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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, DELAWARE-MARYLAND
ATTN: SANDRA JEFFERSON CC:SER:DEM:BAL

FROM: Irwin Halpern
Senior Technical Reviewer CC:INTL:BR3

SUBJECT:

This Field Service Advice responds to your memorandum dated April 14, 2000. 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.

DISCLOSURE STATEMENT

Field Service Advice is Chief Counsel Advice and is open to public inspection pursuant to the provisions of § 6110(i). The provisions of § 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. § 6110(c) and (i). Section 6110(i)(3)(B) also authorizes the Service to delete information from Field Service Advice that is protected from disclosure under 5 U.S.C. § 552 (b) and (c) before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Field Service Advice is authorized to make such deletions and to make the redacted document available for public inspection. **Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of this unredacted document to the taxpayer or their representative.** The recipient of this document may share this unredacted document only with those persons whose official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

TL-N-1885-00

LEGEND

Taxpayer =
 Product A =
 X =
 Year 1 =
 Year 5 =

ISSUE

Whether Taxpayer properly allocated certain legal fee and settlement expense deductions to a class of gross income comprised solely of domestic income.

CONCLUSION

Taxpayer has not established that the legal fee and settlement expense deductions definitely relate to a class of gross income comprised solely of domestic income. As a result, we agree with the Examination Division's proposed reallocation of the deductions to the class of gross income comprised of Taxpayer's worldwide Product A sales. We also agree with the Examination Division's proposed apportionment methodology. Finally, we note the applicability of the § 927(e)(1) source rule.

FACTS

We understand the facts to be as follows.

Taxpayer manufactures and sells Product A on a worldwide basis. X is a particular type of Product A that Taxpayer manufactured in the United States and sold both in the United States and abroad. Taxpayer pays a commission to its wholly owned foreign sales corporation (FSC) with regard to export sales of Product A. Taxpayer computes its FSC commission under the administrative pricing methods of § 925(a)(1) and (2).

In Year 1 Taxpayer discontinued sales of X due to reports that it caused damage. This damage occurred in various countries where Taxpayer sold X. Since Year 1, Taxpayer has incurred legal fees and settlement expenses associated with X.

On its Year 5 federal income tax return Taxpayer allocated the legal fee and settlement expense deductions associated with X to a class of income comprised solely of domestic income. In response to an informal document request concerning the basis for this allocation Taxpayer stated as follows: "The facts support that essentially all [X] litigation-related expenses relate to US legal and

TL-N-1885-00

settlement costs. These costs were incurred to support the class of gross income, sales to the domestic market, that produces domestic source income. Accordingly it is appropriate to allocate these costs to domestic sources.” In addition, Taxpayer orally alleged that all of the litigation at issue occurred within the jurisdiction of the United States and that all of the litigants have been domestic. Taxpayer produced no documentary evidence to substantiate its allocation. Neither did Taxpayer provide information dividing its overall deduction between legal fees and settlement expenses nor did it provide any information regarding the specific nature of the legal fees or settlement expenses.

On audit, the Examination Division has proposed allocating Taxpayer’s legal fee and settlement expense deductions to a class of gross income comprised of Taxpayer’s worldwide Product A sales. This class of gross income includes both statutory and residual groupings for purposes of determining Taxpayer and its FSC’s combined taxable income under the FSC provisions, as well as for purposes of determining Taxpayer’s § 904 foreign tax credit limitation. As a result, Exam has proposed apportioning the deductions between statutory and residual groupings based on relative amounts of gross income in each grouping.

LAW AND ANALYSIS

The determination of combined taxable income under § 925 and the foreign tax credit limitation under § 904 both require the computation of taxable income from specific sources or activities. These computations are governed by the regulations under § 1.861-8. Treas. Reg. §§ 1.861-8(a)(1) and 1.861-8(f)(1). The § 1.861-8 regulations generally require taxpayers to allocate deductions to a class of gross income and, to the extent necessary to make the determination required by an operative Code section, to apportion deductions within the class between statutory and residual groupings of gross income. Treas. Reg. § 1.861-8(a)(2). Where more than one operative Code section applies, taxpayers are required to use the same method of allocation and the same principles of apportionment for all operative sections. Treas. Reg. § 1.861-8(f)(2).

1. Allocation

The § 1.861-8 regulations distinguish between deductions that are definitely related to a specific class of gross income, deductions that are definitely related to all gross income, and deductions that are not definitely related to any gross income. A class of gross income may consist of one or more items (or subdivisions of these items) of gross income enumerated in § 61. Treas. Reg. § 1.861-8(a)(3).

The allocation rules emphasize the factual relationship between a deduction and a class of gross income. As a result, a deduction must be definitely related to a class of income in order to be allocated to that class. Classes of gross income are not

TL-N-1885-00

predetermined, but must be determined on the basis of the deduction to be allocated. Treas. Reg. § 1.861-8(b)(1).

