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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE: March 16, 2001

MEMORANDUM FOR BETTIE N. RICCA
ASSOCIATE AREA COUNSEL, WASHINGTON, D.C.
CC:LM:MCT:WAS
Attention: Karen Chandler, Special Litigation Assistant

FROM: Jacob Feldman
Special Counsel, CC:INTL

SUBJECT:

This Field Service Advice responds to your memorandum dated November 8, 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

Agency A =

Contract 1 =
Contract 2 =
Contract 3 =
Contract 4 =

Corp A =

Corp A-FSC =

Corp B =

Corp C =

Country Group A =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =

Month 1 =
Month 2 =

Organization A =

Predecessor =

Product =

Product Type A =

Quantity a =
Quantity b =
Quantity c =
Quantity d =
Quantity e =

Subsidiary 1 =

Tax Year 1 =
Tax Year 2 =
Tax Year 3 =

United States Location A =

United States Possession A =

x =
y =

z	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=
Year 10	=
Year 11	=
Year 12	=
Year 13	=
Year 14	=
Year 15	=
Year 16	=

ISSUE

Whether receipts attributable to sales of the Product[1] to Agency A by Corp B through a FSC are excluded from status as foreign trading gross receipts under I.R.C. § 924(f)(1)(A)(ii) and Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i).

CONCLUSION

On the facts presented, sales of the Product by Corp B to Agency A for its own use do not generate foreign trading gross receipts within the meaning of section 924 because Agency A 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). The exception for programs where sales are open to competitive bidding under Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(iii)(B) does not apply.

FACTS

Corp A (also referred to as "Taxpayer"), is a domestic corporation. Corp A-FSC is a wholly-owned subsidiary of Corp A, is incorporated in United States

[1] You have advised that some sales for the tax years at issue involved spare parts. This memorandum relates only to sales of the Product itself and does not address any issues uniquely associated with spare parts.

Possession A on Date 1, and acts as a commission agent for Corp A's export sales. Subsidiary 1 is a wholly-owned domestic subsidiary of Corp A. For all tax years at issue, Corp A-FSC had in place a valid election to be treated as a foreign sales corporation (FSC) pursuant to sections 922(a)(2) and 927(f)(1) and in all other respects continuously maintained its status as a FSC as defined in section 922(a). Pursuant to service and commission agreements, Corp A and Subsidiary 1 undertake to perform on behalf of Corp A-FSC, and bill Corp A-FSC for, the foreign economic processes and activities required under sections 924(d) and 924(e) with respect to sales generating foreign trading gross receipts within the meaning of section 924(a). These agreements also obligate Corp A and Subsidiary 1, as related suppliers, to pay to Corp A-FSC the largest commission permitted for Federal income tax purposes.

In Month 1, Agency A, an instrumentality of the United States government, issued a Request for Proposal for the development of a prototype of Product Type A, a type of military equipment, and shortly thereafter selected Corp B and Corp C to develop competing prototypes. Three years later, following a demonstration of the two prototypes, Agency A awarded Contract 1 to Corp B on Date 2 for the full-scale development of what ultimately became the Product. Contract 1 also granted Agency A options to procure production versions (as distinct from the developmental prototypes) of the Product for Years 1, 2 and 3, as well as an option to purchase Quantity a of the Product for use by foreign governments.

In Month 2, shortly following the award of Contract 1, the United States government entered into a Memorandum of Understanding (MOU) with the governments of Country Group A regarding establishment of a program to develop the Product. The MOU contemplated purchases of the Product by Agency A and by the other signatory countries from Corp B. One of the stated objectives of the MOU was to facilitate standardization, rationalization and interoperability of Product Type A within Organization A, an international organization of which the United States as well as the countries in Country Group A are voting members. As to production of the Product for Agency A, the MOU called for industry in Country Group A to be granted subcontracts for a small portion (x percent) of the procurement value of Quantity b of the Product to be sold to Agency A, with final assembly in the United States. Higher percentages of foreign industrial participation were provided with respect to Product production for the Country Group A signatories, with final assembly to be abroad. The MOU provided that procurement of equipment and services for the Product program shall be consistent with Department of Defense regulations, but that with respect to the non-domestic x percent industrial participation called for in the MOU, "[o]ffers shall be evaluated without applying price differentials such as those required by 'Buy American' and 'Balance of payment' laws and regulations."

Approximately five years later, in Year 4, Agency A requested that Corp B analyze potential cost savings of using multi-year contracts for the Product. Corp B surveyed its subcontractors and suppliers to determine whether (and by how much) it could negotiate lower prices for larger purchases and higher production volume. Corp B also evaluated potential labor and overhead savings at the production facility for the Product. On Date 3 in the following year, as required by procurement regulations, Agency A issued a Request for Proposal inviting Corp B to submit comparative proposals for the production of Quantity c of the Product under the alternatives of a series of annual contracts or a multi-year contract. Based on Corp B's response and other data, Agency A concluded that the price of the Product could be reduced significantly under a multi-year contract.

