rules authorized by section 925(b)(2).[5] Temp. Treas. Reg. § 1.925(b)-1T(a) provides that taxpayers may apply the CTI method under section 925(a)(2) on a marginal, rather than full, costing basis where a FSC is seeking to establish or maintain a market for export property. Specifically, Temp. Treas. Reg. § 1.925(b)-1T(a)(second sentence) provides:

> If under paragraph (c)(1) of this section a FSC is treated for its taxable year as seeking to establish or maintain a foreign market for <u>sales</u> of an item, product, or product line of export property (as defined in § 1.927(a)-1T) <u>from which foreign trading gross receipts (as defined in § 1.924(a)-1T) are derived</u>, the marginal costing rules prescribed in paragraph (b) of this section may be applied at the related supplier's election to compute combined taxable income of the FSC and related supplier derived from these <u>sales</u>. (Emphasis added.)

> Under the bill, the Secretary of the Treasury is provided authority to prescribe rules for using marginal costing and for <u>grouping</u> transactions in determining qualifying foreign trade income. It is intended that similar principles under present-law regulations apply for these purposes.

S. Rep. No. 104-416, p.18 (emphasis added and footnote citing Temp. Treas. Reg. § 1.925(a)-1T(c)(8) omitted).

[5] The legislative history of the ETI exclusion provisions states:

> Under the bill, the Secretary of the Treasury is provided authority to prescribe rules for using <u>marginal costing</u> and for grouping transactions in determining qualifying foreign trade income. It is intended that similar principles under present-law regulations apply for these purposes.

S. Rep. No. 104-416, p.18 (emphasis added and footnote citing Temp. Treas. Reg. § 1.925(b)-1T omitted).

Temp. Treas. Reg. § 1.925(b)-1T(c)(1) provides:

> A FSC shall be treated for its taxable year as seeking to establish or maintain a foreign market with respect to sales of an item, product, or product line of export property from which foreign trading gross receipts are derived if the combined taxable income computed under [the marginal costing CTI method] is greater than the full costing combined taxable income computed under the full costing combined taxable income method of § 1.925(a)-1T(c)(3) and (6). (Emphasis added.)

Temp. Treas. Reg. § 1.925(b)-1T(a)(last sentence) further provides that

> the marginal costing rules do not apply to leases of property or to the performances of any services even if they are related and subsidiary services (as defined in § 1.924(a)-1T(d) and § 1.925(a)-1T(b)(2)(iii)(C)).

Under the marginal costing rules,

> only direct production costs of producing a particular item, product, or product line are taken into account for purposes of computing the combined taxable income of the FSC and its related supplier under section 925(a)(2). The costs to be taken into account are the related supplier's direct material and labor costs (as defined in § 1.471-11(b)(2)(i)).

Temp. Treas. Reg. § 1.925(b)-1T(b)(1). The amount of CTI determined under the marginal costing rules

> may not exceed the overall profit percentage (determined under paragraph (c)(2) of this section) multiplied by the FSC's foreign trading gross receipts if the FSC is the principal on the sale (or the related supplier's gross receipts if the FSC is a commission agent) from the sale of export property.

Temp. Treas. Reg. § 1.925(b)-1T(b)(2) (emphasis added). This limitation on the amount of CTI computed under the marginal costing CTI method is known as the OPP limitation ("OPPL").

In a case involving Treas. Reg. § 1.994-2 – the direct predecessor of the FSC marginal costing rules – the United States Tax Court described the function of the OPPL as follows:

> The OPPL essentially limits the 'profitability' of export sales, for purposes of computing taxable income under marginal costing, to the 'profitability' of worldwide sales, or 'overall' profitability, of the product or product line (determined under a full costing method). (Emphasis added.)

Brown-Forman Corp. v. Commissioner, 94 T.C. 919, 929 (1990), aff'd, 955 F.2d 1037 (6th Cir. 1992), cert. denied, 506 U.S. 827 (1992). The Tax Court also observed that the FSC marginal costing regulations are "virtually identical" to Treas. Reg. § 1.994-2. Id. at 947. See also Dow Corning Corp. v. United States, 984 F.2d 416, 421 (Fed. Cir. 1993) (observing that the OPPL "prevented taxable income, after deducting only direct labor and material, from exceeding the normal (overall) profitability of the product").

2. The OPP

Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(i) provides that the OPP for a taxable year of the FSC for a product or product line

> is the percentage which—
>
> (A) The combined taxable income of the FSC and its related supplier from the sale of export property plus all taxable income of its related supplier from all sales (domestic and foreign) of such product or product line during the FSC's taxable year, computed under the full costing method, is of
> (B) The total gross receipts (determined under § 1.927(b)-1T) of the FSC and related supplier from all sales of the product or product line. (Emphasis added.)

