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COORDINATED ISSUE
ALL INDUSTRIES
FOREIGN SALES CORPORATIONS:
ADVANCE PAYMENT TRANSACTIONS
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OVERVIEW:

Taxpayer, Taxpayer-FSC and F-Subs (foreign entities, generally affiliated companies) enter into advance purchase agreements whereby Taxpayer agrees to deliver product to Taxpayer-FSC in Year 2 and Taxpayer-FSC agrees to deliver product to F-Subs, also in Year 2. In Year 1, F-Subs make an advance payment to Taxpayer-FSC and Taxpayer-FSC makes an advance payment to Taxpayer for goods to be delivered in the subsequent year. Taxpayer and Taxpayer-FSC adopt methods of accounting reporting the advance payments in income in Year 1, the year of receipt, and deducting all costs in Year 2, the year of economic performance. By separating income and costs into two different tax periods and by misapplying the "no loss" rule, Taxpayer is able to convert a taxable gain into a net taxable loss for FSC purposes, which in turn generates a tax benefit substantially in excess of the amount intended under the applicable Code provisions.

ISSUES:

1. Whether Taxpayer's method of accounting for the Advance Payment Transactions results in a material distortion of income under I.R.C. §925(a) and Temp. Treas. Reg. §1.925(a)-1T(c)(6)(iii)(B).

2. Whether the reimbursement payment claimed by Taxpayer is a correct application of the "no loss" rule under Temp. Treas. Reg. §1.925(a)-1T(e)(1)(i).

3. Whether the negligence or disregard of rules or regulations penalty under IR.C. §6662(a) and Treas. Reg. §1.6662-3 should be asserted.

CONCLUSIONS:

1. Taxpayer's method of accounting for the Advance Payment Transactions results in a material distortion of income under I.R.C. §925(a) and Temp. Treas. Reg. §1.925(a)-1T(c)(6)(iii)(B).

2. The reimbursement payment claimed by Taxpayer is not a correct application of the "no loss" rule under Temp. Treas. Reg. §1.925(a)-1T(e)(1)(i).

3. The negligence and disregard of rules or regulations penalty under I.R.C. §6662(a) and Treas. Reg. § 1.6662-3 shall be asserted on Taxpayer if it engaged in the described FSC Advance Payment Transactions and has not filed a disclosure under IRS Announcement 2002-2.

FACTS:

Taxpayer is a U.S. corporation that directly owns 100 percent of a foreign sales corporation (FSC). Taxpayer-FSC is a foreign sales corporation under I.R.C. §§922 and 925 and their pertinent regulations. Taxpayer-FSC is the Taxpayer Group's agent and/or distributor for foreign sales of its products. Taxpayer-FSC may serve as either commission agent or seller on the Taxpayer Group's sales to its foreign subsidiaries. Taxpayer-FSC operates as the distributor on the Taxpayer Group's buy-sell transaction to its foreign subsidiaries. This group of wholly owned subsidiaries will be collectively referred to as the "F-Subs." Taxpayer sells its products worldwide through the F-Subs and other foreign subsidiaries to unrelated customers that use the product outside the United States.

The Advance Payment Transaction, Tax Year 1

The contracts detailed below were entered into as part of the Advance Payment Transaction.

1. On Date 1, Taxpayer-FSC entered into a contract with each of the F-Subs, (collectively, the F-Subs advance payment contracts) to sell an unspecified amount of specified products to the F-Subs for a fixed price per unit.

    a. Under these contracts, Taxpayer-FSC agreed to defer delivery of the quantities of products specified by the F-Subs until Tax Year 2.

    b. The advance payments specified in the F-Subs advance payment contracts were payable on or before the end of Tax Year 1.

2. On the same day, Date 1, Taxpayer and Taxpayer-FSC entered into an advance payment contract under which Taxpayer agreed to sell an unspecified quantity of specified products to Taxpayer-FSC for a fixed price per unit.

    a. Taxpayer-FSC agreed to delay delivery of product it paid for in the Tax Year 1 until Tax Year 2 or later.

    b. The product purchase price due under this contract was payable on or before the end of Tax Year 1.

    c. The advance purchase price was based on Taxpayer's expected standard transfer price to the F-Subs from Taxpayer-FSC for the period less a discount. The discount allowed Taxpayer-FSC to retain 23% of the amount received from the F-Subs.

3. Taxpayer reported the entire amount of the advance payment received from Taxpayer-FSC, as gross income on its Form 1120 for Tax Year 1.

4. Taxpayer-FSC reported the full amount of the advance payments received from the F-Subs as taxable income on its Form 1120 FSC for Tax Year 1.

The Advance Payment Transaction, Tax Year 2

1. Taxpayer produced and delivered the specified products to Taxpayer-FSC that were subject to the F-Subs advance payment contracts and the Taxpayer FSC advance payment contract.

2 Taxpayer-FSC sold the products pursuant to the F-Subs advance payment contracts.

3. Title to all goods shipped by Taxpayer to Taxpayer-FSC under the contract passed to Taxpayer-FSC in the United States.

4. Taxpayer deducted the costs of producing the products delivered under the Taxpayer advance payment contract on its tax return for Tax Year 2.

5. Taxpayer also deducted on the return for Tax Year 2 an amount as reimbursement to Taxpayer-FSC for Taxpayer-FSC's loss on the Advance Payment Transaction.

