

is effective for taxable years 1982, 1983, and 1984. The individual may not elect to exclude income under section 911(a)(1) for any taxable year before 1988, unless he obtains consent to reelect under paragraph (b)(2) of this section.

(2) *Reelection before sixth taxable year after revocation.* If an individual revoked an election under paragraph (b)(1) of this section and within five taxable years the individual wishes to reelect the same exclusion, then the individual may apply for consent to the reelection. The application for consent shall be made by requesting a ruling from the Associate Chief Counsel (Technical), National Office, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224. In determining whether to consent to reelection the Associate Chief Counsel or his delegate shall consider any facts and circumstances that may be relevant to the determination. Relevant facts and circumstances may include the following: a period of United States residence, a move from one foreign country to another foreign country with differing tax rates, a substantial change in the tax laws of the foreign country of residence or physical presence, and a change of employer.

(c) *Returns and extensions—(1) In general.* Any return filed before completion of the period necessary to qualify an individual for any exclusion or deduction provided by section 911 shall be filed without regard to any exclusion or deduction provided by that section. A claim for a credit or refund of any overpayment of tax may be filed, however, if the taxpayer subsequently qualifies for any exclusion or deduction under section 911. See section 6012(c) and § 1.6012-1(a)(3), relating to returns to be filed and information to be furnished by individuals who qualify for any exclusion or deduction under section 911.

(d) *Declaration of estimated tax.* In estimating gross income for the purpose of determining whether a declaration of estimated tax must be made for any taxable year, an individual is not required to take into account income which the individual reasonably believes will be excluded from gross income under the provisions of section

911. In computing estimated tax, however, the individual must take into account, among other things, the denial of the foreign tax credit for foreign taxes allocable to the excluded income (see § 1.911-6(c)).

(e) *Effective/applicability date.* This section applies to applications for extension of time to file returns filed after July 1, 2008.

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2976, Jan. 23, 1985, as amended by T.D. 8480, 58 FR 34885, June 30, 1993; 73 FR 37365, July 1, 2008]

§ 1.911-8 Former deduction for certain expenses of living abroad.

For rules relating to the deduction for certain expenses of living abroad applicable to taxable years beginning before January 1, 1982, see 26 CFR 1.913-1 through 1.913-13 as they appeared in the Code of Federal Regulations revised as of April 1, 1982.

(Sec. 911 (95 Stat. 194; 26 U.S.C. 911) and sec. 7805 (68A Stat. 917; 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 8006, 50 FR 2977, Jan. 23, 1985]

EARNED INCOME OF CITIZENS OF UNITED STATES

§ 1.912-1 Exclusion of certain cost-of-living allowances.

(a) Amounts received by Government civilian personnel stationed outside the continental United States as cost-of-living allowances in accordance with regulations approved by the President are, by the provisions of section 912(1), excluded from gross income. Such allowances shall be considered as retaining their characteristics under section 912(1) notwithstanding any combination thereof with any other allowance. For example, the cost-of-living portion of a "living and quarters allowance" would be excluded from gross income whether or not any other portion of such allowance is excluded from gross income.

(b) For purposes of section 912(1), the term "continental United States" includes only the 48 States existing on February 25, 1944 (the date of the enactment of the Revenue Act of 1943 (58 Stat. 21)) and the District of Columbia.

§ 1.912-2

§ 1.912-2 Exclusion of certain allowances of Foreign Service personnel.

Gross income does not include amounts received by personnel of the Foreign Service of the United States as allowances or otherwise under the provisions of chapter 9 of title I of the Foreign Service Act of 1980 or the provisions of section 28 of the State Department Basic Authorities Act (formerly section 914 of title IX of the Foreign Service Act of 1946).

[T.D. 8256, 54 FR 28620, July 6, 1989]

§ 1.921-1T Temporary regulations providing transition rules for DISCs and FSCs.

(a) *Termination of a DISC*—(1) *At end of 1984.*

Q-1: What is the effect of the termination on December 31, 1984, of a DISC's taxable year?

A-1: Without regard to the annual accounting period of the DISC, the last taxable year of each DISC beginning during 1984 shall be deemed to close on December 31, 1984. The corporation's DISC election also shall be deemed revoked at the close of business on December 31, 1984. (A DISC that does not elect to be an interest charge DISC as of January 1, 1985, in addition to a corporation described in section 992(a)(3), shall be referred to as a "former DISC".) A corporation which wishes to be treated as a FSC, a small FSC, or an interest charge DISC must make an election as provided under paragraph (b) (Q & A #1) of this section.

(2) *Deemed distributions for short taxable years.*

Q-2: If the termination of the DISC's taxable year on December 31, 1984, results in a short taxable year, how are the deemed distributions under section 995(b)(1)(E) determined?

A-2: The deemed distributions are determined on the basis of the DISC's taxable income for its short taxable year ending on December 31, 1984. In computing the incremental distribution under section 995(b)(1)(E), the export gross receipts for the short taxable year must be annualized.

(3) *Qualification as a DISC for 1984.*

Q-3: Must the DISC satisfy all the tests set forth in section 992(a)(1) for the DISC's taxable year ending December 31, 1984?

26 CFR Ch. I (4-1-12 Edition)

A-3: All of the tests under section 992(a)(1), except the qualified assets test under section 992(a)(1)(B), must be satisfied.

(4) *Commissions for 1984.*

Q-4: Must commissions be paid by a related supplier to a DISC with respect to the DISC's taxable year ending December 31, 1984?

A-4: No.

Q-4A: Must commissions which were earned prior to January 1, 1985, be paid by a related supplier if the last date payment is required (as set forth in § 1.994-1(e)(3)) is after December 31, 1984?

A-4A: No.

(5) *Producer's loans of 1984.*

Q-5: Must the producer's loan rules under section 993(d) be satisfied with respect to the DISC's taxable year ending December 31, 1984?

A-5: Yes.

(6) *Accumulated DISC income.*

Q-6: Under what circumstances is any remaining accumulated DISC income treated as previously taxed income (and not taxed)?

A-6: The accumulated DISC income of a DISC (but not a DISC described in section 992(a)(3)) as of December 31, 1984, is treated as previously taxed income when actually distributed after December 31, 1984. Any amounts distributed by the former DISC (including a DISC which has elected to be an interest charge DISC) after December 31, 1984, shall be treated as made first out of current earnings and profits and then out of previously taxed income to the extent thereof. For purposes of the preceding sentence, amounts distributed before July 1, 1985, shall be treated as made first out of previously taxed income to the extent thereof. If property other than money is distributed and if such property was a qualified export asset within the meaning of section 993(b) on December 31, 1984, then for purposes of section 311, no gain or loss will be recognized on the distribution and the distributee will have the same basis in the property as the distributor.

Q-7: May a DISC that was previously disqualified, but has requalified as of December 31, 1984, treat any accumulated DISC income as previously taxed income?

A-7: If a DISC was previously disqualified, but has requalified as of December 31, 1984, any accumulated DISC income previously required to be taken into income upon prior disqualification shall not be treated as previously taxed income. All accumulated DISC income derived since requalification, however, will be treated as previously taxed income.

(7) *Distribution of previously taxed income.*

Q-8: What effect will the distribution of previously taxed income have on the earnings and profits of corporate shareholders of the former DISC?

A-8: The earnings and profits of the corporate shareholders of the former DISC will be increased by the amount of money and the adjusted basis of any property which is distributed out of previously taxed income.

Q-9: Will the distribution of the former DISC's accumulated DISC income as previously taxed income after December 31, 1984, result in a reduction in the shareholder's basis of the stock of the former DISC and consequent taxation of the excess of the distribution over such basis as capital gain under section 996(d)?

A-9: No. This distribution will be treated both as amounts representing deemed distributions under section 995(b)(1) and as previously taxed income. Thus, no capital gain will arise.

(8) *Qualifying distributions.*

Q-10: How is a qualifying distribution to satisfy the qualified export receipts tests under section 992(c)(1)(A) which is made with respect to the DISC's taxable year ending on December 31, 1984, treated?

A-10: The distribution will not be treated as previously taxed income but will be taxed to the shareholder of the former DISC, as provided under section 992(c) and 996(a)(2) and the regulations thereunder, in the shareholder's taxable year in which the distribution is made.

(9) *Deficiency distributions.*

Q-11: With respect to an audit adjustment made after December 31, 1984, may a deficiency distribution be made, and if so, in what manner may it be made?

A-11: A deficiency distribution may be made notwithstanding the fact that

after December 31, 1984, the former DISC is a taxable corporation under subchapter C, has elected to be treated as an interest charge DISC, or has been liquidated, reorganized or is otherwise no longer in existence. However, such deficiency distribution shall be treated as made out of accumulated DISC income which is not previously taxed income because it will be treated as distributed prior to December 31, 1984, to the DISC's shareholders.

Q-11A: Must a former DISC remain in existence in order for a former DISC shareholder to take advantage of the spread provided in section 995(b)(2) with respect to DISC disqualification?

A-11A: No. With respect to distributions deemed to be received by a former DISC shareholder under section 995(b)(2) for taxable years beginning after December 31, 1984, if the former DISC shareholder elects, the rules of section 995(b)(2)(B) shall apply even though the former DISC does not continue in existence. If the former DISC is no longer in existence, the former DISC's shareholders will be deemed to have received the distribution on the last day of their taxable years over the applicable period of time determined under section 995(b)(2) as if the former DISC had remained in existence.

(10) *Deemed distribution for 1984.*

Q-12: How is the deemed distribution to a shareholder for the DISC's taxable year ending December 31, 1984, taken into account?

A-12 (i) If the taxable year of the DISC ending on December 31, 1984, (A) is the first taxable year of the DISC which begins in 1984, (B) begins after the date in 1984 on which the taxable year of the DISC's shareholder begins, and (C) if the DISC's shareholder makes an election under section 805(b)(3) of the Tax Reform Act of 1984, the deemed distribution under section 995(b) with respect to income derived by the DISC for such taxable year of the DISC shall be treated as received by the shareholder in 10 equal installments (unless the shareholder elects to be treated as receiving the deemed distribution in income over a smaller number of equal installments). The first installment shall be treated as received by the shareholder on the last day of the shareholder's second taxable

year beginning in 1984 (if any), or if the shareholder had only one taxable year which began in 1984, on the last day of the shareholder's first taxable year beginning in 1985. One installment shall be treated as received by the shareholder on the last day of each succeeding taxable year of the shareholder until the entire amount of the DISC's 1984 deemed distribution has been included in the shareholder's taxable income. To make the election under section 805(b)(3) of the Tax Reform Act of 1984, the DISC shareholder must attach a statement to its timely filed tax return (including extensions) for its taxable year which includes December 31, 1984, indicating the total amount of the shareholder's pro rata share of the DISC's deemed distribution for 1984 (determined under section 995(b) of the Code without regard to the election under section 805(b)(3) of the Tax Reform Act of 1984), and the number of equal installments, if less than 10, over which the shareholder wishes to spread its pro rata share of the deemed distribution for 1984. If the election under section 805(b)(3) of the Tax Reform Act of 1984 is made, it may not be changed or revoked. In determining estimated tax payments, the portion of the deemed distribution includible in the shareholder's taxable income for any taxable year under this subdivision (i) shall be treated as received by the shareholder on the last day of such taxable year.

(ii) Except as provided in subdivision (i), the deemed distribution under section 995(b) with respect to income derived by the DISC for its taxable year ending on December 31, 1984, shall be included in the shareholder's taxable income for its taxable year which includes December 31, 1984. Thus, if the taxable year of the DISC and the DISC's shareholder both begin on January 1, 1984, and end on December 31, 1984 (or, if the taxable year of the DISC beginning in 1984 begins before the taxable year of the DISC's shareholder), the deemed distribution with respect to the DISC's taxable year ending on December 31, 1984, will be included in the DISC shareholder's taxable year ending on (or including) December 31, 1984, and the election described in subdivision (i) may not be made.

(iii) The provisions of this Question and Answer-12 apply without regard to any existence of the DISC after December 31, 1984, as an interest charge DISC.

Q-12A: If under section 805(b)(3) of the Tax Reform Act of 1984 the shareholders of the DISC are permitted to make an election to treat the DISC's 1984 deemed distribution as received over a 10-year period, must the DISC distribute that amount to its shareholders ratably over the 10-year period?

A-12A: No. Under section 805(b)(3) of the Tax Reform Act of 1984, if the DISC's deemed distribution for its taxable year which ended on December 31, 1984, is a qualified distribution, the shareholders of the DISC are permitted to make an election to treat the distribution as received over a 10-year period. The 10-year treatment applies even though the amount of the deemed distribution is distributed to the DISC's shareholders prior to the period in which the distribution is taken into income by the shareholders. In addition, under section 996(e) of the Code, the shareholder's basis in the stock of the DISC will be considered as increased, as of the date of liquidation, by the shareholder's pro rata share of the amount of the undistributed qualified distribution even though that amount is treated as received by the shareholder in later years. Further, the actual distribution in liquidation of the former DISC after 1984 will increase the earnings and profits of a corporate distributee, and the amount actually distributed shall be treated under the rules of section 996.

(11) *Conformity of accounting period.*

Q-13: May a DISC be established or change its annual accounting period for taxable years beginning after March 21, 1984, and before January 1, 1985?

A-13: A DISC that is established or that changes its annual accounting period after March 21, 1984, must conform its annual accounting period to that of its principal shareholder (the shareholder with the highest percentage of voting power as defined in section 441(h)).

(12) *DISC gains and distributions from U.S. sources.*

Q-14: What is the effective date of the amendment to section 996(g), made by

section 801(d)(10) of the Tax Reform Act of 1984, which treats certain DISC gains and distributions as derived from sources within the United States?

