Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:CORP:2 - PLR-115714-99

Date:
August 31, 2000

Legend:

Parent =

US Sub =

FSC =

State A =

Country B =

Business C =

Dear:

This letter responds to initial correspondence, dated September 22, 1999, from your authorized representative and supplemental correspondence. Specifically, you requested a ruling on behalf of the above-referenced taxpayer as to the federal income tax consequences of a proposed transaction.

The information submitted indicates that Parent, a State A corporation, is the common parent of a consolidated group, which files its return on a calendar year basis (the group). Parent is engaged in C business and utilizes the accrual method of accounting.

To facilitate its export sales, Parent formed FSC, a foreign sales corporation that has elected and qualifies for treatment as a foreign sales corporation under § 922 of the Internal Revenue Code. FSC is incorporated under the laws of Country B. Parent has represented that it has a valid related supplier agreement with FSC under which FSC is a commission foreign sales corporation for Parent's export sales.

For valid business reasons, Parent will form a U.S. subsidiary (US Sub) by contributing certain intangibles to US Sub in exchange for all of US Sub stock. US Sub will be a member of Parent's group and will join with Parent in filing a consolidated

return. Parent and US Sub will enter into a written agreement, under which, in consideration for the use of the certain intangible property, Parent will pay US Sub an arm's length royalty. This intangible property will be used by Parent in the United States in connection with the manufacture and sale of certain products, including products subject to the foreign sales corporation commission.

Section 925 provides that, 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 the FSC to derive taxable income attributable to the sale (regardless of the sales price actually charged) in an amount which does not exceed certain limits. Section 925(b) provides authority for the promulgation of regulations applying similar rules to commission sales by FSCs. In either case, the income derived by the FSC (whether via direct sale or commission sale) is limited by the greatest of (1) 1.83 percent of the foreign trading gross receipts derived from the sale of such property by such FSC ("1.83 Percent Method"); (2) 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; or (3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482). The regulations provide that the "23 percent of combined taxable income" method, in turn, is comprised of two separate sub-methods: the "Full Costing Combined Taxable Income" Method ("FC CTI Method"), see Reg. § 1.925(a)-1T(c)(6), and the "Marginal Costing Combined Taxable income" Method ("MC CTI Method"). See Reg. § 1.925(b)-1T. In addition, the result obtained under the 1.83 percent method is capped at twice the greater of (1) the result under the MC CTI Method or (2) the result under the FC CTI Method. See § 1.925(a)-1T(c)(2).

The commission computations under the MC CTI Method and the FC CTI Method both take into account expenses, including cost of goods sold. The 1.83 Percent Method does not directly take into account expenses. However, the ceiling on the commission under the 1.83 Percent Method incorporates the results of the MC CTI Method and the FC CTI Method; thus, the 1.83 Percent Method indirectly takes into account expenses, including cost of goods sold. See Reg. §§ 1.925(a)-1T(a), 1.925(a)-1T(c)(6), 1.925(b)-1T(b)(1) and (2), and 1.925(a)-1T(c)(2).

Section 925(a) provides that the taxpayer is entitled to use whichever method produces the largest commission, and it is entitled to apply different methods to different sales in the same year. The related supplier (who pays the FSC's commission) is entitled to deduct the amount of the commission.

Section 1.861-8(b) provides that for purposes of computing taxable income from sources within the United States and from other sources and activities, the gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of one or more items of gross income and require that the deduction be allocated to such class. Allocation is accomplished by determining

with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to such class of gross income.

Section 1.861-8(f)(1) lists the operative sections that require the determination of taxable income from specific sources or activities and give rise to statutory groupings. The determination of the deductions of related suppliers to be taken into account in computing FSC combined taxable income is one of the listed operative sections.

Section 1.861-14T provides special rules for allocating and apportioning expenses other than interest that are not directly allocable and apportionable to any specific income producing activity or property. Section 1.861-11T provides special rules regarding interest.

Section 263A provides that in the case of tangible personal property that is inventory in the hands of the taxpayer, all of the direct and indirect costs of producing such property shall be included in inventory costs. The term "produce" includes construct, build, install, manufacture, develop, or improve. Section 263A (g)(1). Section 1.263A-1(e)(3)(ii)(U) provides that licensing and franchise costs incurred in securing a right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right associated with property produced must be capitalized.

Section 1.1503-13(b)(1)(i) provides that an intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction.

Section 1.1502-13(b)(2) provides generally that a selling member's income, gain, deduction, and loss from an intercompany transaction are its intercompany items. Section 1.1502-13(b)(3) provides generally that the buying member's income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction, are its corresponding items.

Section 1.1502-13(a) provides rules for taking into account items of income, gain, deduction, and loss of consolidated group members from intercompany transactions. These rules ensure the clear reflection of the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).

Section 1.1502-13(a)(2) provides that the amount and location of one member's intercompany items and another member's corresponding items are determined on a separate entity basis (separate entity treatment). It also provides that the timing, character, source, and other attributes of the intercompany items and corresponding items, although initially determined on a separate entity basis, are redetermined

under this section to produce the effect of transactions between divisions of a single corporation (single entity treatment).

Section 1.1502-13(a)(6) provides, further, that the principal rules of this section that implement single entity treatment are the matching and the acceleration rules found in sections (c) and (d), respectively. Under the matching rule, the members engaging in an intercompany transaction are generally treated as divisions of a single corporation for purposes of taking into account their items from the intercompany transaction.