6. Taxpayer-FSC deducted its cost to purchase the products delivered under the F-Subs advance payment contracts in Tax Year 2.

7. Taxpayer-FSC reported as gross income the amount of reimbursement received from Taxpayer in Tax Year 2.

Taxpayer has not previously established a tax accounting method to defer recognizing the income from the advance payments. Further, the F-Subs and Taxpayer-FSC have not elected under Treas. Reg. §1.461-4(d)(6)(ii) to treat services or property reasonably expected to be provided within 3.5 months after the date of payment as having been provided when payment has been made.

Taxpayer's Purpose for Entering into the Advance Payment Transaction

Taxpayer may claim that the Advance Payment Transaction was entered into to secure supply and to fix the cost for the products under the contracts, as well as to hedge against currency fluctuations and to mitigate commercial risks of doing business in the markets of Taxpayer and the F-Subs.

LAW:

FSC Provisions[1]

Where a foreign corporation qualifies as a FSC, its "exempt foreign trade income" is treated as foreign source income that is not effectively connected with the conduct of a trade or business within the United States and thus is not subject to U.S. income tax. I.R.C. §921(a). Nor is this category of income subject to U.S. tax when repatriated as dividends from the FSC. I.R.C. § 245(c). A FSC's "foreign trade income" is its gross income attributable to foreign trading gross receipts (FTGR) and includes gross income from the sale, exchange, or other disposition of export property, and from the lease or rental of export property for use by the lessee outside the United States, less the transfer price determined under the transfer pricing methods of I.R.C. § 925(a). I.R.C. §§923(b), 924(a)(1); Temp. Treas. Reg. §1.923-1T(a). "Exempt" foreign trade income (as defined in I.R.C. § 923(a)(1)) is a specific portion of overall foreign trade income, determined with reference to: (1) the pricing method used to compute the FSC's income from the export transaction or group of export transactions and (2) ownership of FSC stock. I.R.C. §§291(a)(4), 923(a)(1), 923(a)(6); Temp. Treas. Reg. § 1.923-1T(b).

For purposes of the FSC provisions, the term "related supplier" means a related party that directly supplies to a FSC any property or services that the FSC disposes of in a transaction producing foreign trading gross receipts, or a related party that uses the FSC as a commission agent in the disposition of any property or services producing foreign trading gross receipts. Temp. Treas. Reg. §1.927(d)-2T(a).

Where a FSC determines its income using the administrative pricing rules under I.R.C. §925(a)(1) or (2), either 15/23 or 16/23 of its foreign trade income may be treated as exempt. I.R.C. §§291(a)(4), 923(a)(1) and (3), 923(a)(6); Temp. Treas. Reg. §1.923-1T(b)(1)(i).[2]

The transfer pricing rules contained in Temp. Treas. Reg. §1.925(a)-1T(c) provide, in pertinent part:

> (c) Transfer price for sales of export property –
>
> (1) In general. Under this paragraph, rules are prescribed for computing the allowable price for a transfer from a related supplier to a

[1] The FSC Repeal and Extraterritorial Income Exclusion Act of 2000 repealed the FSC provisions (I.R.C. §§ 921 through 927) and replaced them with the extraterritorial income exclusion provisions (I.R.C. §§ 114 and 941 through 943) for transactions entered into after September 30, 2000. Pub. L. No. 106-519, 114 Stat. 2423 (Nov. 15, 2000).

[2] A similar rule applies where a FSC does not use the administrative pricing rules. See Temp. Treas. Reg. § 1.923-1T(b)(1)(ii) (where a FSC does not use the administrative pricing rules, 30% of its foreign trade income will be exempt foreign trade income; if such a FSC has a non-corporate shareholder (shareholders), 32% of its foreign trade income attributable to the non-corporate shareholder's (shareholders') proportionate interest in the FSC will be exempt foreign trade income.)

FSC in the case of a sale, described in paragraph (b)(2)(iii)(A) of this section, of export property.

(2) <u>The "1.83 percent" gross receipts method</u> – Under the gross receipts method of pricing, described in section 925(a)(1), the transfer price for a sale by the related supplier to the FSC is the price as a result of which the profit derived by the FSC from the sale will not exceed 1.83 percent of the foreign trading gross receipts of the FSC derived from the sale of the export property. Pursuant to section 925(d), the amount of profit derived by the FSC under this method may not exceed twice the amount of profit determined under, at the related supplier's election, either the combined taxable income method of § 1.925(a)-1T(c)(3) or the marginal costing rules of § 1.925(b)-1T. For FSC taxable years beginning after December 31, 1986, if the related supplier elects to determine twice the profit determined under the combined taxable income method using the marginal costing rules, because of the no-loss rule of § 1.925(a)-1T(e)(1)(i), the profit that may be earned by the FSC is limited to 100% of the full costing combined taxable income as determined under § 1.925(a)-1T(c)(3) and (6). Interest or carrying charges with respect to the sale are not foreign trading gross receipts.

(3) <u>The "23 percent" combined taxable income method</u>. Under the combined taxable income method of pricing, described in section 925(a)(2), the transfer price for a sale by the related supplier to the FSC is the price as a result of which the profit derived by the FSC from the sale will not exceed 23 percent of the full costing combined taxable income (as defined in paragraph (c)(6) of this section) of the FSC and the related supplier attributable to the foreign trading gross receipts from such sale.

