

Office of Chief Counsel  
Internal Revenue Service  
**memorandum**

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to: , CEP Case Manager  
District.

from: Associate Area Counsel (Large & Mid-Size Business)

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subject: **-Extraterritorial Income Exclusion**

This memorandum responds to your request for advice regarding whether income computed under Taxpayer's method of accounting constitutes a "transaction" for purposes of the Extraterritorial Income ("ETI") regime.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

LEGEND

USCorp =

Division1 =

Division2 =

Contract1 =

Contract2 =

<u>Contract3</u>	=
<u>Contract4</u>	=

<u>Taxable Year1</u>	=
<u>CountryZ</u>	=
<u>Date1</u>	=
<u>Date2</u>	=
<u>ProductA</u>	=
<u>ProductB</u>	=

### ISSUE

Whether, for long-term contracts entered prior to October 1, 2000, individual inclusions of gross income computed pursuant to the percentage of completion method of accounting under I.R.C. § 460 corresponds to separate transactions entered into at the time of such inclusions for purposes of the ETI régime?

### FACTS

and its U.S. subsidiaries (hereinafter "Taxpayer") is a defense contractor primarily engaged in providing products and services under long-term contracts with the United States Government ("U.S. Government") and, to a lesser degree, with foreign governments or foreign entities. A significant number of these long-term contracts were entered prior to, and during, the tax years currently under examination (taxable years ending December 31, , December 31, , and December 31, ).

Contracts generating over ninety percent of the income in issue are attributable to the following business segments:

Division1<sup>1</sup> - This business segment is engaged in the design, research and development, and production of

Included in this business segment is the production and support programs for the

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Division2 - This business segment is engaged in the design, development, and integration of complex systems of .  
Major products include

### **Relevant Contracts**

Taxpayer's long-term contracts relevant to the ETI issue were entered under both of the systems by which foreign governments may acquire U.S. defense articles and services:

- (1) government-to-government Foreign Military Sales; and
- (2) contractor-to-government Direct Commercial Sales.

### ***Foreign Military Sales ("FMS")***

As described in a United States General Accounting Office Report to the Secretary of Defense:

The Arms Export Control Act gives the President authority to sell defense articles and services to eligible foreign countries, generally at no cost to the U.S. government. While the Defense Security Cooperation Agency (DSCS) has overall responsibility for administering the FMS program, the Army, Navy, and Air Force generally execute the sales agreements—commonly referred to as sales cases.

Foreign military sales are made on an individual case basis. A foreign country representative initiates a case by sending a letter of request to DOD [Department of Defense] asking for information, such as the price and availability of goods, training, technical assistance, follow-on support, or other services. Once the customer decides to proceed with the purchase, DOD prepares a Letter of Offer and Acceptance (LOA) stating the terms of the sale for the items and services being provided. After the LOA is accepted, the FMS customer is generally required to pay, in advance, amounts necessary to cover costs associated with the services or items purchased from DOD. The Department of the Treasury holds these

advance payments in an FMS trust fund.

(United States General Accounting Office Report to the Secretary of Defense, Foreign Military Sales, Air Force Controls Over the FMS Program Need Improvement, May 2000 (GAO/AIMD-00-101).)

After the U.S. Government and the foreign purchaser sign the LOA, except for items supplied directly from Department of Defense inventory, the U.S. Government buys the desired item or weapon system from a U.S. contractor on behalf of the foreign government, employing essentially the same procurement criteria as if the item/system was being purchased for U.S. needs. The U.S. Government, not the foreign government, selects the source and manages the award contract, consistent with the provisions of the Federal Acquisition Regulations ("FAR") and the applicable LOA. FMS and Department of Defense orders often are consolidated to obtain economy-of-scale buys thereby significantly lowering unit prices. In some instances,

, the U.S. Government procures goods for sales to foreign countries by the execution of bilateral modifications to its existing contracts.<sup>2</sup>

Some of Taxpayer's FMS contracts for military equipment and services are funded, in whole or part, by U.S. Government subsidies.<sup>3</sup>

#### ***Direct Commercial Sales ("DCS")<sup>4</sup>***

In a DCS, a U.S. contractor and a foreign government or foreign entity enter into a direct contract in accordance with U.S. laws and regulations, as well as applicable foreign laws and regulations, and provisions of international commercial law. The U.S. Government is not a party to DCS contracts. In a DCS, the foreign government or foreign entity selects the U.S. contractor and manages the contract directly with that U.S. contractor.