The preamble to T.D. 8126, which contains Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(i), describes the OPP fraction as follows:

> the numerator . . . is the FSC's and related supplier's combined taxable income on all sales, foreign and domestic, of the export product or product line determined under the full costing method and the denominator . . . is the total gross receipts from those sales.

1987-1 C.B. 184, 190 (emphasis added). Thus, the OPP may be stated as the following fraction:

$$\frac{\text{worldwide taxable income from sales of the product grouping}}{\text{worldwide gross receipts from sales of the product grouping}}$$

II. The ETI Exclusion Provisions

As noted throughout the preceding discussion of the FSC provisions, the ETI exclusion statutory provisions are similar, in most material respects, to the FSC statutory provisions that are relevant to the issues addressed in this memorandum. In this regard, the ETI exclusion legislative history provides:

> The Committee recognizes 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.

S. Rep. No. 104-416, p.18. In addition, the legislative history specifically identifies the FSC grouping rules (Temp. Treas. Reg. § 1.925(a)-1T(c)(8)), marginal costing rules (Temp. Treas. Reg. § 1.925(b)-1T), and regulatory definition of FTGR (Temp. Treas. Reg. § 1.924(a)-1T(a)(2)) as examples of FSC regulations that should be applied to the ETI exclusion provisions. Id. at p.18-19, nn.34 and 36.

III. Explanation of Analysis to Follow

We address Issues 1 and 2 using the terminology of the FSC provisions (1) for simplicity; (2) because, as discussed briefly above and in detail in the analysis of Issue 3 below, the relevant FSC and ETI exclusion provisions are materially similar; and (3) because we are aware of no policy, intent, or other reason that supports viewing the marginal costing rules as different under the ETI exclusion provisions. Accordingly, our legal analysis for Issues 1 and 2 provided below under the FSC provisions is materially similar to our legal analysis under the ETI exclusion provisions.

IV. Issue 1

A. Background

Under section 925(a)(2), a taxpayer may use the CTI method to determine FSC benefits. Generally, the CTI method applies on a full costing basis. Temp. Treas. Reg. § 1.925(a)-1T(c)(3) and (6). Where a taxpayer's marginal costing profit percentage on sales of export property is lower than its full costing profit percentage on worldwide sales, the taxpayer may apply the CTI method on a marginal costing basis. I.R.C. § 925(b)(2) and Temp. Treas. Reg. § 1.925(b)-1T(a) and (c)(1). The marginal costing CTI method is similar to the full costing CTI method, with two notable exceptions. First, the full costing rules take into account all costs and expenses, both direct and indirect, whereas the marginal costing rules take into account only direct costs of production (except to the extent limited by the OPPL). Temp. Treas. Reg. §§ 1.925(a)-1T(c)(6) and 1.925(b)-1T(b)(1). Second, the full costing rules apply to all FSC transactions, whereas the marginal costing rules apply only to sale transactions. Temp. Treas. Reg. §§ 1.925(a)-1T(b)(2)(iii) and 1.925(b)-1T(a).

Thus, in some cases, the marginal costing rules allow a taxpayer to determine an amount of CTI with respect to sales that is greater than the amount that would otherwise be permissible under section 925(a). The dispute under Issue 1 is whether, for purposes of the marginal costing rules, the term "sale" includes licenses, thus permitting the application of the marginal costing rules to licenses.

B. Taxpayer's Argument

Taxpayer asserts that Congress intended the marginal costing rules to apply to software licenses in the same way as they apply to sales of copyrighted articles that incorporate software. In this regard, Taxpayer claims that the marginal costing rules do not address the treatment of licenses of export property because the rules (1) explicitly apply to sales; (2) explicitly do not apply to leases and services; and (3) do not mention licenses directly. Thus, Taxpayer argues that a license of export property should be included in the category of a "sale, exchange, or other disposition" of export property (i.e., as an "other disposition") within the meaning of section 924(a)(1).

Taxpayer further claims that, although the FSC rules for leases apply to licenses (under Temp. Treas. Reg. § 1.924(a)-1T(a)(2)) for purposes of Temp. Treas. Reg. § 1.924(a)-1T, no authority specifies that licenses are to be treated in the same manner as leases for marginal costing purposes or for any other purposes under the FSC provisions. Therefore, Taxpayer asserts that we should interpret and apply the marginal costing rules as applying to licenses. In other words, Taxpayer argues that licenses must be treated as leases solely for purposes of Temp. Treas. Reg. § 1.924(a)-1T, but must be treated as sales for every other purpose under the FSC provisions.