(4) <u>Section 482 method</u>. If the methods of paragraph (c)(2) and (3) of this section are inapplicable to a sale or if the related supplier does not choose to use them, the transfer price for a sale by the related supplier to the FSC is to be determined on the basis of the sales price actually charged but subject to the rules provided by section 482 and the regulations for that section and by § 1.925(a)-1T(a)(3)(ii).

The so-called administrative pricing rules, which consist of the gross receipts and combined taxable income (CTI) methods described above, are only available if the FSC (or another person acting under contract with the FSC) meets certain foreign economic process requirements. <u>See</u> I.R.C. § 925(a), (c) and Temp. Treas. Reg. § 1.925(a)-1T(b)(2)(ii). The legislative history of the administrative pricing provisions and their predecessor provisions under the Domestic International Sales Corporation (DISC) regime indicate that Congress intended that the administrative pricing rules would in all events be applied in a manner that would "prevent pricing at a loss to the related supplier." Report of the Senate Committee on Finance, Deficit Reduction Act of 1984, S. Prt. No. 98-169, 98th Cong., 2d Sess., Vol. I, 1, 649 (1984). <u>See</u> <u>also</u> H.R. Rep. No.

92-533, 92d Cong., 1st Sess. 1, 58 (1971), 1972-1 C.B. 498, 537 (similar intent re administrative pricing rules for DISCs); S. Rep. No. 92-437, 92d Cong., 1st Sess. 1, 90 (1971), 1972-1 C.B. 559, 618 (same).

FTGR includes the gross receipts of a FSC derived from the sale, exchange or other disposition of export property. I.R.C. § 924(a). Combined taxable income is the excess of the FTGR of the FSC from the sale over the total costs of the FSC and related supplier, including the related supplier's cost of goods sold and its and the FSC's noninventoriable costs that are related to the foreign trading gross receipts. Temp. Treas. Reg. 1.925(a)-1T(c)(6)(i).

For purposes of determining gross receipts and total costs of the FSC, Temp. Treas. Reg. §1.925(a)-1T(c)(6)(iii) provides, in pertinent part:

> (iii) Rules for determination of gross receipts and total costs.
>
> * * *
>
> (A) Subject to the provisions of subdivision (iii)(B) through (E) of this paragraph, the methods of accounting used by the FSC and related supplier to compute their taxable incomes will be accepted for purposes of determining the amounts of items of income and expense (including depreciation) and the taxable year for which those items are taken into account.
>
> (B) A FSC may, generally, choose any method of accounting permissible under section 446(c) and the regulations under that section. However, if a FSC is a member of a controlled group (as defined in section 927(d)(4) and § 1.924(a)-1T(h)), 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 the 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.

Temp. Treas. Reg. §1.925(a)-1T(e) provides, in pertinent part:

> (e) Special rules for applying paragraphs (c) and (d) of this section – (1) Limitation on FSC income ("no loss" rules). (i) If there is a combined loss on a transaction or group of transactions, a FSC may not earn a profit under either the combined taxable income method or the gross receipts method. Also, for FSC taxable years beginning after December 31, 1986, in applying the gross receipts method, the FSC's profit may not exceed 100% of full costing combined taxable income determined under the full costing method of § 1.925(a)-1T(c)(3) and (6).

> This rule prevents pricing at a loss to the related supplier. The related supplier may in all situations set a transfer price or rental payment or pay a commission in an amount that will allow the FSC to recover an amount not in excess of its costs, if any, even if to do so would create, or increase, a loss in the related supplier.

Income Tax Accounting Methods Provisions

Section 446(b) of the Code provides that "if the method of accounting used [by the taxpayer] does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."

Treas. Reg. § 1.451-1(a) provides that, under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. See also Treas. Reg. § 1.446-1(c)(1)(ii)(A). All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is received, whichever happens earliest. See Schlude v. Commissioner, 372 U.S. 128, 133 (1963); Rev. Rul. 84-31, 1984-1 C.B. 127.

Treas. Reg. §1.451-5(b)(1) provides:

> (1) In general. Advance payments must be included in income either –
>
> (i) In the taxable year of receipt; or
>
> (ii) Except as provided in paragraph (c) of this section.
>
> (a) In the taxable year in which properly accruable under the taxpayer's method of accounting for tax purposes if such method results in including advance payments in gross receipts no later than the time such advance payments are included in gross receipts for purposes of all of his reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes, or
>
> (b) If the taxpayer's method of accounting for purposes of such reports results in advance payments (or any portion of such payments) being included in gross receipts earlier than for tax purposes, in the taxable year in which includible in gross receipts pursuant to his method of accounting for purposes of such reports.

The exception in paragraph (c) does not apply in this case.

Treas. Reg. §1.461-1(a)(2) provides that under an accrual method of accounting, a liability is incurred and generally taken into account for Federal income tax purposes in the taxable year in which all the events have occurred that establish the fact of the

liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 461(h)(2)(B) of the Code provides that with respect to liabilities that require the taxpayer to provide property or services, economic performance occurs as the taxpayer provides such property or services.

Penalty Provisions

Section 6662 of the Code imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to, among other things: (1) negligence or disregard of rules or regulations, and (2) any substantial understatement of income tax. Treas. Reg. §1.6662-2(c) provides that there is no stacking of the accuracy-related penalty components. Thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is 20 percent (40% for gross valuation misstatements), even if that portion of the underpayment is attributable to more than one type of misconduct (e.g., negligence and substantial understatement).

