DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

Number: **200010027**
Release Date: 3/10/2000
TL-N-3915-99
CC:INTL:6
UILC: 925.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATED: December 8, 1999

MEMORANDUM FOR:

FROM: Elizabeth G. Beck
Senior Technical Reviewer
CC:INTL:6

SUBJECT:

This Field Service Advice responds to your memorandum dated October 25, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

US Corp. =
FSC1 =
Date A =
Date B =
Tax Year A =

FACTS:

USCorp. is a domestic corporation, and FSC1 is a wholly-owned subsidiary that elected to be treated as a foreign sales corporation (FSC) pursuant to I.R.C. §§ 922(a)(2) and 927(f)(1). USCorp. pays a commission to FSC1 for goods exported by it, and claimed a deduction on its Tax Year A income tax return (Form 1120) for such commissions. With respect to Tax Year A, the refund and assessment statutes of limitation applicable to FSC1 will expire on Date A, and the assessment and refund

statutes of limitation applicable to the related supplier (USCorp.) will expire on Date B (six months after Date A). The Examination team believes that it will have insufficient time to complete its examination of the FSC-commission deductions claimed by USCorp. before the period of limitations applicable to FSC1 expires on Date A. The Service has on several occasions requested FSC1 to execute a consent to extend the period of limitations for assessment of tax (Form 872), but FSC1 has declined to do so. Therefore, guidance is requested regarding the ability of the Service to adjust the related supplier's FSC commission deduction after the period of limitations applicable to FSC1 expires on Date A.

ISSUE:

Whether the Service may adjust the FSC-commission deduction of a related supplier where the assessment period of limitations applicable to the related supplier is open, but the assessment and refund periods of limitations applicable to the FSC have previously expired.

CONCLUSION:

Neither the "dual refund statute of limitations" nor the "shall affect" requirements contained in Temp. Treas. Reg. § 1.925(a)-1T(e)(4) apply to FSC redeterminations initiated by the Commissioner. The only substantive limitation applicable to such redeterminations is that the assessment period of limitations must be open for the party that is subject to the primary adjustment.

LAW AND ANALYSIS:

A FSC and its related supplier (collectively, Taxpayers) may determine the transfer price for merchandise exported by the FSC (or the commission payable, in the case of a commission-FSC) by reference to "administrative pricing rules," or, under certain circumstances, by reference to section 482. See I.R.C. § 925(a). Where applicable, the FSC administrative pricing rules eliminate the need for difficult, case-by-case determinations of arm's length transfer prices for transactions between the related supplier and the FSC:

> Congress intended that the pricing principles that govern the determination of the taxable income of a FSC comply with the GATT rules. If export property is sold to a FSC by a related person (or a commission is paid by a related principal to a FSC with respect to export property), the taxable income of the FSC and related person is based upon a transfer price determined under an arm's length pricing approach or under one of two formulae which are intended to approximate arm's length pricing.

Staff of Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 1054 (1984) (General Explanation) (emphasis added). Substantially identical considerations were present under the predecessor Domestic International Sales Corporation (DISC) regime. See H.R. Rep. No. 533, 92d Cong., 1st Sess. 1, 58 (1971), reprinted in 1972-1 C.B. 498, 529; S. Rep. No. 437, 92d Cong., 1st Sess. 1, 90 (1971), reprinted in 1972-1 C.B. 559, 609.

The administrative pricing rules are applicable only if the FSC satisfies certain foreign economic process requirements in section 925(c). In such cases, section 925(a) and Temp. Treas. Reg. § 1.925(a)-1T allow Taxpayers to apply, at their option, either of two administrative pricing methods, in order to report the greatest amount of taxable income attributable to the FSC. See generally St. Jude Medical, Inc. v. Commissioner, 34 F.3d 1394, 1397 (8th Cir. 1994). Consistent with the goal of maximizing income attributable to the FSC, Taxpayers may change from one administrative pricing method to another, or to make other specified changes, after the income tax returns of the FSC and the related supplier for a given year have been filed. Temp. Treas. Reg. § 1.925(a)-1T(e)(4).