C. Service Position and Analysis

Taxpayer's position is illogical and is supported by no legal authority. Taxpayer's argument (1) relies on inconsistent interpretations of section 924(a) and Temp. Treas. Reg. § 1.924(a)-1T; (2) disregards both the plain language of Temp. Treas. Reg. § 1.925(b)-1T and general tax principles; (3) yields peculiar results when followed to its logical conclusion; and (4) provides no evidence of Congressional intent that licenses be treated like sales for any purpose, not to mention for marginal costing. We explain these points in the following discussion and conclude that the marginal costing rules apply on their face only to the sale category of transactions and, therefore, do not apply to licenses or any other type of transaction that is not properly classified as in the sale category.

1. Taxpayer Disregards Temp. Treas. Reg. § 1.924(a)-1T

A clear and necessary nexus exists between the section 924 and 925 provisions and the regulations thereunder. Section 925(a)(2) provides for a computation of

> 23 percent of the combined taxable income of such FSC and such person which is attributable to the foreign trading gross receipts derived from the sale of such export property by such FSC. . . (Emphasis added.)

Section 925(b)(1) authorizes regulations that allow the rules set forth in section 925(a) to apply to transactions other than sales. In other words, section 925(a)(2) applies not only to FTGR from sales but also to FTGR from non-sales. Section 924(a) explains which transactions – both sales and non-sales -- generate FTGR.

Section 924(a) provides that, for purposes of sections 921 through 927, FTGR is composed of the following five separate categories of gross receipts of a FSC: (1) gross receipts from the sale, exchange, or other disposition of export property, (2) gross receipts from the lease or rental of export property, and (3) through (5) gross receipts from three types of services. Temp. Treas. Reg. § 1.924(a)-1T expands on the section 924(a) definition of FTGR. Temp. Treas. Reg. § 1.924(a)-1T(a)(first sentence). In particular, Temp. Treas. Reg. § 1.924(a)-1T(a)(2) provides:

> The term 'sale' includes an exchange or other disposition and the term 'lease' includes a rental or a sublease. The term 'license' includes a sublicense. All rules under this section applicable to leases of export property apply in the same manner to licenses of export property.

Thus, the reference to leases in section 924(a)(2) is interpreted to refer also to licenses. If the drafters of the FSC regulations had intended for "sale" to mean "license," they presumably would have clarified that point in Temp. Treas. Reg. § 1.924(a)-1T(a)(2).

These rules date back to the predecessor, materially similar rules in Treas. Reg. § 1.993-1(a)(2), issued in 1977. T.D. 7514, 1977-2 C.B. 266. Furthermore, Congress approved of these rules in the ETI exclusion legislative history:

> Under the bill, foreign trading gross receipts are

> gross receipts from, among other things, the sale, exchange, or other disposition of qualifying foreign trade property, and from the lease of qualifying foreign trade property for use by the lessee outside the United States. It is intended that the principles of present-law regulations that define foreign trading gross receipts apply for this purpose. For example, a sale includes an exchange or other disposition and a lease includes a rental or a sublease, and a license or a sublicense.

S. Rep. No. 104-416, p.19 (emphasis added and footnote citing Temp. Treas. Reg. § 924(a)-1T(a)(2) omitted).

To summarize, section 925(a)(2) – which on its face applies only to sales – applies to all transactions that may generate FTGR as described in section 924(a), the provision that defines FTGR for purposes of section 925 and all other FSC statutes. Absent FTGR, FSC benefits cannot be calculated. For this purpose, Temp. Treas. Reg. § 1.924(a)-1T(a)(2) clarifies that, although not explicitly mentioned in section 924(a), the transaction category of licenses should be treated as leases and, thus, capable of generating FTGR and FSC benefits for purposes of all FSC provisions, including section 925(b)(2). In the ETI exclusion legislative history, Congress confirmed that leases include licenses for FTGR purposes. Therefore, licenses are not in the "other disposition" category of transactions.

This regulatory approach makes sense for several reasons. First, in light of the copyright-carve out in section 927(a)(2)(B), FTGR logically must include at least some income from licenses of export property despite the fact that licenses are not mentioned in section 924(a) or anywhere else in the FSC provisions. Second, because licenses are, by their nature, more akin to leases than to sales (because both licenses and leases involve the transfer of less than all substantial rights in property whereas sales involve the transfer of all substantial rights in property), one would expect that the regulations would analogize licenses to leases. Third, the regulatory treatment of leases and licenses as relatively similar to each other but relatively different from sales is consistent with other authorities. See, e.g., I.R.C. §§ 861(a)(4) and 862(a)(4) (providing the same sourcing rules for both leases and licenses) and Treas. Reg. § 1.861-18(f)(1) and (2) (reflecting the "all substantial rights" standard and, thus, differentiating between sales on the one hand and leases/licenses on the other).[6]

[6] Taxpayer's submission asserts that leases and licenses are significantly different from each other and that such difference supports its position. We do not understand Taxpayer's point. Even if leases and licenses are different in some respects (for example, because licenses generally involve transfers of intellectual property whereas leases generally involve transfers of property other than intellectual property), that distinction does not support Taxpayer's argument. Even if licenses are different from leases, they are different from sales also. This does not advance Taxpayer's argument.