Negligence and Disregard of Rules and Regulations

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. See I.R.C. §6662(c) and Treas. Reg. §1.6662-3(b)(1). Treas. Reg. §1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances.

A return position that has a reasonable basis is not attributable to negligence. Treas. Reg. §1.6662-3(c). A reasonable basis is a relatively high standard of tax reporting, significantly higher than not frivolous or not patently improper. Thus, the reasonable basis standard is not satisfied by a return position that is merely arguable or colorable. Conversely, under Treas. Reg. §1.6662-(3)(b)(3), a return position is reasonable where it is based on one or more of the authorities listed in Treas. Reg. §1.6662-4(d)(3)(iii), taking into account the relevance and persuasiveness of the authorities and subsequent developments, even if the position does not satisfy the substantial authority standard defined in Treas. Reg. §1.6662-4(d)(2). Furthermore, the reasonable cause and good faith exception in Treas. Reg. § 1.6664-4 may relieve the taxpayer from liability from the negligence penalty, even if the return position does not satisfy the reasonable basis standard. See Treas. Reg. §1.6662-3(b)(3).

"Disregard of rules and regulations" is defined by Treas. Reg. §1.6662-3(b)(2) and includes any careless, reckless, or intentional disregard of rules and regulations. A disregard of rules or regulations is “careless” if the taxpayer does not exercise reasonable diligence in determining the correctness of a position taken on its return that is contrary to the rule or regulation. A disregard is “reckless” if the taxpayer makes little or no effort

to determine whether a rule or regulation exists, under circumstances demonstrating a substantial deviation from the standard of conduct observed by a reasonable person. Additionally, disregard of the rules and regulations is “intentional” where the taxpayer has knowledge of the rule or regulation that it disregards. Treas. Reg. §1.6662-3(b)(2).

The term "rules and regulations" includes the provisions of the Internal Revenue Code, temporary or final Treasury regulations issued under the Code, and revenue rulings or notices issued by the Internal Revenue Service and published in the Internal Revenue Bulletin. Treas. Reg. §1.6662-3(b)(2).

Substantial Understatement

Section 6662(d)(1) provides that a 20% accuracy related penalty applies to any portion of an underpayment for which there is a substantial understatement of income tax. A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 for a corporation, other than an S corporation or a personal holding company). I.R.C. § 6662(d)(1).

Specific rules apply to the calculation of the understatement when any portion of the understatement arises from an item attributable to a tax shelter. For purposes of I.R.C. §6662(d)(2)(C), a tax shelter is a partnership or other entity, an investment plan or arrangement, or other plan or arrangement where a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of federal income tax. I.R.C. §6662(d)(2)(C)(iii). If a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the accuracy related penalty applies to the entire underpayment arising from the understatement, unless the reasonable cause and good faith exception applies. See I.R.C. §6662(d)(2)(C).

Exceptions to the Accuracy-Related Penalty

Section 6664(c) provides an exception, applicable to all types of taxpayers, to the imposition of any accuracy-related penalty if the taxpayer shows that there was reasonable cause and the taxpayer acted in good faith.

The determination of whether the taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all relevant facts and circumstances. See Treas. Reg. §1.6664-4(b)(1) and (f)(1). All relevant facts, including the nature of the tax investment, the complexity of the tax issues, issues of independence of a tax advisor, the competence of a tax advisor, the sophistication of the taxpayer, and the quality of an opinion, must be developed in order to determine whether the taxpayer was reasonable and acted in good faith.

Generally, the most important factor in determining whether the taxpayer has reasonable cause and acted in good faith is the extent of the taxpayer’s effort to assess the proper tax

liability. See Treas. Reg. § 1.6664-4(b)(1); see also Larson v. Commissioner, T.C. Memo. 2002-295.

Reliance upon a tax opinion provided by a professional tax advisor may serve as a basis for the reasonable cause and good faith exception to the accuracy-related penalty. The reliance, however, must be objectively reasonable. Treas. Reg. §1.6664-4(c). The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. Treas. Reg. §1.6664-4(c).

The fact that a taxpayer consulted an independent tax advisor is not, standing alone, conclusive evidence of reasonable cause and good faith if additional facts suggest that the advice obtained is not dependable. Edwards v. Commissioner, T.C. Memo. 2002-169; Spears v. Commissioner, T.C. Memo. 1996-341, aff'd, 131 F.3d 131 (2d Cir. 1997). For example, a taxpayer may not rely on an independent tax advisor if the taxpayer knew or should have known that the tax advisor lacked sufficient expertise, the taxpayer did not provide the advisor with all necessary information, the information the advisor was provided was not accurate, or the taxpayer knew or had reason to know that the transaction was "too good to be true." Baldwin v. Commissioner, T.C. Memo. 2002-162; Spears v. Commissioner, T.C. Memo. 1996-341, aff'd, 131 F.3d 131 (2d Cir. 1997).