#### ***Common Elements of FMS and DCS Transactions***

The long-term contracts under consideration are generally fixed-price contracts with fixed payment schedules, thereby enabling the purchaser to know the final price at the time of contract signature. Since the specific configuration of military equipment sold is defined in the FMS or DCS contract, U.S. contractors do not produce items in anticipation of military equipment sales and generally do not maintain an inventory of defense articles. Pursuant to FMS and DCS contract provisions, agencies of the U.S. Government and other customers generally have title to, or a security interest in, inventories related to such contracts as a result of advances or progress payments.<sup>5</sup>

FMS and DCS contracts are subject to extensive legal and regulatory requirements and, from time to time, agencies of the U.S. Government investigate whether a U.S. contractor's operations are being conducted in accordance with these requirements.

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<sup>3</sup> Subsidized sales generally are not eligible for favorable tax treatment under either the FSC or ETI tax régimes. Although contracts for some subsidized sales were included in Taxpayer's initial ETI claims, Taxpayer agrees subsidized sales are not eligible for favorable treatment under either régime (with the exception of subsidized sales with "the possibility of competitive bidding" (Treas. Reg. § 1.924(a)-1T(g)(3)) and is revising its claims accordingly.

<sup>4</sup> The U.S. Government uses the term DCS to identify this type of contract.

<sup>5</sup> Taxpayer notes that, in some instances, progress payments may be treated as loans from the U.S. Government.

Any foreign acquisition of U.S. defense items requires prior approval by the U.S. Government. A variety of procedural regulations govern the manner in which both marketing and sales approval must be obtained. For example, with respect to many contracts for the sale of military equipment which has not been previously approved for export, before a company can make a sales proposal to a prospective foreign purchaser, approval must be obtained from the Department of State.<sup>6</sup> A favorable decision would permit a U.S. contractor to conduct unclassified discussions and to make a sales proposal involving the sale of a specific item of military equipment to a particular country. An approval, however, is not required if the specific item of equipment has been previously approved for export to any foreign country. Where such export has been previously approved, the Department of State must be notified in writing 30 days in advance of the intended sale presentation or proposal.

Neither Department of State approval nor the 30-day notification discussed in the prior paragraph authorizes the actual export of defense articles or services. Such exports are authorized only after a munitions export license is obtained from the Office of Defense Trade Controls in the Department of State. An application for such a license must be accompanied by a copy of a purchase order, letter of intent, or other appropriate documents describing the sale. The U.S. Congress must be notified of all cases for which the Office of Defense Trade Controls intends to issue an export license for the sale of any major defense equipment or services which meet or exceed the statutory dollar value thresholds established in the Arms Export Control Act of 1976 (AECA), 22 U.S.C. 2751 et seq., and related legislation. This notification requirement applies to proposed FMS and DCS sales.<sup>7</sup>

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<sup>6</sup> This requirement does not apply to NATO governments or to Australia, New Zealand, or Japan.

<sup>7</sup> The AECA requires that Congress be provided a total of 30 days notification prior to the authorization to export by either FMS or DCS any major defense equipment valued at \$14 million or more. The statutory notification period is 15 days for NATO, NATO member countries, Japan, Australia, or New Zealand.

Another consideration for both FMS and DCS involves components which are provided under Department of Defense contracting procedures to U.S. defense contractors as government-furnished equipment (GFE) or material (GFM). Such items are generally incorporated by the U.S. contractor into larger systems which are then sold. Under the FMS system, the Department of Defense provides GFE or GFM directly to the prime contractor on an equal priority basis for both U.S. and foreign requirements, and the Department of Defense coordinates the production of the end item.

### ***Contract Samples***

Taxpayer asserts that income received pursuant to FMS and DCS contracts qualify for favorable tax treatment under the ETI regime. To evaluate the Taxpayer's claims, the Examination Team selected a small representative number of long-term contracts to initially review.<sup>8</sup> The Examination Team's review included the following four contracts discussed herein by way of example.

#### FMS CONTRACTS

##### *Contract 1*

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<sup>8</sup> This review was limited to whether income computed under Taxpayer's method of accounting qualifies for ETI reporting under the ETI regime.

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Contract2

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<sup>9</sup> Taxpayer computed its claimed FSC and ETI sales by applying the POC method of accounting to each of the contracts at issue. The POC method of accounting is discussed infra.



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DCS CONTRACTS

Contract 3

Contract4

**Taxpayer's Accounting for FMS and DCS Contracts**

Under both the ETI and FSC régimes, Taxpayer assigned each contract a work order/master account number. Charges for material, labor, subcontractor activity and an allocated portion of overhead were charged against each specific contract. Income was also accounted for on a contract-by-contract basis.