A-14: Under section 805(a)(3) of the Act, the amendment to section 996(g) shall apply to all gains referred to in section 995(c) and all distributions out of accumulated DISC income including deemed distributions made on or after June 22, 1984.

(b) *Establishing and electing status as a FSC, small FSC or interest charge DISC—(1) Ninety-day period.*

Q-1: How does a corporation elect to be treated as a FSC, a small FSC, or an interest charge DISC?

A-1: A corporation electing FSC or small FSC status must file Form 8279. A corporation electing interest charge DISC status must file Form 4876A. A corporation electing to be treated as a FSC, small FSC, or interest charge DISC for its first taxable year shall make its election within 90 days after the beginning of that year. A corporation electing to be treated as a FSC, small FSC, or interest charge DISC for any taxable year other than its first taxable year shall make its election during the 90-day period immediately preceding the first day of that taxable year. The election to be a FSC, small FSC, or interest charge DISC may be made by the corporation, however, during the first 90 days of a taxable year, even if that taxable year is not the corporation's first taxable year, if that taxable year begins before July 1, 1985. Likewise, the election to be a FSC (or a small FSC) may be made during the first 90 days of any taxable year of a corporation if the corporation had in a prior taxable year elected small FSC (or FSC) status and the corporation revokes the small FSC (or FSC) election within the 90 day period. A corporation which was a DISC for its taxable year ending December 31, 1984, which wishes to be treated as an interest charge DISC beginning with its first taxable year beginning after December 31, 1984, may make the election to be treated as an interest charge DISC by filing Form 4876A on or before July 1, 1987. Also, if a corporation which has elected FSC, small FSC or interest charge DISC status, or a shareholder of that corporation, is acquired in a qualified stock

purchase under section 338(d)(3), and if an election under section 338(a) is effective with regard to that corporation, the corporation may re-elect FSC, small FSC or interest charge DISC status, (whichever is applicable) not later than the date of the election under section 338(a), see section 338(g)(i) and § 1.338-2(d). This re-election is necessary because the original elections are deemed terminated if an election is made under section 338(a). The rules contained in § 1.992-2 (a)(1), (b)(1) and (b)(3) shall apply to the manner of making the election and the manner and form of shareholder consent.

(2) *FSC incorporated in a possession.*

Q-2: Where does a FSC which is incorporated in a U.S. possession file its election?

A-2: The election is filed with the Internal Revenue Service Center, Philadelphia, Pennsylvania 19255.

(3) *Information returns.*

Q-3: Must Form 5471 be filed with respect to the organization of a FSC pursuant to section 6046 or to provide information with respect to a FSC pursuant to section 6038?

A-3: A Form 5471 required under section 6046 need not be filed with respect to the organization of a FSC. The requirements of section 6046 shall be satisfied by the filing of a Form 8279 dealing with the election to be treated as a FSC or small FSC. However, a Form 5471 will be required with respect to a reorganization of a FSC (or small FSC) or an acquisition of stock of a FSC (or small FSC), as required under section 6046 and the regulations thereunder. Provided that a Form 1120 FSC is filed, a Form 5471 need not be filed to satisfy the requirements of section 6038.

(4) *Conformity of accounting period.*

Q-4: Since a FSC, small FSC, and interest charge DISC must use the same annual accounting period as the principal shareholder, must such corporation delay the beginning of its first taxable year beyond January 1, 1985 if the principal shareholder (the shareholder with the highest percentage of voting power as defined in section 441(h)) is not a calendar year taxpayer?

A-4: No. Where the principal shareholder is not a calendar year taxpayer, a corporation may elect to be treated as a FFSC, small FSC, or interest

charge DISC for a taxable year beginning January 1, 1985. However, such corporation must close its first taxable year and adopt the annual accounting period of its principal shareholder as of the first day of the principal shareholder's first taxable year beginning in 1985. A FSC, small FSC, or interest charge DISC need not obtain the consent of the Commissioner under section 442 to conform its annual accounting period to the annual accounting period of its principal shareholder.

(5) *Dollar limitations for short taxable years.*

Q-5: If a small FSC or an interest charge DISC has a short taxable year, how are the dollar limitations on foreign trading export gross receipts and qualified export gross receipts, respectively, determined for small FSCs and interest charge DISCs?

A-5: The dollar limitations are to be prorated on a daily basis. Thus, for example, if for its 1985 taxable year a small FSC has a short taxable year of 73 days, then in determining exempt foreign trade income, any foreign trading gross receipts that exceed \$1 million ($73/365 \times \5 million) will not be taken into account.

(6) *Change of accounting period.*

Q-6: If the principal shareholder of a FSC, a small FSC, or an interest charge DISC (hereinafter referred to as a "FSC") changes its annual accounting period or is replaced by a new principal shareholder during a taxable year, is it necessary for the FSC to change its annual accounting period?

A-6: If the principal shareholder changes its annual accounting period, the FSC must also change its annual accounting period to conform to that of its principal shareholder. If the voting power of the principal shareholder is reduced by an amount equal to at least 10 percent of the total shares entitled to vote and such shareholder is no longer the principal shareholder, the FSC must conform its accounting period to that of its new principal shareholder. However, in determining whether a shareholder is a principal shareholder, the voting power of the shareholders is determined as of the beginning of the FSC's taxable year. Thus, for example, assume that for 1985 a FSC adopts a calendar year period as

its annual accounting period to conform to that of its principal shareholder. Assume further than in March 1985 there is a 10 percent change in voting power and a different shareholder whose annual accounting period begins on July 1 becomes the new principal shareholder. The FSC will not be required to adopt the annual accounting period of its new principal shareholder until July 1, 1986. The FSC will have a short taxable year for the period January 1 to June 30, 1986.

(7) *Transition transfers.*

Q-7: Under what circumstances may a DISC or former DISC transfer its assets to a FSC or small FSC without incurring any tax liability on the transfer?

A-7: A DISC or former DISC will recognize no income, gain, or loss on a transfer of its qualified assets (as defined in section 993(b)) to a FSC or small FSC if all of the following conditions are met:

(i) The assets transferred were held by the DISC on August 4, 1983, and were transferred by the DISC or former DISC to the FSC or small FSC in a transfer completed before January 1, 1986; and

(ii) The assets are transferred in a transaction which would qualify for nonrecognition under subchapter C of chapter 1 of the Code, or would so qualify but for section 367 of the Code.

In such case, section 367 shall not apply to the transfer.

In addition, other provisions of subchapter C will apply to the transfer, such as section 358 (basis to shareholders), section 362 (basis to corporations), and section 381 (carryovers in corporate acquisitions). In determining whether a transfer by a DISC to a FSC or small FSC qualifies for nonrecognition under subchapter C, a liquidation of the assets of the DISC into a parent corporation followed by a transfer by the parent of those assets to the FSC or small FSC will be treated as a transaction described in section 368(a)(1)(D).

Notwithstanding the foregoing answer, a taxpayer which transfers a right to use its corporate name to a FSC in a transaction described in sections 332, 351, 354, 356 and 361 shall not be treated as having sold that right

under section 367(d) or as having transferred that right to an entity that is not a corporation under section 367(a) provided that the corporate name is used only by the FSC and is not licensed or otherwise made available to others by the FSC.

(8) *Completed contract method.*

Q-8: Under what conditions is a taxpayer using the completed contract method of accounting as defined in § 1.451-3(d) exempted from satisfying the foreign management and foreign economic process requirements of subsections (c) and (d) of section 924?

A-8: If the taxpayer has entered into a binding contract before March 16, 1984, or has on March 15, 1984, and at all times thereafter a firm plan, evidenced in writing, to enter the contract and enters into a binding contract by December 31, 1984, then the taxpayer will be treated as having satisfied the foreign management tests of section 924(c) for periods before December 31, 1984, and the foreign economic process tests of section 924(d) with respect to costs incurred before December 31, 1984, with respect to the transaction. The FSC rules will apply to the income from the long-term contract if an election is made and the general FSC requirements under section 922 are satisfied. However, such taxpayer need not satisfy the activities test under section 925(c) for activities which occur before January 1, 1985 in order to use the transfer pricing rules under section 925.

(9) *Long-term contract—before March 15, 1984.*

Q-9: Under what conditions is a taxpayer who enters into a binding long-term contract (*i.e.*, a contract which is not completed in the taxable year in which it is entered into) before March 15, 1984, but does not use the completed contract method of accounting exempted from satisfying the foreign management and economic process requirements of subsections (c) and (d) of section 924?

A-9: If a taxpayer enters into a binding contract before March 15, 1984, the taxpayer will be treated as having satisfied the foreign management tests of section 924(c) for periods before December 31, 1984, and the foreign economic process tests of section 924(d) with respect to costs incurred before Decem-

ber 31, 1984, but only with respect to income attributable to such contracts that is recognized before December 31, 1986. The FSC rules will apply to the income from the long-term contract if an election is made and the general FSC requirements under section 922 are satisfied. However, such taxpayer need not satisfy the activities test under section 925(c) for activities which occur before January 1, 1985, in order to use the transfer pricing rules under section 925.

(10) *Long-term contract—after March 15, 1984.*

Q-10: Under what conditions is a taxpayer who has a long-term contract (*i.e.*, a contract which is not completed in the taxable year in which it is entered into) but does not use the completed contract method of accounting exempted from satisfying the foreign management and economic process requirements of subsections (c) and (d) of section 924 if such taxpayer enters into a binding contract after March 15, 1984 and before January 1, 1985?

A-10: If a taxpayer enters into a contract after March 15, 1984, and before January 1, 1985, the taxpayer will be treated as having satisfied the foreign management tests of section 924(c) for periods before December 31, 1984, and the foreign economic process tests of section 924(d) with respect to costs incurred before December 31, 1984, but only with respect to income attributable to such contract that is recognized before December 31, 1985.

The FSC rules will apply to the income from the long-term contract if an election is made and the general requirements under section 922 are satisfied. However, such taxpayer need not satisfy the activities test under section 925(c) for activities which occur before January 1, 1985 in order to use the transfer pricing rules under section 925.

(11) *Incomplete transactions.*

Q-11: In computing its foreign trade income, how should a FSC treat transfers of export property from a related supplier to a DISC which is subsequently resold by a FSC after the DISC's termination?

A-11: In applying the gross receipts and combined taxable income methods under section 925 (a)(1) and (a)(2), the transaction is treated as if the transfer

of export property were made by the related supplier to the FSC except that the foreign management and economic processes tests under section 924 and the activities test under section 925(c) shall be deemed to be satisfied for purposes of the transaction.

(12) *Pre-effective date costs and activities.*

Q-12: Are costs incurred and activities performed prior to January 1, 1985 taken into account for purposes of satisfying the foreign management and foreign economic processes requirements of subsections (c) and (d) of section 924 and the activities test under section 925(c)?

A-12: For purposes of determining the costs incurred and the activities performed to be taken into account with respect to contracts entered into after December 31, 1984, only those costs incurred and activities performed after December 31, 1984, are taken into consideration. Costs incurred and activities performed by a related supplier prior to January 1, 1985 (or prior to the effective date of a corporation's election to be treated as a FSC if other than January 1, 1985) with respect to transactions occurring after January 1, 1985 (or after the effective date of a corporation's election to be treated as a FSC) need not be taken into account for purposes of computing the FSC's profit under section 925 but are treated for section 925(c) purposes as if they were performed on behalf of the FSC.

(13) *FSC and interest charge DISC.*

Q-13: Can a FSC and an interest charge DISC be members of the same controlled group?

A-13: A FSC and an interest charge DISC cannot be members of the same controlled group. If any controlled group of corporations of which an interest charge DISC is a member establishes a FSC, then any interest charge DISC which is a member of such group shall be treated as having terminated its status as an interest charge DISC.

(c) *Export Trade Corporations—(1) Previously taxed income.*

Q-1: Under what circumstances are earnings of an export trade corporation that have not been included in income under section 951 treated as previously taxed income previously included in

the income of a U.S. shareholder for purposes of section 959 (and not taxed)?

A-1: A corporation which qualifies as an export trade corporation (ETC) with respect to its last taxable year beginning before January 1, 1985, and elects to discontinue operations as an ETC for all taxable years beginning after December 31, 1984, shall not be required to take into income earnings attributable to previously excluded export trade income, as defined in § 1.970-1(b), derived with respect to taxable years beginning before January 1, 1985. However, any amounts distributed by the former ETC (*i.e.* a corporation which was an ETC for its last taxable year beginning before January 1, 1985) shall be treated as being made out of current earnings and profits and then out of previously taxed income. For purposes of determining the shareholder's basis in the ETC stock, distributions of previously excluded export trade income shall be treated as if made out of previously taxed income which has already been included in gross income under section 951(a)(1)(B). Thus, no basis adjustment under section 961 is necessary. In addition, upon the sale or exchange of the stock of such corporation in a transaction described in section 1248(a), the earnings and profits of the corporation attributable to such previously untaxed income shall not be subject to section 1248(a).

(2) *Qualification as an ETC for last year.*

Q-2: Must an ETC satisfy all of the tests set forth in section 971(a)(1) for the ETC's last taxable year beginning before January 1, 1985?

A-2: All of the tests in section 971(a)(1) must be satisfied, except that for purposes of the working capital requirements set forth in section 971(c)(1), the working capital of the ETC at the close of its last taxable year beginning before January 1, 1985 shall be deemed reasonable.

(3) *Continuation of ETC status.*

Q-3: May a corporation which chooses to remain an ETC after December 31, 1984, continue to do so?

A-3: Yes. However, previously untaxed income of such ETC shall not be treated as previously taxed income in accordance with Q&A #1 of this section.

(4) *Discontinuation of ETC status.*

Q-4: How does an ETC make an election to discontinue its operation as an ETC?