ANALYSIS:

Issue 1: Taxpayer's Method of Accounting for the Advance Payment Transaction Results in a Material Distortion of Income

As a threshold matter, the method of accounting used by a FSC and its related supplier must be valid under general income tax principles. See Temp. Treas. Reg. §1.925(a)-1T(c)(6)(iii). A FSC and its related supplier may "generally" use any method of accounting that accords with I.R.C. § 446(c) and the regulations under that section. Taxpayer's method of accounting for the Advance Payment Transaction qualifies as a valid method under I.R.C. §446(b). Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(B). See also Temp. Treas. Reg. §1.925(a)-1T(d)(2)(ii). A method of accounting that otherwise constitutes a valid method of accounting for general Federal income tax purposes may nonetheless, in some cases, be subject to adjustment by the Service pursuant to Temp. Treas. Reg. §1.925(a)-1T(c)(6)(iii), if it materially distorts the income of the FSC, or if it fails to clearly reflect the income of the FSC and the related-supplier.

A buy-sell FSC or a commission FSC, which may lack a distinct method of accounting for items of expense or income that are necessary to compute CTI, is in effect bound by the method of accounting used by the related supplier for purposes of computing the transfer price or the FSC commission, respectively. In the present case, the method of accounting applied by Taxpayer (the related supplier) to the Advance Payment Transaction constitutes a "method of accounting of the FSC" within the meaning of Temp. Treas. Reg. §1.925(a)-1T(c)(6)(iii)(B) and that method is therefore subject to the "clear reflection of income" standard of I.R.C. §446(b), as well as the prohibition in

Temp. Treas. Reg. §1.925(a)-1T(c)(6)(iii)(B) against "material distortion" of the income of the FSC and the related supplier. Thus, the related supplier's method of accounting must clearly reflect the income of both the related supplier and the FSC from export transactions. In other words, the related supplier's method of accounting must provide an accurate measure of the profit generated from the FSC's transactions, by reasonably matching the revenue from such transactions against the related costs.

Taxpayer uses a permissible accrual method of accounting. Taxpayer's inclusion in income of the advance payments when they were received in Tax Year 1 follows the general rule under Treas. Reg. §§1.451-1(a) and 1.451-5(b)(1) that advance payments should be included in gross income in the year of receipt. Similarly, Taxpayer's deduction in Year 2 of costs associated with producing and providing the products covered by the advance payment contracts follows the general rule under I.R.C. §461 that a liability is not incurred until economic performance has occurred. In the Advance Payment Transaction, economic performance occurred in Year 2, when the products were delivered.

Although Taxpayer's method of accounting for the Advance Payment Transaction otherwise qualifies as a valid method under general Federal income tax accounting principles, it nonetheless violates the additional requirement under Temp. Treas. Reg. §1.925(a)-1T(c)(6)(iii)(B) that it not result in a material distortion of the income of Taxpayer-FSC or any other member of the Taxpayer Group. Because Taxpayer's method of accounting for the Advance Payment Transaction separates the income and deductions over two years, CTI cannot be accurately reflected in either Tax Year 1 or Tax Year 2. As a result, the income of both Taxpayer and Taxpayer-FSC with respect to the Advance Payment Transaction is materially distorted.

CTI is defined as the FTGR less the total costs of the FSC and related supplier that are related to the FTGR. Temp. Treas. Reg. §1.925(a)-1T(c)(6)(i). Viewing the Advance Payment Transaction as an integrated transaction, the FTGR with respect to the overall transaction should be equal to the advance payments received from F Subs and the CTI should be the FTGR less total costs. After application of the administrative pricing rules under Temp. Treas. Reg. §1.925(a)-1T(c), the foreign trade income of Taxpayer-FSC, 15/23 of which is exempt income pursuant to I.R.C. §923(a), should be limited to the greater of: (1) 1.83% of FTGR (but not more than 46% of CTI) or (2) 23% of CTI; in this case 23% of CTI.

In Tax Year 1, Taxpayer's calculation overstates CTI because it does not take into account the total costs related to the FTGR. In particular, Taxpayer's cost of goods sold is not taken into account because it is deferred until Tax Year 2. Applying the administrative pricing rules to this overstated CTI alone would cause a distortion by overstating FSC foreign trade income, but Taxpayer's method of accounting also causes an additional distortion in the calculation of Taxpayer-FSC's foreign trade income. Following the administrative pricing rules, Taxpayer calculated a transfer price that when deducted from CTI should result in foreign trade income of Taxpayer-FSC in Tax Year 1 equal to 23% of the CTI as calculated by Taxpayer. However, because Taxpayer-FSC

deferred its deduction of the transfer price until Tax Year 2, the foreign trade income reported by Taxpayer-FSC in Tax Year 1 consisted not of 23%, but rather 100%, of CTI. The result of these distortions in Tax Year 1 is that the amount of foreign trade income reported by Taxpayer-FSC, which should be equal to 23% of the combined taxable income of Taxpayer and Taxpayer-FSC, is instead 100% of that amount, or of an amount that correlates approximately to the gross receipts from the transaction. Taxpayer-FSC's foreign trade income in Tax Year 1 is therefore overstated.

This result conflicts with the purpose and structure of the administrative pricing rules provided for in I.R.C. §925 and the regulations under that provision. The administrative pricing rules, including rules not directly relevant here that under certain circumstances permit CTI to be calculated by reference to marginal costs, are intended to prevent an excessive amount of profit from being allocated to a FSC. Generally speaking, the appropriate amount of profit that can be allocated to the FSC is capped at the higher of 1.83% of FTGR (not to exceed 46% of CTI), or 23% of CTI. I.R.C. § 925(a), (d). Taxpayer's accounting method, in contrast, allocates nearly 100% of FTGR to the FSC as profit.