Section 925(b)(2) authorizes the use of marginal costing rules for purposes of the section 925(a) computation. Specifically, Temp. Treas. Reg. § 1.925(b)-1T(a) provides:

> If . . . a FSC is treated for its taxable year as seeking to establish or maintain a foreign market for <u>sales</u> of an item, product, or product line of export property (as defined in § 1.927(a)-1T) <u>from which foreign trading gross receipts (as defined in § 1.924(a)-1T) are derived</u>, the marginal costing rules . . . may be applied at the related supplier's election to compute <u>combined taxable income</u> of the FSC and related supplier derived <u>from those sales</u>. (Emphasis added).

Thus, just as the term "sale" as used in section 925(a) and (b) has the same meaning as the term "sale" as used in section 924, the term "sale" as used in the marginal costing rules of Temp. Treas. Reg. § 1.925(b)-1T has the same meaning as the term "sale" as used in Temp. Treas. Reg. § 1.924(a)-1T(a). Temp. Treas. Reg. § 1.924(a)-1T(a)(2) defines sale for purposes of section 924 and, therefore, for purposes of section 925, as including "an exchange or other disposition." Temp. Treas. Reg. § 1.924(a)-1T(a)(2) also provides that the rules of Temp. Treas. Reg. § 1.924(a)-1T that apply to leases also apply to licenses. In other words, licenses are not included in the "other dispositions" category. S. Rep. No. 104-416, p.19.

The regulation that clarifies the treatment of licenses under section 924 and, therefore, for all other FSC provisions including section 925 and the marginal costing rules thereunder <u>not only</u> defines "sale" as not including licenses <u>but also</u> provides that licenses must be treated as leases. This is directly contrary to Taxpayer's position. For similar reasons, the statement in Temp. Treas. Reg. § 1.925(b)-1T(a) that the marginal costing rules do not apply to leases lends additional support to our conclusion that the marginal costing rules do not apply to licenses. To put it another way, in order to apply the plain language of the marginal costing rules, Taxpayer must first determine the amount of <u>FTGR from its sales</u> of export property as defined in Temp. Treas. Reg. § 1.924(a)-1T. For this purpose, licenses are treated as leases, not sales. Taxpayer cannot find support for its position in either the FSC statutes or the FSC regulations. The FSC provisions support the Service's position.

2. Plain Language of the Regulations and General Tax Principles

The marginal costing rules apply on their face only to sales. Unlike the full costing rules, which are set forth generally in terms of sales but specify that they <u>may also apply</u> to leases and services, the marginal costing rules are written in terms of sales and specify that they <u>do not also apply</u> to leases and services. Temp. Treas. Reg. § 1.925(a)-1T(d)(1) and (3) and Temp. Treas. Reg. § 1.925(b)-1T(a)(last sentence). Under general tax principles, it is a truism that the term "sale" does not include "license," just as "sale" does not mean lease or service. Treas. Reg. § 1.861-18 explicitly provides guidance based on general tax principles for the proper characterization of transactions involving computer software as sales, licenses, leases, or services. See generally T.D. 8785, 1998-2 C.B. 494, 498-499. For example, a so-called "shrinkwrap license" is properly characterized as a sale under Treas. Reg. § 1.861-18(f)(2) even though it is commonly referred to as a license for intellectual property law purposes. Treas. Reg. § 1.861-18(h)(Ex. 1). Treas. Reg. § 1.861-18 applies to the FSC and ETI exclusion provisions. Treas. Reg. § 1.861-18(a)(1).

Despite conceding that the transactions at issue are licenses under Treas. Reg. § 1.861-18, Taxpayer nonetheless claims that they should fall under the category of "sale" for purposes of the FSC marginal costing rules. Thus, Taxpayer admits the transactions are licenses for FSC purposes, but treats the licenses as sales for purposes of applying certain portions of the FSC regulations. Taxpayer assumes that, for purposes of the marginal costing rules, "sale" loses its accepted meaning and instead becomes a catch-all term meaning "any transaction." By redefining "sale" to mean "any transaction," Taxpayer creates the artificial possibility that "sale" can include "license."