A-4: The United States shareholders (as defined in section 951(b)) must file a statement of election on behalf of the ETC indicating the intent of the ETC to discontinue operations as an ETC for taxable years beginning after December 31, 1984. In addition, the statement of election must include the name, address, taxpayer identification number and stock interest of each United States shareholder. The statement must also indicate that the corporation on behalf of which the shareholders are making the election qualified as an ETC for its last taxable year beginning before January 1, 1985, and also the amount of earnings attributable to previously excluded export trade income. The statement must be jointly signed by each United States shareholder with each shareholder stating under penalties of perjury that he or she holds the stock interest specified for such shareholder in the statement of election. A copy of the statement of election must be attached to Form 5471 (information return with respect to a foreign corporation) filed with respect to the ETC's last taxable year beginning before January 1, 1985.

(5) *Transition transfers.*

Q-5: Under what circumstances may an electing ETC transfer its assets to a FSC without incurring any tax liability on the transfer?

A-5: An electing ETC will recognize no income, gain, or loss on a transfer of its assets to a FSC but only if all of the following conditions are met:

(i) The assets transferred were held by the ETC on August 4, 1983, and were transferred by the ETC to the FSC in a transfer completed before January 1, 1986; and

(ii) The assets are transferred in a transaction which would qualify for nonrecognition under subchapter C of chapter 1 of the Code, or would so qualify but for section 367 of the Code.

In such case, section 367 shall not apply to the transfer. In addition, other provisions of subchapter C will apply to the transfer such as section 358 (basis to shareholders), section 362 (basis to corporation) and section 381

(carryovers in corporate acquisitions). In determining whether a transfer by an ETC to a FSC qualifies for nonrecognition under subchapter C, a liquidation of the assets of the ETC into a parent corporation followed by a transfer by the parent of those assets to the FSC will be treated as a transaction described in section 368(a)(1)(D).

(Secs. 803 and 805 of the Tax Reform Act of 1984 (98 Stat. 1001) and sec. 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805); sec. 805 (b)(3)(C) and (D) of the Tax Reform Act of 1984 (98 Stat. 1002), and sec. 7805 of the Code (68A Stat. 917; 26 U.S.C. 7805); secs. 367, 927, and 7805 of the Internal Revenue Code of 1954 (98 Stat. 662, 26 U.S.C. 367; 98 Stat. 663, 26 U.S.C. 367; 98 Stat. 993, 26 U.S.C. 927; 98 Stat. 994, 26 U.S.C. 927; and 68A Stat. 917, 26 U.S.C. 7805); sec. 805 of the Tax Reform Act of 1984 (Pub. L. 98-69, 98 Stat. 1000))

[T.D. 7983, 49 FR 40013, Oct. 12, 1984, as amended by T.D. 7992, 49 FR 48283, Dec. 12, 1984; T.D. 7993, 49 FR 48291, Dec. 12, 1984; T.D. 7992, 49 FR 49450, Dec. 20, 1984; T.D. 8126, 52 FR 6434, 6435, Mar. 3, 1987; T.D. 8515, 59 FR 2984, Jan. 20, 1994; T.D. 8858, 65 FR 1237, Jan. 7, 2000; T.D. 8940, 66 FR 9929, Feb. 13, 2001]

§ 1.921-2 Foreign Sales Corporation—general rules.

(a) *Definition of a FSC and the Effect of a FSC Election.*

Q-1. What is the definition of a Foreign Sales Corporation (hereinafter referred to as a "FSC" (All references to FSCs include small FSCs unless indicated otherwise))?

A-1. As defined in section 922(a), an FSC must satisfy the following eight requirements.

(i) The FSC must be a corporation organized or created under the laws of a foreign country that meets the requirements of section 927(e)(3) (a "qualifying foreign country") or a U.S. possession other than Puerto Rico (an "eligible possession"). See Q&As 3, 4, and 5 of § 1.922-1.

(ii) A FSC may not have more than 25 shareholders at any time during the taxable year. See Q&A 6 of § 1.922-1.

(iii) A FSC may not have any preferred stock outstanding during the taxable year. See Q&As 7 and 8 of § 1.922-1.

(iv) A FSC must maintain an office outside of the United States in a qualifying foreign country or an eligible

possession and maintain a set of permanent books of account (including invoices or summaries of invoices) at such office. See Q&As 9, 10, 11, 12, 13, 14, and 15 of § 1.922-1.

(v) A FSC must maintain within the United States the records required under section 6001. See Q&A 16 of § 1.922-1.

(vi) The FSC must have a board of directors which includes at least one individual who is not a resident of the United States at all times during the taxable year. See Q&As 17, 18, 19, 20, and 21 of § 1.922-1.

(vii) A FSC may not be a member, at any time during the taxable year, of any controlled group of corporations of which an interest charge DISC is a member. See Q&A 2 of this section and Q&A 13, of § 1.921-1T(b)(13).

(viii) A FSC must have made an election under section 927(f)(1) which is in effect for the taxable year. See Q&A 1 of § 1.921-1T(b)(1) and § 1.927(f)-1.

In addition, under section 441(h), the taxable year of a FSC must conform to the taxable year of its principal shareholder. See Q&A 4 of § 1.921-1T(b)(4).

Q-2. Does the reference to a DISC under section 922(a)(1)(F) which provides that a FSC cannot be a member, at any time during the taxable year, of any controlled group of corporations of which a DISC is a member refer solely to an interest charge DISC?

A-2. Yes.

(b) *Small FSC.*

Q-3. What is a small FSC?

A-3. A small FSC is a Foreign Sales Corporation which meets the requirements of section 922(a)(1) enumerated in Q&A 1 of this section as well as the requirements of section 922(b). Section 922(b) requires that a small FSC make a separate election to be treated as a small FSC. See Q&A 1 of § 1.921-1T(b) and § 1.927(f)-1. In addition, section 922(b) requires that the small FSC not be a member, at any time during the taxable year, of a controlled group of corporations which includes a FSC unless such FSC is a small FSC.

Q-4. What is the effect of an election as a small FSC?

A-4. Under section 924(b)(2), a small FSC need not meet the foreign management and economic processes tests of section 924(b)(1) in order to have for-

eign trading gross receipts. However, in determining the exempt foreign trade income of a small FSC, any foreign trading gross receipts for the taxable year in excess of \$5 million are not taken into account. If the foreign trading gross receipts of a small FSC for the taxable year exceed the \$5 million limitation, the FSC may select the gross receipts to which the limitation is allocated. In order to use the administrative pricing rules under section 925(a), a small FSC must satisfy the activities test under section 925(c). In addition, under section 441(h), the taxable year of a small FSC must conform to the taxable year of its principal shareholder (defined in Q&A 4 of § 1.921-1T(b)(4) as the shareholder with the highest percentage of its voting power).

Q-5. What is the effect on a small FSC (or FSC) ("target") if it is acquired, directly or indirectly, by a corporation if that acquiring corporation ("acquiring"), or a member of the acquiring corporation's controlled group, is a FSC (or small FSC)?

A-5. Unless the corporations in the controlled group elect to terminate the FSC (or small (FSC) election of the acquiring corporation, the target's small FSC's (or FSC's) taxable year and election will terminate as of the day preceding the date the target small FSC and acquiring FSC became members of the same controlled group. The target small FSC will receive FSC benefits for the period prior to termination, but the \$5 million small FSC limitation will be reduced to the amount which bears the same ratio to the \$5 million as the number of days in the short year created by the termination bears to 365. The due date of the income tax return for the short taxable year created by this provision will be the date prescribed by section 6072(b), including extensions, starting with the last day of the short taxable year. If the short taxable year created by this provision ends prior to March 3, 1987, the filing date of the tax return for the short taxable year will be automatically extended until the earlier of May 18, 1987 or the date under section 6072 (b) assuming a short taxable year had not been created by these regulations.

(c) *Comparison of FSC to DISC.*

Q-6. How does a FSC differ from a DISC?

A-6. A DISC is a domestic corporation which is not itself taxable while a FSC must be created or organized under the laws of a jurisdiction which is outside of the United States (including certain U.S. possessions) and may be taxable on its income except for its exempt foreign trade income. The DISC provisions enable a shareholder to obtain a partial deferral of tax on income from export sales and certain services, if 95 percent of its receipts and assets are export related. The FSC provisions contain no assets test, but a portion of income for export sales and certain services is exempt from U.S. taxes if the FSC satisfies certain foreign presence, foreign management, and foreign economic processes tests.

(d) *Organization of a FSC.*

Q-7. Under the laws of what countries may a FSC be organized?

A-7. A FSC may not be created or organized under the laws of the United States, a state, or other political subdivision. However, a FSC may be created or organized under the laws of a possession of the United States, including Guam, American Samoa, the Commonwealth of the Northern Mariana Islands and the Virgin Islands of the United States, but not Puerto Rico. These eligible possessions are located outside the U.S. customs territory. In addition, a FSC may incorporate under the laws of a foreign country that is a party to—

(i) An exchange of information agreement that meets the standards of the Caribbean Basin Economic Recovery Act of 1983 (Code section 274(h)(6)(C)), or

(ii) A bilateral income tax treaty with the United States if the Secretary certifies that the exchange of information program under the treaty carries out the purpose of the exchange of information requirements of the FSC legislation as set forth in section 927(e)(3), if the company is covered under the exchange of information program under subdivision (i) or (ii). The Secretary may terminate the certification. Any termination by the Secretary will be effective six months after the date of the publication of the notice of such termination in the FEDERAL REGISTER.

(e) *Foreign Trade Income.*

Q-8. How is foreign trade income defined?

A-8. Foreign trade income, defined in section 923(b), is gross income of an FSC attributable to foreign trading gross receipts. It includes both the profits earned by the FSC itself from exports and commissions earned by the FSC from products and services exported by others.

(f) *Investment Income and Carrying Charges.*

Q-9. What do the terms “investment income” and “carrying charges” mean?

A-9.

(i) Investment income means:

- (A) Dividends,
- (B) Interest,
- (C) Royalties,
- (D) Annuities,

(E) Rents (other than rents from the lease or rental of export property for use by the lessee outside of the United States);

(F) Gains from the sale of stock or securities,

(G) Gains from future transactions in any commodity on, or subject to the rules of, a board of trade or commodity exchange (other than gains which arise out of a bona fide hedging transaction reasonably necessary to conduct the business of the FSC in the manner in which such business is customarily conducted by others),

(H) Amounts includable in computing the taxable income of the corporation under part I of subchapter J, and

(I) Gains from the sale or other disposition of any interest in an estate or trust.

(ii) Carrying charges means:

(A) Charges that are imposed by a FSC or a related supplier and that are identified as carrying charges, (“stated carrying charges”) and

(B)(1) Charges that are considered to be included in the price of the property or services sold by an FSC or a related supplier, as provided under Q&As 1 and 2 of § 1.927(d)-1, and

(2) Any other unstated interest.

Q-10. How are investment income and carrying charges treated?

A-10. Investment income and carrying charges are not foreign trading gross receipts. Investment income and carrying charges are includable in the

taxable income of an FSC, except in the case of a commission FSC where carrying charges are treated as income of the related supplier, and are treated as income effectively connected with a trade or business conducted through a permanent establishment within the United States. The source of investment income and carrying charges is determined under sections 861, 862, and 863 of the Code.

(g) *Small Businesses.*

Q-11. What options are available to small businesses engaged in exporting?

A-11. A small business may elect to be treated as either a small FSC or an interest charge DISC. See Q&As 3 & 4 of §1.921-2 relating to a small FSC. Rules with respect to interest charge DISCs are the subject of another regulations project.

[T.D. 8127, 52 FR 6469, Mar. 3, 1987]

§ 1.921-3T Temporary regulations; Foreign sales corporation general rules.

(a) *Exclusion—(1) Classifications of income.* The extent to which income of a FSC (any further reference to a FSC in this section shall include a small FSC unless indicated otherwise) is subject to the corporate income tax of section 11, or, in the alternative, section 1201(a), is dependent upon the allocation of the FSC's income to the following five categories:

(i) Exempt foreign trade income determined under section 923 and §1.923-1T;

(ii) Non-exempt foreign trade income determined with regard to the administrative pricing rules of section 925(a)(1) or (2);

(iii) Non-exempt foreign trade income determined without regard to the administrative pricing rules of section 925(a)(1) or (2) (section 923(a)(2) non-exempt income as defined in section 927(d)(6));

(iv) Investment income and carrying charges; and

(v) Other non-foreign trade income.

(2) *Source and characterization of FSC income—(i) Exempt foreign trade income.* The exempt foreign trade income of a FSC determined under section 923 and §1.923-1T is treated as foreign source income which is not effectively connected with a United States trade or

business. See §1.923-1T(a) for the definition of foreign trade income and §1.923-1T(b) for the definition of exempt foreign trade income.

(ii) *Non-exempt foreign trade income determined with regard to the administrative pricing rules.* The FSC's non-exempt foreign trade income with respect to a transaction or group of transactions will be treated as United States source income which is effectively connected with the FSC's trade or business which is conducted through its permanent establishment within the United States if either of the administrative pricing rules of section 925(a)(1) or (2) is used to determine the FSC's foreign trade income from a transaction or group of transactions. See §1.923-1T(b) for the definition of non-exempt foreign trade income.

(iii) *Non-exempt foreign trade income determined without regard to the administrative pricing rules.* The source and taxation of the FSC's non-exempt foreign trade income not classified in paragraph (a)(2)(ii) of this section will be determined under the appropriate sections of the Internal Revenue Code and the regulations under those sections. This type of income (section 923(a)(2) non-exempt income) includes both income that is not effectively connected with the conduct of a trade or business in the United States and income that is effectively connected.