In Tax Year 2, Taxpayer's calculation understates CTI. As stated above, CTI is equal to FTGR less total related costs. Whereas in Tax Year 1, CTI is overstated because the calculation failed to include the total costs, in Tax Year 2, a loss is created because the calculation takes into account the costs but includes no FTGR. Although it is clear that, viewed on an integrated basis, the Advance Payment Transaction generates income, Taxpayer's method of accounting in effect treats the Advance Payment Transaction as two distinct transactions: a gain transaction in Tax Year 1 and a loss transaction in Tax Year 2. Taxpayer then asserts that the "no loss" rule of Temp. Treas. Reg. § 1.925(a)-1T(e)(1)(i) permits it to set a transfer price in Year 2 that will permit Taxpayer-FSC to recover its costs in that year. Taxpayer in effect establishes a "negative" transfer price, whereby it makes a payment to Taxpayer-FSC to reimburse it for its deduction in Year 2 of its costs of goods sold. As a result, Taxpayer-FSC's deduction for its costs of goods sold in Tax Year 2, which should properly have offset FSC foreign trade income in Tax Year 1, subject to a reduced rate of tax on account of the 15/23 exemption, instead generates a tax benefit in Tax Year 2 for Taxpayer at the full 35% tax rate applicable to domestic corporations.

In light of the distortions of income in both Tax Year 1 and Tax Year 2 described above, although Taxpayer's method of accounting otherwise qualifies as a valid method under I.R.C. §446 for general Federal income tax accounting purposes, Taxpayer's method of accounting is impermissible for purposes of calculating CTI and FSC foreign trade income under Temp. Treas. Reg. §1.925(a)-1T(c)(6)(iii).

Issue 2: Taxpayer's Reimbursement Payment is not a Correct Application of the "No Loss" Rule

In the unlikely event that Taxpayer's method of accounting for the Advance Payment Transaction satisfies the "material distortion of income" standard under Temp. Treas.

Reg. §1.925(a)-1T(c)(6)(iii)(B), Taxpayer's interpretation of the "no loss" rule under Temp. Treas. Reg. §1.925(a)-1T(e)(1)(i) is unsupported and accordingly the reimbursement payment by Taxpayer to Taxpayer-FSC in Tax Year 2 should be disallowed.

In accordance with congressional intent, the "no loss" rule is intended to prevent pricing at a loss to the related supplier in most circumstances. Temp. Treas. Reg. §1.925(a)-1T(e)(1) and Report of the Senate Committee on Finance, Deficit Reduction Act of 1984, S. Prt. No. 98-169, 98th Cong., 2d Sess. Vol. I, 649 (1984). This rule provides that where a particular transaction or grouping of transactions yields a combined loss (as opposed to combined taxable income), the administrative pricing rules may not be used to create a profit in the FSC. The "no loss" rule is intended to prevent use of the administrative pricing rules to allocate income to a FSC inappropriately, at the expense of its related supplier. A limited exception to the "no loss" rule applies. The related supplier may set a transfer price in an amount that will allow the FSC to recover its costs associated with the sale, even if doing so would create or increase a loss in the related supplier. Temp. Treas. Reg. §1.925(a)-1T(e)(1)(i).

A simple example of the application of the "no loss" rule is as follows: assume FTGR of $1000, related supplier's cost of goods sold of $900, and FSC expenses of $150. The general "no loss" rule provides that because there is an overall loss of $50 on the transaction ($1000, gross receipts, less $900 of related-supplier costs, less $150 of FSC expenses), the FSC may not earn a profit through application of the administrative pricing rules. However, the exception to the rule permits the related supplier to set a transfer price of $850, which when subtracted from the gross receipts of $1000 allows the FSC net proceeds of $150, which is sufficient to cover its expenses. This result is permitted even though it "creates" a loss to the related supplier of $50 ($850, amount received from FSC, less $900, costs of goods sold). See generally Temp. Treas. Reg. § 1.925(a)-1T(f), Example 9.

Taxpayer's application of the "no loss" rule to the Advance Payment Transaction conflicts with the general rule as well as the exception. First, the sale of products from Taxpayer to Taxpayer-FSC and from Taxpayer-FSC to F-Subs constitutes a single FSC transaction that generated a gain. The "no loss" rule does not apply to gain transactions. Taxpayer generates a loss by bifurcating the transaction into a gain transaction in Tax Year 1 and a separate loss transaction in Tax Year 2. In the unlikely event that the bifurcation of the transaction clearly reflects income (see Issue 1, above), it does not change the fact that the transaction generated an economic gain, thus rendering the "no loss" rule inapplicable.

Second, by setting one transfer price in Tax Year 1 and then setting a second transfer price in Tax Year 2 in the form of a reimbursement of the same amount, Taxpayer in effect calculated two distinct transfer prices for a single transfer of products between Taxpayer and Taxpayer-FSC. In addition, when these two transfer prices are combined, they fully offset one another. As a result, Taxpayer-FSC pays nothing for the products it receives from Taxpayer, even though it realizes a profit on the overall transaction.

