Monthly rental payable by F to R for 1985:	
F's sublease rental receipts for year	$10,800.00
Less:	
F's expenses	1,150.00
F's profit	1,483.50
Total	(2,633.50)
Rental payable for 1985	8,166.50
Rental payable each month ($8,166.50/9 months)	$907.39

COMPUTATION FOR 1986

Combined taxable income:	
F's sublease rental receipts for year ($1,200 x 3 months)	$3,600.00
Less:	
R's depreciation (($40,000 x 1⁄10) x 3⁄12)	(1,000.00)
Combined taxable income	2,600.00
The combined taxable income method—F's profit:	
F's profit—23% of combined taxable income ($2,600)	598.00
The gross receipts method—F's profit:	
F's profit—lesser of 1.83% of F's foreign trading gross receipts ($3,600) or two times F's profit under the combined taxable income method ($1,196)	65.88
The section 482 method—F's profit:	
F's sublease rental receipts for year	$3,600.00
Less:	
F's lease rental payments for year	(3,000.00)
F's profit	600.00

Since the section 482 method results in a greater profit to F ($600) than does either the combined taxable income method ($598) or the gross receipts method ($65.88), F may earn a profit of $600 for 1986. Accordingly, the monthly rental payable by F to R for 1986 may be readjusted as long as the monthly rental payable is not readjusted below $1,000, computed as follows:

Monthly rental payable by F to R for 1986:	
F's sublease rental receipts for year	$3,600.00
Less:	
F's profit	(600.00)
Rental payable for 1986	3,000.00
Rental payable for each month ($3,000/3 months)	1,000.00

(g) *Effective date.* The provisions of this section and §1.925(b)–1T apply with respect to taxable year ending after December 31, 1984, except that a corporation may not be a FSC for any taxable year beginning before January 1, 1985.

[T.D. 8126, 52 FR 6443, Mar. 3, 1987, as amended by T.D. 8764, 63 FR 10306, Mar. 3, 1998; T.D. 8944, 66 FR 13426, Mar. 6, 2001]

§ 1.925(b)–1T Temporary regulations; marginal costing rules.

(a) *In general.* This section prescribes the marginal costing rules authorized by section 925(b)(2). 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 sales of an item, product, or product line of export property (as defined in §1.927(a)–1T) from which foreign trading gross receipts (as defined in §1.924(a)–1T) are derived, 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 those sales. (Any further reference to a FSC in this section shall include a small FSC unless indicated otherwise.) The combined taxable income determined under these marginal costing rules may be used to determine whether the ''twice the amount determined under the combined taxable income method'' limitation for the 1.83% of gross receipts test of section 925(d) has been met.

For FSC taxable years beginning after December 31, 1986, if the marginal costing rules are used to determine the section 925(d) limitation, the FSC may not earn more than 100% of full costing combined taxable income determined under the full costing combined taxable income method of §1.925(a)–1T(c)(3) and (6). The marginal costing rules may be applied even if the related supplier does not manufacture, produce, grow, or extract the export property sold. The marginal costing rules do not apply to sales of export property which in the hands of a purchaser related under section 954(d)(3) to the seller give rise to foreign base company sales income as described in section 954(d) unless, for the purchaser's year in which it resells the export property, section 954(b)(3)(A) is applicable or that income is under the exceptions in section 954(b)(4). In addition, 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)).

(b) *Marginal costing rules*—(1) *In general*. Marginal costing is a method under which 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)). Costs which are incurred by the FSC and which are not taken into account in computing combined taxable income are deductible by the FSC only to the extent of the FSC's non-foreign trade income. If the related supplier is not the manufacturer or producer of the export property that is sold, the related supplier's purchase price shall be taken into account.

(2) *Overall profit percentage limitation*. Under marginal costing, the combined taxable income of the FSC and its related supplier 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.