(iv) *Investment income and carrying charges.* All of the FSC's investment income and carrying charges will be treated as income which is effectively connected with the FSC's trade or business which is conducted through its permanent establishment within the United States. The source of that income will be determined under the appropriate sections of the Internal Revenue Code and the regulations under those sections. See §1.921-2(f) (Q & A9) for definition of investment income and carrying charges.

(v) *Non-foreign trade income (other than investment income and carrying charges).* The source and taxation of the FSC's non-foreign trade income (other than investment income and carrying charges) will be determined under the appropriate sections of the Internal Revenue Code and the regulations under those sections.

(b) *Allocation and apportionment of deductions.* Expenses, losses and deductions incurred by the FSC shall be allocated and apportioned under the rules set forth in §1.861-8 to the FSC's foreign trade income and to the FSC's non-foreign trade income. Any deductions incurred by the FSC on a transaction, or group of transactions, which are allocated and apportioned to the FSC's foreign trade income from that transaction, or group of transactions, shall be allocated on a proportionate basis between exempt foreign trade income and non-exempt foreign trade income.

(c) *Net operating losses and capital losses—(1) General rule.* (i) If a FSC for any taxable year incurs a deficit in earnings and profits attributable to foreign trade income determined without regard to the administrative pricing rules of section 925(a)(1) or (2), that deficit shall be applied to reduce current earnings and profits, if any, attributable to—

(A) First, exempt foreign trade income determined with regard to the administrative pricing rules,

(B) Second, non-exempt foreign trade income determined with regard to the administrative pricing rules,

(C) Third, investment income and carrying charges, and

(D) Fourth, other non-foreign trade income.

(ii) If a FSC for any taxable year incurs a deficit in earnings and profits attributable to non-foreign trade income (other than investment income, carrying charges and net capital losses), that deficit shall be applied to reduce current earnings and profits, if any, attributable to—

(A) First, investment income and carrying charges,

(B) Second, exempt foreign trade income determined with regard to the administrative pricing rules,

(C) Third, exempt foreign trade income determined without regard to the administrative pricing rules,

(D) Fourth, non-exempt foreign trade income determined with regard to the administrative pricing rules, and

(E) Fifth, section 923(a)(2) non-exempt income.

(iii) If a FSC for any taxable year incurs a deficit in earnings and profits

attributable to investment income and carrying charges, that deficit shall be applied to reduce current earnings and profits, if any, attributable to—

(A) First, non-foreign trade income other than capital gains,

(B) Second, exempt foreign trade income determined with regard to the administrative pricing rules,

(C) Third, exempt foreign trade income determined without regard to the administrative pricing rules,

(D) Fourth, non-exempt foreign trade income determined with regard to the administrative pricing rules, and

(E) Fifth, section 923(a)(2) non-exempt income.

(iv) Net capital losses will be available for carryback or carryover pursuant to paragraph (c)(2) of this section.

(v) Because the no-loss rules provide that a related supplier may always compensate the FSC for its expenses either as part of the commission payment or as part of the transfer price if the administrative pricing rules are used (see §1.925(a)-1T(e)(1)(i)), a FSC will not have a deficit in its earnings and profits relating to foreign trade income determined with regard to the administrative pricing rules. To determine the amount of any division of earnings and profits for the purpose of determining under §1.926(a)-1T (a) and (b) the treatment and order of distributions, the portion of a deficit in earnings and profits chargeable under this paragraph to such division prior to such distribution shall be determined in a manner consistent with the rules in §1.316-2(b) for determining the amount of earnings and profits available on the date of any distribution.

(2) *Carryback or carryover of net operating losses and capital losses to other taxable years of a FSC (or former FSC).*

(i) The amount of the deduction for the taxable year under section 172 for a net operating loss carryback or carryover, or under section 1212 for a capital loss carryback or carryover, shall be determined in the same manner as if the FSC were a foreign corporation which had not elected to be treated as a FSC. Thus, the amount of the deduction will be the same whether or not the corporation was a FSC in the year of the loss or in the year to which the loss is carried.

(ii) Any carryback or carryover of a FSC's (or former FSC's) net operating loss which is attributable to transactions which give rise to foreign trade income shall be charged—

(A) First, to earnings and profits attributable to exempt foreign trade income which is determined without regard to the administrative pricing rules,

(B) Second, to earnings and profits attributable to section 923(a)(2) non-exempt income,

(C) Third, to earnings and profits attributable to exempt foreign trade income determined with regard to the administrative pricing rules,

(D) Fourth, to earnings and profits attributable to non-exempt foreign trade income determined with regard to the administrative pricing rules,

(E) Fifth, to earnings and profits attributable to investment income and carrying charges (other than capital gain income), and

(F) Sixth, to earnings and profits attributable to non-foreign trade income (other than investment income, carrying charges and capital gain income).

(iii) Any carryback or carryover of a FSC's (or former FSC's) net operating loss which is attributable to non-foreign trade income (other than capital gain income) shall be charged—

(A) First, to earnings and profits attributable to non-foreign trade income (other than investment income, carrying charges and capital gain income),

(B) Second, to earnings and profits attributable to investment income and carrying charges,

(C) Third, to earnings and profits attributable to exempt foreign trade income determined with regard to the administrative pricing rules,

(D) Fourth, to earnings and profits attributable to non-exempt foreign trade income determined with regard to the administrative pricing rules,

(E) Fifth, to earnings and profits attributable to exempt foreign trade income which is determined without regard to the administrative pricing rules, and

(F) Sixth, to earnings and profits attributable to section 923(a)(2) non-exempt income.

(iv) Any carryback or carryover of a net operating loss to a year in which

the corporation was (or is) a FSC from a taxable year in which the corporation was not a FSC shall be applied in a manner consistent with subdivision (iii) of this paragraph.

(d) *Credits against tax*—(1) *General rule.* Notwithstanding any other provision of chapter 1, subtitle A, a FSC is allowed under section 921(c) as credits against tax only the following credits:

(i) The foreign tax credit, section 27(a);

(ii) The credit for tax withheld at source on foreign corporations, section 33; and

(iii) The certain uses of gasoline and special fuels credit, section 34.

(2) *Foreign tax credit.* (i) The direct foreign tax credit of section 901(b)(4) as determined under section 906 for income, war profits, and excess profits taxes (or taxes in lieu thereof) paid or accrued to any foreign country or possession of the United States is allowed a FSC only to the extent that those taxes are attributable to the FSC's foreign source non-foreign trade income which is effectively connected with its conduct of a trade or business within the United States. See section 906(b)(5).

(ii) The foreign tax credit for domestic corporate shareholders in foreign corporations (the deemed paid credit) provided under section 901(a) as determined under section 902 is allowed for income, war profits, and excess profits taxes deemed paid or accrued by a FSC (or former FSC) only to the extent those taxes are deemed paid or accrued with respect to the FSC's (or former FSC's) section 923(a)(2) non-exempt income and its non-foreign trade income.

(iii) The foreign tax credit allowed by sections 901 and 903 for tax withheld at source is allowed only to the extent the dividends paid to the FSC's (or former FSC's) shareholder are attributable to the FSC's (or former FSC's) section 923(a)(2) non-exempt income and its non-foreign trade income.

(3) *Foreign tax credit limitation.* (i) For purposes of computation of the direct foreign tax credit of section 901(b)(4) as determined under section 906, the separate limitation of section 904(d)(1)(C) for the FSC's taxable income attributable to its foreign trade income will apply. The direct foreign tax credit is not allowed to a FSC with regard to

taxes it paid which are attributable to its foreign trade income. Since the foreign tax credit is not allowed for that type of income, the effect of the separate limitation is to remove the FSC's foreign trade income from the numerator of the fraction used to compute the FSC's overall foreign tax credit limitation.

(ii) A separate limitation under section 904(d)(1)(D) is provided for distributions from a FSC (or former FSC) that arise through operation of the deemed paid credit of section 902 and are attributable to foreign trade income earned during the period when the distributing corporation was a FSC. This limitation is computed by multiplying the FSC's shareholder's tentative United States tax by a fraction the numerator of which is the foreign source dividend (determined with regard to section 78) attributable to the foreign trade income less dividends received deductions and other expenses allocated and apportioned under § 1.861-8 allowed to the shareholder and the denominator of which is the shareholder's worldwide income. The effect of this separate limitation is to remove dividends attributable to the FSC's foreign trade income from the numerator of the fraction used to compute the overall foreign tax credit limitation of the FSC's shareholder.

(iii) The separate limitation under section 904(d)(1)(D) also applies to the foreign tax credit allowed to a FSC shareholder by sections 901 and 903 for tax withheld at source on dividends paid by the FSC. The numerator of this fraction is the part of the dividend attributable to the FSC's foreign trade income and the denominator is the shareholder's worldwide income. The effect of this separate limitation is to remove dividends attributable to foreign trade income of a FSC (or former FSC) from the numerator of the fraction used to compute the overall foreign tax credit limitation of the FSC's shareholder.

(e) *Deduction for foreign income, war profits and excess profits taxes.* Under section 275(a)(4)(B), income, war profits and excess profits taxes imposed by a foreign country or possession of the United States may not be deducted by a FSC to the extent those taxes are

paid or accrued with respect to its foreign trade income.

(f) *Payment of estimated tax.* Every FSC which is subject to tax under section 11 or 1201(a) and section 882 must make payment of its estimated tax in accordance with section 6154 and the regulations under that section. In determining the amount of the estimated tax, the FSC must treat the tax imposed by section 881 as though it were a tax imposed by section 11. See section 6154(g).

(g) *Accumulated earnings, personal holding company and foreign personal holding company.* The provisions covering the accumulated earnings tax (sections 531 through 537), personal holding companies (sections 541 through 547) and foreign personal holding companies (sections 551 through 558) apply to FSCs to the extent they would apply to foreign corporations that are not FSCs.

(h) *Subpart F income and increase of earnings invested in U.S. property.* For the mandatory inclusion in the gross income of the U.S. shareholders of the subpart F income and of the increase in earnings invested in U.S. property of a FSC, see sections 951 through 964 and the regulations under those sections. However, the foreign trade income (other than section 923(a)(2) non-exempt income) and, generally, the investment income and carrying charges of a FSC and any deductions which are allocated and apportioned to those classes of income, are not taken into account under sections 951 through 964. See sections 951(e) and 952(b).

(i) *Certain accumulations of earnings and profits.* For the inclusion in the gross income of U.S. persons as a dividend on the gain recognized on certain sales or exchanges of stock in a FSC, to the extent of certain earnings and profits attributable to the stock which were accumulated while the FSC was a controlled foreign corporation, see section 1248 and the regulations under that section. However, section 1248 and the regulations under that section do not apply to a FSC's earnings and profits attributable to foreign trade income, see section 1248(d)(6).

(j) *Limitations on certain multiple tax benefits.* The provisions of section 1561, Limitations on Certain Multiple Tax

Benefits in the Case of Certain Controlled Corporations, and section 1563, Definitions and Special Rules, and the regulations under those sections apply to a FSC and its controlled group.

[T.D. 8126, 52 FR 6435, Mar. 3, 1987]

§ 1.922-1 Requirements that a corporation must satisfy to be a FSC or a small FSC.

(a) FSC requirements.

Q-1. What are the requirements that a corporation must satisfy to be an FSC?

A-1. A corporation must satisfy all of the requirements of section 922(a).

(b) Small FSC requirements.

Q-2. What are the requirements that a corporation must satisfy to be a small FSC?

A-2. A corporation must satisfy all of the requirements of sections 922(a)(1) and (b).

(c) Definition of corporation.

Q-3. What type of entity is considered a corporation for purposes of qualifying as an FSC or a small FSC under section 922?

A-3. A foreign entity that is classified as a corporation under section 7701(a)(3) (other than an insurance company) is considered a corporation for purposes of this requirement.

(d) Eligible possession.

Q-4. For purposes of meeting the place of incorporation requirement of section 922(a)(1)(A), what is a possession of the United States?

A-4. For purposes of section 922(a)(1)(A), the possessions of the United States are Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Virgin Islands of the United States ("eligible possessions"). Puerto Rico, although a possession for certain tax purposes, does not qualify as a jurisdiction in which a FSC or small FSC may be incorporated.

(e) Qualifying countries.

Q-5. For purposes of meeting the place of incorporation requirement of section 922(a)(1)(A), what is a foreign country and which foreign countries meet the requirements of section 927(e)(3)?

A-5. (i) A foreign country is a jurisdiction outside the 50 states, the District of Columbia, the Commonwealth

of Puerto Rico, and the possessions of the United States. (ii) A list of the foreign countries that meet the requirements of section 927(e)(3) ("qualifying countries") will be published from time to time in the FEDERAL REGISTER and the Internal Revenue Bulletin. A corporation is considered to be created or organized under the laws of a foreign country that meets the requirements of section 927(e)(3) only if the foreign country is a party to (A) an exchange of information agreement under the Caribbean Basin Economic Recovery Act (Code section 274(h)(6)(C)), or (B) a bilateral income tax treaty with the United States if the Secretary certifies that the exchange of information program under the treaty carries out the purposes of the exchange of information requirements of the FSC legislation as set forth in Code section 927(e)(3) and if the corporation is covered under exchange of information program under subdivision (A) or (B).

(f) Number of shareholders.

Q-6. Who is counted as a shareholder of a corporation for purposes of determining whether a corporation meets the limitation on the number of shareholders to no more than 25 under section 922(a)(1)(B)?

A-6. Solely for purposes of the limitation on the number of shareholders, the following rules apply:

(i) In general, an individual who owns an interest in stock of the corporation is counted as a shareholder. In the case of joint owners, each joint owner is counted as a shareholder. A member of a corporation's board of directors who holds qualifying shares that are required to be owned by a resident of the country of incorporation is not counted as a shareholder.