Later that year, on Date 4, upon securing Congressional approval, and as negotiated pursuant to the sole-source provisions of former 10 U.S.C. § 2304(a)(14), Agency A entered into Contract 2 with Corp B, which followed on Contract 1 and provided for the production of Quantity c of the Product, spread evenly over each of Years 5, 6, 7 and 8.

Approximately three years later, Corp B and Agency A entered into Contract 3, effective Date 5, providing for production of Quantity d of the Product over Years 9, 10, 11 and 12. Like Contract 2, Contract 3 was negotiated on a sole-source basis.

Approximately four years later, Corp B and Agency A entered into Contract 4, effective Date 6, providing for production of Quantity e of the Product over Years 13, 14, 15 and 16. Contract 4 was negotiated pursuant to 10 U.S.C. § 2304(c)(1), 41 U.S.C. § 253(c), and 10 U.S.C. § 2567, providing "authority for using other than full and open competition."

Receipts attributable to Contracts 2, 3 and 4 are at issue. Several clauses are common to each of these three contracts. For example, each contract incorporates by reference numerous clauses from regulations promulgated by the Department of Defense in both the "DAR" and "FAR" series. These incorporated clauses relate to Military Security Requirements[2]; the Walsh-Healey Public Contracts Act, prescribing minimum wages and working conditions[3]; Affirmative Action for Disabled Veterans and Veterans of the Vietnam Era[4]; Utilization of

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[2] DAR 7-104.12; FAR 52.204-2.

[3] DAR 7-103.17; FAR 52.222-20.

[4] DAR 7-103.27; FAR 52.222-35.

Business and Small Disadvantaged Business Concerns[5]; Equal Opportunity[6]; Clean Air and Water[7]; and Utilization of Labor Surplus Area[8] concerns. Some of these provisions are explicitly made inapplicable to that limited portion of work performed outside the United States by foreign subcontractors (as distinct from work performed in the United States by the prime contractor and/or United States subcontractors).

Each of the three contracts at issue required that the Product be manufactured by Corp B's division located in a government-owned, contractor-operated manufacturing facility in United States Location A. Corp B was authorized to use this facility on a rent-free basis. An employee of Agency A, the "Administrative Contracting Officer" (ACO), was responsible for day-to-day administration of the contracts. The ACO was stationed at United States Location A. The contracts explicitly provide:

> The contractor agrees that in the performance of this contract, or any major subcontract hereunder, that no direct or indirect costs will be incurred for the duplication of work or support capacity which the Government determines is available at, or through, any [Agency A] installation where this contract will be performed, without prior written approval of the contracting officer. Accordingly, the contractor agrees to use or cause to be used, on subcontracts, if any, all Government or Government-controlled working space, equipment, supplies, materials, services (including automatic data processing) or other support (including communication services excluding use of autovon lines) which the Government determines can be made available at, or through, any [Agency A] installation where this contract will be performed. [FAR 52.245-9000.]

In this regard Contract 3 further states Corp B's "intention to invest in modern manufacturing facilities at [United States Location A]." The contract recites the projected amount of such investment to be $y.

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[5] DAR 7-104.14(a); FAR 52.219-8.

[6] DAR 7-103.18(a); FAR 52.222-6.

[7] FAR 52.223-2.

[8] DAR 7-104.20(a); FAR 52.220-3.

Each contract incorporates by reference the requirements of the Buy American Act and Balance of Payments Program.[9] Contracts 3 and 4 additionally state that these provisions are inapplicable to that portion of the work performed outside the United States by foreign subcontractors (as distinct from work performed in the United States by the prime contractor and/or United States subcontractors).

A memorandum from Agency A dated Date 7 provides that certain requested FAR deviations are approved with respect to Contract 4. Among the requested deviations approved is a "waiver from [Department of Defense regulations] clause 52.225-7001, Buy American Act and the Balance of Payments Program."

Certain clauses are included in some but not all of the contracts at issue. Under the heading "SECURITY INFORMATION," Contracts 3 and 4 provide:

> The contractor is governed by DoD 5220-22S, COMSEC supplement to the Industrial Security Manual. Access to COMSEC material/information is restricted to U.S. citizens holding final U.S. Government clearance and is not releasable to personnel holding only a reciprocal clearance....

Under the heading "SPECIAL REQUIREMENT FOR CLASSIFIED FOREIGN SUBCONTRACTS," Contracts 3 and 4 further provide:

> Solicitation and/or award of any lower tier subcontracts requiring the use of or access to any classified material shall require prior approval from the prime contractor with the concurrence of the contracting officer....