Section 1.1502-13(b)(6) provides that the attributes of an intercompany item or corresponding item are all of the item's characteristics, except amount, location, and timing, necessary to determine the item's effect on taxable income (and tax liability). Examples provided in this section include character, source, treatment as excluded from gross income or as a noncapital, nondeductible amount, and treatment as built-in gain or loss under section 382(h) or section 384.

Section 1.1502-13(c)(1)(i) provides that the separate entity attributes of the member's intercompany items and the other member's corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if the members were divisions of a single corporation, and the intercompany transaction constituted a transaction between those divisions.

Section 1.1502-13(c)(4) provides special rules for redetermining and allocating attributes under § 1.1502-13(c)(1)(i). Section 1.1502-13(c)(4)(i)(A) and (B) provide specific methods of redetermination applicable in cases in which the intercompany and corresponding items offset in amount. The regulations provide no specific method of redetermination for those cases in which the intercompany and corresponding items do not offset in amount. However, §1.1502-13(c)(4)(ii) provides that the redetermined attributes of items that do not offset in amount will be allocated to the intercompany item and the corresponding item by using a method that is reasonable in light of all of the facts and circumstances.

In the instant case, Parent's licensing of intangibles from US Sub, to which it pays a royalty, will be an intercompany transaction. US Sub will be a member providing services, and Parent will be the recipient of those services. Section 1.1502-13(c)(1) provides a matching rule under which the separate entity attributes of US Sub's intercompany item and Parent's corresponding item are redetermined to produce the same effect on consolidated taxable income (and tax liability) as if Parent and US Sub were divisions of a single corporation. The regulations require that the royalty payment expense be taken into account as a cost of producing Parent and FSC's combined taxable income. See § 1.861-14T. However, under the FSC rules, the royalty income is not included in foreign trading gross receipts because the

income would not be earned by the FSC or its related supplier, and because royalty income is not treated as foreign trading gross receipts or export property under sections 924 and 927. Thus, the expense and income would not offset, and the expense would reduce the commission computed, as well as Parent's commission deduction. If Parent and US Sub were divisions of a single entity, there would not be a royalty payment expense taken into account in computing combined taxable income, and Parent's commission deduction would be higher (and the group's consolidated income lower). A further mismatch occurs for foreign tax credit purposes. The royalty expense would be in part included in cost of goods sold with respect to foreign sales and thus would reduce foreign taxable income in the numerator of the foreign tax credit limitation fraction under section 904(d). However, the royalty income would be entirely U.S. source, under section 861(a)(4), based on place of use, and would be included in its entirety in the denominator of the foreign tax credit limitation fraction. Therefore, the expense and income would not offset, and the result of the foreign tax limitation would be different from that computed on a single entity basis.

Because of the existence of these discrepancies, the matching rule of the intercompany transaction regulations will apply to redetermine the separate entity attributes of seller's intercompany items and buyer's corresponding items to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions.

In this case, the intercompany item resulting from the intercompany transaction will be US Sub's royalty income, and the corresponding item will be Parent's income from sales. See §§ 1.1502-13(b)(2) and (3), and 1.1502-13(c)(7)(ii), example 14(c). Because these two items are both income items and will not offset in amount, redetermination under the matching rule is governed by the general rule of §1.1502-13(c)(1)(i), rather than the specific rules of §1.1502-13(c)(4)(i).

Based solely on the facts information submitted, it is held as follows:

(a) Under §1.1502-13(c)(1)(i), the separate entity attributes of US Sub's intercompany items (the royalty received) and Parent's corresponding items (income from sales) shall be redetermined for purposes of computing the allowable FSC commissions payable by Parent only to the extent necessary to produce the same effect on consolidated taxable income of parent's group as if Parent and US Sub were divisions of a single corporation and the License Transaction were between divisions of a single corporation.

(b) Under §1.1502-13(c)(1)(i), the separate entity attributes of US Sub's intercompany items (the royalty received) and Parent's corresponding items (income from sales) shall be redetermined for purposes of computing the

allowable credits for foreign taxes of Parent's group only to the extent necessary to produce the same effect on consolidated taxable income of parent's group as if Parent and US Sub were divisions of a single corporation and the License Transaction were between divisions of a single corporation.

(c) The separate entity attributes as redetermined in accordance with Ruling (a) and Ruling (b) must be allocated to Parent's corresponding item and US Sub's intercompany item by using a method that is reasonable in light of all of the facts and circumstances. § 1.1502-13(c)(4)(ii).

The redeterminations discussed in rulings (a) through (c) are made solely for the purposes of effectuating the consolidated return regulations, and will not affect the relationship of the FSC and the related supplier (e.g., there will be no change in the identity of the related supplier, the party who pays the commission).

No opinion is expressed or implied about the tax treatment of the proposed transaction under other provisions of the Code and Regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transaction that are not specifically covered by the above rulings.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. A copy of this letter should be attached to the federal income tax return to which it is relevant.

In accordance with the Power of Attorney on file, a copy of this letter has been sent to your authorized representative.

Sincerely,
Associate Chief Counsel (Corporate)
By: Edward S. Cohen
Chief, Branch 2