(ii) A corporation that owns an interest in stock of the corporation is counted as a single shareholder.

(iii) An estate that owns an interest in stock of the corporation is counted as a single shareholder. If the limitation on number of shareholders is not satisfied by reason of the closing of an estate, the FSC will continue to qualify for the taxable year of the FSC in which the estate is closed.

(iv) A trust is not counted as a shareholder. In the case of a trust all of which is treated as owned by one or

more persons under sections 671 through 679, those persons are counted as shareholders. In the case of all other trusts, a beneficiary is counted as a shareholder.

(v) A partnership is not counted as a shareholder. A general or limited partner is counted as a shareholder if it is a corporation, an individual, or an estate, under the rules contained in subdivisions (i) through (iii). A general or limited partner is not counted as a shareholder if it is a partnership or a trust; the rules contained in subdivision (iv) and this subdivision (v) apply to the determination of who is counted as a shareholder.

(g) *Class of stock.*

Q-7. What is preferred stock for purposes of determining whether a corporation satisfies the requirement under section 922(a)(1)(C) that no preferred stock be outstanding?

A-7. Preferred stock is stock that is limited and preferred as to dividends or distributions in liquidation.

Q-8. Can a corporation have outstanding more than one class of common stock?

A-8. Yes. However, the rights of a class of stock will be disregarded if the right has the effect of avoidance of Federal income tax. For instance, dividend rights may not be used to direct dividends from exempt foreign trade income to shareholders that have taxable income and to direct other dividends to shareholders that have met operating loss carryovers.

(h) *Office.*

Q-9. What is an office for purposes of determining whether a corporation satisfies the requirement of section 922(a)(1)(D)(i)?

A-9. An office is a place for the transaction of the business of the corporation. To be an office a place must meet all of the following requirements;

(i) *It must have a fixed location.* A transient location is not a fixed location.

(ii) *It must be a building or a portion of a building consisting of at least one room.* A room is a partitioned part of the inside of a building. The building or portion thereof used as the corporation's office must be large enough to accommodate the equipment required in subdivision (iii) of this answer 9 and the

activity required in subdivision (iv) of this answer 9. However, an office is not limited to a room with communication equipment or an adjacent room. Non-contiguous space within the same building will also constitute an office if it is equipped for the retention of the documentation required to be stored by the FSC and if access to the necessary communication equipment is available for use by the FSC.

(iii) *It must be equipped for the performance of the corporation's business.* An office must be equipped for the communication and retention of information and must be supplied with communication services.

(iv) *It must be regularly used for some business activity of the corporation.* A corporation's business activities must include the maintenance of the documentation described in Q&A 12 of this section. These documents need not be prepared at the office. Any person, whether or not related to the corporation, may perform the business activities of the corporation at the office if the activity is performed pursuant to a contract, oral or written, for the performance of the activity on behalf of the corporation.

(v) *It must be operated, and owned or leased, by the corporation or by a person, whether or not related to the corporation, under contract to the corporation.*

(vi) *It must be maintained by the corporation or by a person, whether or not related, to the corporation, under contract to the corporation at all times during the taxable year.* In the case of a corporation newly organized as a FSC, thirty days may elapse between the time the corporation is organized as a FSC (*i.e.*, the first day for which the FSC election is effective) and the time an office is maintained by the corporation or a person under contract with the corporation. A place that meets the requirements in subdivision (i) through (vi) of this answer 9 can also be used for activities that are unrelated to the business activity of the corporation.

Q-10. Can a corporation locate an office in any foreign country if it has at least one office in a U.S. possession or in a foreign country that meets the requirements of section 927 (e)(3) as provided Q&A 5 of this section?

A-10. Yes.

Q-11. Must a corporation locate the office that is required under section 922(a)(1)(D)(i) in the country or possession of its incorporation?

A-11. No.

(i) *Documentation.*

Q-12. What documentation must be maintained at the corporation's office for purposes of section 922(a)(1)(D)(ii)?

A-12. At least the following documentation must be maintained at the corporation's office under section 922(a)(1)(D)(ii):

(i) The quarterly income statements, a final year-end income statement and a year-end balance sheet of the FSC; and

(ii) All final invoices (or a summary of them) or statements of account with respect to (A) sales by the FSC, and (B) sales by a related person if the FSC realizes income with respect to such sales. A final invoice is an invoice upon which payment is made by the customer. A invoice must contain, at a minimum, the customer's name or identifying number and, with respect to the transaction or transactions, the date, product or product code or service of service code, quantity, price, and amount due. In the alternative, a document will be acceptable as a final invoice even though it does not include all of the above listed information if the FSC establishes that the document is considered to be a final invoice under normal commercial practices. An invoice forwarded to the customer after payment has been tendered or received pursuant to a letter of credit, as a receipt for payment, satisfies this definition. A single final invoice may cover more than one transaction with a customer.

(iii) A summary of final invoices may be in any reasonable form provided that the summary contains all substantive information from the invoices. All substantive information includes the customer's name or identifying number, the invoice number, date, product or product code, and amount owed. In the alternative, all substantive information includes a summary of the information that is included on documents considered to be final invoices under normal commercial practice. A statement of account is any summary statement forwarded to a

customer to inform of, or confirm, the status of transactions occurring within an accounting period during a taxable year that is not less than one month. A statement of account must contain, at a minimum, the customer's name or identifying number, date of the statement of account and the balance due (even if the balance due is zero) as of the last day of the accounting period covered by the statement of account. In the alternative, a document will be accepted as a statement of account even though it does not include all of the above listed information if the FSC establishes that the document is considered a statement of account under normal commercial practice. For these purposes, a document will be considered to be a statement of account under normal commercial practice if it is sent to domestic as well as to export customers in order to inform the customers of the status of transactions during an accounting period. With regard to quarterly income statements, a reasonable estimate of the FSC's income and expense items will be acceptable. If the FSC is a commission FSC, 1.83% of the related supplier's gross receipts will be considered a reasonable estimate of the FSC's income. The documents required by this Q&A 12 need not be prepared by the FSC. In addition they need not be prepared at the FSC's office.

(iv) The FSC will satisfy the requirement that the documents be maintained at its office even if not all final invoices (or summaries) or statements of account or items to be included on statements of account are maintained at its office as long as it makes a good faith effort to do so and provided that any failure to maintain the required documents is cured within a reasonable time of discovery of the failure.

Q-13. If the required documents are not prepared at the FSC's office, by what date must the documents be maintained at its office?

A-13. With regard to the applicable quarters of years prior to March 3, 1987, the quarterly income statements, final invoices (or summaries), or statements of account and the year-end balance sheet must be maintained at the FSC's

office no later than the due date, including extensions, of the FSC tax return for the applicable taxable year in which the period ends. With regard to the applicable quarters or years ending after March 3, 1987, the quarterly income statements for the first three quarters of the FSC year must be maintained at the FSC's office no later than 90 days after the end of the quarter. The quarterly income statement for the fourth quarter of the FSC year, the final year-end income statement, the year-end balance sheet, and the final invoices (or summaries) or statements of account must be maintained at the FSC's office no later than the due date, including extensions, of the FSC tax return for the applicable taxable year.

Q-14. In what form must the documentation required under section 922(a)(1)(D)(ii) be maintained?

A-14. The documentation required to be maintained by the office may be originals or duplicates and may be in any form that qualifies as a record under Rev. Rul. 71-20, 1971-1 C.B. 392. Therefore, documentation may be maintained in the form of punch cards, magnetic tapes, disks, and other machine-sensible media used for recording, consolidating, and summarizing accounting transactions and records within a taxpayer's automatic data processing system. The corporation need not maintain at its office equipment capable of reading the machine-sensible media. That equipment, however, must be situated in a location that is readily accessible to the corporation. The equipment need not be owned by the corporation.

Q-15. How long must the documentation required under section 922(a)(1)(D)(ii) be maintained?

A-15. The documentation required under section 922(a)(1)(D)(ii) for a taxable year must be maintained at the FSC's office described in section 922(a)(1)(D)(i) until the period of limitations for assessment of tax for the taxable year has expired under section 6501.

Q-16. Under what circumstances will a corporation be considered to satisfy the requirement of section 922(a)(1)(D)(iii) that it maintain the records it is required to keep under sec-

tion 6001 at a location within the United States?

A-16. A corporation will be considered to satisfy this requirement if the records required under section 6001 are kept by any person at any location in the United States provided that the records are retained in accordance with section 6001 and the regulations thereunder.

(j) *Board of directors.*

Q-17. What is a corporation's "board of directors" for purposes of the requirement under section 922(a)(1)(E) that, at all times during the taxable year, the corporation must have a board of directors which includes at least one individual who is not a resident of the United States?

A-17. The "board of directors" is the body that manages and directs the corporation according to the law of the qualifying country or eligible possession under the laws of which the corporation was created or organized.

Q-18. Can the member of the board of directors who is a nonresident of the United States be a citizen of the United States?

A-18. Yes. For purposes of meeting the requirement under section 922(a)(1)(E), the member of the board who cannot be a United States resident can be a United States citizen. The principles of section 7701(b) shall be used to determine whether a United States citizen is a United States resident.

Q-19. If the only member of the board of directors who is not a resident of the United States dies, or resigns, is removed from the board or becomes a resident of the United States will the corporation be considered to fail the requirement under section 922(a)(1)(E)?

A-19. If the corporation appoints a new member who is a nonresident of the United States to the board within 30 days after the death, resignation or removal of the former nonresident member, the corporation will be considered to satisfy the requirement under section 922(a)(1)(E). Also, the corporation will be considered to satisfy the requirement under section 922(a)(1)(E) if the corporation appoints a new member who is a nonresident of the United States to the board within 30 days after the corporation has

knowledge, or reason to know, that the board's former nonresident member was in fact a resident of the United States.

Q-20. Is a nonresident alien individual who elects to be treated as a resident of the United States for a taxable year under section 6013(g) considered a nonresident of the United States for purposes of the requirement under section 922(a)(1)(E)?

A-20. Yes.

Q-21. Will the requirement that a FSC's board of directors have a nonresident member at all times during the taxable year be satisfied if the nonresident member is elected or appointed to the board of directors no later than 30 days after the first day for which the FSC election is effective?

A-21. Yes.

[T.D. 8127, 52 FR 6470, Mar. 3, 1987]

§ 1.923-1T Temporary regulations; exempt foreign trade income.

(a) *Foreign trade income.* Foreign trade income of a FSC is the FSC's gross income attributable to its foreign trading gross receipts. (Any further reference to a FSC in this section shall include a small FSC unless indicated otherwise.) If the FSC is the principal on the sale of export property which it purchased from a related supplier, the FSC's gross income is determined by subtracting from its foreign trading gross receipts the transfer price determined under the transfer pricing methods of section 925(a). If the FSC is the commission agent on the sale of export property by its related supplier, the FSC's gross income is the commission paid or payable by the related supplier to the FSC with respect to the transactions that would have generated foreign trading gross receipts had the FSC been the principal on the transaction. See § 1.925(a)-1T(f) *Examples 1 and 6* for illustrations of the computation of a FSC's foreign trade income, exempt foreign trade income and taxable income.

(b) *Exempt foreign trade income—(1) Determination.* (i) If a FSC uses either of the two administrative pricing rules, provided for by sections 925(a)(1) and (2), to determine its income from a transaction, or group of transactions, to which section 925 applies (see

§ 1.925(a)-1T(b)(2) (ii) and (iii)), 15/23 of the foreign trade income that it earns from the transaction, or group of transactions, will be exempt foreign trade income. If a FSC has a non-corporate shareholder (shareholders), 16/23 of its foreign trade income attributable to the noncorporate shareholder's (shareholders') proportionate interest in the FSC will be exempt foreign trade income. See section 291(a)(4).

(ii) If a FSC does not use the administrative pricing rules to determine its income from a transaction, or group of transactions, which gives rise to foreign trade income, 30 percent of its foreign trade income will be exempt foreign trade income. If a FSC has a non-corporate shareholder (shareholders), 32 percent of its foreign trade income attributable to the non-corporate shareholder's (shareholders') proportionate interest in the FSC will be exempt foreign trade income. See section 291(a)(4).

(iii) Exempt foreign trade income so determined under subdivisions (1)(i) and (ii) of this paragraph is treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States. See section 921(a).

(2) *Special rule for foreign trade income allocable to a qualified cooperative.* (i) Pursuant to section 923(a)(4), if a qualified cooperative is a shareholder of a FSC, the FSC's non-exempt foreign trade income determined by use of either of the administrative pricing methods of section 925(a)(1) or (2) which is allocable to the marketing of agricultural or horticultural products, or the providing of related services, for any taxable year will be treated as exempt foreign trade income to the extent that it is distributed to the qualified cooperative shareholder. A qualified cooperative is defined as any organization to which chapter 1, subchapter T, part 1 of the Code applies. See section 1381(a).

(ii) This special rule of section 923(a)(4) shall apply only if the distribution is made before the due date under section 6072(b), including extensions, for filing the FSC's income tax return for that year. Any distribution which satisfies this requirement will be treated as made on the last day of the

FSC's taxable year. In addition, this special rule shall apply only if the income of the cooperative is based on arm's length transactions between the cooperative and its members or patrons.

(iii) Income attributable to the marketing of agricultural or horticultural products, or the providing of related services, shall be allocated to the FSC shareholders on a per share basis. See § 1.926(a)-1T(b) for ordering rules for distributions from a FSC.

(3) *Special rule for military property.* (i) Under section 923(a)(5), the exempt foreign trade income of a FSC relating to the disposition of, or services relating to, military property shall be equal to 50 percent of the amount which, but for section 923(a)(5), would be treated as exempt foreign trade income under section 923(a)(2) or (3). The foreign trade income no longer treated as exempt because of this special rule of section 923(a)(5) will remain income of the FSC and will be treated as non-exempt foreign trade income.