Under the same heading, these contracts provide restrictions on use of or access to classified information and equipment for use in foreign countries in accordance with security safeguards adopted by Organization A.

Under the heading "SUBCONTRACT MANAGEMENT," Contracts 3 and 4 further provide: "The Contractor's management of the subcontract effort shall be continually reviewed by the Contracting Officer."

Contract 4 contains a clause entitled "FOREIGN NATIONALS," which provides:

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[9] DAR 1-104.3; FAR 52.225-7001.

> In the event that the Contractor anticipates soliciting foreign sources for any work under this contract, the Contractor shall notify the contracting Officer (CO) 10 working days before either applying for an export license under International Traffic in Arms Regulation (ITAR), 22 CFR Sections 121-128, or before solicitation of the foreign sources, whichever shall occur first. This notification shall include detailed description of the government data/equipment to be exported and a copy of the application for an export license, if such application has been made....

Contract 4 also contains a clause entitled "FOREIGN NATIONALS," which provides:

> The Contractor acknowledges that equipment/technical data generated or delivered in performance of this contract is controlled by the International Traffic in Arms Regulations (ITAR), 22 CFR Sections 121-128, and may require an export license before assigning any foreign national to perform work under this contract or before granting access to foreign nationals to any equipment/technical data generated or delivered in performance of this contract. (See 22 CFR Section 125.03 in this regard). The contractor agrees to notify the Contracting Officer (CO) 10 working days prior to assigning or granting access to any work, equipment or technical data generated or delivered in performance of this contract....

On Date 8, Corp A[10] acquired from Corp B all contracts and other assets and liabilities related to the production of the Product. Subsequently, during Tax Years 1, 2 and 3, Agency A paid to Corp A portions of the contract price whose calculation had been deferred under Corp B's accounting method and the formulas set forth in the contracts. Agency A also paid Corp A for Product warranty and repair services that Corp A had assumed in the acquisition.

In its original income tax returns filed for Tax Years 1, 2 and 3, Corp A did not claim deductions for commissions payable to Corp A-FSC with respect to sales of the Product or related services. Subsequently, however, Corp A determined that Agency A used some of the Product outside the United States for the period of time required by Temp. Treas. Reg. § 1.927(a)-1T(d)(4)(iii). See Temp. Treas. Reg.

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[10] You have advised us that the taxpayer that made this acquisition and filed the original returns under audit was Predecessor, and that Corp A has succeeded to all of Predecessor's Federal income tax attributes as the surviving entity in a subsequent corporate reorganization. All references to "Corp A" or "Taxpayer" in this memorandum are to be understood as including both Corp A and Predecessor.

§ 1.924(a)-1T(g)(2). Corp A now claims refunds of income taxes pursuant to Temp. Treas. Reg. § 1.925(a)-1T(e)(4) based on a redetermination of its commissions payable to Corp A-FSC for Tax Years 1, 2 and 3, resulting from adding certain sales of the Product under Contracts 2, 3 and 4 to those reported as eligible for FSC treatment. This claim is grounded on Corp A's position that such quantities of the Product constitute export property within the meaning of section 927(a) and that receipts attributable to such sales of the Product and related services constitute foreign trading gross receipts within the meaning of section 924(a). For purposes of this advice, we assume that the Product constitutes export property and that the receipts attributable thereto would constitute foreign trading gross receipts but for the application of section 924(f)(1)(A)(ii) and Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i).[11]

LAW AND ANALYSIS

Overview

Under the FSC provisions, a FSC may exclude a portion of its gross income attributable to "foreign trading gross receipts." I.R.C. §§ 921(a), 923(a)(1), 923(b). Foreign trading gross receipts generally include gross receipts from the sale of export property received by a principal for whom a FSC acts as a commission agent. I.R.C. §§ 924(a)(1), 925(b)(1); Temp. Treas. Reg. §§ 1.924(a)-1T(b), 1.927(b)-1T(e)(1). Section 924(f)(1) excludes certain receipts from this general definition. The sole issue to be addressed in this advice is the applicability of one of these exclusions.

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." Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i) elaborates:

> 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

[11] The acquisition of contracts by Corp A from Corp B raises certain issues related to application of the basic definition of foreign trading gross receipts under section 924(a) as well as the foreign economic processes tests of sections 924(b)(1)(B), 924(d) and 924(e) and the restrictions on use of administrative pricing rules under section 925(c). Those issues are not addressed herein, and no inference is to be drawn with respect to them.

> 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. The Department of Defense's regulations do not require that items purchased by the Department for resale in post or base exchanges and commissary stores located on United States military installations in foreign countries be items grown, reprocessed, reused or produced in the United States. Therefore, receipts arising from the sale by a FSC to those post or base exchanges and commissary stores will not be excluded from the definition of foreign trading gross receipts by this paragraph (g)(4).
>
> (Emphasis added).

Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(iii)(B) provides an exception to this rule "if the purchase is pursuant to ... [a] program (whether bilateral or unilateral) under which sales to the United States government are open to international competitive bidding." (Emphasis added).

Summarizing these provisions, receipts attributable to sales of export property to the United States government for its own use are generally excluded from the definition of foreign trading gross receipts where the government is required "in any manner" by law or regulation to purchase items produced in the United States, unless the sales were pursuant to a program open to international competitive bidding. The regulation sets forth as the principal example of such a law or regulation the Department of Defense Federal Acquisition Regulations ("DFARs") in Title 48 of the Code of Federal Regulations. The DFARs, in turn, incorporate by reference many other specific laws and regulations and require that procurement contracts include clauses implementing such legal authority.

Analysis of the FSC regime necessarily involves examination of the earlier domestic international sales corporation (DISC) regime, which included parallel provisions. Section 993(a)(2) grants the Secretary authority to exclude receipts from the general definition of qualified export receipts (a DISC concept parallel to FSC foreign trading gross receipts). Through such exclusions, Congress intended that DISC treatment be denied to enumerated types of transactions. H.R. Rep. No.

533, 92d Cong., 1st Sess. 65-66, reprinted in 1972-1 C.B. 498, 533; S. Rep. No. 437, 92d Cong., 1st Sess. 98-99, reprinted in 1972-1 C.B. 559, 614. Section 993(a)(2)(C) specifically authorizes an exclusion for sales to the United States government for its own use that are "required by law or regulation."

In the process of developing the DISC regulations, Treasury carefully implemented and refined a carve-out of sales to the government that are required "in any manner." The 1972 proposed regulations gave an example in which purchases of domestic goods for resale at military commissaries abroad would be ineligible for DISC treatment (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 (PXs) would be eligible for DISC treatment (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 regulations revealed that, in fact, commissary purchases were excepted from the BAA/BPP provisions of procurement regulations. Accordingly, the final regulation dropped the commissary/PX example and clarified that only those purchases in fact subject to such restrictions would be subject to the DISC exclusion. Treas. Reg. § 1.993-1(j)(4)(i); Technical Memorandum, T.D. 7514, 1977 TM Lexis 65, at 28-29 (Jun. 10, 1977). The eligibility of commissary purchases for DISC purposes was later confirmed by Rev. Rul. 88-11, 1988-1 C.B. 296, and for FSC purposes was confirmed by the last two sentences of Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i).

When Congress replaced DISC with the FSC regime, the legislative history clarified 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 government-sale exclusion at section 924(f)(1)(A)(ii) and Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i), quoted above and here at issue, are parallel to their DISC counterparts. Congress and Treasury thus have continued in the FSC regime to carve out sales to the United States government for its own use where required "in any manner" by law or regulation.

Application of government-sale exclusion

You have identified several legal and regulatory provisions that potentially restricted Agency A to domestic sources in its acquisition of the Product in a way that would exclude Taxpayer's receipts attributable to such sales from foreign

trading gross receipts under section 924(f)(1)(A)(ii) and Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i). We consider these laws and regulations in turn.

1. Among the laws referenced in the DFARs are the Buy American Act, 41 U.S.C. §§ 10a-d, and the related Balance of Payments Program (collectively, "BAA/BPP"). The Buy American Act generally provides that only property manufactured in the United States may be acquired by the United States government for use within the United States. The Balance of Payments Program generally provides that the United States government may acquire only products made in the United States for use outside the United States. 48 C.F.R. § 25.302(a). The DFARs implement these laws by imposing a pricing preference whereby the offering price of a foreign-made product is increased by 50% for purposes of evaluating the offer against offers of domestic goods. 48 C.F.R. § 252.225-7001(d).[12] Where applicable, this pricing preference operates as a substantial restriction on governmental purchase of foreign products. We consider that such a preference "requires in any manner" the purchase of domestic products within the meaning of Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i).

Taxpayer argues that the restrictions under the BAA/BPP did not apply to any of the contracts or tax years at issue. Taxpayer asserts that such restrictions were waived by the Department of Defense under the DFARs and/or specific "deviations" and waivers granted with respect to the MOU and the contracts at issue.

Based solely on the material submitted by Taxpayer, we are not convinced that these laws were effectively waived with respect to the contracts at issue. First, we agree that the law is clear that in appropriate cases the Department of Defense may effectively waive the BAA/BPP, but the regulations and case law cited by Taxpayer are equally clear that the official, case-specific "Determination and Finding" is the operative legal document that effects a waiver.[13] Taxpayer has not produced any "Determination and Finding" by the Secretary of Defense implementing such waivers with respect to the contracts or the Product.

