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

CC:INTL:Br6

UILC: 924.01-00

Number: **199918026**
Release Date: 5/7/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE: January 29, 1999

MEMORANDUM TO:

FROM: JACOB FELDMAN
FIELD SERVICE SPECIAL COUNSEL CC:INTL

SUBJECT:

This Field Service Advice responds to your memorandum dated July 30, 1998. 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:

Agency A =

Corp A =
Corp B =
Corp C =
Corp D =

Country A =
Country B =

Date 1 =

Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =

Division A =

FSC =

Location A =

Official A =

Organization A =

Product A =

Product Type A =

Prototype A =
Prototype B =

Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =

x =
y =

ISSUE:

Whether, on the facts presented, sales of Product A to the United States Government by taxpayer Corp A through FSC generated foreign trading gross receipts within the meaning of section 924 of the Code.

CONCLUSION:

Sales of Product A by Corp A to the United States Government for its own use did not generate foreign trading gross receipts within the meaning of section 924 because the Government was required by law or regulation to purchase products manufactured in the United States within the meaning of section 924(f)(1)(A)(ii) and Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i). On the facts presented, the exception for

international competitive bidding under Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(iii)(B) was inapplicable.

FACTS:

In Year 1, Agency A, an instrumentality of the United States Government, held a bidding conference to implement an effort to develop and manufacture a new prototype Product Type A, ultimately to be named Product A. Nearly x companies, all domestic, attended the bidding conference. Ultimately only two bids were submitted, one from Corp B's Product Type A division and the other from Corp C. Corp B and Corp C were domestic corporations engaged in the business of manufacturing Product Type A. In Date 1, Agency A awarded development contracts to each of the bidders, with the understanding that the resulting experimental prototype equipment (named Prototype A) would be compared and the superior prototype selected for further production.

In Date 2, the United States and Country A, a foreign country, executed a Memorandum of Understanding (MOU) intended to advance the standardization of Product Type A engineering among members of Organization A. The MOU provided that a Country A prototype being developed, Prototype B, would be given an opportunity to be tested against the Corp B's and Corp C's Prototype A upon completion, with the selected Prototype A to serve as the uniform design for Product Type A built for both countries (amended by Year 2 protocol to standardize only logistically critical elements). With funds provided in part by Country A, Corp D, a Country A company, proceeded to develop and build Prototype B.

Comparative testing of the Corp B and Corp C prototypes was conducted at Location A in the spring of Year 2. The Corp B prototype prevailed. Several months later the Country A Prototype B was tested against the Corp A Prototype A. The Prototype B entry was managed by a domestic corporation to which Agency A awarded a contract to determine the cost of production in the United States should Prototype B be selected as the new design for Product A. It was soon discovered, however, that Prototype B failed to comply with critical specifications. Corp D and Country A withdrew from consideration.

Corp B, as the prevailing and only remaining contestant, was selected for the second phase, which involved a pre-production contract to build y Product A prototypes. Subsequently, Corp B and its successors were awarded full production contracts to manufacture Product A in the United States for sale to Agency A. Corp A acquired the Corp B Product Type A division in Date 3 and renamed it Division A. Corp A continues to manufacture Product A in the United states for Agency A to the present day.

It is undisputed that, apart from the preliminary development stage involving the testing of experimental prototypes (including Corp D's short-lived entry of Prototype

B), the history of Product A has never involved any competition, domestic or foreign.

FSC is a wholly-owned foreign subsidiary of Corp A, incorporated in Country B on Date 4. FSC timely elected FSC treatment pursuant to sections 922(a)(2) and 927(f)(1) for Year 3 and all subsequent tax years, and in all other respects has continuously maintained its status as a FSC as defined in section 922(a). Pursuant to a Foreign Sales Commission Agreement dated Date 5, FSC provides consultation and representation to Corp A with respect to Corp A's export sales, and Corp A pays FSC a commission equal to the maximum amount permitted under the transfer pricing provisions of section 925.

At issue are Corp A's sales of Product A to Agency A for use outside the United States during the taxable years Year 4 through Year 5. In claims for refund, Corp A maintains that such Product A sales were export transactions entitled to FSC benefits.