(3) *Grouping of transactions*. (i) In general, for purposes of this section, an item, product, or product line is the item or group consisting of the product or product line pursuant to §1.925(a)–1T(c)(8) used by the taxpayer for purposes of applying the full costing combined taxable income method of §1.925(a)–1T(c)(3) and (6).

(ii) However, for purposes of determining the overall profit percentage under paragraph (c)(2) of this section, any product or product line grouping permissible under §1.925(a)–1T(c)(8) may be used at the annual choice of the FSC even though it may not be the same item or grouping referred to in subdivision (i) of this paragraph as long as the grouping chosen for determining the overall profit percentage is at least as broad as the grouping referred to in the above subdivision (i) of this paragraph. A product may be included for this purpose, however, in only one product group even though under the grouping rules it would otherwise fall in more than one group. Thus, the marginal costing rules will not apply with respect to any regrouping if the regrouping does not include any product (or products) that was included in the group for purposes of the full costing method.

(4) *Application of limitation on FSC income (''no loss'' rules)*. The marginal costing rules of this section will not apply if there is a combined loss of the related supplier and the FSC determined in accordance with paragraph (b)(1) of this section. In addition, for FSC taxable years beginning after December 31, 1986, the profit determined under the marginal costing method may be allowed to the FSC only to the extent it does not exceed the FSC's and the related supplier's full costing combined taxable income determined under the full costing combined taxable income method of §1.925(a)–1T(c)(3) and (6). This rule prevents pricing at a loss to the related supplier. If either of these ''no loss'' rules apply, the related supplier may nonetheless charge a transfer price or pay a commission in an amount that will allow the FSC to recover an amount not in excess of its full costs, if any, even if to do so would create or increase a loss in the related supplier. The effect of these no-loss rules and of the overall profit percentage limitation of paragraph (c)(2) of

this section is that the FSC's profit under these marginal costing rules is limited to the lesser of the following:

(i) 23% of maximum combined taxable income determined under the marginal costing rules,

(ii) 23% of the overall profit percentage limitation, or

(iii) For FSC taxable years beginning after December 31, 1986, 100% of the full costing combined taxable income determined under the full costing combined taxable income method of §1.925(a)–1T(c)(3) and (6).

(c) *Definitions*—(1) *Establishing or maintaining a foreign market.* 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 paragraph (b) of this section 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).

(2) *Overall profit percentage.* (i) For purposes of this section, the overall profit percentage 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 other 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.

(ii) At the annual option of the related supplier, the overall profit percentage for the FSC's taxable year for all products and product lines may be determined by aggregating the amounts described in subdivisions (i)(A) and (B) of this paragraph of the FSC, and all domestic members of the controlled group (as defined in section 927(d)(4) and §1.924(a)–1T(h)) of which the FSC is a member, for the FSC's taxable year and for taxable years of the members ending with or within the FSC's taxable year.

(iii) For purposes of determining the amounts in subdivisions (i) and (ii) of this paragraph, a sale of property between a FSC and its related supplier or between domestic members of the controlled group shall be taken into account only during the FSC's taxable year (or taxable year of the member ending within the FSC's taxable year) during which the property is ultimately sold to a person which is not related to the FSC or if related, is a foreign person that is not a FSC.

(3) *Full costing method.* For purposes of section 925 and this section, the term "full costing combined taxable income method" is the method for determining full costing combined taxable income set forth in §1.925(a)–1T(c)(3) and (6).

(d) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, a FSC for the taxable year. During 1985, R produces and sells 100 units of export property A to F under a written agreement which provides that the transfer price between R and F shall be that price which allocates to F the maximum profit permitted to be received under the administrative pricing rules of section 925(a)(1) and (2). Thereafter, the 100 units are resold for export by F for $950. R's cost of goods sold attributable to the 100 units is $650 consisting in part of $400 of direct materials and $200 of direct labor. R incurs selling expenses directly attributable to the sale in the amount of $100. Those expenses were not required to be incurred by F. For purposes of this example, it is assumed that R does not have general and administrative expenses that are not definitely allocable to any item of gross income. F's expenses attributable to the resale of the 100 units are $120. For purposes of this example, R and F have gross receipts of $4,000 from all domestic and foreign sales. R's total cost of goods sold and total expenses relating to its foreign and domestic sales are $2,730 and $450, respectively. Under full costing, the combined taxable income will be $80, computed as follows:

