

[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8764]

RIN 1545-AV91

Source and Grouping Rules for Foreign Sales Corporation Transfer Pricing

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that provide guidance to taxpayers who have made an election to be treated as a foreign sales corporation (FSC). The regulations provide rules that clarify the special sourcing rules under section 927(e)(1) and provide a deadline for the election to group transactions. The text of the temporary regulations also serves as the text of the proposed regulations on this subject in the Proposed Rules section of this issue of the **Federal Register**.

DATES: Effective date: These regulations are effective March 3, 1998.

Applicability: For dates of applicability, see §§1.925(a)-1T(c)(8)(i) and 1.927(e)-1T(c).

FOR FURTHER INFORMATION CONTACT: Elizabeth Beck (202) 622-3880 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under sections 925 and 927 which were added by the Deficit Reduction Act of 1984, applicable for taxable years of foreign sales corporations beginning after December 31, 1984. Temporary regulations were published in the **Federal Register** (52 FR 6468) as a Treasury Decision (TD 8126) on March 3, 1987. Treasury and IRS believe that immediate guidance in the form of these temporary regulations is necessary for the reasons stated below.

Explanation of Provisions

These regulations set a deadline for an election to group transactions for purposes of the foreign sales corporation (FSC) administrative pricing methods and clarify that the foreign source limit for a FSC's related supplier extends to all transactions giving rise to foreign trading gross receipts.

- I. Grouping Election Deadline.
- A. Current temporary regulations.

Current §1.925(a)-1T(c)(8) and §1.925(b)-1T(b)(3) permit taxpayers annually to group transactions in applying the administrative pricing (including the marginal costing) rules to determine FSC benefits. Current §1.925(a)-1T(c)(8)(i) requires an election to group to be evidenced on the FSC income tax return

for the taxable year. Current §1.925(a)-1T(e)(4) authorizes taxpayers to file amended returns subsequently (within the statute of limitations period) to redetermine FSC benefits based on a different grouping of transactions than that originally elected. Pursuant to this provision, taxpayers may change their grouping basis, or change from a grouping to a transaction-by-transaction basis. The IRS and the Treasury have become increasingly aware of taxpayers who, through the use of sophisticated computer programs, substantially revise their transaction groupings just prior to the expiration of the statute of limitations and many years after the original returns were filed. These revised groupings typically employ complex estimating techniques. The recent rise in this practice is placing a significant burden on the auditing process and is creating a potential for abuse.

B. Revised temporary regulations.

Under §1.925(a)-1T(c)(8)(i), the election to group must be made on Schedule P of the FSC's timely filed U.S. income tax return (including extensions thereof) for the taxable year. No untimely or amended returns will be allowed to elect to group, to change a grouping basis, or to change from a grouping basis to a transaction-by-transaction basis for such year.

Conforming changes and cross-references are reflected in §1.925(a)-1T(e)(4) and §1.925(b)-1T(b)(3).

The regulations apply to taxable years beginning after

December 31, 1997. There is also a transition rule providing that the regulations also apply to taxable years beginning before January 1, 1998. For these taxable years, the transition rule allows taxpayers to redetermine their grouping of transactions with respect to such years provided such redetermination is made no later than the due date of the FSC's timely filed U.S. income tax return (including extensions thereof) for its first taxable year beginning after December 31, 1997.

II. Scope of Related Supplier Foreign Source Limit.

A. Current temporary regulations and TRA 97.

Section 927(e)(1) provides that "[u]nder regulations, the income of a person described in section 482 from a transaction giving rise to foreign trading gross receipts of a FSC which is treated as from sources outside the United States shall not exceed the amount which would be treated as foreign source income earned by such person if the pricing rule under section 994 which corresponds to the rule used under section 925 with respect to such transaction applied to such transaction." Transactions giving rise to foreign trading gross receipts include qualifying sales, leases, licenses and services. Current §1.927(e)-1T restates the section 927(e)(1) rule as applicable on "the sale of export property." While the statute is not limited to export sale transactions in that it applies to any transaction giving rise to foreign trading gross receipts of a FSC, the current regulation might be interpreted to apply the special foreign

sourcing limit only to sales of export property.

Section 1171 of the Taxpayer Relief Act of 1997 (TRA 97) amended section 927(a)(2)(B) (without any inference intended regarding prior law) to provide that computer software licensed for reproduction abroad is included within the definition of export property for purposes of the FSC provisions. The amendment applies to gross receipts from computer software licenses attributable to periods after December 31, 1997, in tax years ending after such date.

In light of TRA 97, it is important to clarify the scope of the related supplier's foreign source limit under the regulations. This clarification needs to be implemented immediately in order to provide clear guidance to taxpayers, including those utilizing the TRA 97 amendment to section 927(a)(2)(B).