A deduction is considered definitely related to a class of gross income if the deduction is incurred as a result of, or incident to, an activity or in connection with the property from which such class of gross income is derived. Where a deduction is incurred as a result of, or incident to, an activity or in connection with property, which activity or property generates, has generated, or could reasonably have been expected to generate gross income, such deduction is considered definitely related to such gross income as a class. In some cases, it is appropriate to determine the categories of gross income to which a deduction does not relate, and conclude that the deduction relates to a class of income consisting of all other gross income. Treas. Reg. § 1.861-8(b)(2).

As applied to legal fees and expenses, the § 1.861-8 principles focus on the nature of the specific deductions. As a result, fees for legal services are ordinarily definitely related and allocable to specific classes of gross income or to all of a taxpayer's gross income, depending on the nature of the services rendered. Treas. Reg. § 1.861-8(e)(5).

Because § 1.861-8 determinations are highly factual, § 1.861-8(f)(5) emphasizes a taxpayer's general obligation to furnish, upon request, information supporting its return positions. Because allocations are based on the factual relationship between deductions and gross income, this information must substantiate the factual relationships between a taxpayer's deductions and related classes of gross income. See also Treas. Reg. § 1.6001-1 (stating taxpayers' general recordkeeping requirements).

Taxpayer's allocation methodology and support therefor do not meet the regulatory standards. Taxpayer provided no documentary evidence to substantiate its position that the legal fees and settlement costs at issue definitely related to a class of gross income comprised solely of domestic income. The Examination Division appropriately focused on this lack of substantiation, supplemented by the facts that Taxpayer sold X both within the United States and abroad and that damages associated with X arose both within the United States and abroad. Based on these considerations, the Examination Division's proposed reallocation of Taxpayer's legal fee and settlement expense deductions to the class of gross income comprised of Taxpayer's worldwide Product A sales is reasonable and consistent with the regulations.

2. Apportionment

Once a deduction has been allocated to a class of gross income, the § 1.861-8 regulations next require a consideration of its apportionment. Apportionment arises

TL-N-1885-00

if a deduction has been allocated to a class of gross income that includes both statutory and residual groupings of gross income. A statutory grouping is the gross income from a specific source or activity that must first be determined in order to arrive at taxable income from such specific source or activity under an operative Code section. Treas. Reg. § 1.861-8(a)(4).

The apportionment of a deduction must be accomplished in a manner that reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. Examples of bases and factors that may be used for apportionment include: (i) Comparison of units sold, (ii) Comparison of the amount of gross sales or receipts, (iii) Comparison of costs of goods sold, (iv) Comparison of profit contributions, (v) Comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent that are attributable to the activity or properties giving rise to the class of gross income, and (vi) Comparison of the amount of gross income. However, a method of apportionment may not be used when it does not reflect, to a reasonably close extent, the factual relationship between the deduction and the groupings of income. Treas. Reg. § 1.861-8T(c)(1).

Taxpayer allocated its legal fee and settlement expense deductions to a class of gross income that is in a residual grouping for purposes of both the FSC combined taxable income and foreign tax credit limitation provisions. As a result, Taxpayer did not apportion the deductions. However, an apportionment is required by the Examination Division's reallocation of the deductions to the class of gross income comprised of Taxpayer's worldwide Product A sales, because that class includes both statutory and residual groupings of gross income. While an exhaustive discussion of the apportionment of these deductions is beyond the scope of your inquiry, we include the following general points related to Taxpayer's FSC and foreign tax credit determinations.

a. Computation of combined taxable income under the FSC provisions.

Treas. Reg. § 1.925(a)-1T(c)(6) defines the combined taxable income of a related supplier and its FSC as the excess of the foreign trading gross receipts over the total costs of the related supplier and the FSC that relate to such receipts. For this purpose, the following costs (other than cost of goods sold) are considered to be related to gross receipts from export property sales: (a) the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned thereto, and (b) a ratable part of any other expenses, losses, or deductions that are not definitely related to any class of gross income. The determination of these costs is to be made in a manner consistent with the rules of § 1.861-8. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(D). Please note that the combined taxable income amount is relevant to the computation of Taxpayer's FSC benefits under both the § 925(a)(2) combined taxable income and § 925(a)(1) gross receipts administrative pricing methods. See § 925(d) (limiting the § 925(a)(1) gross receipts amount to

TL-N-1885-00

two times the amount that would have been determined under the § 925(a)(2) combined taxable income method).

Accordingly, consistent with the Examination Division's reallocation of Taxpayer's legal fee and settlement expense deductions to the class of income comprised of Taxpayer's worldwide Product A sales, these deductions must be apportioned between the statutory grouping of gross income from exports and the residual grouping of other income. The Examination Division's proposed apportionment of these deductions on the basis of relative amounts of gross income in the groupings is reasonable and permissible under the standards of Treas. Reg. § 1.861-8T(c)(1).

b. Computation of the allowable foreign tax credit.

