Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **AM2008-008**

Release Date: 7/11/08
CC:INTL:B06:GASpring
POSTN-116048-08

UILC: 943.00-00

date: July 2, 2008

to: James Guidone and Richard LaRusso, International Technical Advisors
LMSB:PFTG

from: Steven A. Musher, Associate Chief Counsel (International), CC:INTL

---

subject: Applicability of section 943(c) and (h) to certain transactions

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

1. Whether section 943(c)[1] applies to income that generates an exclusion determined under section 101(d) of the American Jobs Creation Act of 2004[2] ("AJCA") and, therefore, limits the amount of such income that may be treated as from foreign sources.

2. Whether section 943(h) applies to income that otherwise would generate an exclusion determined under section 101(d) of the AJCA and, therefore, prevents such income from being excluded from gross income if, at any time during the taxable year, the taxpayer belongs to any controlled group of corporations (as defined in former section 927(d)(4)) of which a domestic international sales corporation ("DISC") is a member.

---

[1] Section references in this memorandum are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.
[2] Pub. L. No. 108-357, 118 Stat. 1418 (2004).

CONCLUSIONS

1. No. Section 943(c) does not apply to income that generates an exclusion determined under section 101(d) of the AJCA and, therefore, does not limit the amount of such income that may be treated as from foreign sources.

2. Yes. Section 943(h) applies to income that otherwise would generate an exclusion determined under section 101(d) of the AJCA and, therefore, prevents such income from being excluded from gross income if, at any time during the taxable year, the taxpayer belongs to any controlled group of corporations (as defined in former section 927(d)(4)) of which a DISC is a member.

LAW

Section 114 excludes certain amounts from gross income. Specifically, section 114(a), (b) and (e) provide:

> (a) *Exclusion*. Gross income does not include extraterritorial income.
> (b) *Exception*. Subsection (a) shall not apply to extraterritorial income which is not qualifying foreign trade income as determined under subpart I of part III of subchapter N.
>
> * * *
>
> (e) *Extraterritorial Income*. For purposes of this section, the term ‘extraterritorial income’ means the gross income of the taxpayer attributable to foreign trading gross receipts (as defined in section 942) of the taxpayer.

Thus, section 114 excludes qualifying foreign trade income from gross income. Qualifying foreign trade income is defined in section 941(a).

Section 943 provides, among other things, special rules with respect to the ETI exclusion provisions. One such special rule is section 943(c), which limits the amount of income from the sale of qualifying foreign trade property, as defined in section 943(a), that will be treated as from sources outside the United States as follows:

> (c) Source rule.—Under regulations, in the case of qualifying foreign trade property manufactured, produced, grown, or extracted within the United States, the amount of income of a taxpayer from any sales transaction with

> respect to such property which is treated as from sources without the United States shall not exceed–
> (1) in the case of a taxpayer computing its qualifying foreign trade income under section 941(a)(1)(B), the amount of the taxpayer's foreign trade income which would (but for this subsection) be treated as from sources without the United States if the foreign trade income were reduced by an amount equal to 4 percent of the foreign trading gross receipts with respect to the transaction, and
> (2) in the case of a taxpayer computing its qualifying foreign trade income under section 941(a)(1)(C), 50 percent of the amount of the taxpayer's foreign trade income which would (but for this subsection) be treated as sources without the Untied States.

Another special rule, section 943(h), denies ETI exclusions to a taxpayer with respect to a taxable year if such taxpayer bears a certain relationship to a DISC in that taxable year:

> (h) Special rule for DISCs.—Section 114 shall not apply to any taxpayer for any taxable year if, at any time during the taxable year, the taxpayer is a member of any controlled group of corporations (as defined in section 927(d)(4), as in effect before the date of the enactment of this subsection) of which a DISC is a member.

Congress generally repealed the ETI exclusion provisions in the AJCA for transactions after December 31, 2004. Pub. L. No. 108-357, 118 Stat. 1418, § 101(a), (b), and (c) (2004). Section 101(d) of the AJCA ("Section 101(d)") provides exclusions for certain transactions during 2005 and 2006:

> (d) TRANSITIONAL RULE FOR 2005 AND 2006.—
> (1) IN GENERAL.—In the case of transactions during 2005 or 2006, the amount includible in gross income by reason of the amendments made by this section shall not exceed the applicable percentage of the amount which

> would have been so included but for this subsection.
> (2) APPLICABLE PERCENTAGE.—For purposes of paragraph (1), the applicable percentage shall be as follows:
> (A) For 2005, the applicable percentage shall be 20 percent.
> (B) For 2006, the applicable percentage shall be 40 percent.