(ii) The term "military property" is defined in section 995(b)(3)(B) and includes any property which is an arm, ammunition, or implement of war designated in the munitions list published pursuant to section 38 of the International Security Assistance and Arms Export Control Act of 1976 (22 U.S.C. 2778) (which repealed and replaced the Military Security Act of 1954).

[T.D. 8126, 52 FR 6438, Mar. 3, 1987]

§ 1.924(a)-1T Temporary regulations; definition of foreign trading gross receipts.

(a) *In general.* The term "foreign trading gross receipts" means any of the five amounts described in paragraphs (b) through (f) of this section, except to the extent that any of the five amounts is an excluded receipt within the meaning of paragraph (g) of this section. These amounts will not be foreign trading gross receipts if the FSC is not managed outside the United States, pursuant to section 924(c), or if the economic processes with regard to a transaction, or group of transactions, that are required of a FSC by section 924(d) do not take place outside the United States. The requirement that these activities take place outside the

United States does not apply to a small FSC. The activities required by sections 924 (c) and (d) may be performed either by the FSC or by any person (whether or not related to the FSC) acting under contract with the FSC for the performance of the required activities. Sections 1.924(c)-1 and 1.924(d)-1 provide rules to determine whether these requirements have been met. For purposes of this section—

(1) *FSC.* All references to a FSC in this section mean a FSC, except when the context indicates that such term means a corporation in the process of meeting the conditions necessary for that corporation to become a FSC. All references to a FSC in this section shall include a small FSC unless indicated otherwise.

(2) *Sale and lease.* The term "sale" includes an exchange or other disposition and the term "lease" includes a rental or a sublease. The term "license" includes a sublicense. All rules under this section applicable to leases of export property apply in the same manner to licenses of export property. See § 1.927(a)-1T(f)(3) for a description of intangible property which cannot be export property.

(3) *Gross receipts.* The term "gross receipts" is defined by section 927(b) and § 1.927(b)-1T.

(4) *Export property.* The term "export property" is defined by section 927(a) and § 1.927(a)-1T.

(5) *Controlled group.* The term "controlled group" is defined by paragraph (h) of this section.

(6) *Related supplier and related party.* The terms related supplier and related party are defined by § 1.927(d)-2T.

(b) *Sales of export property.* Foreign trading gross receipts of a FSC include gross receipts from the sale of export property by the FSC, or by any principal for whom the FSC acts as a commission agent (whether or not the principal is a related supplier), pursuant to the terms of a contract entered into with a purchaser by the FSC or by the principal at any time or by any other person and assigned to the FSC or the principal at any time prior to the shipment of the property to the purchaser. Any agreement, oral or written, which constitutes a contract at law, satisfies the contractual requirements of this

paragraph. Gross receipts from the sale of export property, whenever received, do not constitute foreign trading gross receipts unless the seller (or the corporation acting as commission agent for the seller) is a FSC at the time of the shipment of the property to the purchaser. For example, if a corporation which sells export property under the installment method is not a FSC for the taxable year in which the property is shipped to the purchaser, gross receipts from the sale do not constitute foreign trading gross receipts for any taxable year of the corporation.

(c) *Leases of export property*—(1) *In general.* Foreign trading gross receipts of a FSC include gross receipts from the lease of export property provided that—

(i) The property is held by the FSC (or by a principal for whom the FSC acts as commission agent with respect to the lease) either as an owner or lessee at the beginning of the term of the lease, and

(ii) The FSC qualified (or was treated) as a FSC for its taxable year in which the term of the lease began.

(2) *Prepayment of lease receipts.* If the gross receipts from a lease of export property are prepaid, then—

(i) All the prepaid gross receipts are foreign trading gross receipts of a FSC if it is reasonably expected at the time of the prepayment that, throughout the term of the lease, the lease will meet the requirements of this paragraph and the property will be export property; or

(ii) If it is reasonably expected at the time of the prepayment that the prepaid receipts would not be foreign trading gross receipts throughout the term of the lease if those receipts were not received as a prepayment, then only those prepaid receipts, for the taxable years of the FSC for which they would be foreign trading gross receipts, are foreign trading gross receipts. Thus, for example, if a lessee makes a prepayment of the first and last years' rent, and it is reasonably expected that the leased property will be export property for the first half of the lease period but not the second half of such period, the amount of the prepayment which represents the first year's rent will be considered foreign trading gross

receipts if it would otherwise qualify, whereas the amount of the prepayment which represents the last year's rent will not be considered foreign trading gross receipts.

(d) *Related and subsidiary services*—(1) *In general.* Foreign trading gross receipts of a FSC include gross receipts from services furnished by the FSC which are related and subsidiary to any sale or lease (as described in paragraph (b) or (c) of this section) of export property by the FSC or with respect to which the FSC acts as a commission agent, provided that the FSC derives foreign trading gross receipts from the sale or lease. The services may be performed within or without the United States.

(2) *Services furnished by the FSC.* Services are considered to be furnished by a FSC for purposes of this paragraph if the services are provided by—

(i) The person who sold or leased the export property to which the services are related and subsidiary, provided that the FSC acts as a commission agent with respect to the sale or lease of the property and with respect to the services,

(ii) The FSC as principal, or any other person pursuant to a contract with the FSC, provided the FSC acted as principal or commission agent with respect to the sale or lease of the property, or

(iii) A member of the same controlled group as the FSC if the sale or lease of the export property is made by another member of the controlled group provided, however, that the FSC acts as principal or commission agent with respect to the sale or lease and as commission agent with respect to the services.

(3) *Related services.* Services which may be related to a sale or lease of export property include but are not limited to warranty service, maintenance service, repair service, and installation service. Transportation (including insurance related to such transportation) will be related to a sale or lease of export property, if the cost of the transportation is included in the sale price or rental of the property or, if the cost is separately stated, is paid by the FSC (or its principal) which sold or leased the property to the person furnishing

the transportation service. Financing or the obtaining of financing for a sale or lease is not a related service for purposes of this paragraph. A service is related to a sale or lease of export property if—

(i) The service is of the type customarily and usually furnished with the type of transaction in the trade or business in which the sale or lease arose, and

(ii) The contract to furnish the service—

(A) Is expressly provided for in or is provided for by implied warranty under the contract of sale or lease,

(B) Is entered into on or before the date which is 2 years after the date on which the contract under which the sale or lease was entered into, provided that the person described in paragraph (d)(2) of this section which is to furnish the service delivers to the purchaser or lessor a written offer or option to furnish the services on or before the date on which the first shipment of goods with respect to which the service is to be performed is delivered, or

(C) Is a renewal of the services contract described in subdivisions (ii)(A) and (B) of this paragraph.

(4) *Subsidiary services*—(i) *In general.* Services related to a sale or lease of export property are subsidiary to the sale or lease only if it is reasonably expected at the time of the sale or lease that the gross receipts from all related services furnished by the FSC (as defined in this paragraph (d)(2)) will not exceed 50 percent of the sum of the gross receipts from the sale or lease and the gross receipts from related services furnished by the FSC (as described in this paragraph (d)(2)). In the case of a sale, reasonable expectations at the time of the sale are based on the gross receipts from all related services which may reasonably be performed at any time before the end of the 10-year period following the date of the sale. In the case of a lease, reasonable expectations at the time of the lease are based on the gross receipts from all related services which may reasonably be performed at any time before the end of the term of the lease (determined without regard to renewal options).

(ii) *Allocation of gross receipts from services.* In determining whether the

services related to a sale or lease of export property are subsidiary to the sale or lease, the gross receipts to be treated as derived from the furnishing of services may not be less than the amount of gross receipts reasonably allocated to the services as determined under the facts and circumstances of each case without regard to whether—

(A) The services are furnished under a separate contract or under the same contract pursuant to which the sale or lease occurs, or

(B) The cost of the services is specified in the contract of sale or lease.

(iii) *Transactions involving more than one item of export property.* If more than one item of export property is sold or leased in a single transaction pursuant to one contract, the total gross receipts from the transaction and the total gross receipts from all services related to the transaction are each taken into account in determining whether the services are subsidiary to the transaction. However, the provisions of this subdivision apply only if the items could be included in the same product line, as determined under § 1.925(a)-1T(c)(8).

(iv) *Renewed service contracts.* If under the terms of a contract for related services, the contract is renewable within 10 years after a sale of export property, or during the term of a lease of export property, related services to be performed under the renewed contract are subsidiary to the sale or lease if it is reasonably expected at the time of the renewal that the gross receipts from all related services which have been and which are to be furnished by the FSC (as described in paragraph (d)(2) of this section) will not exceed 50 percent of the sum of the gross receipts from the sale or lease and the gross receipts from related services furnished by the FSC (as so described). Reasonable expectations are determined as provided in subdivision (i) of this paragraph.

(v) *Parts used in services.* If a services contract described in paragraph (d)(3) of this section provides for the furnishing of parts in connection with the furnishing of related services, gross receipts from the furnishing of the parts are not taken into account in determining whether under this paragraph

(d)(4) the services are subsidiary. See paragraph (b) or (c) of this section to determine whether the gross receipts from the furnishing of parts constitute foreign trading gross receipts. See § 1.927(a)-1T (c)(2) and (e)(3) for rules regarding the treatment of the parts with respect to the manufacture of export property and the foreign content of the property, respectively.

(5) *Relation to leases.* If the gross receipts for services which are related and subsidiary to a lease of property have been prepaid at any time for all the services which are to be performed before the end of the term of the lease, then the rules in paragraph (c)(2) of this section (relating to prepayment of lease receipts) will determine whether prepaid services under this paragraph (d)(5) are foreign trading gross receipts. Thus, for example, if it is reasonably expected that leased property will be export property for the first year of the term of the lease but will not be export property for the second year of the term, prepaid gross receipts for related and subsidiary services to be furnished in the first year may be foreign trading gross receipts. However, any prepaid gross receipts for the services to be furnished in the second year cannot be foreign trading gross receipts.

(6) *Relation with export property determination.* The determination as to whether gross receipts from the sale or lease of export property constitute foreign trading gross receipts does not depend upon whether services connected with the sale or lease are related and subsidiary to the sale or lease. Thus, for example, assume that a FSC receives gross receipts of \$1,000 from the sale of export property and gross receipts of \$1,100 from installation and maintenance services which are to be furnished by the FSC within 10 years after the sale and which are related to the sale. The \$1,100 which the FSC receives for the services would not be foreign trading gross receipts since the gross receipts from the services exceed 50 percent of the sum of the gross receipts from the sale and the gross receipts from the related services furnished by the FSC. The \$1,000 which the FSC receives from the sale of export property would, however, be foreign trading gross receipts if the sale met

the requirements of paragraph (b) of this section.

(e) *Engineering and architectural services*—(1) *In general.* Foreign trading gross receipts of a FSC include gross receipts from engineering services (as described in paragraph (e)(5) of this section) or architectural services (as described in paragraph (e)(6) of this section) furnished by such FSC (as described in paragraph (e)(7) of this section) for a construction project (as defined in paragraph (e)(8) of this section) located, or proposed for location, outside the United States. Such services may be performed within or without the United States.

(2) *Services included.* Engineering and architectural services include feasibility studies for a proposed construction project whether or not such project is ultimately initiated.

(3) *Excluded services.* Engineering and architectural services do not include—

(i) Services connected with the exploration for oil or gas, or

(ii) Technical assistance or know-how. For purposes of this paragraph, the term “technical assistance or know-how” includes activities or programs designed to enable business, commerce, industrial establishments, and governmental organizations to acquire or use scientific, architectural, or engineering information.

(4) *Other services.* Receipts from the performance of construction activities other than engineering and architectural services constitute foreign trading gross receipts to the extent that the activities are related and subsidiary services (within the meaning of paragraph (d) of this section) with respect to a sale or lease of export property.

(5) *Engineering services.* For purposes of this paragraph, engineering services in connection with any construction project (within the meaning of paragraph (e)(8) of this section) include any professional services requiring engineering education, training, and experience and the application of special knowledge of the mathematical, physical, or engineering sciences to those professional services as consultation, investigation, evaluation, planning, design, or responsible supervision of construction for the purpose of assuring

compliance with plans, specifications, and design.

(6) *Architectural services.* For purposes of this paragraph, architectural services include the offering or furnishing of any professional services such as consultation, planning, aesthetic and structural design, drawings and specifications, or responsible supervision of construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project (within the meaning of paragraph (e)(8) of this section).

(7) *Definition of "furnished by the FSC".* For purposes of this paragraph, the term "furnished by the FSC" means architectural and engineering services furnished:

(i) By the FSC,

(ii) By another person (whether or not that person is a United States person) pursuant to a contract entered into with the FSC at any time prior to the furnishing of the services, provided that the FSC acts as principal, or

(iii) By another person (whether or not that person is a United States person) pursuant to a contract for the furnishing of the services entered into by, or assigned to, the person at any time, provided that the FSC acts as a commission agent for the furnishing of the services.

(8) *Definition of "construction project".* For purposes of this paragraph, the term "construction project" includes the erection, expansion, or repair (but not including minor remodeling or minor repairs) of new or existing buildings or other physical facilities including, for example, roads, dams, canals, bridges, tunnels, railroad tracks, and pipelines. The term also includes site grading and improvement and installation of equipment necessary for the construction. Gross receipts from the sale or lease of construction equipment are not foreign trading gross receipts unless the equipment is export property.