Second, Taxpayer's indirect evidence in the form of the Date 7 memorandum from Agency A, referring to a BAA/BPP waiver with respect to Contract 4, appears

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[12] Except where indicated, we cite to the current version of laws and regulations. You have preliminarily determined, and Taxpayer does not dispute, that substantially similar laws and regulations were applicable with respect to each contract and tax year at issue.

[13] Defense Acquisition Circular 76-25 (1980); Self-Powered Lighting, Ltd. v. United States, 492 F. Supp. 1267, 1274 (S.D.N.Y. 1980); E-Systems, Inc., U.S. Comp. Gen. Lexis 928, at 8 (1982).

to be reflected in Contract 4 itself as being limited to the relatively small portion (x percent) of the procurement value that the MOU mandates be subcontracted to foreign businesses.

Third, contrary to Taxpayer's position that the waiver was originally provided in the MOU, the plain language of that document waives the BAA/BPP only with respect to foreign subcontractors, not with respect to the final Product.

Fourth, Taxpayer points to the adoption of 48 C.F.R. § 225.872-1(a), which provides:

> (a) As a result of memoranda of understanding and other international agreements, the DoD has determined it inconsistent with the public interest to apply restrictions of the Buy American Act/Balance of Payments Program to the acquisition of defense equipment which is mined, produced, or manufactured in any of the following countries (referred to in this part as "qualifying countries")....

Each country in Country Group A is among the enumerated "qualifying countries" to which this blanket BAA/BPP waiver is applied with respect to the acquisition of defense equipment. However, Taxpayer fails to demonstrate that this provision was intended to apply retroactively to existing contracts such as those involved in this case. In this regard, Taxpayer relies only on vague assertions that the DFAR change was adopted "in response to" prior MOUs and "serves to validate" the asserted waivers in the MOU and contract documents. Moreover, this regulatory waiver provision itself is subject to discretion and restrictions. For example, 48 C.F.R. § 225.872-1(c) provides:

> The determination in paragraph (a) of this subsection does not limit the authority of the cognizant Secretary to restrict acquisitions to domestic sources or reject an otherwise acceptable offer from a qualifying country source in instances where considered necessary for national defense reasons.

Thus it may be expected that in cases involving national security the Department of Defense might choose to enforce the BAA/BPP restrictions despite the general waiver in 48 C.F.R. § 225.872-1(a).

Absent adequate substantiation of a waiver, the BAA/BPP appears to be one of the several laws and regulations that effectively "require in any manner" manufacture of the Product in the United States within the meaning of Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i).

2. The Arms Export Control Act, 22 U.S.C. § 2778, imposes a system of constraints and procedural conditions on the export of military equipment. Generally, such equipment may not be exported or "otherwise transferred to the control or possession of a foreign person" without an export license issued by the Department of State in conjunction with the Departments of Defense and Treasury. 22 U.S.C. § 2778(b)(2), (g)(6), (g)(8). Violation of these rules is a criminal offense. 22 U.S.C. § 2778(c).

In considering such transfers, "special emphasis shall be placed on procurement in the United States." 22 U.S.C. § 2791(a). Export transactions are scrutinized on a host of statutory criteria, including "the portion of the defense articles ... which is of United States origin" and "the extent to which such sale might contribute to an arms race, or increase the possibility of outbreak or escalation of conflict, or prejudice the development of bilateral or multilateral arms control arrangements." Id. Procurement may be:

> outside the United States only if the President determines that such procurement will not result in adverse effects upon the economy of the United States or the industrial mobilization base, with special reference to any areas of labor surplus or to the net position of the United States in this balance of payments with the rest of the world, which outweigh the economic or other advantages to the United States of less costly procurement outside the United States.

22 U.S.C. § 2791(c).

In the manufacture of military equipment such as the Product, we understand that it is necessary for the manufacturer and, to a lesser degree subcontractors, to gain access to data, specifications, components, equipment and technology that normally are available only to the United States government or that are proprietary to a United States manufacturer. Where the manufacturer or a subcontractor is foreign, the foregoing statutory and regulatory provisions would require an export license to authorize the foreign entity to gain such access.

The facts in this case involve a United States manufacturer subcontracting the production of some components to foreign subcontractors as contemplated by the MOU. Accordingly, Contract 4 contains detailed clauses (quoted above) recognizing the need for an export license.

Taxpayer argues that foreign entities not only performed the limited functions of subcontractors but also legally could have served as the manufacturer of the Product. However, in the latter case, Taxpayer ignores the fact that the export control laws and regulations would pose a significant obstacle to foreign manufacture. It is questionable whether an export license would be granted with

respect to data, specifications, components, equipment and technology having a high degree of strategic significance.[14] Without access to these items, it would be impossible to manufacture the military product at issue.