*Financial Reporting for FMS and DCS*

***Income Tax Reporting for FMS and DCS***

With respect to its long-term contracts, as defined in I.R.C. § 460, Taxpayer utilizes the percentage of completion method of accounting to report income and loss. Under this method, a percentage of the total contract revenue is included in taxable income during each year of the contract.<sup>10</sup>

Beginning in Taxable Year1, Taxpayer utilized a Foreign Sales Corporation ("FSC"), a subsidiary incorporated in CountryZ, with respect to its export sales for U.S. Federal income tax purposes, including sales from long-term contracts under both the FMS and DCS systems. Taxpayer's U.S. subsidiaries or business units involved in the production of military equipment sold under FMS or DCS long-term contracts entered agreements with the FSC which provided that the FSC would arrange for sales to export customers.<sup>11</sup>

When the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423 (Nov. 15, 2000) (hereinafter "ETI Act") was enacted, Taxpayer sought to apply the

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<sup>10</sup> Taxpayer has elected to apply the modified "10-percent" method under which no income is included until the first year in which 10 percent of the estimated total contract costs have been incurred.

<sup>11</sup> An example of such an agreement is the

ETI rules to income relating to certain long-term contracts which were entered into prior to October 1, 2000 (the general effective date of the 2000 Act). Under the FSC regime, only fifty percent of the foreign trading gross receipts ("FTGR") attributable to the sale of military property was eligible for the partial exemption from U.S. income tax provided by sections 923(a)(1) and 921(a). I.R.C. § 923(a)(5). This provision, referred to as the military property "haircut", was not retained in the ETI exclusion provisions. Reporting its military property sales under the ETI regime, consequently, doubles Taxpayer's tax benefit in comparison with the benefit available under the FSC regime.

Only FTGR are eligible for the favorable tax treatment available under both the FSC and ETI regimes. An excerpt from discusses in detail the FSC régime.

correctly states that FTGR are gross receipts from the sale, exchange or other disposition of export property<sup>12</sup> and the performance of services which are related or subsidiary to such sale, exchange or other disposition.

For purposes of the FSC and ETI tax regimes, FTGR are defined, in part, as gross receipts from the sale, exchange, or other disposition of qualifying foreign trade property. Further, a taxpayer is treated as having FTGR from a transaction only if the taxpayer satisfies the foreign economic process requirements with respect to such transaction. I.R.C. §§ 942(b) and 924(b)(1)(B).

To meet the foreign economic process requirements when sales were made through its FSC, Taxpayer's FSC entered into agreements with related corporations

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<sup>12</sup> § 927(a) "export property" applies in the FSC context and is materially similar to §943(a) "qualifying foreign trade property" in the ETI context for purposes of the legal issue addressed in this memorandum.

Under these agreements, the related corporations agreed to perform services for the FSC including "the solicitation (other than advertising), negotiation, and making of the sale contracts" with respect to transactions and to incur direct costs associated with the performance of specified foreign economic processes relating to each transactions. The related corporations also agreed to pay Taxpayer's FSC a commission on each transaction.

Beginning with the tax year, Taxpayer prepared Forms 8873, "Extraterritorial Income Exclusion", relating to existing FMS and DCS contract proceeds.

With the enactment of the ETI Act, Taxpayer revised its to ensure that it met the foreign economic process requirements<sup>13</sup> for all transactions generating extraterritorial income.

separately reporting: direct foreign marketing expenses attributable to each contract; any fees for letters of credit or banker's acceptances by contract; the face amount of any receivable if insurance was obtained to cover non-payment on a contract; and, any fees charged by an offshore credit investigating agency for any credit reports obtained on ET contracts.

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<sup>13</sup> The identified activities include: (1) advertising and sales promotion; (2) processing of customer orders and arranging for delivery; (3) transportation outside the U.S. 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. I.R.C. § 942(b)(3).

**DISCUSSION**

Section 5(a) of the ETI Act provides that, in general, the Act "applies to transactions after September 30, 2000."<sup>14</sup> The legislative history expands on the meaning of "transactions after" in section 5(a) of the ETI Act stating that the Act "is effective for transactions entered into after September 30, 2000." (Emphasis added.) Joint Committee on Taxation, Technical Explanation of the Senate Amendment to H.R. 4986, the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000" (JCX-111-00), p. 22 (November 1, 2000)(hereinafter "Joint Committee on Taxation, ETI Technical Explanation"). I.R.C. § 943(b)(1)(A) defines the term "transaction" as any sale, exchange, or other disposition, any lease or rental, and any furnishing of related or subsidiary services. A parallel definition is included in the I.R.C. § 942 definition of FTGR as gross receipts from the sale, exchange, or other disposition, lease or rental and related or subsidiary services of qualifying foreign trade property. I.R.C. § 942(a)(1).