LAW AND ANALYSIS:

Under I.R.C. § 921 et seq., portions of the foreign trade income of a foreign sales corporation (FSC) are exempt from tax. Foreign trade income is the gross income of a FSC attributable to foreign trading gross receipts. I.R.C. § 923(b). Foreign trading gross receipts of a FSC generally include gross receipts from the sale of export property by either the FSC or any principal for whom the FSC acts as a commission agent. I.R.C. § 924(a)(1); Temp. Treas. Reg. § 1.924(a)-1T(b). Export property is defined, in pertinent part, as property manufactured in the United States by a person other than a FSC, held primarily for sale in the ordinary course of business by a FSC for direct use outside of the United States, and no more than 50% of the value of which is attributable to articles imported into the United States. I.R.C. § 927(a)(1); Temp. Treas. Reg. § 1.927(a)-1T. Accordingly, in order for a sale transaction to be entitled to FSC benefits, it must involve export property, and the receipts from the sale must qualify as foreign trading gross receipts.

You have advised our office that there is no dispute regarding the qualification of Product A as export property as defined. The sole dispute involves whether the sales of Product A generated foreign trading gross receipts within the meaning of § 924. More specifically, the issue is whether the "buy American" provision of section 924(f)(1)(A)(ii) operates to disqualify the receipts from such sales as foreign trading gross receipts.

Section 924(f)(1) provides certain exclusions from the general definition of foreign trading gross receipts in section 924(a)(1) noted above. Section 924(f)(1)(A)(ii) provides that foreign trading gross receipts "shall not include receipts of a FSC from a transaction" involving export property that is "for use by the United States or any instrumentality thereof and such use of export property ... is required by law or

regulation." Section 927(d)(2)(A) defines the term "transaction" to include any sale, exchange or other disposition; any lease or rental; and any furnishing of services. With respect to the scope of the "buy American" exclusion, section 1.924(a)-1T(g)(4)(i) provides:

> Foreign trading gross receipts of a FSC do not include [otherwise qualifying] gross receipts ... if a sale ... of export property ... is for use by the United States or an instrumentality thereof in any case in which any law or regulation requires in any manner the purchase ... of property manufactured, produced, grown, or extracted in the United States.... For example, a sale by a FSC of export property to the Department of Defense for use outside the United States would not produce foreign trading gross receipts for the FSC if the Department of Defense purchased the property from appropriated funds subject to either any provision of the Department of Defense Federal Acquisition Regulations Supplement (48 CFR Chapter 2) or any appropriations act for the Department of Defense for the applicable year if the regulations or appropriations act requires that the items purchased must have been grown, reprocessed, reused, or produced in the United States.

Section 1.924(a)-1T(g)(4)(iii)(B) recognizes an exception to this exclusion where the purchase of export property:

> is pursuant to ... [a] program (whether bilateral or multilateral) under which sales to the United States Government are open to international competitive bidding.

Summarizing these provisions, receipts from sales of export property to the United States Government for its own use are excluded from the definition of foreign trading gross receipts where the Government was required in any manner by law or regulation to purchase only items produced in the United States, i.e., was required to "buy American." However, such receipts will nevertheless qualify as foreign trading gross receipts if the purchase was part of a program allowing foreign manufacturers to bid competitively on the sale.

By letter dated Date 6, Official A has confirmed to our office, and Corp A and FSC do not dispute, that the Product A sales were subject to "buy American" laws and regulations as well as "sole-source" provisions of governing procurement statutes. The Defense Department acquisition regulations referenced in section 1.924(a)-1T(g)(4)(i) quoted above expressly incorporate the Buy American Act of 1988, 41 U.S.C. § 10a et seq., and require that procurement contracts include clauses implementing such legislation. See 48 C.F.R. § 252.225.7001, which in turn is expressly incorporated by the Product A contracts.