Under Taxpayer's reasoning, "sale" has no real meaning for tax purposes (or at least not in the FSC marginal costing context). Taxpayer's position would render the plain language of Temp. Treas. Reg. § 1.925(b)-1T meaningless, would render Treas. Reg. § 1.861-18 ineffectual, and is inconsistent with the general principle that licenses are not sales for tax purposes. Taxpayer does not explain why we should depart from general tax principles to interpret a term as well-understood and unambiguous as "sale" in such an unusual manner.

3. Internal Inconsistency

In support of its assertion that "sale" should be read broadly to include any category of transaction that is neither a lease nor a service, Taxpayer relies on section 924(a)(1), which refers to FTGR from a "sale, exchange, or other disposition of export property. . . ." Taxpayer claims that the terms "FTGR" and "sale" as used in Temp. Treas. Reg. § 1.925(b)-1T should be interpreted as referring broadly to the section 924(a)(1) concepts and that the term "other disposition" should be read broadly to include licenses.

As a preliminary matter, we observe that, under the same general tax principles discussed above, the term "other disposition" – especially as used in this context – refers to transfers of substantially all rights in property (like sales and exchanges), not transfers of less than all substantial rights (like leases). Otherwise, section 924(a)(1) would describe all transfers (including leases), and section 924(a)(2) would be surplusage. In addition, Taxpayer's argument contains a fatal internal inconsistency. Taxpayer wants to rely on the language of section 924(a)(1) and Temp. Treas. Reg. § 1.924(a)-1T(a)(2) to support its interpretation of "sale" under Temp. Treas. Reg.

§ 1.925(b)-1T (i.e., “sale” means “other disposition” which means “license”). But simultaneously, Taxpayer wants to disregard Temp. Treas. Reg. § 1.924(a)-1T(a)(2) to the extent it clarifies that licenses are subsumed within the lease category of section 924(a)(2), not the sale category of section 924(a)(1).

Taxpayer cannot have it both ways. If Taxpayer attempts to rely on section 924(a)(1) in support of its position, Taxpayer must concede that Temp. Treas. Reg. § 1.924(a)-1T(a)(2) applies for purposes of the marginal costing provisions. Instead, Taxpayer invokes section 924(a) and Temp. Treas. Reg. § 1.924(a)-1T(a)(2) for some purposes but disregards them for others. This inconsistency in Taxpayer’s argument further reveals its deficiencies.

4. Taxpayer’s Argument Proves Too Much

Taxpayer argues in effect that, under the marginal costing rules, “sale” means “transaction,” and “transaction” is limited only by the last sentence of Temp. Treas. Reg. § 1.925(b)-1T(a), which provides that the marginal costing rules do not apply to leases or services. In contrast and as explained above, the better interpretation is that “sale” means only “sale, exchange, or other disposition” as mandated by Temp. Treas. Reg. § 1.924(a)-1T(a)(2). Moreover, the last sentence of Temp. Treas. Reg. § 1.925(b)-1T(a) emphasizes that the marginal costing rules do not also apply to non-sales. This is in stark contrast to the full costing rules that, although generally written only in terms of sales, contain special rules expanding their application to non-sales such as leases and services. Temp. Treas. Reg. § 1.925(a)-1T(d)(1) and (3).

In other words, the last sentence of Temp. Treas. Reg. § 1.925(b)-1T(a) is a cautionary reminder that the marginal costing rules apply only to FTGR from sales as defined in Temp. Treas. Reg. § 1.924(a)-1T(a)(2). Taxpayer attempts to turn that reminder on its head, but unusual results flow from following Taxpayer’s reasoning to its logical conclusion. For example, Taxpayer must conclude, based on its own reasoning, that the marginal costing rules apply to subleases because the last sentence of Temp. Treas. Reg. § 1.925(b)-1T(a) mentions only “leases” and “services” as excluded from the marginal costing rules, not subleases. Thus, following its own logic, Taxpayer must conclude that the marginal costing rules do apply to subleases, but do not apply to leases. Such a result would make little sense.

5. Special Treatment of Software Licenses

As a general proposition, Taxpayer asserts that the copyright carve-out for software, as reflected in TRA 1997 and the appellate decision in Microsoft, demonstrates that Congress intended for software licenses to qualify automatically for FSC benefits ("First Assertion"). Based on its First Assertion, Taxpayer further asserts that the marginal costing rules apply to software licenses ("Second Assertion"). Both assertions are without merit.