In other words, the ETI exclusion provisions apply to transactions entered into on or after October 1, 2000. For purposes of this rule, "transaction" and "contract" are not synonymous. See, e.g., ETI Act § 5(c)(1)(B) (distinguishing between transactions and contracts). A contract may give rise to more than one transaction. And such transactions may be entered into, for ETI exclusion and FSC purposes, at different times. As an example, consider Contract1 described above. The contract was signed on Date1, and called for production and delivery of ProductA. Pursuant to that same contract, the purchaser exercised an option, in Date2, for production and delivery of ProductB. In this fact pattern, a contract made before the effective date of the ETI Act gave rise to two transactions, the original sale of ProductA and the second sale of ProductB. As we understand the facts of the case, the original sale was entered into on the same date that the contract was made, Date1, and the second sale was entered into in Date2 when the option was exercised. The FSC

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<sup>14</sup> § 5(c) of the ETI Act provides for a transition period for existing FSCs. Initially, Taxpayer focused on the language of the transition provisions in arguing it was entitled to report income under the ETI régime. However, Taxpayer has now recast it's argument to apply to all income generated pursuant to pre-existing long-term contracts under the general effective date of the ETI Act.

provisions apply to the pre-ETI Act original transaction, and the ETI exclusion provisions apply to the post-ETI Act second transaction.

In contrast, Taxpayer asserts it is entitled to report income from military equipment sales after September 30, 2000 under the ETI regime rather than the FSC regime which, essentially, doubles it's tax benefit. Taxpayer insists it:

may apply the new ETI régime to taxable income reportable after September 30, , regardless of whether the income is attributable to a contract in effect prior to the enactment of ETI, and regardless of whether income from previous years relating to the same contract was reported under the FSC rules.

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" (hereinafter "Taxpayer's Position Paper"), p. 1.)

The crux of Taxpayer's assertion that it is entitled to the benefits of the ETI Act rests on the definition of "transaction" and, more specifically, "sale transaction." The determination of when a sale transaction occurs is factual. Persuasive arguments can be made, depending on the specific facts, that Taxpayer's sale transactions for military equipment: (1) preceded the actual signing of the contract when the buyer (the U.S. Government, foreign government or foreign entity) accepted the seller's (Taxpayer) offer and agreement on the terms of the sale was reached<sup>15</sup>; (2) occurred when the contract<sup>16</sup> memorializing the

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<sup>15</sup> The legislative history of the FSC regime sheds light on the definition of the term "transaction" as follows:

..."solicitation" refers to the communication ... by the FSC, or its agent, to a customer or potential customer of the terms of sale, such as the price, credit, delivery, or other specification. The term "making of the contract" includes the performance by the FSC, or its agent, of any of the elements necessary to complete a sale such as making an offer or accepting the offer. (Emphasis added.)

General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, III. General Explanation of the Revenue Provisions of the Act, Title VIII- Foreign Sales Corporation (H.R. 4170, 98th Congress; P. L. 98-369); JCS-41-84; (Part 58 of 81 Parts)(hereinafter "General Explanation of FSC Act").

<sup>16</sup> Taxpayer makes much of the fact that, in the transition rule,



terms of the agreement and specifying the rights and obligations of the buyer and seller was awarded or signed<sup>17</sup>; or, (3) occurred when a munitions export license for the military equipment was obtained.<sup>18</sup> For all purposes except the ETI regime, Taxpayer places the greatest emphasis on its contracts.

None of the above definitions of "sale transaction" would entitle Taxpayer to the benefits of the ETI Act for income from its pre-existing long-term contracts. Consequently, Taxpayer argues that the sale transaction does not occur until it reports sale income under the I.R.C. § 460 percentage of completion ("POC") method of accounting. Under the POC method of accounting, Taxpayer includes in gross income, in each taxable year ending after the date the contract is entered, a percentage of the total revenue it estimates it will receive from the contract. The computation itself is based on all items under the contract and is inconsistent with treating such items independently. Without any cited authority or support, Taxpayer asserts that the use of the words "gross receipts" in I.R.C. § 460:

... clearly indicates that the Service contemplates a sale or exchange at the time when gross receipts are reportable. In other words, under the POC method of accounting, the "sale or exchange" under Federal tax principles is really deemed to occur when the income is reported. (Taxpayer's Position Paper, p. 4.)