B. Revised temporary regulations.

Under §1.927(e)-1T(a)(1), the related supplier's foreign source limit applies to any transaction, including but not limited to any sale, lease, license or service, giving rise to foreign trading gross receipts of a FSC. No inference is intended regarding the scope of application of the prior regulation.

Conforming changes are reflected in §1.927(e)-1T(a)(2) and (3). Special rules are added in §1.927(e)-1T(a)(3)(ii) to clarify how the corresponding DISC transfer pricing rules are to

be applied for purposes of the foreign source limit. Three examples set forth in §1.927(e)-1T(b) illustrate how the limit is applied under different transfer pricing methods and for different types of transactions.

The regulations apply to taxable years beginning after December 31, 1997.

Special Analyses

It has been determined that this Treasury Decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Elizabeth Beck of the Office of the Associate Chief Counsel (International). Other personnel from the IRS and Treasury Department also participated in the development of these regulations.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirement

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entries for sections 1.925(a)-1T and 1.925(b)-1T to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.925(a)-1T is also issued under 26 U.S.C. 925(b)(1) and (2) and 927(d)(2)(B).

Section 1.925(b)-1T is also issued under 26 U.S.C. 925(b)(1) and (2) and 927(d)(2)(B) * * *

Par. 2. Section 1.925(a)-1T is amended by:

1. Removing the last sentence of paragraph (c)(8)(i) and adding five sentences in its place.

2. Paragraph (e)(4) is amended by:

a. Removing the language "or grouping of transactions" from the fourth sentence.

b. Adding a sentence to the end of the paragraph.

The additions read as follows:

§1.925(a)-1T Temporary Regulations; Transfer pricing rules for FSCs.

* * * * *

(c) * * *

(8) * * * (i) * * * The election to group transactions shall be evidenced on Schedule P of the FSC's timely filed U.S. income tax return (including extensions thereof) for the taxable year. No untimely or amended returns will be allowed to elect to group, to change a grouping basis, or to change from a grouping basis to a transaction-by-transaction basis. The rules of the previous two sentences of this paragraph (c)(8)(i) are applicable to taxable years beginning after December 31, 1997. For any taxable year beginning before January 1, 1998, for which a redetermination is otherwise permissible under paragraph (e)(4) of this section as in effect for taxable years beginning before January 1, 1998, a redetermination of grouping of transactions cannot be made later than the due date of the FSC's timely filed U.S. income tax return (including extensions thereof) for the FSC's first taxable year beginning after December 31, 1997. The language "or grouping of transactions" is removed from the fourth sentence of paragraph (e)(4) of this section, applicable to taxable years beginning after December 31, 1997.

* * * * *

(e) * * *

(4) * * * For the election to group transactions for purposes of applying the administrative pricing methods, see paragraph (c)(8)(i) of this section.

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Par. 3. In §1.925(b)-1T, paragraph (b)(3)(i) is amended by adding at the end of the paragraph the following sentence:

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

* * * * *

(b) * * *

(3) * * * (i) * * * For the election to group transactions for purposes of applying the administrative pricing methods, see §1.925(a)-1T(c)(8)(i).

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Par. 4. Section 1.927(e)-1T is revised to read as follows:
§1.927(e)-1T Temporary regulations; special sourcing rule.

(a) Source rules for related persons--(1) In general. The income of a person described in section 482 from a transaction giving rise to foreign trading gross receipts of a FSC which is treated as from sources outside the United States shall not exceed the amount which would be treated as foreign source income earned by such person if the pricing rule under section 994 which corresponds to the rule used under section 925 with respect to such transaction applied to such transaction. This section applies to any transaction, including but not limited to any sale, lease, license or service, giving rise to foreign trading gross receipts of a FSC. This special sourcing rule also applies if the FSC is acting as a commission agent for the related supplier with respect to the transaction described above which gives rise to foreign trading gross receipts and the transfer

pricing rules of section 925 are used to determine the commission payable to the FSC. No limitation results under this section with respect to a transaction to which the section 482 pricing rule under section 925(a)(3) applies.

(2) Grouping of transactions. If, for purposes of determining the FSC's profits under the administrative pricing rules of sections 925(a)(1) and (2), grouping of transactions under §1.925(a)-1T(c)(8) was elected, the same grouping shall be used for making the determinations under this special sourcing rule.

(3) Corresponding DISC pricing rules--(i) In general. For purposes of this section--

(A) The DISC gross receipts pricing rule of section 994(a)(1) corresponds to the gross receipts pricing rule of section 925(a)(1);

(B) The DISC combined taxable income pricing rule of section 994(a)(2) corresponds to the combined taxable income pricing rule of section 925(a)(2); and

(C) The DISC section 482 pricing rule of section 994(a)(3) corresponds to the section 482 pricing rule of section 925(a)(3).

