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INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, LMSB

FROM: Anne O'Connell Devereaux
Senior Technical Reviewer
CC:INTL:Br3

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated June 12, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Parent =
year 1 =
year 2 =
year 3 =
year 4 =
year 5 =
year 6 =
business a =
FSCsub =
b contracts =

ISSUE

Whether, when applying the tax book value method of apportioning interest expense of Temp. Treas. Reg. §1.861-9T(g) for purposes of determining combined taxable income under section 925(a) of the Internal Revenue Code, the value of Parent's inventory should be reduced by advance and progress payments.

CONCLUSION

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When applying the tax book value method of apportioning interest expense of Temp. Treas. Reg. §1.861-9T(g) for purposes of determining combined taxable income under section 925(a) of the Internal Revenue Code, the value of Parent's inventory should not be reduced by advance and progress payments regardless of the method of accounting Parent uses to account for those payments.

FACTS

During years 1 through 6, Parent was engaged in business a, including sales made under b contracts. During those years, Parent sold for use outside the United States some of the products produced in business a, including sales made under b contracts, through its wholly-owned subsidiary, FSCsub, a commission foreign sales corporation (FSC). During years 1 and 2, Parent recognized revenue on its b contracts using the percentage-of-completion method of accounting. Beginning in year 3, Parent used the accrual method of accounting with respect to some of the b contracts. During years 1 through 6, Parent, as FSCsub's related supplier, apportioned interest expense to combined taxable income for purposes of section 925(a) of the Code with regard to the sales made under the b contracts on the basis of book value rather than on the basis of the tax book value method that it elected under Temp. Treas. Reg. §1.861-9T.¹ For purposes of valuing its assets, Parent reduced the value of its inventories by advance and progress payments. In some years those reductions resulted in the inventories being valued at \$0.

LAW AND ANALYSIS

Where the combined taxable income method is used, the expenses, losses, or deductions definitely related, and therefore allocated and apportioned, to gross receipts from sales of export property, and a ratable part of any expenses, losses, or deductions which are not definitely related to any class of gross income, are determined in a manner consistent with the rules set forth in Treas. Reg. §1.861-8. Temp. Treas. Reg. §1.925(a)-1T(c)(6)(iii)(D) and (d)(2). In general, Treas. Reg. §1.861-8 requires 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). A class of gross income may consist of one or more items (or subdivisions of these items) of gross income enumerated in section 61. Treas. Reg. §1.861-8(a)(3).

¹Your submission indicates that the Service has already informed Parent that its use of book value was incorrect under the regulations, and that Parent must instead use the tax book value of assets for purposes of apportioning interest expense. We agree with your position but because your request for advice does not raise it, we do not further address the issue below.

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Once a deduction has been allocated to a class of gross income, Treas. Reg. §1.861-8 next requires that the deduction be apportioned between statutory and residual groupings of gross income within that class. 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 that specific source or activity under an operative Code section. Treas. Reg. §1.861-8(a)(4). One such statutory grouping is FSC combined taxable income. Treas. Reg. 1.861-8(f)(1)(iii).

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. Temp. Treas. Reg. §1.861-8T(c)(1).

In the case of interest expense, the regulations apply the factual relationship principle for both allocation and apportionment purposes in a manner that emphasizes the fungibility of money. Temp. Treas. Reg. §1.861-9T(a). The fungibility approach recognizes that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid. (There are several narrow exceptions to this general fungibility rule, none of which apply in this case.)

Prior to the Tax Reform Act of 1986, taxpayers were generally allowed to apportion interest expense using either a "gross income" method or an "asset" method. However, use of the gross income method was restricted. The Tax Reform Act of 1986 revised the treatment of interest expense in several respects. As relevant here, new section 864(e)(2) of the Code provided that all allocations and apportionments of interest expense must be made on the basis of assets rather than gross income. Under section 864(e)(1) and (5), the taxable income of each member of an affiliated group is determined by allocating and apportioning interest expense of each member as if all members of the group were a single corporation. Temp. Treas. Reg. §§1.861-9T(a) and (f)(4) and 1.861-11T(c)(2) and (f).