Taxpayer's use of the POC method of accounting for long-term contracts to define the scope of transactions encompassed within the ETI régime is untenable. A method of accounting addresses the recognition of income - it is irrelevant to determining the character of the income for

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Congress utilized the words "transaction" and "contract" in the same sentence arguing that this is proof that the terms can never equate. If use in the same sentence was the touchstone for interpretation, a more compelling conclusion is that income and transaction are never equivalents. See, I.R.C. §§ 941 through 943.

<sup>17</sup> The award of the contract is generally the point at which disappointed competitors of the seller challenge the sale. See, e.g., Northrop Grumman Corp. v. U.S., 50 Fed. Cl. 443 (2001); Aero Corp. v. Department of the Navy, 558 F.Supp. 404 (D.D.C. 1983).

<sup>18</sup> See, e.g., LTR 82-12-043 (December 23, 1981). An export license applies to the total quantity of a defense article or articles contracted for subject to a time limitation (four years). The application for an export license for defense articles must be accompanied by a copy of a purchase order, letter of intent or other appropriate documentation.

purposes of the ETI régime. In General Dynamics Corp. v. Commissioner, 108 T.C. 107 (1997), another taxpayer argued that the use of a particular method of accounting could affect the amount of tax benefits the taxpayer could claim under the precursor DISC provisions. In that case, petitioners used the completed contract method of accounting to report income and deductions from long-term contracts and sought to use that method to avoid the matching of costs with income from export sales for purposes of computing combined taxable income ["CTI"] under the DISC régime. The Court pointed out that:

...The completed contract method is an accounting method that allocates to a particular taxable year the items of income and expenses that must be reported within that year. It is relevant only to the timing of deductions and income recognition. ... Like other accounting methods, the completed contract method relies on other sections of the Code, such as the DISC provisions, to determine the amount of income to be recognized and the amount of allowable deductions.

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Allowing taxpayers to use their normal method of accounting to compute CTI does not necessarily cede to the accounting methodology the computation of the limitation of the benefit to be generated by foreign exports.

The ETI régime determines what part of income from export sales are entitled to the beneficial treatment provided in the ETI Act. The POC method of accounting is limited to computing the amount of that income required to be recognized in a given year.

The FSC regime, which Taxpayer acknowledges is instructive in construing the ETI regime<sup>19</sup>, reinforces the

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<sup>19</sup> The Joint Committee on Taxation, ETI Technical Explanation states:

It is recognized that there may be a gap in time between the enactment of the Senate amendment 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 Senate amendment.

conclusion that inclusions in gross income pursuant to the

POC method of accounting do not correspond to separate transactions entered into on the date of each inclusion. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(B) provides, in part:

A FSC may, generally, choose any method of accounting permissible under section 446 and the regulations under that section...the FSC may not choose a method of accounting which, when applied to transactions between the FSC and other members of the controlled group, will result in a material distortion of income of the FSC or of any other member of the controlled group. Changes in the method of accounting of a FSC are subject to the requirements of section 446(e) and the regulations under that section. (Emphasis added.)

Taxpayer, noting the application of FSC guidance to analogous ETI concepts, analyzes the explicit provisions provided when the FSC régime was enacted. Taxpayer focuses on those provisions dealing with the availability of the FSC régime for taxpayers using the completed contract method of reporting income<sup>20</sup> and argues that, by analogy, it should be able to use the POC method of accounting to define "sale transaction". What Taxpayer ignores is that there is no analogous provision for unique treatment of income recognized under the POC method of accounting for long-term contracts in the ETI Act. Had Congress intended that result, it arguably would have included explicit provisions as it did when the FSC regime was enacted.

The ETI Act itself demonstrates the inapplicability of the POC method of accounting in defining a "transaction". The ETI Act, and I.R.C. § 114, provides that extraterritorial income is excluded from gross income. However, to constitute extraterritorial income and qualify for exclusion, the income must be qualifying foreign trade income as defined in I.R.C. §§ 941 through 943. The term "foreign trade income" means the taxable income of the taxpayer attributable to FTGR. I.R.C. § 941(b)(1).

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<sup>20</sup> Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 805(a)(2), 98 Stat. 1000-1001 (1984); 1984-3 C.B., vol.1, 1, 508-509.