Combined taxable income—full costing:	
F's foreign trading gross receipts	$950.00
R's cost of goods sold	(650.00)

Combined gross income	300.00
Less:	
R's direct selling expenses	100.00
F's expenses	120.00
Total	(220.00)
Combined taxable income (loss)	80.00

F's profit under the full costing combined taxable income method is $18.40, *i.e.*, 23% of full costing combined taxable income ($80). F's profit under the gross receipts method will be $17.39, *i.e.*, 1.83% of F's foreign trading gross receipts ($950). However, under the marginal costing rules, F would have a profit attributable to the export sale in the amount of $38.24, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of $166.25). As shown by the computation below, the combined taxable income under marginal costing is limited to the overall profit percentage limitation ($166.25) since that amount is less than the maximum combined taxable income amount ($350):

Maximum combined taxable income (determined under paragraph (b)(1) of this section):	
F's foreign trading gross receipts	$950.00
Less:	
R's direct materials	400.00
R's direct labor	200.00
Total	(600.00)
Maximum combined total income	350.00

Overall profit percentage limitation calculation (determined under paragraph (c)(2) of this section):	
Gross receipts of R and F from all domestic and foreign sales	$4,000.00
R's cost of goods sold	(2,730.00)
Combined gross income	1,270.00
Less:	
R's expenses	450.00
F's expenses	120.00
Total	(570.00)
Total taxable income from all sales computed on a full costing method	700.00
Overall profit percentage (total taxable income ($700) divided by total gross receipts ($4,000)	17.5%
Overall profit percentage limitation Overall profit percentage times F's foreign trading gross receipts (17.5% times $950.00)	$166.25

The transfer price from R to F may be set at $791.76, computed as follows:

Transfer price to F:	
F's foreign trading gross receipts	$950.00
Less:	
F's expenses	120.00
F's profit	38.24
Total	(158.24)
Transfer price	791.76

Example 2. Assume the same facts as in *Example 1* except that F's expenses are $170. Under full costing, the combined taxable income will be $30, computed as follows:

Combined taxable income—full costing:	
F's foreign trading gross receipts	$950.00
R's cost of goods sold	(650.00)
Combined gross income	300.00
Less:	
R's expenses	100.00
F's expenses	170.00
Total	(270.00)
Combined taxable income (loss)	30.00

F's profit under the full costing combined taxable income method is $6.90, *i.e.*, 23% of combined taxable income, $30. Under the marginal costing rules, F may earn a profit attributable to the export sale in the amount of $35.51, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of $154.38). Had the transaction occurred in 1987, F would have had a profit attributable to the export sale under these marginal costing rules of only $30, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of $154.38) limited, for FSC taxable years beginning after December 31, 1986, to combined taxable income determined under full costing ($30), see paragraph (b)(4) of this section. F's profit under the gross receipts method will be $17.39 *i.e.*, 1.83% of F's foreign trading gross receipts ($950). The computations are as follows:

Maximum combined taxable income (determined under paragraph (b)(1) of this section):	
F's foreign trading gross receipts	$950.00
Less:	
R's direct materials	400.00
R's direct labor	200.00
Total	(600.00)
Maximum combined taxable income	350.00
Overall profit percentage limitation calculation (determined under paragraph (c)(2) of this section):	
Gross receipts of R and F from all domestic and foreign sales	4,000.00
R's cost of goods sold	(2,730.00)
Combined gross income	1,270.00
Less:	
R's expenses	450.00
F's expenses	170.00
Total	(620.00)
Total taxable income from all sales computed on a full costing method	650.00
Overall profit percentage (total taxable income ($650) divided by total gross receipts ($4,000))	16.25%
Overall profit percentage limitation Overall profit percentage times F's foreign trading gross receipts (16.25% times $950.00)	154.38
The transfer price from R to F may be set at $744.49, computed as follows:	
Transfer price to F:	
F's foreign trading gross receipts	950.00
Less:	
F's expenses	170.00
F's profit	35.51
Total	(205.51)
Transfer price	744.49