Thus, for transactions entered into during 2005 and 2006 (the "ETI transition years"), taxpayers may exclude from gross income 80% and 60%, respectively, of the amount of income that would have been excluded as an ETI exclusion but for the repeal of the ETI exclusion provisions ("Phase-out Rule").

The AJCA also contains a binding contract rule that provides:

> (f) BINDING CONTRACTS.—The amendments made by this section shall not apply to any transaction in the ordinary course of a trade or business which occurs pursuant to a binding contract—
> (1) which is between the taxpayer and a person who is not a related person (as defined in section 943(b)(3) of such Code, as in effect on the day before the date of the enactment of this Act), and
> (2) which is in effect on September 17, 2003, and at all times thereafter.
>
> For purposes of this subsection, a binding contract shall include a purchase option, renewal option, or replacement option which is included in such contract and which is enforceable against the seller or lessor.

AJCA, § 101(f). Section 101 of the AJCA does not apply to transactions described in section 101(f). In other words, the ETI exclusion provisions are not repealed and, thus, the Phase-out Rule does not apply, with respect to transactions that are described in the binding contract rule under section 101(f).[3]

[3] The binding contract rule is limited by the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"). Pub. L. No. 109-222, 120 Stat. 345, § 513(b) (2006).

Neither the AJCA nor its legislative history explains how to compute the exclusions permitted under the Phase-out Rule. Questions have repeatedly arisen regarding whether section 943(c) or (h) must be taken into account when applying the Phase-out Rule.

ISSUES

Some Examination teams have taken the position that taxpayers must take section 943(c) into account in order to exclude income under Section 101(d). This position seems based on policy concerns, rather than specific legal authority or technical arguments.

Some taxpayers have taken the position that they are permitted to claim exclusions under Section 101(d) even though they are a member of a group of controlled corporations of which a DISC is also a member, which violates section 943(h). Taxpayers have advanced several theories in support of this position. For example, taxpayers claim that section 943(h) does not apply for purposes of Section 101(d) because the ETI exclusion provisions are repealed. Under an alternate argument, section 943(h) applies, but the taxpayer should be viewed as not being a member of a controlled group that includes a DISC because, if the ETI exclusion provisions had not been repealed, the taxpayer would not have formed the DISC in the first place. Under the third theory, taxpayers take the position that section 943(h) does not prevent them from excluding income under Section 101(d) because section 943(h) applies only to ETI exclusions, not Section 101(d) exclusions.

The remainder of this memorandum explains why these positions are incorrect.

ANALYSIS – ISSUE 1

During the ETI transition years, Section 101(d) allows taxpayers to exclude from gross income a percentage of the amount of income that would have been excluded as ETI if the ETI exclusion provisions had not been repealed. Logically, to determine the amount that would have been excluded as ETI, taxpayers must apply sections 114 and 941 through 943, even though those sections are repealed. The amount of the ETI exclusion that would have been permitted but for the repeal is the amount of qualifying foreign trade income that the taxpayer could have claimed but for the repeal. Section 941 defines qualifying foreign trade income. Section 943(c) limits, in certain cases, the amount of income from sales of qualifying foreign trade property that may be treated as from foreign sources.

To determine the exclusion permitted under Section 101(d), a taxpayer must first determine the amount of the hypothetical ETI exclusion that would have been permitted under section 114 if section 114 were not repealed. The amount of the hypothetical ETI exclusion depends on the amount of the hypothetical qualifying foreign trade income. Sourcing rules generally, and the special source rule of section 943(c) specifically, are

not relevant to the determination of qualifying foreign trade income and, therefore, are not relevant to the determination of the amount of the ETI exclusion or the Section 101(d) exclusion. Accordingly, we disagree with the position proposed by some Examination teams that section 943(c) applies for purposes of applying Section 101(d).

ANALYSIS – ISSUE 2

Section 943(h) prohibits a taxpayer from claiming ETI exclusions for a taxable year if, at any time during the taxable year, it is a member of any controlled group of corporations of which a DISC is a member. Section 943(h) achieves this result by rendering section 114 inapplicable. If section 114 is inapplicable, no ETI exclusion can be computed.