We consider that these kinds of export control restrictions in themselves require domestic manufacture "in any manner" within the meaning of section 924(f)(1)(A)(ii) and Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i).

3. Another set of laws applicable to the sales of the Product are the "sole source" rules of former 10 U.S.C. § 2304(a)(14), which provided that a purchase of "technical or special property" could be negotiated on a sole-source basis where the agency head determines that the contract requires:

> a substantial initial investment or an extended period of preparation for manufacture, and for which he determines that formal advertising would be likely to result in additional cost to the Government by reason of duplication of investment or would result in duplication of necessary preparation which would unduly delay the procurement of the property....

Similarly, section 3.214-2 of the Armed Service Procurement Regulations (ASPR) provided:

> The authority of § 3.214 may be used for procurement of technical or specialized supplies -- for example: aircraft, tanks, radar, guided missiles, rockets, and similar items of equipment; major components of any of the foregoing; and any supplies of a technical or specialized nature which may be necessary for the use or operation of any of the foregoing. Such procurement generally involves:
>
> (a) High starting costs which already have been paid for by the Government or by the supplier;
>
> (b) Preliminary engineering and development work that would not be useful to or usable by any other supplier;
>
> (c) Elaborate special tooling already acquired;

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[14] Taxpayer argues that an American manufacturer theoretically could locate its plant abroad free of export controls. Even if this is true, export control laws still represent a substantial restriction for purposes of this regulation because often it would be a foreign manufacturer that undertakes production activity outside the United States.

(d) Substantial time and effort already expended in developing a prototype or an initial production model; and

(e) Important design changes which will continue to be developed by the supplier.

The authority of § 3.214 will in general be used in situations where it is preferable to place a production contract with the supplier who had developed the equipment, and thereby either assure the Government the benefit of the techniques, tooling, and equipment already acquired by that supplier, or avoid undue delay arising from a new supplier having to acquire such techniques, tooling and equipment....

(Emphasis added).

The evolution of the Product from the time of Corp B's development of the prototype of the Product through the time of Corp B's role in the initial production of the Product precisely match the situation contemplated by these sole-source rules. In fact, Contracts 2 and 3 were negotiated and awarded to Corp B under these rules. Similarly Contract 4 was negotiated and awarded to Corp B under the similar provisions of 10 U.S.C. § 2304(d)(1), which additionally provide that where normal procurement procedures would result in duplication of costs or delays:

in the case of a follow-on contract for the continued development or production of a major system or highly specialized equipment..., such property ... may be deemed to be available only from the original source and may be procured through [sole-source] procedures....

Substantially similar language is used in the procedural title of the statute. See 41 U.S.C. § 253(d).

In the instant case, the application of the sole-source laws and regulations resulted in manufacture of the Product in the United States by a domestic producer, Corp B. The contracts entered into under those laws and regulations designated as the place of manufacture the production facilities owned by Agency A at United States Location A. Moreover, the MOU expressly provided that the Product produced for Agency A be assembled in the United States by Corp B with American components representing almost all (z percent) of the procurement value.[15] Therefore, at no time was it legally possible for the Product to be manufactured

[15] Such assembly is a key indicator of a manufacturing process within the meaning of the FSC provisions. See Temp Treas. Reg. § 1.927(a)-1T(c)(2); Treas. Reg. § 1.954-3(a)(4).

outside the United States. We consider that the sole-source laws and regulations, in enabling that result, require “in any manner” manufacture in the United States. Consequently, the receipts attributable to the contracts are excluded as foreign trading gross receipts under section 924(f)(1)(A)(ii) and Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i).

4. You note that many laws incorporated by reference in the DFARs and in Contracts 2, 3 and 4, such as the Walsh-Healey Public Contracts Act and the laws regarding affirmative action for disabled veterans, small disadvantaged business, equal opportunity, clean air and water, and utilization of labor surplus, may be premised on manufacture in the United States. We have not independently reviewed these laws. However, assuming that compliance with these laws would not be possible or required as a factual matter if manufacture occurred outside the United States, then considering these laws in the aggregate, the DFARs should be read as contemplating manufacture in the United States. Consequently, receipts attributable to the contracts at issue could be excluded from foreign trading gross receipts under Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i) because these laws, as incorporated in the DFARs, would be among those that "require in any manner" manufacture in the United States.

Exception for international competitive bidding

In the alternative, Taxpayer argues that even if manufacture in the United States would otherwise be considered required by law or regulation within the meaning of Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i), Taxpayer’s situation falls within the "international competitive bidding" exception of Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(iii)(B). This exception would remove receipts attributable to sales of the Product to Agency A from the regulatory exclusion "if the purchase is pursuant to ... [a] program (whether bilateral or unilateral) under which sales to the United States government are open to international competitive bidding."