The Commissioner may challenge FSC transactions based on the results of an examination, but he may not alter the pricing method selected by Taxpayers, nor may he modify the Taxpayers' transaction-grouping methodology (if any), unless that methodology constitutes an improper grouping. Id. Changes, on the part of either Taxpayers or the Commissioner, to the FSC income as originally reported, are commonly referred to as "FSC redeterminations."

Because the amount of income reported by the FSC is directly related to the amount of income reported by the related supplier, a FSC redetermination affects the taxable income of both entities. Generally, a Taxpayer-initiated FSC redetermination results in an increase in the income of the FSC (requiring payment of additional tax by the FSC) and a corresponding decrease in the income of the related supplier (generating a refund of tax for the related supplier). A Service-initiated FSC redetermination generally has the opposite effects on income (i.e., increase in income of related supplier, reduction of income of FSC) and tax liability (i.e., additional tax to related supplier, refund to FSC).

As noted above, the administrative pricing rules serve as a substitute for the transfer pricing rules of section 482, which would otherwise apply to transactions between controlled parties (including a related supplier and its wholly-owned FSC subsidiary). Consequently, except as specifically provided to the contrary, a FSC redetermination is subject to the same constraints and procedural limitations as would apply to a redetermination pursuant to section 482.

Under section 482, the Service possesses broad authority to re-allocate a taxpayer's income or deductions. Thus, for example, the Service may allocate income

or deductions among controlled parties, regardless of whether it is possible to make correlative or compensating adjustments. Expiration of the statute of limitations applicable to a party subject to a correlative adjustment generally does not bar the Commissioner from making a primary section 482 adjustment with respect to the another party as to which the statute of limitations remains open.

In contrast, the ability of taxpayers affirmatively to apply section 482 is narrowly circumscribed. For example, only since 1994 have taxpayers been permitted to apply section 482 sua sponte, and then only on a timely-filed tax return to claim a decrease in tax for the tax year in question. See Treas. Reg. § 1.482-1(a)(3). Generally, applications of section 482 by taxpayers with respect to prior tax years are barred. See generally Rev. Proc. 99-32, 1999-34 I.R.B. 296.

Consistent with these general principles, the temporary regulations provide detailed rules governing FSC redeterminations. The temporary regulation applicable to tax years beginning before January 1, 1998, states as follows:

> (4) *Subsequent determination of transfer price, rental income or commission.* The FSC and its related supplier would ordinarily determine under section 925 and this section the transfer price or rental payment payable by the FSC or the commission payable to the FSC for a transaction before the FSC files its return for the taxable year of the transaction. After the FSC has filed its return, a redetermination of those amounts by the **Commissioner** may only be made if specifically permitted by a Code provision or regulations under the Code. Such a redetermination would include a redetermination by reason of an adjustment under section 482 and the regulations under that section or section 861 and § 1.861-8 which affects the amounts which entered into the determination. In addition, a redetermination may be made by the **FSC and related supplier** if their taxable years are still open under the statute of limitations for making claims for refund under section 6511 if they determine that a different transfer pricing method or grouping of transactions may be more beneficial. Also, the **FSC and related supplier** may redetermine the amount of foreign trading gross receipts and the amount of the costs and expenses that are used to determine the FSC's and related supplier's profits under the transfer pricing methods. Any redetermination shall affect both the **FSC and the related supplier**. The **FSC and the related supplier** may not redetermine that the FSC was operating as a commission FSC rather than a buy-sell FSC, and vice versa.

Temp. Treas. Reg. § 1.925(a)-1T(e)(4) (emphasis and highlights added).

The temporary regulation affords the Commissioner essentially the same broad-based authority to redetermine FSC income as he possesses to redetermine income under section 482. In contrast, Taxpayers' authority to make FSC redeterminations, although substantially broader than that in the section 482 context, is subject to constraints. We do not believe that these constraints apply, expressly or by implication, to FSC redeterminations initiated by the Commissioner.