Third, the reimbursement to Taxpayer-FSC in Tax Year 2 pertains to costs that are not properly subject to the "no loss" rule. Pursuant to the "no loss" rule, a related supplier may set a transfer price that allows the FSC to recover its costs. Such costs do not include the cost of paying the transfer price itself. Setting a transfer price that allocates income from a related supplier to a FSC in order to cover the cost of FSC's payment of the transfer price to the related supplier would be a meaningless circular flow of cash. The only Taxpayer-FSC's "cost" in Tax Year 2 that is covered by the negative transfer price, or reimbursement payment, consists of its payment of the transfer price that was set in Tax Year 1. The net result is a circular flow of cash: Taxpayer-FSC pays Taxpayer a transfer price in Tax Year 1 and an equal amount is paid back by Taxpayer in Tax Year 2.

The reimbursement payment in Tax Year 2 is based on an incorrect application of the "no loss" rule. The allocation of excessive income to Taxpayer-FSC and the corresponding creation of a loss for Taxpayer is in fact the type of result that the "no loss" rule was designed to prevent. Therefore, even if Taxpayer's accounting method for the Advance Payment Transaction were otherwise permissible, i.e., if that method did not materially distort income, the Tax Year 2 reimbursement payment should be disallowed.

Note that even without the reimbursement payment, the net tax payable is still less than the net taxable payable without the Advance Payment Transaction.

Issue 3: The Accuracy-related Penalty Pursuant to IRC § 6662(a) and Treas. Reg. §1.6662-3 Shall be Asserted if Taxpayer Engaged in the FSC Advance Payment Transaction and Has not Filed a Disclosure Under IRS Announcement 2002-2.

Taxpayer's treatment of the advance payment transaction is attributable to negligence or disregard of rules or regulations as defined in Treas. Reg. §1.6662-3(b) for failure to make a reasonable attempt to comply with the Internal Revenue Regulations or to exercise ordinary and reasonable care in the preparation of its tax return. In particular, Taxpayer failed to make a reasonable attempt to ascertain the correctness of the tax treatment of the advance payment transaction. The tax treatment of the advance payment transaction would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. This penalty cannot be avoided because Taxpayer did not have a reasonable basis (as defined in Treas. Reg. §1.6662-3(b)(3)) for its position.
In addition this penalty applies because of Taxpayer's careless or reckless disregard of rules and regulations as defined above. Taxpayer cannot avoid the penalty for adequate disclosure under Treas. Reg. §1.6662-3 (c) because it did not have a reasonable basis and also because the position taken on the return was attributable to a tax shelter arrangement. Treas. Reg. §1.6662-4(e) and 1.6662-4(g)(2).

On the assumption that Taxpayer's understatement of income tax will exceed the statutory limits (10% or $10,000 for a corporation), the substantial understatement penalty, as described in I.R.C. §6662(d), should apply in the alternative. Because the purpose of the FSC Advance Payment Transaction is tax avoidance, it is a tax shelter

pursuant to I.R.C. §6662(d)(2)(C) and the calculation rules thereunder should be applied. As previously stated, even if both the negligence and substantial understatement penalties apply, the maximum penalty that may be imposed is 20% of the understatement (or 40% for gross valuation misstatements).

It is unlikely that Taxpayer will qualify for the reasonable cause and good faith exception to the accuracy penalties as described in I.R.C. §6664(c) and Treas. Reg. §1.6664-4. Although Taxpayer relied on the advice of an independent tax advisor, in this case such reliance was not reasonable. Taxpayer, as a large, sophisticated, corporate taxpayer, either knew or had reason to know that the transaction was "too good to be true."

On December 21, 2001, the Service issued Announcement 2002-2, which waives the above penalties if Taxpayer disclosed tax shelter and other questionable transactions. Under that Announcement, disclosure had to be made by April 23, 2002. Therefore, if Taxpayer failed to disclose the shelter, or transactions substantially similar to the shelter, the accuracy-related penalty pursuant to section 6662(b)(1) should be asserted. If however, Taxpayer made a timely disclosure under Announcement 2002-2, no accuracy-related penalty should be asserted.

APPENDIX- Examples of Audit Applications and Alternative Position

Example of Taxpayer's Reporting of the Transaction
(See Facts in Attached Issue Write-Up)

Year 1

Taxpayer (1120)		Taxpayer-FSC (1120 FSC)	
Advance Payment from Taxpayer- FSC	$77	Advance Payment from Foreign Subs	$100
	-----		-----
Taxable Income	$77	Taxable Income	$100
	===		===
		(8/23 Taxable)	
		(15/23 Exempt)	

Year 2

Taxpayer (1120)		Taxpayer-FSC (1120 FSC)	
Cost to Manufacture Products	($55)	Cost of Sales (Transfer Price to Supplier	($77)
Reimbursement of FSC's Loss	($77)	Reimbursement from Supplier	77
	--------		-------
Taxable Income	($132)	Taxable Income	-0-
	=====		=====

Government's Position and Adjustments

1. Primary Position – Distortion of Income and Misapplication of the "No Loss" Rule

   a) In order to resolve the distortion of income issue at the Examination level, Taxpayer will be allowed to make a one-time-only, retroactive change in accounting method. If Taxpayer elects to defer reporting of the advance payments until Year 2, and the issue is "agreed" in Exam, FSC benefits essentially equivalent to those that Taxpayer would have received without use of the advance payment scheme will be allowed in Year 2. When the advance payments are deferred, the issue of whether the "no loss" rule was misapplied disappears, because there is no longer a "loss" in Year 2 that could be reimbursed.