Taxpayer's reliance on the exception is misplaced. The plain language of the exception requires competition with respect to sales. The only competition in the history of the Product occurred in the development of a prototype of Product Type A, resulting in the selection of Corp B’s prototype over Corp C’s prototype. Such development activity did not include sales of the Product or any other kind of transaction, as defined in section 927(d)(2)(A), relevant here. The production portion of the Product program was never open to competitive bidding, international or otherwise. There was no bidding or other competitive process of any kind for any contract to supply Agency A with the Product. Corp B was exclusively granted all sale contracts without further competition once its prototype was selected. Consistently, the sole-source procedures under which the contracts at issue were negotiated are referred to as "noncompetitive" procedures in the statute. See 41 U.S.C. § 253(c). The only foreign participation consisted of subcontracts for

components in the small amount (x percent of procurement value) predetermined, on a noncompetitive basis, in the MOU.

Accordingly, the exception under Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(iii)(B) does not apply because the requirement that the program at issue be open to competitive bidding was not met in this case.

Narrow construction of tax exclusions/deductions

Our conclusion is consistent with well-established principles of tax policy and statutory construction. The FSC provisions confer a partial exclusion of income from the tax base. The Tax Court has applied the doctrine of narrow construction of tax exclusions and deductions to issues under the DISC regime. See Napp Systems, Inc. v. Commissioner, T.C. Memo. 1993-196 ("[S]ince the regulation results in a tax deduction, we are ... required to construe it narrowly"). Applying the same principle to this case, the scope of "foreign trading gross receipts" should be narrowly construed.[16]

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[16] This doctrine has been consistently applied in a variety of tax cases by the Supreme Court and Circuit Courts of Appeal. See United States v. Burke, 504 U.S. 229, 248 (1992) (Title VII back-pay award held not within scope of section 104 exclusion of damages for personal injury; "exclusions from income must be narrowly construed"); Commissioner v. Clark, 489 U.S. 726, 739 (1989) ("In construing provisions such as § 356, in which a general statement of policy is qualified by an exception, we usually read the exception narrowly in order to preserve the primary operation of the provision"); Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 265 (1958) (rate exception for capital gain "has always been narrowly construed so as to protect the revenue against artful devices"); Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 52 (1956) ("Since [capital gain treatment] is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied...."); Commissioner v. Jacobson, 336 U.S. 28, 49 (1949) ("The income taxed is described in sweeping terms and should be broadly construed in accordance with an obvious purpose to tax income comprehensively. The exemptions, on the other hand, are specifically stated and should be construed with restraint in the light of the same policy"); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934) ("[O]nly in exceptional situations, clearly defined, has there been provision for an allowance for losses suffered in an earlier year"); Finley v. United States, 123 F.3d 1342, 1348 (10th Cir. 1997) ("[W]e must narrowly construe the 'reasonable cause' exception to § 6672 liability in order to ... further the basic purpose of § 6672 to protect government revenue"); Estate of Shelfer v. Commissioner, 86 F.3d 1045, 1050 (11th Cir. 1996) ("Because the terminable property rule is an exception to this general public policy, it should be narrowly construed"); Commissioner v. Miller, 914 F.2d 586, 590 (4th Cir.

(continued...)

Product Type A is in its nature and scale wholly unlike the commissary/PX merchandise that is eligible for FSC treatment because specifically exempted from DFARs restrictions. Unlike that merchandise, the Product was subject to export control restrictions, sole-source procurement provisions and other constraints as reflected in Agency A's contract with a domestic manufacturer to manufacture the Product in the United States. The only permitted foreign participation was with respect to components provided by subcontractors, and then only to the extent of a small amount (x percent) of procurement value as predetermined on a noncompetitive basis in the MOU.

Accordingly, based on the information provided, we conclude that the receipts attributable to sales of the Product to Agency A for its own use do not generate foreign trading gross receipts within the meaning of section 924 because Agency A 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). We further conclude that the exception for programs where sales are open to competitive bidding under Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(iii)(B) does not apply.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