Example 3. Assume the same facts as in *Example 1* except that the transaction occurs in 1987 and that F incurs expenses in the amount of $250. Since a $50 combined loss, as computed below, is incurred, F will not have any profit under either the full costing combined taxable income method, the gross receipts method or the marginal costing rules:

Combined taxable income—full costing:	
F's foreign trading gross receipts	$950.00
R's cost of goods sold	(650.00)
Combined gross income	300.00
Less:	
R's expenses	100.00
F's expenses	250.00
Total	(350.00)
Combined taxable income (loss)	(50.00)

The transfer price to R may be set at $700 so that F may recover its expenses.

Example 4. R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, a FSC for the taxable year. During 1985, R manufactures export property A. R enters into a written agreement with F whereby F will receive a commission with respect to sales of export property A by R which result in gross receipts to R which would have been foreign trading gross receipts had F and not R been the principal on the sale. F will receive commissions with respect to such export sales equal to the maximum amount permitted to be received under the transfer pricing rules of section 925. The maximum commission may be earned by F under these marginal costing rules. In this example, R received $950 from the sale of export property A. R's cost of goods sold for that property was $620. R incurred direct selling expenses of $20. Also, it is assumed that R incurred total general and administrative expenses, in addition to those incurred relating to its contract to perform on behalf of F the functions and activities of section 924 (c), (d) and (e), of $50. R incurred direct and indirect expenses of $130 in performing those functions and activities on behalf of F. During 1985, R had gross receipts from all domestic and foreign sales of $3,500, total cost of goods sold and total expenses relating to the domestic and foreign sales of $1,600 and $259, respectively. The election provided for in §1.925(a)–1T(b)(2)(ii) was not made by R and F.

Combined taxable income—full costing:		
R's gross receipts from the sale of the export property		$950.00
R's cost of goods sold		(620.00)

Combined gross income		330.00
Less:		
R's direct selling expenses		20.00
F's expenses		130.00
Apportionment of R's general and administrative expenses:		
R's total G/A expenses	$50	
Combined gross income	330	
R's total gross income	1,900	
Apportionment of G/A expenses $50 x $330/$1,900		8.68
Total		(158.68)
Combined taxable income (loss)		171.32

Maximum combined taxable income (determined under paragraph (b)(1) of this section):	
R's gross receipts from the sale of the export property	$950.00
Less:	
R's direct materials	450.00
R's direct labor	100.00
Total	(550.00)
Maximum combined taxable income	400.00
Overall profit percentage limitation calculation (determined under paragraph (c)(2) of this section):	
Gross receipts of R from all domestic and foreign sales	3,500.00
R's cost of goods sold	(1,600.00)
Combined gross income	1,900.00
Less:	
R's total expenses	259.00
F's total expenses	130.00
Total	(450.00)
Total taxable income from all sales computed on a full costing method	1,511.00
Overall profit percentage (total taxable income ($1,511) divided by total gross receipts ($3,500))	43.17%
Overall profit percentage limitation Overall profit percentage times R's gross receipts from the sale of export property (*i.e.*, 43.17% times $950.00)	410.12

Since the overall profit percentage limitation ($410.12) is greater than the maximum combined taxable income ($400), combined taxable income under marginal costing and for purposes of computing F's commission is limited to $400. Under these marginal costing rules, F will have a profit attributable to the sale of $92, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of $400). Accordingly, the commission F receives from R is $222, *i.e.*, F's expenses ($130) plus F's profit ($92).