(ii) Special rules. For purposes of this section--

(A) The DISC pricing rules of section 994(a)(1) and (2) shall be determined without regard to export promotion expenses;

(B) Qualified export receipts under section 994(a)(1) and (2) shall be deemed to be an amount equal to the foreign trading

gross receipts arising from the transaction; and

(C) Combined taxable income for purposes of section 994(a)(2) shall be deemed to be an amount equal to the combined taxable income for purposes of section 925(a)(2) arising from the transaction.

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

Example 1. (i) R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, which is a FSC acting as a commission agent for R. For the taxable year, R and F used the combined taxable income pricing rule of section 925(a)(2). For the taxable year, the combined taxable income of R and F is \$100 from the sale of export property, as defined in section 927(a), manufactured by R using production assets located in the United States. Title to the export property passed outside of the United States.

(ii) Under section 925(a)(2), 23 percent of the \$100 combined taxable income of R and F, that is \$23, is allocated to F and the remaining \$77 is allocated to R. Absent the special sourcing rule, under section 863(b) the \$77 income allocated to R would be sourced \$38.50 U.S. source and \$38.50 foreign source. Under the special sourcing rule, the amount of foreign source income earned by a related supplier of a FSC shall not exceed the amount that would result if the corresponding DISC pricing rule applied. The DISC combined taxable income pricing rule of section 994(a)(2) corresponds to the combined taxable income pricing rule of section 925(a)(2). Under section 994(a)(2), \$50 of the combined taxable income ($\$100 \times .50$) would be allocated to the DISC and the remaining \$50 would be allocated to the related supplier. Under section 863(b), the \$50 income allocated to the DISC's related supplier would be sourced \$25 U.S. source and \$25 foreign source. Accordingly, under the special sourcing rule, the foreign source income of R shall not exceed \$25.

Example 2. (i) Assume the same facts as in Example 1 except that the combined taxable income arises from the licensing of the copyright rights in computer software for use outside of the United States and that R developed the computer software in the United States.

(ii) Under section 925(a)(2), 23 percent of the \$100 combined taxable income of R and F, that is \$23, is allocated to F and the remaining \$77 is allocated to R. Absent the special sourcing rule, under section 862(a)(4) the \$77 income allocated to R would be sourced \$77 foreign source in its entirety. Under the special sourcing rule, the amount of foreign source income earned by a related supplier of a FSC shall not exceed the amount that would result if the corresponding DISC pricing rule applied. The DISC combined taxable income pricing rule of section 994(a)(2) corresponds to the combined taxable income pricing rule of section 925(a)(2). Under section 994(a)(2), \$50 of the combined taxable income ($\$100 \times .50$) would be allocated to the DISC and the remaining \$50 would be allocated to the related supplier. Under section 862(a)(4), the \$50 income allocated to the DISC's related supplier would be sourced \$50 foreign source in its entirety. Accordingly, under the special sourcing rule, the foreign source income of R shall not exceed \$50.

Example 3. (i) Assume the same facts as in Example 1 except that R and F used the gross receipts pricing rule of section 925(a)(1). In addition, for the taxable year foreign trading gross receipts derived from the sale of the export property are \$2,000.

(ii) Under section 925(a)(1), 1.83 percent of the \$2,000 foreign trading gross receipts, that is \$36.60, is allocated to F and the \$63.40 remaining combined taxable income ($\$100 - \36.60) is allocated to R. Absent the special sourcing rule, under section 863(b) the \$63.40 income allocated to R would be sourced \$31.70 U.S. source and \$31.70 foreign source. Under the special sourcing rule, the amount of foreign source income earned by a related supplier of a FSC shall not exceed the amount that would result if the corresponding DISC pricing rule applied. The DISC gross receipts pricing rule of section 994(a)(1) corresponds to the gross receipts pricing rule of section 925(a)(1). Under section 994(a)(1), \$80 ($\$2,000 \times .04$) would be allocated to the DISC and the \$20 remaining combined taxable income would be allocated to the related supplier. Under section 863(b), the \$20 income allocated to the DISC's related supplier would be sourced \$10 U.S. source and \$10 foreign source. Accordingly, under the special sourcing rule, the foreign source income of R shall not exceed \$10.

(c) Effective Date. The rules of this section are applicable to taxable years beginning after December 31, 1997.

Michael P. Dolan
Deputy Commissioner of Internal Revenue

Approved: February 20, 1998

Donald C. Lubick
Acting Assistant Secretary of the Treasury