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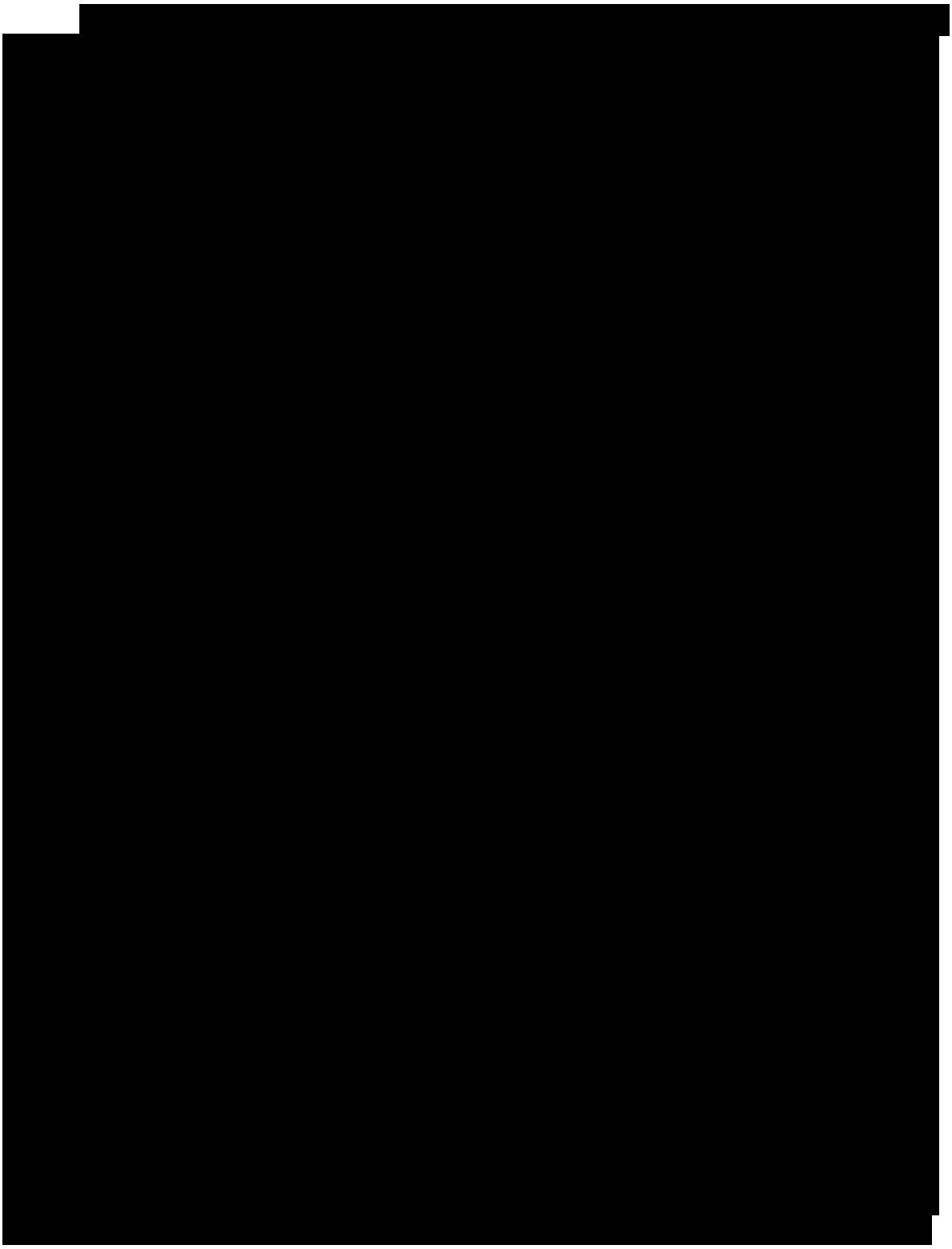
[16](...continued)
1990) (defamation damages held not within scope of section 104 exclusion of damages for personal injury; "it is a well-recognized, even venerable, principle that exclusions to income are to be narrowly construed"); Commissioner v. Baertschi, 412 F.2d 494, 499 (6th Cir. 1969) (deferral of gain on residence denied; "income tax provisions which exempt taxpayers under given circumstances from paying taxes (or as here, postponing them) are strictly construed"); Kentucky Utilities Co. v. Glenn, 394 F.2d 631, 637 (6th Cir. 1968) (dividend credit denied; "[i]t is standard tax law that income deductions and tax credits are narrowly construed. And the taxpayer has the burden of showing he comes within the provision relied upon"); Holt v. Commissioner, 364 F.2d 38, 40, 42 (8th Cir. 1966) (income of Native American lessee of tribal land not entitled to statutory exemption relating to fee interests; "exemptions from taxation are matters of legislative grace" while here there was "no treaty or statute expressly or impliedly exempting such income"); United States v. Foster, 324 F.2d 702, 706 (5th Cir. 1963) ("This treatment is an exception to the general rule of taxing all net income as ordinary income, and, as an exception, it should be narrowly construed"); O'Gilvie v. United States, 92-2 USTC ¶ 50,344 (D. Kan. 1992), mot. for recons. granted, 92-2 USTC ¶ 50,567, rev'd, 66 F.3d 1550 (10th Cir. 1995), aff'd, 519 U.S. 79 (1996) (punitive damages held not within scope of section 104 exclusion; "[i]t is a cardinal rule of taxation that exclusions to income are to be narrowly construed").



If you have any further questions, please call 202-622-3810 or 202-874-1490.

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