The copyright carve-out in section 927(a)(2)(B) identifies certain intellectual property, including copyright rights in software, that may qualify as export property. But the copyright carve-out does not provide that software always constitutes export property. Rather, like any other property, software must meet all other requirements of section 927 and the regulations thereunder to qualify as export property. Furthermore, even if copyright rights in software in a particular case constitute export property, Taxpayer must meet all other requirements under the other FSC provisions in order for the gross receipts from the sale or license of the copyright rights to constitute FTGR. Thus, Taxpayer's First Assertion is simply untrue, which renders Taxpayer's Second Assertion regarding the marginal costing rules moot.

But assuming arguendo Taxpayer is correct that all software licenses automatically qualify for FSC benefits, such fact would not support the Second Assertion. Neither TRA 1997 nor the Microsoft opinion contains the slightest suggestion of Congressional intent that the marginal costing rules should apply to licenses. The authorities demonstrate only that copyright rights in software are not precluded from qualifying for FSC benefits by virtue of being intellectual property – nothing more nor less.

Taxpayer presents no legal justification for its two assertions. Rather, Taxpayer seems to believe that software licenses deserve special treatment under the FSC provisions. In this regard, we infer Taxpayer's belief that software licenses can or should be viewed as standing in the place of sales of copyrighted articles. Taxpayer makes a logical leap by concluding that, because software is not barred from constituting export property, the marginal costing rules apply to licenses. The copyright carve-out is irrelevant to determining how FTGR are categorized for marginal costing purposes.

V. Issue 2

A. Background

A taxpayer that applies the marginal costing rules to compute CTI with respect to a sale or group of sales ("method grouping") must also calculate an OPPL with respect to such CTI amount. Temp. Treas. Reg. § 1.925(b)-1T(b)(2). The amount of CTI computed under the marginal costing rules cannot exceed the OPPL. Id. The OPPL is the product of the OPP and the taxpayer's FTGR from the sale or method grouping. Id. The OPP is determined with respect to a grouping that, among other requirements, includes the sale or method grouping for which the underlying CTI amount was determined ("OPP grouping"). Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii) and (c)(2)(i). The OPP may be stated as the following fraction:

$$\frac{\text{worldwide taxable income from sales of the OPP grouping}}{\text{worldwide gross receipts from sales of the OPP grouping}}$$

More specifically, the OPP numerator consists only of taxable income amounts "from all sales," and the denominator consists only of gross receipts "from all sales." Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(i). In other words, the OPPL limits a taxpayer's CTI from sales determined under the marginal costing rules to the amount that would result if the taxpayer's profit percentage on sales of export property were equal to its worldwide profit percentage on all sales of the same product or product line.
In sum, the marginal costing rules set forth a sales-centered pricing method that boosts CTI (by disregarding certain expenses) while limiting FSC-sales profitability to worldwide-sales profitability. The dispute under Issue 2 is whether, for this narrow purpose, we should interpret "sale" to include licenses.

B. Taxpayer's Argument

Taxpayer argues in the alternative that, even if the marginal costing rules do not apply to licenses as we have determined under Issue 1, the OPP that is applied to limit Taxpayer's marginal costing CTI from only sales of Products includes both sales income and licensing income. In short, as with Issue 1, Taxpayer argues that despite the numerous references to sales throughout the OPP rules, we should interpret the OPP rules as referring to both sales and licenses.

C. Service Position and Analysis

Taxpayer's interpretation of the OPP fraction is incorrect and suffers from some of the same infirmities as Taxpayer's position under Issue 1. In particular, Taxpayer's argument (1) disregards the plain language of the OPP rules and other FSC provisions by redefining "sale" to mean "any transaction;" and (2) undermines the purpose of the OPP rules as confirmed by the only two courts that have discussed the OPPL provisions and, thus, results in limiting the profitability of selling copyrighted articles by reference to the profitability of licensing copyright rights. As under Issue 1, our reasoning is straightforward – licensing income is not included in the OPP fraction because it is not sales income.

1. Taxpayer Redefines “Sale” to Mean “Any Transaction”

The OPP rules refer repeatedly to sales. Logically, the term “sale” as used not only in the OPP rules but throughout the FSC statutes and regulations must have the same meaning as the term “sale” found in section 924(a). Moreover, neither the OPP rules nor any other FSC statute or regulation provides that “sale” has different meanings for different purposes.

These facts notwithstanding, Taxpayer assumes that, in the OPP context, “sale” means “any transaction.” Furthermore, Taxpayer claims that “sale” as used in the OPP rules is limited only by the prohibition in Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(iii) and (d)(1) against grouping sales with leases. Taxpayer concludes that, solely for purposes of the OPP rules, “sale” means any transaction (whether or not actually considered a sale for tax purposes) other than a lease. But Taxpayer provides no explanation why the drafters would use the term “sale” to refer to the much broader concept of “transaction” when the drafters could have used the term “transaction,” which is defined in section 927(d)(2)(A).[7] So, according to Taxpayer’s reasoning, when the OPP fraction repeatedly mentions sales, it actually refers not only to sales but also to subleases, licenses, and any other transaction that is not a lease. As explained under Issue 1 above, Taxpayer’s interpretation of “sale” as meaning “license” disregards section 924(a) and the regulations thereunder, is inconsistent with general tax principles, and is wholly unsupported by authority.