As discussed in Issue 1, determination of the exclusion permitted under Section 101(d) requires a determination of the hypothetical ETI exclusion. Under the facts presented (i.e., the taxpayer was a member of a controlled group that included a DISC during the relevant taxable year), the amount of the hypothetical ETI exclusion must be $0 because, pursuant to section 943(h), section 114 would not have applied. This is no different from a situation where the hypothetical ETI exclusion would have been $0 (even if section 114 were not rendered inapplicable by section 943(h)) because, for example, the taxpayer had no foreign trading gross receipts or qualifying foreign trade income, or otherwise failed to qualify for an ETI exclusion.

The various arguments presented by taxpayers fail in the face of this simple logic. The argument that section 943(h) does not apply for purposes of Section 101(d) proves too much. That is, if the taxpayers that espouse this view were correct that section 943(h) does not apply, then it would be equally true that none of the other ETI exclusion provisions (including section 114) applies either. Without the application of those provisions, the hypothetical ETI exclusion and, therefore, the Section 101(d) exclusion cannot be computed.

The argument that the existence of a DISC should be disregarded because the DISC would not have been formed absent the repeal of the ETI exclusion provisions is circular at best. Under this alternate theory, taxpayers argue that Section 101(d) requires the IRS not only to apply the ETI exclusion provisions as if they had not been repealed (which, as explained above, is correct), but also to replace the actual facts of the case with hypothetical facts that the taxpayers claim would have occurred if the ETI exclusion provisions had not been repealed. In other words, taxpayers read into Section 101(d) a requirement that taxpayers (and presumably Examination teams) must assume facts (based on the non-repeal of the ETI exclusions) that are different from the actual facts. Central to that approach is the assumption that the taxpayer would not have formed a DISC.

This theory is flawed in a number of respects. First, neither the AJCA nor the legislative history contains any support for this theory. This theory also fails because it

is inadministrable; Examination teams cannot and should not be expected to conduct audits based on assumed facts that are different from the actual facts of the case. It is unreasonable to believe that an Examination team and a taxpayer would agree on which facts should be assumed. Furthermore, like the previously discussed theory, this theory is inherently unsupportable when followed to its logical conclusion. Under the taxpayers' reasoning, a taxpayer could restructure its business operations following the repeal of the ETI exclusion provisions (presumably in a way that provides the most favorable tax results) such that its products would no longer qualify for ETI exclusions if those provisions had not been repealed (something the taxpayer never would have done if the ETI exclusion provisions had not been repealed), but then argue that it should be treated for purposes of Section 101(d) as having not restructured its business operations. For this argument to prevail, the Service would have to interpret Section 101(d) as requiring no ongoing compliance with the former ETI exclusion requirements while allowing for an exclusion that is based on hypothetical compliance with the ETI exclusion requirements. Nothing in the AJCA or legislative history suggests that Congress intended to provide exclusions with respect to transactions that are not in compliance with the former ETI exclusion provisions. Moreover, we see no reason to interpret Section 101(d) in a manner inconsistent with its plain language.

Under another alternate argument, taxpayers take the position that section 943(h) is irrelevant for Section 101(d) purposes because it denies only ETI exclusions, not Section 101(d) exclusions. For the reasons stated in connection with our analysis of the first two taxpayer arguments regarding section 943(h), this argument reflects a misunderstanding of the interaction between the repealed ETI exclusion provisions and Section 101(d). Indeed, this argument inadvertently concedes the issue by admitting that section 943(h) denies ETI exclusions. If the hypothetical ETI exclusion would be denied, then the Section 101(d) exclusion, which is based on the hypothetical ETI exclusion, must similarly be denied.

During the ETI transition years, if a taxpayer was a member of a group of controlled corporations of which a DISC was a member, the taxpayer would not have been entitled to an ETI exclusion even if the ETI exclusion provisions had not been repealed and, consequently, may not exclude any income under the plain language of Section 101(d). Because section 943(h) bears directly on the calculation of the ETI exclusion, we conclude that taxpayers must apply section 943(h) (along with all other ETI exclusion provisions that bear on the calculation of the ETI exclusion) for purposes of determining their exclusion under Section 101(d).

Please call CC:INTL:6 at (202) 435-5265 if you have any further questions.