Again, the FSC regulations provide guidance on the definition of "transaction". Treas. Reg. § 1.924(a)-1T(b) addressing "Sales of export property" provides:

Foreign trading gross receipts of a FSC include gross receipts from the sale of export property by the FSC, or by any principal for whom the FSC acts as a commission agent ..., pursuant to a contract entered into with a purchaser by the FSC or by the principal at any time... Any agreement, oral or written, which constitutes a contract at law, satisfies the contractual requirements of this paragraph.

The term "transaction" is used extensively in I.R.C. § 942, enacted as part of the ETI Act, which defines FTGRs. A taxpayer is treated as having FTGR from a transaction only if economic processes with respect to such transaction take place outside the United States. I.R.C. § 942(b)(1). That economic processes are required in relationship to each transaction to qualify for ETI treatment highlights the flaw in Taxpayer's argument.

The economic processes requirement applies to all of the varieties of transactions the ETI regime encompasses, e.g., sales, exchanges, leases and the provision of services. The identified foreign economic processes which must be performed with respect to a transaction include: advertising and sales promotion; processing of customer orders and arranging for delivery; transportation outside the United States in connection with delivery to the customer; the determination and transmittal of a final invoice or statement of account or the receipt of payment; and, the assumption of credit risk. I.R.C. § 942(b)(3). Economic processes are extraneous to the POC method of accounting.

Although inapplicable to foreign military sales,<sup>21</sup> the requirement of solicitation, negotiation and making of the contract relating to a transaction<sup>22</sup> provides additional insight

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<sup>21</sup> Treas. Reg. § 1.924(d)-1(f).

<sup>22</sup> In enacting the FSC regime, "... Congress recognized that certain foreign military sales must be made through the US Government, typically to foreign governments. Accordingly, because of negotiation and other activities with the US Government, many of the expenses incurred by the FSC in connection with such sales are incurred within the United States. Congress intended, therefore, that for purposes of the foreign presence

into the intended meaning of the term "transaction."

"Negotiation" refers to:

any communication by the FSC to a customer or potential customer aimed at an agreement on one or more of the terms of a transaction, including, but not limited to, price, credit terms, quantity, or time or manner of delivery.

Treas. Reg. § 1.924(d)-1(c)(3). "Making of a contract" refers to:

performance by the FSC of any of the elements necessary to complete a sale, such as making an offer or accepting an offer... The written confirmation by the FSC to the customer of an oral or written agreement which confirms variable contract terms, such as price, credit terms, quantity, or time or manner of delivery, or specifies... additional contract terms will be considered the making of a contract.

Treas. Reg. § 1.924(d)-1(c)(4). Clearly the "negotiations" and "making of a contract" provisions emphasize that inclusions in gross income pursuant to the POC method of accounting do not correspond to separate transactions entered into on the date of each inclusion.

Congress would not have intended one definition for the term "transaction" in I.R.C. § 942 and an entirely different definition for the effective date of the ETI Act. Further, if transaction is equated with income recognized under the POC method of accounting, FTGR and foreign economic processes are irrelevant. More significantly, if a "transaction" is deemed synonymous with income recognition under Taxpayer's method of accounting, that "transaction" arguably could not generate FTGR entitled to the benefits of the ETI regime.

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and economic process test such expenses (and the expenses of the US Government in connection with the sale) will not be taken into account." General explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, III. General Explanation of the Revenue Provisions of the Act, Title VIII- Foreign Sales Corporation (H.R. 4170, 98th Congress; Public Lost 98-369); JCS-41-84; (Part 58 of 81 Parts). Negotiations and activities of the U.S. Government are "in connection with the sale" but irrelevant to Taxpayer's method of accounting.

**CONCLUSION**

Based on the above discussion, an individual inclusion in gross income pursuant to Taxpayer's POC method of accounting does not correspond to an individual transaction entered into on the date of such inclusion for purposes of the ETI regime. In order for a POC method inclusion by Taxpayer pursuant to a contract made before October 1, 2000, to qualify for ETI exclusion treatment, a threshold requirement must be satisfied under the effective date rule of section 5(a) of the ETI Act (in addition to the general ETI exclusion rules in sections 114 and 941 through 943). The transaction that gave rise to such inclusion must have been entered into after September 30, 2000. The determination of when the transaction was entered into is based on the facts and circumstances of the case.

If you have any question regarding this memorandum, please contact

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Associate Area Counsel  
(Large & Mid-Size Business)