2. Apples-to-Oranges Comparison

Taxpayer’s position under Issue 2 also suffers from an additional weakness in comparison with its Issue 1 position. If Taxpayer’s position were adopted, Taxpayer would limit its marginal costing profitability on <u>sales</u> to worldwide profitability on <u>both sales and licenses</u>. In other words, Taxpayer’s OPPL cap on marginal costing CTI would amount to an apples-to-oranges comparison.

Taxpayer's argument that non-sale income factors into the OPP fraction runs contrary to the purpose of the OPPL as a limitation on a taxpayer's profit on sales of export property under the marginal costing rules. In upholding the validity of the OPPL, both the Tax Court and the Court of Appeals for the Federal Circuit observed that the OPPL limits the profit on sales of export property to the average profit that the taxpayer realizes on its worldwide sales of the OPP grouping. Brown-Forman, 94 T.C. at 929; Dow Corning, 984 F.2d at 421.

In <u>Brown-Forman</u>, the taxpayer claimed that a portion of its gross receipts were attributable to an excise tax because the taxpayer increased its sales prices to

[7] Section 927(d)(2)(A) defines “transaction” as including, consistent with section 924(a), (1) sales, exchanges, and other dispositions; (2) leases and rentals; and (3) furnishing of services.

compensate for the excise tax it must pay. Based on that assertion, the taxpayer claimed that it should disregard income attributable to the excise tax for purposes of the OPP denominator but not for the OPP numerator. The Government countered that such income must be included in gross receipts for both the numerator and the denominator. Brown-Forman, 94 T.C. at 937-38. The taxpayer charged that the Government's approach would result in an "apples and oranges" comparison thus distorting the OPPL. Id. The Tax Court did not agree with the taxpayer's characterization of the Government's position as an apples-to-oranges comparison. Id. Rather, it was the taxpayer's position that resulted in an apples-to-oranges comparison. The Tax Court rejected the taxpayer's position. Id. The implication of this discussion in Brown-Forman is that an interpretation of the OPP fraction that results in an apples-to-oranges comparison (such as Taxpayer's interpretation in this case) is not appropriate.

Taxpayer's interpretation of the OPP fraction contradicts the plain language and purpose of the marginal costing rules as confirmed by the Brown-Forman and Dow Corning courts. It disregards the sales-only premise of the marginal costing rules and, thereby, bases the OPPL partially on licenses of copyright rights. Taxpayer's position requires an apples-to-oranges comparison whereby profitability from sales of copyrighted articles (the apples) is limited by OPPL determined with respect profitability from licensing copyright rights (the oranges). We do not believe that the drafters of the regulations intended an apples-to-oranges comparison.[8]

VI. Issue 3

Taxpayer asserts that the resolution of Issues 1 and 2 may depend on whether those issues are analyzed under the FSC provisions or the ETI exclusion provisions. In other words, Taxpayer proposes that, even if we are adverse to Taxpayer on Issues 1 and 2 as analyzed under the FSC provisions, we can nonetheless adopt Taxpayer's positions for licenses to which the ETI exclusion provisions apply.[9] We provide background, summarize Taxpayer's reasoning, and explain our disagreement below.

Section 943(a)(3)(B) contains the ETI exclusion copyright carve-out for software and is materially similar to section 927(a)(2)(B), which contains the FSC copyright

[8] We need not reach the question of whether the export property that Taxpayer sells (i.e., Products/copyrighted articles) falls within the same product line as the export property that Taxpayer licenses (i.e., Property/copyright rights). If it is determined that these two categories of export property do not fall within the same product line within the meaning of Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii), such determination would provide an additional and independent basis for rejecting Taxpayer's position because Taxpayer's groupings under Temp. Treas. Reg. § 1.925(b)-1T(b)(3)(ii), as reflected in the OPP fraction, would be invalid.