(f) *Managerial services—(1) In general.* Foreign trading gross receipts of a first FSC for its taxable year include gross receipts from the furnishing of managerial services provided for an unrelated FSC or unrelated interest charge DISC to aid the unrelated FSC or unre-

lated interest charge DISC in deriving foreign trading gross receipts or qualified export receipts, as the case may be, provided that at least 50 percent of the first FSC's gross receipts for such year consists of foreign trading gross receipts derived from the sale or lease of export property and the furnishing of related and subsidiary services. For purposes of this paragraph, managerial services are considered furnished by a FSC if the services are provided—

(i) By the first FSC,

(ii) By another person (whether or not a United States person) pursuant to a contract entered into by that person with the first FSC at any time prior to the furnishing of the services, provided that the first FSC acts as principal with respect to the furnishing of the services, or

(iii) By another person (whether or not a United States person) pursuant to a contract for the furnishing of services entered into at any time prior to the furnishing of the services provided that the first FSC acts as commission agent with respect to those services.

(2) *Definition of "managerial services".* The term "managerial services" as used in this paragraph means activities relating to the operation of an unrelated FSC or an unrelated interest charge DISC which derives foreign trading gross receipts or qualified export receipts as the case may be from the sale or lease of export property and from the furnishing of services related and subsidiary to those sales or leases. The term includes staffing and operational services necessary to operate the unrelated FSC or unrelated interest charge DISC, but does not include legal, accounting, scientific, or technical services. Examples of managerial services are: conducting export market studies, making shipping arrangements, and contacting potential foreign purchasers.

(3) *Status of recipient of managerial services.* Foreign trading gross receipts of a first FSC include receipts from the furnishing of managerial services during any taxable year of a recipient of such services if the recipient qualifies as a FSC or interest charge DISC for the taxable year. For purposes of this paragraph, a recipient is deemed to qualify as a FSC or interest charge

DISC for its taxable year if the first FSC obtains from the recipient a copy of the recipient's election to be treated as a FSC or interest charge DISC together with the recipient's sworn statement that an election has been timely filed with the Internal Revenue Service Center. The recipient may mark out the names of its shareholders on a copy of its election to be treated as a FSC or interest charge DISC before submitting it to the first FSC. The copy of the election and the sworn statement of the recipient must be received by the first FSC within six months after the first FSC furnishes managerial services for the recipient. The copy of the election and the sworn statement of the recipient need not be obtained by the first FSC for subsequent taxable years of the recipient. A recipient of managerial services is not treated as a FSC or interest charge DISC with respect to the services performed during a taxable year for which the recipient does not qualify as a FSC or interest charge DISC if the first FSC performing such services does not believe or if a reasonable person would not believe (taking into account the furnishing FSC's managerial relationship with such recipient FSC or interest charge DISC) at the beginning of such taxable year that the recipient will qualify as a FSC or an interest charge DISC for such taxable year.

(g) *Excluded receipts*—(1) *In general.* Notwithstanding the provisions of paragraphs (b) through (f) of this section, foreign trading gross receipts of a FSC do not include any of the six amounts described in paragraphs (g)(2) through (7) of this section.

(2) *Sales and leases of property for ultimate use in the United States.* Property which is sold or leased for ultimate use in the United States does not constitute export property. See § 1.927(a)-1T(d)(4) relating to determination of where the ultimate use of the property occurs. Thus, foreign trading gross receipts of a FSC described in paragraph (b) or (c) of this section do not include gross receipts of the FSC from the sale or lease of this property.

(3) *Sales or leases of export property and furnishing of services accomplished by subsidy.* Foreign trading gross receipts of a FSC do not include gross re-

ceipts described in paragraphs (b) through (f) of this section if the sale or lease of export property or the furnishing of services is accomplished by a subsidy granted by the United States or any instrumentality thereof, see section 924(f)(1)(B). Subsidies covered by section 924(f)(1)(B) are listed in subdivisions (i) through (vi) of this paragraph.

(i) The development loan program, or grants under the technical cooperation and development grants program of the Agency for International Development, or grants under the military assistance program administered by the Department of Defense, pursuant to the Foreign Assistance Act of 1961, as amended (22 U.S.C. 2151) unless the FSC shows to the satisfaction of the Commissioner that, under the conditions existing at the time of the sale (or at the time of lease or at the time the services were rendered), the purchaser (or lessor or recipient of the services) had a reasonable opportunity to purchase (or lease or contract for services) on competitive terms and from a seller (or lessor or performer of services) who was not a U.S. person, goods (or services) which were substantially identical to such property (or services) and which were not manufactured, produced, grown, or extracted in the United States (or performed by a U.S. person);

(ii) The Public Law 480 program authorized under Title I of the Agricultural Trade Development and Assistance Act of 1954, as amended (7 U.S.C. 1691, 1701-1714);

(iii) The Export Payment program of the Commodity Credit Corporation authorized by sections 5 (d) and (f) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714c (d) and (f));

(iv) The section 32 export payment programs authorized by section 32 of the Act of August 24, 1935, as amended (7 U.S.C. 612c);

(v) The Export Sales program of Commodity Credit Corporation authorized by sections 5 (d) and (f) of the Commodity Credit Corporation Charter Act, as amended (15 U.S.C. 714c (d) and (f)), other than the GSM-4 program provided under 7 CFR part 1488, and section 407 of the Agricultural Act of 1949, as amended (7 U.S.C. 1427), for the

purpose of disposing of surplus agricultural commodities and exporting or causing to be exported agricultural commodities; and

(vi) The Foreign Military Sales direct credit program (22 U.S.C. 2763) or the Foreign Military Sales loan guaranty program (22 U.S.C. 2764) if—

(A) The borrowing country is released from its contractual liability to repay the United States government with respect to those credits or guaranteed loans;

(B) The repayment period exceeds twelve years; or

(C) The interest rate charged is less than the market rate of interest as defined in 22 U.S.C. 2763(c)(2)(B);

unless the FSC shows to the satisfaction of the Commissioner that, under the conditions existing at the time of the sale, the purchaser had a reasonable opportunity to purchase, on competitive terms from a seller who was not a U.S. person, goods which were substantially identical to this property and which were not manufactured, produced, grown, or extracted in the United States. Information regarding whether an export is financed, in whole or in part, with funds derived from the programs identified in this subdivision may be obtained from the Comptroller, Defense Security Assistance Agency, Department of Defense, Washington, DC 20301.

(4) *Sales or leases of export property and furnishing of architectural or engineering services for use by the United States*—(i) *In general.* Foreign trading gross receipts of a FSC do not include gross receipts described in paragraph (b), (c), or (e) of this section if a sale or lease of export property, or the furnishing of architectural or engineering services, 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 or lease of property manufactured, produced, grown, or extracted in the United States or requires the use of architectural or engineering services performed by a United States person. See section 924(f)(1)(A)(ii). 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).

(ii) *Direct or indirect sales or leases.* Any sale or lease of export property is for use by the United States or an instrumentality thereof if such property is sold or leased by a FSC (or by a principal for whom the FSC acts as commission agent) to—

(A) A person who is a related person with respect to the FSC or such principal and who sells or leases the property for use by the United States or an instrumentality thereof, or

(B) A person who is not a related person with respect to the FSC or such principal if, at the time of the sale or lease, there is an agreement or understanding that the property will be sold or leased for use by the United States or an instrumentality thereof (or if a reasonable person would have known at the time of the sale or lease that the property would be sold or leased for use by the United States or an instrumentality thereof) within 3 years after the sale or lease.

(iii) *Excluded programs.* The provisions of subdivisions (4)(i) and (ii) of this paragraph do not apply in the case of a purchase by the United States or an instrumentality thereof if the purchase is pursuant to—

(A) The Foreign Military Sales Act, as amended (22 U.S.C. 2751 *et seq.*), or a program under which the United States

government purchases property for resale, on commercial terms, to a foreign government or agency or instrumentality thereof, or

(B) A program (whether bilateral or multilateral) under which sales to the United States government are open to international competitive bidding.

(5) *Services.* Foreign trading gross receipts described in paragraph (d) of this section (concerning related and subsidiary services) if the services from which such gross receipts are derived are related and subsidiary to the sale or lease of property which results in excluded receipts under this paragraph.

(6) *Receipts within controlled group.* (i) For purposes of the transfer pricing methods of section 925(a), gross receipts of a corporation do not constitute foreign trading gross receipts for any taxable year of the corporation if at the time of the sale, lease, or other transaction resulting in the gross receipts, the corporation and the person from whom the gross receipts are directly or indirectly derived (whether or not such corporation and such person are the same person) are members of the same controlled group, and either

(A) The corporation and the person each qualifies as a FSC (or if related FSCs are commission agents of each party to the transaction) for its taxable year in which its receipts arise, or

(B) With regard to sale transactions, a sale of export property to a FSC (or to a related person if the FSC is the commission agent of the related person) by a non-FSC within the same controlled group follows any sale of the export property to a FSC (or to a related person if the FSC is the commission agent of the related person) within the same controlled group if foreign trading gross receipts resulted from the sale. Thus for example, assume that R, S, X, and Y are members of the same controlled group and that X and Y are FSCs. If R sells property to S and pays X a commission relating to that sale and if S sells the same property to an unrelated foreign party and pays Y a commission relating to that sale, the receipts received by X from the sale of such property by R to S will be considered to be derived from Y, a FSC which

is a member of the same controlled group as X, and thus will not result in foreign trading gross receipts to X. The receipts received by Y from the sale to an unrelated foreign party may, however, result in foreign trading gross receipts to Y. For another example, if R and S both assign the commissions to X, receipts derived from the sale from R to S will be considered to be derived from X acting as commission agent for S and will not result in foreign trading gross receipts to X. Receipts derived by X from the sale of property by S to an unrelated foreign party may, however, constitute foreign trading gross receipts.

(ii) Section 1.927(a)-1T(f)(2) provides rules regarding property not constituting export property in certain cases where such property is leased to any corporation which is a member of the same controlled group as the lessor.

(7) *Factoring of receivables by a related supplier.* If an account receivable arising with respect to export property is transferred to any person for an amount reflecting a discount from the selling price of the export property, then the gross receipts from the sale which are treated as foreign trading gross receipts for purposes of computing a FSC's profit under the administrative pricing methods of section 925(a)(1) and (2) shall be reduced by the amount of the discount. See § 1.925(a)-1T(f) *Example 11* for illustration of how this special rule affects computation of combined taxable income of a FSC and its related supplier.

(h) *Definition of "controlled group".* For purposes of sections 921 through 927 and the regulations under those sections, the term "controlled group" has the same meaning as is assigned to the term "controlled group of corporations" by section 1563(a), except that (1) the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent" each place the latter phrase appears in section 1563(a), and (2) section 1563(b) shall not apply. Thus, for example, a foreign corporation subject to tax under section 882 may be a member of a controlled group. Furthermore, two or more corporations (including a foreign corporation) are members of a controlled group at any time such corporations

meet the requirements of section 1563(a) (as modified by this paragraph).

(i) *FSC's entitlement to income*—(1) *Application of administrative pricing rules of section 925(a)*. A corporation which meets the requirements of section 922(a) (or section 922(b) if the corporation elects small FSC status) and § 1.921-2(a) (Q&A1) to be treated as a FSC (or small FSC) for a taxable year is entitled to income, and the administrative pricing rules of section 925(a)(1) or (2) apply, in the case of any transaction described in § 1.925(a)-1T(b)(iii) between the FSC and its related supplier (as defined in § 1.927(d)-2T(a)) as long as the FSC, or someone under contract to it, satisfies the requirements of section 925(c). The requirements of section 925(c) must be met by a commission FSC as well as by a buy-sell FSC. See § 1.925 (a)-1T(a)(3)(i) and (b)(2)(ii).

(2) *Other transactions*. In the case of a transaction to which the provisions of paragraph (i)(1) of this section do not apply but from which a FSC derives gross receipts, the income to which the FSC is entitled as a result of the transaction is determined pursuant to the terms of the contract for the transaction and, if applicable, section 482 and the regulations under that section. For applicability of the section 482 transfer pricing method, see § 1.925(a)-1T (a)(3)(ii) and (b)(2)(i).

(j) *Small FSC limitation*—(1) *In general*. Under section 924(b)(2)(B), in determining exempt foreign trade income of a small FSC, the foreign trading gross receipts of the small FSC for the taxable year which exceed \$5 million are not taken into account. The foreign trading gross receipts of the small FSC not taken into account for purposes of computing the small FSC's exempt foreign trade income shall be taken into account in computing the small FSC's non-exempt foreign trade income. If the foreign trading gross receipts of the small FSC exceed the \$5 million limitation, the small FSC may select the gross receipts to which the limitation is allocated. See section 922(b) and § 1.921-2(b) (Q&A3) for a definition of a small FSC.

(2) *Members of a controlled group limited to one \$5 million amount*—(i) *General rule*. All small FSCs which are mem-

bers of a controlled group on a December 31, shall, for their taxable years which include that December 31, be limited to one \$5 million amount. The \$5 million amount shall be allocated equally among the member small FSCs of the controlled group for their taxable years including that December 31, unless all of the member small FSCs consent to an apportionment plan providing for an unequal allocation of the \$5 million amount. The apportionment plan shall provide for the apportionment of a fixed dollar amount to one or more of the corporations, and the sum of the amounts so apportioned shall not exceed the \$5 million amount. If the taxable year including the December 31 of any member small FSC is a short period (as defined in section 443), the portion of the \$5 million amount allocated to that member small FSC for that short period under the preceding sentence shall be reduced to the amount which bears the same ratio to the amount so allocated as the number of days in such short period bears to 365. The consent of each member small FSC to the apportionment plan for the taxable year shall be signified by completing the form (*i.e.*, Schedule O or any successor to that form) which satisfies the requirements of and is filed in the manner specified in § 1.1561-3. An apportionment plan may be amended in the manner prescribed in § 1.1561-3(a), except that an original or an amended plan may not be adopted with respect to a particular December 31 if at the time the original or amended plan is sought to be adopted, less than 12 full months remain in the statutory period (including extensions) for the assessment of a deficiency against any shareholder of a member small FSC the tax liability of which would change by the adoption of the original or amended plan. If less than 12 full months of the period remain with respect to any such shareholder, the director of the service center with which the shareholder files its income tax return will, upon request, enter into an agreement extending the statutory period for the limited purpose of assessing any deficiency against that shareholder attributable to the adoption of the original or amended apportionment plan.