Corp A and FSC maintain, however, that the role of Country A industry with respect to Prototype B constituted "international competitive bidding" within the meaning of section 1.924(a)-1T(g)(4)(iii)(B). Thus the Product A sales would be taken outside the scope of the "buy American" exclusion so that the receipts from such sales would remain included in FSC's foreign trading gross receipts. Upon examining both (1) the plain language of the regulatory exception and (2) the applicable legislative and regulatory history of the FSC provisions, we find this conclusion misplaced.

Plain Language

The plain language of the regulatory "international competitive bidding" exception requires that there be a program (whether bilateral or multilateral) under which sales to the United States Government are open to international competitive bidding. Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(iii)(B). None of these elements are present here.

First and most importantly, the "sale" element of the regulatory exception is absent. Country A and Corp D were involved solely in the development of Prototype A. Such prototype development did not include sales of Product A or any other kind of transaction as defined in section 927(d)(2)(A). Corp A's predecessor, Corp B, was exclusively granted all sale contracts without further competition once its prototype was selected. Indeed, selection of Corp D for sale contracts would have been impossible because Prototype B never met basic specifications for Product A. Additionally, the protocol between the United States and Country A expressly contemplated that each country would separately and concurrently produce its own Product Type A, using the selected design. Such a scheme would be inconsistent with international competition for procurement contracts. Even assuming the early developmental competition is a part of the overall Product A history so that the overall history may be said to have involved international competition, the language of the regulations compel consideration of solely the sales phase of the history in determining the applicability of the exception.

Second, the bidding element is not present. Whatever competitive role Country A or Corp D may be said to have played, neither of them engaged in the activity of bidding. The sole episode of bidding in the history of Product A occurred at the Year 1 bidding conference, which was attended only by domestic entities. Both bids received were domestic. The bidding process had long since ended when Country A participation began. The competition between Prototypes A and B was merely a comparison of equipment that already had been built. It did not involve bidding. Corp D never sought a procurement contract from Agency A but funded Prototype B with its own capital and with subsidies from Country A. Corp D was never eligible to bid on production of Product A because Prototype B failed to meet the basic specifications.

Third, Product A sales were never subject to any bilateral or multilateral competitive program of the kind referred to in the regulations. The only bilateral arrangement involving Product A was the MOU between the United States and Country A. This MOU dealt with comparative testing of prototypes with a view to standardization of designs, but expressly contemplated that the parties would proceed on separate tracks with respect to production. Because the MOU dealt with prototype development, not Product A sales -- a critical distinction as discussed above -- it did not constitute the kind of program described in the international competitive bidding exception, which is targeted at sales.

Thus, the facts relied upon by Corp A and FSC do not fit within the plain language of section 1.924(a)-1T(g)(4)(iii)(B), which sets forth the exception on which Corp A relies. There was no program under which sales to the United States Government were open to international competitive bidding. There was no competitive process, domestic or international, for any production or pre-production contract to supply Agency A with Product A. By letter dated Date 6, Official A has confirmed that Corp D "was not in competition for the [Agency A Product Type A] program" and has further confirmed that despite Corp D's participation, "[t]here has been no competitive bidding involved in the procurement of [Product A]."

FSC Legislative and Regulatory History

The purpose and policy underlying both the FSC regime in general and the "buy American" exclusion in particular are inconsistent with Corp A's and FSC's claims. Analysis of the FSC regime is rooted in examination of the earlier domestic international sales corporation (DISC) regime from which the FSC provisions were largely drawn.

The legislative history of the DISC provisions makes explicit Congress' overall purpose "to provide tax incentives for U.S. firms to increase their exports." H.R. Rep. No. 533, 92d Cong., 1st Sess., reprinted in 1972-1 C.B. 498, 529; S. Rep. No. 437, 92d Cong., 1st Sess., reprinted in 1972-1 C.B. 559, 609. The DISC statutory "buy American" exclusion at section 993(a)(2)(C) provides that the Secretary may by regulations exclude from qualified export receipts (analogous to FSC foreign trading gross receipts) those receipts from sales and other transactions in domestic products for use by the United States that are found to be required by law or regulations.