For purposes of computing the § 904 foreign tax credit limitation, taxpayers must apportion their deductions between the statutory groupings described in § 904(d) and the residual grouping of other income. Treas. Reg. § 1.861-8T(f)(1)(ii).

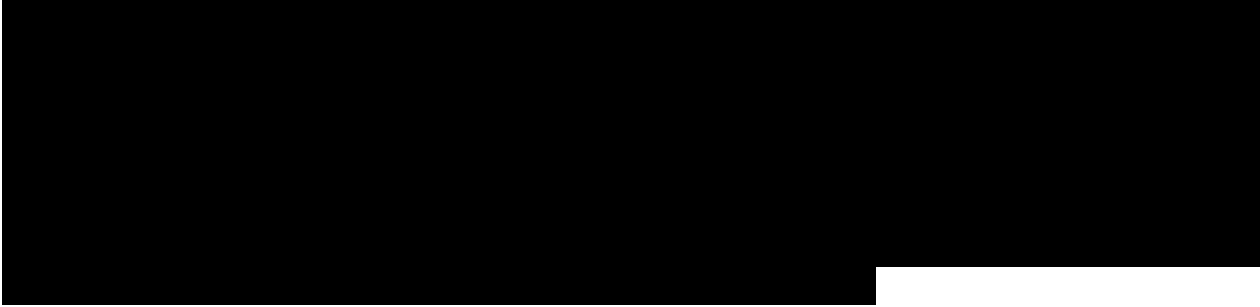
Sales of inventory property produced within the United States and sold outside the United States are subject to the mixed sourcing rules of § 863. Taxpayer's sales that included its FSC acting as a commission agent are subject to Example 2 of § 1.863-3T(b)(2) (1988) (applicable for tax years beginning before December 30, 1996). See Notice 89-11, 1989-1 C.B. 632. Example 2 states a "50/50" methodology for apportioning § 863(b) gross income between U.S. and foreign sources. Under this methodology, deductions that are allocable and apportionable to the § 863(b) gross income are apportioned between the gross U.S. and foreign source amounts on a pro rata basis. Treas. Reg. § 1.863-3T(b)(2), Example 2(ii) (1988) (applicable for tax years beginning before December 30, 1996). See also Treas. Reg. § 1.861-8(f)(3)(i) (deferring to the § 1.863-3 rules with regard to activities under § 863(b)). The Examination Division's proposed apportionment methodology is consistent with the § 863(b) rules.

Finally, we note the applicability of the § 927(e)(1) source rule for purposes of determining Taxpayer's § 904(d) foreign source taxable income amounts. Section 927(e)(1) limits a related supplier's foreign source taxable income from FSC sales to the amount of foreign source taxable income that the related supplier would have earned under the analogous § 994 domestic international sales corporation ("DISC") transfer pricing rule. The § 927(e)(1) limitation applies to FSC § 863(b) and non-§ 863(b) sales that generate foreign source income and utilize either the § 925(a)(1) gross receipts or the § 925(a)(2) combined taxable income administrative pricing method. In computing the limitation, foreign source taxable income from each transaction or § 927(d)(2)(B) grouping is compared against the foreign source limitation for DISC sales under § 927(e)(1). Any residual amount of foreign source taxable income for each transaction or grouping in excess of the applicable § 927(e)(1) limitation is resourced as U.S. source taxable income. See, e.g., Rev.

TL-N-1885-00

Rul. 89-93, 1989-2 C.B. 133. Treasury Regulations provide further guidance on the § 927(e)(1) limitation. Compare Treas. Reg. § 1.927(e)-1T (T.D. 8126, March 2, 1987) and Treas. Reg. §§ 1.927(e)-1(a)(3), 1.927(e)-1(b) (applicable to taxable years beginning after December 31, 1997).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



Please contact our Office to discuss and review any revised allocation or apportionment methodology that Taxpayer submits, either as a result of Taxpayer providing more detailed factual analysis, Taxpayer revising its legal analysis, or both. In the event Taxpayer reallocates its expenses for purposes of computing combined taxable income under the FSC provisions, it may attempt to understate the amount of the allocable deductions under Treas. Reg. § 1.925(a)-1T(c)(6) by relying on St. Jude Medical, Inc. v. Commissioner, 34 F.3d 1394 (8th Cir.), rev'g in part 97 T.C. 457 (1991) and Boeing Co. and Consolidated Subsidiaries and Boeing Sales Corp. v. United States, 98-2 USTC ¶150,722 (W.D. Wash. 1998), appeal docketed, No. 98-36119 (9th Cir. Nov. 11, 1998). Please contact our Office if this occurs. The Service has nonacquiesced to St. Jude, AOD CC-1999-005 (August 30, 1999) and AOD CC-1995-001 (Feb. 13, 1995). The Department of Justice is currently appealing the Boeing decision to the Ninth Circuit.

If you have any further questions, please call (202) 622-3850.

IRWIN HALPERN
Senior Technical Reviewer
Branch 3
Office of the Associate Chief
Counsel (International)