[9] We noted in the Facts section of this memorandum our belief that some or all of the income that Taxpayer claims is subject to the ETI exclusion provisions is, in fact, subject to the FSC provisions. To the extent our belief is determined to be correct, Issue 3 is moot. However, the parties have not requested such a determination.

carve-out for software. Section 993(c)(2)(B) of the predecessor domestic international sales corporation ("DISC") provisions is materially similar to sections 943(a)(3)(B) and section 927(a)(2)(B), except that its copyright carve-out does not mention software. Thus, it carves out – from the general prohibition against treating intellectual property as export property – copyright rights in "films, tapes, and records" but not software. However, the Microsoft decision instructs that section 993(c)(2)(B) – as with the pre-TRA 1997 version of section 927(d)(2)(b) – should be interpreted as carving out copyright rights in software.

The DISC provisions were enacted in 1971. Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 535 § 501 (1971). Because sections 993(c)(2)(B), 927(a)(2)(B), and 943(a)(3)(B) provide that certain copyright rights may constitute export property or qualifying foreign trade property (as the case may be), all three regimes contemplate that some licenses may generate tax benefits. The treatment of licenses under the DISC provisions is similar to that under the FSC provisions. That is, the DISC statutes do not mention licenses, but Treas. Reg. § 1.993-1(a)(2) provides, in part:

> All rules under this section and §§ 1.993-2 through 1.993-6 applicable to leases of export property apply in the same manner to licenses of export property.

Similarly, the DISC marginal costing rules explicitly apply to sales income and explicitly do not apply to income from leases and services. Treas. Reg. § 1.994-2(a).

Against this background, Taxpayer asserts, without evidence, that some Taxpayers have believed, dating back to the enactment of the DISC provisions, that the marginal costing rules apply to licenses. Taxpayer further asserts that any confusion in this area was resolved in favor of taxpayers by the TRA 1997 amendment of the FSC copyright carve-out and subsequent Microsoft decision, both of which post-date the issuance of the FSC regulations. Accordingly, Taxpayer argues that, if our adverse conclusions regarding Issue 1 and 2 result because we feel constrained by the language of the FSC regulations, we should consider that the ETI exclusion provisions present an opportunity to disregard the FSC regulations and reach a different answer.

Taxpayer argues that, although Congress generally instructs that the FSC marginal costing rules should be followed for ETI exclusion purposes in the absence of new guidance, the Service should not follow the FSC regulations to the extent that they are now known to be incorrect (or at least susceptible to an interpretation adverse to Taxpayer). Thus, Taxpayer concludes that we may exercise our discretion to disregard the FSC regulations with respect to transactions to which the ETI exclusion provisions apply.

Taxpayer's argument is flawed. Taxpayer suggests that the TRA 1997 amendment and Microsoft finally confirmed that licenses may qualify for FSC benefits.

As noted in the discussion of Issue 1 above, neither TRA 1997 nor the Microsoft opinion addresses the marginal costing rules either explicitly or implicitly. On the contrary, it was understood from the time that Treas. Reg. § 1.993-1(a)(2) was issued in 1977[10] and Temp. Treas. Reg. § 1.924(a)-1T(a)(2) was issued in 1987, that licenses can generate DISC and FSC benefits, respectively. So Taxpayer's claim – that the FSC marginal costing rules inappropriately exclude licenses because they were drafted and issued before TRA 1997 and the Microsoft decision – is incorrect. The drafters understood that the DISC provisions applied to certain licenses when they issued Treas. Reg. §§ 1.993-1(a)(2) and 1.994-2, just as they understood that the FSC provisions applied to certain licenses when they issued Temp. Treas. Reg. §§ 1.924(a)-1T(a)(2) and 1.925(b)-1T. And we have no reason to believe that software licenses merit different treatment than licenses of copyright rights in films, tapes, or records.

Moreover, the ETI exclusion provisions themselves do not suggest that licenses should be treated differently under the ETI exclusion provisions than under the FSC provisions. 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 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. Some examples of the application of the principles of present-law regulations to the bill are described below.

S. Rep. No. 104-416, p.18. Moreover, the legislative history identifies both the FSC marginal costing rules and definition of FTGR as examples of present-law regulations that should be applied to the ETI exclusion provisions. Id. at 18-19. In so doing, the legislative history specifically states that "a lease. . . includes a license or sublicense."

Because (1) the ETI exclusion provisions are materially similar to the relevant FSC provisions; (2) the ETI exclusion legislative history specifically endorses Temp. Treas. Reg. § 1.924(a)-1T(a)(2) and Temp. Treas. Reg. § 1.925(b)-1T; and (3) such FSC regulations were promulgated with the Service's full understanding that some FTGR are from licenses, we see no reason to conclude that our analysis under Issues 1 and 2 should be any different under the ETI exclusion provisions.

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[10] Actually, Prop. Treas. Reg. § 1.993-1(c), issued in 1972, acknowledged that licenses can generate DISC benefits. 37 Fed. Reg. 20853, 20855 (Oct. 4, 1972).

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.