First, Taxpayers may redetermine FSC income only if the applicable refund statutes of limitations for both the FSC and the related supplier are open. Temp. Treas. Reg. § 1.925(a)-1T(e)(4). The Tax Court specifically upheld this requirement in Union Carbide:

> [T]he fact that the Regulation utilizes section 6511 as a point of reference, even though any commission expense redetermination automatically places one of the taxpayers (either the FSC or the related supplier) in a deficiency position, does not effect an absurd or nonsensical result in our judgment. [Citation omitted]. The dual section 6511 requirement simply specifies an uncomplicated timeframe within which the taxpayer seeking an additional deduction must act, nothing more.

100 T.C. at 387.

Second, Taxpayers may redetermine FSC income only if the resulting redetermination will "affect" both the FSC and the related supplier. Temp. Treas. Reg. § 1.925(a)-1T(e)(4). Assuming that the "dual refund statute of limitations" requirement (above) is satisfied, the "shall affect" requirement mandates that the assessment statute of limitations be open for the party that is placed in a deficiency position by the FSC redetermination -- generally the FSC in Taxpayer-initiated redeterminations. The "shall affect" requirement thus ensures that the Service is able to collect any additional tax due as a result of the FSC redetermination.

The structure, plain meaning, and context of the temporary regulation indicate that the "dual refund statute of limitations" requirement and the "shall affect" requirement apply only to FSC redeterminations initiated by Taxpayers. The temporary regulation is structured so that all of the Taxpayer-initiated provisions are grouped together after the Commissioner-initiated provisions. The "dual refund" requirement provides an "uncomplicated timeframe" within which Taxpayers must make FSC redeterminations. Union Carbide, 110 T.C. at 387. Such guidance is superfluous in the case of a FSC redetemination initiated by the Commissioner, given that the primary adjustment is, by definition, one "permitted by the Code or regulations." Temp. Treas. Reg. § 1.925(a)-1T(e)(4). The "shall affect" requirement prevents "whipsaw" results, by protecting the Service's ability to collect additional tax resulting from the FSC redetermination. Again, such a requirement is superfluous in the context of a

Commissioner-initiated FSC redetermination, as the assessment statute is by definition open with respect to the party subject to the adjustment of income.

In the present case, the Service's examination-based adjustment of USCorp.'s FSC commission deduction will have a correlative effect on FSC1's income. In this context, however, the imminent expiration of the assessment and refund statutes of limitation applicable to FSC1 does not prevent the Service from adjusting the income of USCorp., provided that the Service acts before the expiration of the statute of limitations applicable to USCorp. (i.e., Date B). For the reasons described above, we believe that the "dual-refund" requirement in the temporary regulation does not apply to FSC redeterminations initiated by the Commissioner.

If, as is likely, the Service's examination-based adjustment reduces USCorp.'s FSC commission deduction, FSC1 will have less commission income than originally reported, and will therefore have a claim for refund of tax. Any refund claim by FSC1 will be untimely if the refund statute of limitations applicable to FSC1 has previously expired. In that case, the FSC redetermination would fail to "affect" FSC1. However, as discussed above, we believe that the "shall affect" requirement does not apply to FSC redeterminations initiated by the Commissioner. Thus, that requirement does not prevent the Commissioner from making the FSC redetermination contemplated in this case.

In this case, FSC1 has refused to execute a consent to extend the period of limitations for assessment (Form 872). We do not believe that Temp. Treas. Reg. § 1.925(a)-1T(e)(4) should be interpreted as allowing taxpayers to limit the options available to the Service by refusing to sign consents. In any event, FSC1 can readily prevent any hardship that may result from an examination-based adjustment to its related supplier, by executing a consent to extend the period of limitations applicable to it.

In summary, we recommend that, prior to Date B, Examination perform any necessary adjustments with respect to the FSC commission deductions of USCorp. Clearly, if possible, it would be preferable to obtain an extension of the statute of limitations applicable to FSC1 to a date beyond Date B. However, assuming that FSC1 continues to decline to execute such an extension, we believe that the Commissioner is not barred from adjusting the FSC commission deduction of USCorp. based on the results of examination.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

If you have any additional questions, please call Branch 6 at (202) 874-1490.

ELIZABETH G. BECK
Senior Technical Reviewer
Branch 6