Under the asset method, interest expense is apportioned between statutory and residual groupings of gross income (or among statutory groupings) in proportion to the average total values of the assets within each such grouping for the taxable year. Temp. Treas. Reg. §1.861-9T(g)(1)(i). This average is generally computed on the basis of values at the beginning and end of the year. Temp. Treas. Reg. §1.861-9T(g)(2)(i). Taxpayers may elect to value their assets based on their tax book value or fair market value. For purposes of these regulations, the term "tax

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book value” means adjusted basis. See Temp. Treas. Reg. §1.861-9T(g)(1)(v) *Example* (1)(i). Adjusted basis is defined in Treas. Reg. §1.1011-1 as “the cost or other basis prescribed in section 1012 or other applicable provisions of subtitle A of the Code, adjusted to the extent provided in sections 1016, 1017, and 1018 or as otherwise specifically provided for under applicable provisions of internal revenue law.”

Temp. Treas. Reg. §1.861-11T(f) provides that, in computing the combined taxable income of any FSC and its related supplier which is a member of an affiliated group, the combined taxable income of such FSC and its related supplier is reduced by the portion of the total interest expense of the affiliated group that is incurred in connection with those assets of the group used in connection with export sales involving that FSC. This amount is computed by multiplying the total interest expense of the affiliated group and interest expense of the FSC by a fraction the numerator of which is the assets of the affiliated group and of the FSC generating foreign trade income. The denominator of the fraction is the total assets of the affiliated group and the FSC.

As stated above, during years 1 and 2, Parent recognized revenue on its b contracts using the percentage-of-completion method of accounting. Beginning in year 3, Parent used the accrual method of accounting on some of the b contracts. Also, during years 1 through 6, for purposes of valuing its assets, Parent reduced the value of its inventories by advance and progress payments.

As discussed above, the tax book value of a taxpayer’s assets is equal to the taxpayer’s adjusted basis in those assets. The basis of property included in inventory is the last inventory value of such property. Section 1013 of the Code; Treas. Reg. §1.1013-1. Manufacturers must include all of the direct and indirect costs of manufacturing inventoriable goods in the inventory value. Section 263A; Treas. Reg. §§1.263A-1, 1.263A-2, and 1.471-3(c). Thus, the value of inventory increases due to direct and indirect production costs. The regulations permit manufacturers to reduce the value of property included in inventory only in circumstances where the cost to reproduce the goods or the selling value of the goods declines. Treas. Reg. §§1.471-2(c), 1.471-4(a), and 1.471-4(b). There is no provision in the Code or the regulations that permits a taxpayer to reduce its inventory value as a result of receiving payments for goods in advance of a sale. Accordingly, Parent’s tax book value (i.e., adjusted basis) in inventory will be unaffected by the advance and progress payments. Therefore, the advance and progress payments from customers that Parent received in years 1 through 6 pursuant to the b contracts will have no effect on the tax book value of the inventory for purposes of determining the proper amount of interest expense to be apportioned to combined taxable income of Parent and FSCsub.

Furthermore, the advance and progress payments received with respect to those contracts for which Parent used the percentage-of-completion method will have no effect on the tax book value of Parent’s assets since under that method inventory is

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not created during the production process. Under section 460(c)(1) of the Code, all costs that “directly benefit, or are incurred by reason of, the long-term contract [e.g., percentage-of-completion] activities of [a] taxpayer shall be allocated to such contract.” Under section 460(b)(1)(A), all such costs are deducted in the taxable year in which the costs are incurred. Thus, costs that would be allocated to goods as inventory under an accrual method of accounting are instead allocated to the percentage-of-completion contract when the goods are associated with the contract. Instead of being treated as basis in inventory items and deducted as cost of goods sold on the sale of those items, the related costs are instead deducted in the year incurred under the percentage-of-completion method. Accordingly, Parent’s goods associated with the b contracts on which it used the percentage-of-completion method are removed from inventory when the goods are allocated to the contract. Thus, with regard to those b contracts, Parent has no basis in the property that is the subject matter of the contract and therefore, the property will not be taken into account for purposes of Temp. Treas. Reg. §1.861-9T(g)(1)(i). Therefore, the advance and progress payments from customers that Parent received in years 1 through 6 on the b contracts on which Parent used the percentage-of-completion method will have no effect on the tax book value of the inventory for purposes of determining the proper amount of interest expense to be apportioned to combined taxable income of Parent and FSCsub.

Please call (202) 622-3850 if you have any further questions.

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