   This would represent a change in accounting for purposes of I.R.C. §925(a) and Temp. Treas. Reg. §1.925(a) –1T(c)(6)(iii)(B) only.

   Exam will secure Taxpayer's election on Form 3115 (Application for Change in Accounting Method) and retain it in the work paper files.

   This election will only be valid if secured in Exam prior to case closing.

Audit Adjustments: If T/P Elects to Defer Reporting of Advance Payments to Year 2

Year 1

Taxpayer (1120)		Taxpayer-FSC (1120-FSC)	
Advance Payment from Taxpayer-FSC	($77)	Advance Payment from Foreign Subs	($100)
	-------		-------
Decrease in TI	($77)	Decrease in TI	($100)
	=====		====
		(8/23 Taxable)	
		(15/23 Exempt)	

Year 2

CTI Computation

Export Sales	$100
Cost of Sales	55

CTI	$ 45
	=====

FSC Profit: $45 x 23% = $10
=====

Computation of Transfer Price

FSC Sales	$100
FSC Profit	10

Transfer Price	$ 90
	====

Computation of Adjustment

Taxpayer (1120)		Taxpayer- FSC (1120 FSC)	
Sales to FSC	$ 90	Export Sales	$100
Cost of Sales (already deducted)	-0-	Cost of Sales	(90)
		Reversal of Cost of Sales	77
Disallowance of Loss Reimbursement	77	Reversal of Loss Reimbursement	(77)
	-------		-------
Increase in TI	$167	Increase in TI	$ 10
	=====		=====

b) If Taxpayer does not elect to defer reporting of the advance payments until Year 2, the FSC benefits allowed on the advance payment transactions in either year will be limited through the application of I.R.C. §482 and by disallowing Taxpayer's application of the "no loss" rule.

Taxpayer and Taxpayer-FSC are using a method of accounting which is impermissible under I.R.C. §925(a) and Temp. Treas. Reg. §1.925(a) – 1T(c)(6)(iii)(B) because it distorts the income of both the FSC and related supplier for purposes of computing combined taxable income. Therefore, the administrative pricing methods of I.R.C. §925(a) and Temp. Treas. Reg. §1.925(a)-1T(c) cannot be used. Taxpayer is limited to using the rules of I.R.C. §482 (i.e., the arm's length standard) to compute the transfer price and accordingly, the allowable income to be earned by the FSC. Typically, the activities of the FSC (functions performed, assets employed, risks assumed, etc.) would not entitle the FSC to earn more than a de minimis amount of income from the transactions. Taxpayer may affirmatively assert otherwise. The following hypothetical adjustment assumes that Taxpayer has not made such a showing.

In addition, Taxpayer incorrectly applied the transfer pricing formula "no loss" rule in Temp. Treas. Reg. §1.925(a)-1T(e)(1)(i). The loss reimbursement in Year 2 is therefore disallowed.

Audit Adjustments: If T/P does not elect to defer Reporting of the Advance Payments

Computation of CTI – Year 1

Export Sales by Taxpayer-FSC	$100
Costs	-0-

CTI	$100
	====

Under the rules of I.R.C. §482, assuming Taxpayer has not demonstrated that substantial activities were performed by the FSC, the FSC is not entitled to any income:

FSC's Share	-0-
	====

Computation of Transfer Price – Year 1

Taxpayer- FSC Receipts	$100
Taxpayer- FSC Profit	-0-

Transfer Price	$100
	====

Year 1 Adjustments

Taxpayer (1120)

Transfer Price From Taxpayer- FSC	$100
Advance Payment Reported	(77)

Increase in TI	$23
	=====

Taxpayer-FSC (1120-FSC)

No Change

Year 2 Adjustments

Taxpayer (1120)

Disallowance of FSC Reimbursement	$77
Cost of Goods Sold (already deducted)	-0-

Increase in TI	$77
	=====

Taxpayer-FSC (1120 FSC)

Reversal of Loss Reimbursement	($77)
Cost of Goods Sold	(100)
Reversal of Cost of Goods Deducted	77

Decrease in TI	($100)
	=====

2. **Alternative Position** – Misapplication of the "No Loss" Rule

This issue shall be raised on all cases as an alternative issue pursuant to IRM 4.60.9.5.

Taxpayer incorrectly applied the transfer pricing formula "no loss" rule in Temp. Treas. Reg. §1.925(a)-1T(e)(1)(i). The loss reimbursement in Year 2 is disallowed.

Alternative Audit Adjustments: Deny T/P's Application of the "No Loss" Rule

Computation of CTI

FSC Receipts	$100
Costs	-0-

CTI	$100
	====

FSC Profit	
$100 x 23% =	$ 23
	====

Computation of Transfer Price

FSC Receipts	$100
FSC Profit	23

Transfer Price	$ 77
	====

Year 1 Adjustments

Taxpayer (1120)	Taxpayer-FSC (1120FSC)
No Change	No Change

Year 2 Adjustments

Taxpayer (1120)		Taxpayer-FSC (1120FSC)	
Reimbursement of Loss	$77	Reimbursement of Loss	($77)
	------		-------
Increase in TI	$77	Decrease in TI	($77)
	====		=====