Example 5. Assume the same facts as in *Example 4*, except that R's gross receipts from the sale of export property which would have been foreign trading gross receipts had F been the principal on the sale are $1,050 and gross receipts from all sales, domestic and foreign, remain at $3,500. For purposes of applying the combined taxable income method, R and F may compute their combined taxable income attributable to the product line of export property under the marginal costing rules as follows:

Combined taxable income—full costing:	
R's gross receipts from the sale of the export property	$1,050.00
R's cost of goods sold	(620.00)
Combined gross income	430.00
Less:	
R's direct selling expenses	20.00
F's expenses	130.00
Apportionment of R's G/A expenses $50 x $430/$1,900	11.32
Total	(161.32)
Combined taxable income (loss)	268.68

Maximum combined taxable income (determined under paragraph (b)(1) of this section):	
R's gross receipts from the sale of export property	$1,050.00
Less:	
R's direct materials	450.00

R's direct labor	100.00
Total	(550.00)
Maximum combined taxable income	500.00
Overall profit percentage (see example 4)	43.17%
Overall profit percentage limitation (determined under paragraph (c)(2) of this section) (R's gross receipts from sale ($1,050.00) times the overall profit percentage (43.17%))	453.29

Since maximum combined taxable income ($500) is greater than the overall profit percentage limitation ($453.29), combined taxable income under marginal costing and for purposes of computing F's commission is limited to $453.29. Under these marginal costing rules, F will have a profit attributable to the sales of $104.26, *i.e.*, 23% of combined taxable income (23% of $453.29). Accordingly, the commission F receives from R is $234.26, *i.e.*, F's expenses ($130) plus F's profit ($104.26).

Example 6. Assume the same facts as in *Example 5*, except that F has expenses of $140 and R's cost of goods sold for the export sale was $900. R does not incur any direct selling expenses. Since cost of goods sold has increased by $280, R's total gross income has been reduced from $1,900 to $1,620. For purposes of applying the combined taxable income method, R and F may compute their combined taxable income under the marginal costing rules as follows:

Combined taxable income—full costing:	
R's gross receipts from the sale of export property	$1,050.00
R's cost of goods sold	(900.00)
Combined gross income	150.00
Less:	
F's expenses	140.00
Apportionment of R's G/A expenses $50 x $150/$1,620	4.63
Total	(144.63)
Combined taxable income (loss)	5.37
Maximum combined taxable income (determined under paragraph (b)(1) of this section):	
R's gross receipts from the sale of export property	$1,050.00
Less:	
R's direct materials	630.00
R's direct labor	200.00
Total	(830.00)
Maximum combined taxable income	220.00
Overall profit percentage limitation calculation (determined under paragraph (c)(2) of this section):	
Gross receipts of R and F from all domestic and foreign sales	$3,500.00
R's cost of goods sold	(1,880.00)
Combined gross income	1,620.000
Less:	
R's total expenses	259.00
F's total expenses	140.00
Total	(399.00)
Total taxable income from all sales computed on a full costing method	$1,221.00
Overall profit percentage (total taxable income ($1,221) divided by total gross receipts ($3,500))	34.89%
Overall profit percentage limitation—overall profit percentage times R's gross receipts from the sale of export property (i.e., 34.89% times $1,050)	$366.35

Since the overall profit percentage limitation ($366.35) is greater than the maximum combined taxable income ($220), combined taxable income under marginal costing and for purposes of computing F's commission is limited to $220. Under these marginal costing rules, F will have a profit attributable to the sale of $50.60, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of $220). If the transaction occurred in 1987, F's profit would be limited, however, by paragraph (b)(4) of this section to the full costing combined taxable income of $5.37.

[T.D. 8126, 52 FR 6455, Mar. 3, 1987, as amended by T.D.8764, 63 FR 10306, Mar. 3, 1998; T.D. 8944, 66 FR 13429, Mar. 6, 2001]

§ 1.926(a)–1 Distributions to shareholders.

(a) *Treatment of distributions.* [Reserved] For guidance, see § 1.926(a)–1T(a).