By excluding certain receipts from the general definition of DISC qualified export receipts, Congress sought to "limit the application of the tax-[favored] treatment to situations which, in fact, involve export transactions" and to deny such treatment to receipts from enumerated types of transactions (including those compelled or preferred by "buy American" constraints) that were "not really export transactions." H. Rep. No. 533, supra, at 1972-1 C.B. 533; S. Rep. No. 437, supra, at 1972-1 C.B. 614. Thus Congress determined to carve out of the FSC regime transactions

subject to “buy American” constraints because such transactions would not advance the stated legislative purpose.

Treasury further implemented and refined this carve-out throughout the process of developing the DISC regulations. The 1972 proposed regulations gave an example of the “buy American” exclusion whereby purchases of domestic goods for resale at military commissaries abroad would be ineligible for DISC benefits (subject to the exclusion) because such purchases were found subject to Department of Defense procurement regulations, while purchases of goods for resale at military post or base exchanges would be eligible for DISC benefits (not subject to the exclusion) because they were believed not subject to procurement regulations. Prop. Treas. Reg. § 1.993-1(j)(4)(i), 37 Fed. Reg. 20853, 20857 (Oct. 4, 1972). During the ensuing several years, further research and numerous comments received on the proposed regulation revealed that in fact commissary purchases were excepted from the “buy American” provisions of procurement regulations. Accordingly, the final regulation dropped the commissary/PX example and clarified that only those purchases in fact subject to restrictions would be subject to the DISC exclusion. T.D. 7514, 1977-2 C.B. 266 (1977). The eligibility of commissary purchases for DISC benefits was later confirmed by Rev. Rul. 88-11, 1988-1 C.B. 296.

The DISC “buy American” exclusion was further liberalized when the DISC regulations modified the absolute exclusion of the statute with the “international competitive bidding” exception of section 1.993-1(j)(4)(iii)(b). This exception recognizes that if the purchase and sale of an item would be generally subject to a “buy American” restriction but, under a specific program, is open to competitive bidding from foreign industry, the use of a DISC nevertheless is consistent with the legislative purpose of the DISC regime.

When Congress replaced DISC with the FSC regime, the legislative history clarified that the purpose of FSC was “to afford U.S. exporters treatment comparable to what exporters customarily obtain in territorial systems of taxation” and that Congress generally “intends excluded receipts to be the same as excluded receipts under the ... DISC rules....” S. Rep. No. 169 (Vol. 1), 98th Cong., 2d Sess. 635, 645 (1984). Moreover, the preamble to the FSC regulations provides: “The detailed definitions of foreign trading gross receipts of a FSC are taken in all important respects from the definition of qualified export receipts of a DISC at § 1.993-1." T.D. 8126, 1987-1 C.B. 184, 186. Specifically, the FSC “buy American” exclusion at section 924(f)(1)(A)(ii), quoted above and here at issue, is substantially similar to its DISC counterpart (but expressly includes a taxpayer-favorable example on commissary/PX merchandise), and the FSC exception for international competitive bidding at section 1.924(a)-1T(g)(4)(iii)(B), also quoted above and at issue here, is substantially similar to its DISC counterpart. Congress and Treasury thus have continued in the FSC regime to carve out “buy American” transactions as inconsistent with the legislative purpose, but to refine the exclusion to restore FSC

benefits in cases qualifying for a narrowly defined exception for international competitive bidding.

Product Type A is in its nature and scale wholly unlike the commissary/PX merchandise treated as eligible for FSC benefits. As confirmed by Official A and not disputed by Corp A, Product A was subject to "buy American" restrictions and was consistently treated by Agency A as subject to those restrictions in awarding the procurement contracts to Corp B without consideration of foreign competition. The role of Country A and Corp D at an early developmental stage did not change this result. Moreover, as explained above, the sales at issue failed to meet the requirements of the exception for programs involving international competitive bidding within the meaning of section 1.924(a)-1T(g)(4)(iii)(B).

Accordingly, the receipts from sales of Product A to Agency A should be excluded from foreign trading gross receipts of FSC under section 924(f)(1)(A)(ii) and section 1.924(a)-1T(g)(4)(i).

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:

If you have any further questions, please call (202) 874-1490.

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JACOB FELDMAN
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Office of Associate Chief Counsel
(International)