§ 1.924(c)-1

26 CFR Ch. I (4-1-12 Edition)

(ii) *Membership determined under section 1563(b)*. For purposes of this paragraph (j)(2), the determination of whether a small FSC is a member of a controlled group of corporations with respect to any taxable year shall be made in the manner prescribed in section 1563(b) and the regulations under that section.

(iii) *Certain short taxable years—(A) General rule*. If a small FSC has a short period (as defined in section 443) which does not include a December 31, and that small FSC is a member of a controlled group of corporations which includes one or more other small FSC's with respect to the short period, then the amount described in section 924(b)(2)(B) with respect to the short period of that small FSC shall be determined by—

(1) Dividing \$5 million by the number of small FSCs which are members of that group on the last day of the short period, and

(2) Multiplying the result by a fraction, the numerator of which is the number of days in the short period and the denominator of which is 365.

For purposes of the preceding sentence, section 1563(b) shall be applied as if the last day of the short period were substituted for December 31. Except as provided in subdivision (2)(iii)(B) of this paragraph, the small FSC having a short period not including a December 31 may not enter into an apportionment plan with respect to the short period.

(B) *Exception*. If the short period not including a December 31 of two or more small FSCs begins on the same date and ends on the same date and those small FSCs are members of the same controlled group, those small FSCs may enter into an apportionment plan for such short period in the manner provided in subdivision (2)(i) of this paragraph with respect to the combined amount allowed to each of those small FSCs under subdivision (2)(iii)(A) of this paragraph.

[T.D. 8126, 52 FR 6438, Mar. 3, 1987, as amended by T.D. 9304, 71 FR 76907, Dec. 22, 2006; T.D. 9476, 74 FR 68531, Dec. 28, 2009]

§ 1.924(c)-1 Requirement that a FSC be managed outside the United States.

(a) *In general*. Section 924(b)(1)(A) provides that a FSC shall be treated as having foreign trading gross receipts for the taxable year only if the management of the FSC during the year takes place outside the United States, as provided in section 924(c). Section 924(c) and this section set forth the management activities that must take place outside the United States in order to satisfy the requirement of section 924(b)(1)(A). Paragraph (b) of this section provides rules for determining whether the requirements of section 924(c)(1) have been met. Section 924(c)(1) requires that all meetings of the board of directors of the FSC during the taxable year and all meetings of the shareholders of the FSC during the taxable year take place outside the United States. Paragraph (c) of this section provides rules for maintaining the FSC's principal bank account outside the United States as provided in section 924(c)(2). Paragraph (d) of this section provides rules for disbursements required by section 924(c)(3) to be made from bank accounts of the FSC maintained outside the United States.

(b) *Meetings of board of directors and meetings of shareholders must be outside the United States*. All meetings of the board of directors of the FSC and all meetings of the shareholders of the FSC that take place during a taxable year must take place outside the United States to meet the requirements of section 924(c)(1). Only meetings that are formally convened as meetings of the board of directors or as shareholder meetings will be taken into account in determining whether those requirements have been met. In addition, all such meetings must comply with the local laws of the foreign country or possession of the United States in which the FSC was created or organized. The local laws determine whether a meeting must be held, when and where it must be held (if it is held at all), who must be present, quorum requirements, use of proxies, and so on. Where the local law permits action by the board of directors or shareholders to be taken by written consent without a meeting, use of such procedure will

not constitute a meeting for purposes of section 924(c)(1). Section 924(c)(1) and this section impose no other requirements except the requirement that meetings that are actually held take place outside the United States. If the participants in a meeting are not all physically present in the same location, the location of the meeting is determined by the location of the persons exercising a majority of the voting power (including proxies) participating in the meeting. For example, a FSC has five directors, and is organized in country A. Country A's law requires that a majority of the directors of a corporation must participate in a meeting to constitute a quorum (and, thus, a meeting), but there is no requirement that the meeting be held in country A or that the directors must be physically present to participate. One director is in country A, another director is in country B, and a third director is in the United States.

These three directors convene a meeting by telephone that constitutes a meeting under the law of country A. The meeting occurs outside the United States because the persons exercising a majority of the voting power participating in the meeting are located outside the United States.

(c) *Maintenance of the principal bank account outside the United States*—(1) *In general.* For purposes of section 924(c), the bank account that shall be regarded as the principal bank account of a FSC is the bank account from which the disbursements described in paragraph (d) of this section are made. A FSC may have more than one principal bank account. The bank account that is regarded as the principal bank account must be maintained in a foreign country which meets the requirements of section 927(e)(3), or in any possession of the United States (as defined in section 927(d)(5)), and it must be so maintained at all times during the taxable year. For taxable years beginning on or after February 19, 1987, a principal bank account or accounts must be designated on the annual return of the FSC by providing the bank name(s) and account number(s).

(2) *Maintenance of the account in a bank.* The bank account that is regarded as the principal bank account

must be maintained in an institution that is engaged in the conduct of a banking, financing, or similar business, as defined in §1.954-2(d)(2)(ii) (without regard to whether it is a controlled foreign corporation). The institution may be a U.S. bank, provided that the account is maintained in a branch outside the United States.

(3) *Maintenance of an account outside the United States.* Maintenance of the principal bank account outside the United States means that the account regarded as the principal bank account must be an account maintained on the books of the banking institution at an office outside the United States, but does not require that access to the account may be made only outside the United States. Instructions providing for deposits into or disbursements from the account may originate in the United States without affecting the status of maintenance of the account outside the United States.

(4) *Maintenance of the account at all times during the taxable year.* The term "at all times during the taxable year" generally means for each day of the taxable year. In the case of a newly created or organized corporation, thirty days may elapse between the effective date of the corporation's election to be treated as a FSC and the date a bank account is opened without causing the FSC to fail the requirement that it maintain its principal bank account outside the United States at all times during the taxable year. For example, if a corporation is created or organized prior to January 1, 1985, and makes an election to be treated as a FSC within the first 90 days of 1985, the election is effective as of January 1, 1985. Thus, the FSC must open a bank account within 30 days of January 1, or as of January 31, 1985, to satisfy this requirement. Also, a FSC shall be treated as satisfying this requirement if the account that is regarded as its principal bank account is terminated during the taxable year, provided that (i) such termination is the result of circumstances beyond the FSC's control, and (ii) the FSC establishes a new principal bank account within thirty days after such termination. A FSC may close its principal bank account and replace it with another account that

qualifies under this paragraph (c) as a principal bank account at any time provided that no lapse of time occurs between the closing of the principal bank account and the opening of the replacement account.

(5) *Other accounts.* The FSC may maintain other bank accounts in addition to its principal bank account. Such other accounts may be located anywhere, without limitation. The mere existence of such other accounts will not cause the FSC to fail to satisfy the requirements of section 924(c).

(d) *Disbursement of dividends, legal and accounting fees, and salaries of officers and directors out of the principal bank account of the FSC*—(1) *In general.* All dividends, legal fees, accounting fees, salaries of officers of the FSC, and salaries or fees paid to members of the board of directors of the FSC that are disbursed during the taxable year must be disbursed out of bank account(s) of the FSC maintained outside the United States. Such an account is treated as the principal bank account of the FSC for purposes of section 924(c). Dividends, however, may be netted against amounts owed to the FSC (e.g., commissions) by a related supplier through book entries. If the FSC regularly disburses its legal or accounting fees, salaries of officers, and salaries or fees of directors out of its principal bank account, the occasional, inadvertent payment by mistake of fact or law of such amounts out of another bank account will not be considered a disbursement by the FSC if, upon determination that such payment was made from another account, reimbursement to such other account is made from the principal bank account of the FSC within a reasonable period from the date of the determination. Disbursement out of the principal bank account of the FSC may be made by transferring funds from the principal bank account to a U.S. account of the FSC provided that (i) the payment of the dividends, salaries or fees to the recipients is made within 12 months of the transfer, (ii) the purpose of the expenditures is designated and, (iii) the payment of the dividends, salaries or fees is actually made out of the same U.S. account that received the disbursement from the principal bank account.

(2) *Reimbursement.* Legal or accounting fees, salaries of officers, and salaries or fees of directors that are paid by a related person wholly or partially on behalf of a FSC must be reimbursed by the FSC. The amounts paid by the related person are not considered disbursed by the FSC until the related person is reimbursed by the FSC. The related person must be reimbursed no later than the last date prescribed for filing the FSC's tax return (including extensions) for the taxable year to which the reimbursement relates. Any reimbursement for amounts paid on behalf of the FSC must be disbursed out of the FSC's principal bank account (and not netted against any obligation owed by the related person to the FSC), as set forth in paragraph (c) of this section. To determine the amounts paid on behalf of the FSC, the FSC may rely upon a written statement or invoice furnished to it by the related person which shows the following:

(i) The actual fees charged for performing the legal or accounting services for the FSC or, if such fees cannot be ascertained by the related person, a good faith estimate thereof, and the actual salaries or fees paid for services as officers and directors of the FSC, and

(ii) The person who performed or provided the services.

(3) *Good faith exception.* If, after the FSC has filed its tax return, a determination is made by the Commissioner that all or a part of the legal or accounting fees, salaries of officers, and salaries or fees of directors of the FSC were paid by a related person without receiving reimbursement, the FSC may, nonetheless, satisfy the requirements of section 924(c)(3) if the fees and salaries were paid by the related person in good faith, and the FSC reimburses the related person for the fees and salaries paid within 90 days after the determination. The reimbursement shall be treated as made as of the end of the taxable year of the FSC for which the reimbursement is made.

(4) *Dividends*—(i) *Definition.* For purposes of section 924(c) and this section only, the term “dividends” refers solely to cash dividends (including a dividend paid in a foreign functional currency) actually paid pursuant to a declaration or authorization by the FSC.

Accordingly, a “dividend” will not include a constructive dividend that is deemed to be paid (regardless of the source of such constructive dividend) or a distribution of property that is a dividend under section 316 other than a distribution of U.S. dollars or a foreign functional currency.

(ii) *Offset accounting entries.* Payment of dividends by the FSC to its related supplier may be in the form of an accounting entry offsetting an amount payable to the related supplier for the dividend against an existing debt owed to the FSC. The offset accounting entries must be clearly identified in the books of account of both the related supplier and the FSC.

(5) *Legal and accounting fees.* For purposes of this section, legal and accounting fees do not include salaries paid to legal and accounting employees of the FSC (or a related person). Legal and accounting fees are limited to fees paid to independent persons performing legal or accounting services for or with respect to the FSC.

(6) *Salaries of officers and directors.* For purposes of this section, salaries of officers and salaries or fees of directors are only those salaries or fees paid for services as officers or directors of the FSC. Salaries do not include reimbursed travel and entertainment expenses. If an individual officer, director, or employee of a related person is also an officer or director of a FSC and receives additional compensation for services performed for the FSC, the portion of the compensation paid to the individual which is for services performed for the FSC is required to be disbursed out of the FSC’s principal bank account. For purposes of this section, the term “compensation” is defined as set forth §1.415(c)-2(b) and (c).

[T.D. 8125, 52 FR 5089, Feb. 19, 1987, as amended by T.D. 9319, 72 FR 16894, Apr. 5, 2007]

§ 1.924(d)-1 Requirement that economic processes take place outside the United States.

(a) *In general.* Section 924(b)(1)(B) provides that a FSC has foreign trading gross receipts from any transaction only if economic processes with respect to such transaction take place outside the United States as provided in section 924(d). Section 924(d) and this sec-

tion set forth the rules for determining whether a sufficient amount of the economic processes of a transaction take place outside the United States. Generally, a transaction will qualify if the FSC satisfies two different requirements: Participation outside the United States in the sales portion of the transaction, and satisfaction of either the 50-percent or the 85-percent foreign direct cost test. The activities comprising these economic processes may be performed by the FSC or by any other person acting under contract with the FSC. (All references to “FSC” in §§1.924(d)-1 and 1.924(e)-1 shall mean the FSC or, if applicable, the person performing the relevant activity under contract on behalf of the FSC.) The FSC may act upon standing instructions from another person in the performance of any activity, whether a sales activity under paragraph (c) of this section or an activity relating to the disposition of export property under paragraph (d) of this section and §1.924(e)-1. The identity of the FSC as a separate entity is not required to be disclosed in the performance of any of the activities comprising the economic processes. Except as otherwise provided, the location of any activity is determined by the place where the activity is initiated by the FSC, and not by the location of any person transmitting instructions to the FSC.

(b) *Activities performed by another person—(1) In general.* Any person, whether domestic or foreign, and whether related or unrelated to the FSC, may perform any activity required to satisfy this section, provided that the activity is performed pursuant to a contract for the performance of that activity on behalf of the FSC. Such a contract may be any oral or written agreement which constitutes a contract at law. The person performing the activity is not required to enter into a contract directly with the FSC and, thus, may be a direct or indirect subcontractor of a person under contract with the FSC. For example, assume that a buy-sell FSC enters into an agreement with its related supplier in which the related supplier agrees to perform on behalf of the FSC all sales activities with respect to the FSC’s transactions with

its foreign customers. Through its existing agreements with a domestic unrelated person, the related supplier subcontracts the performance of these activities to the domestic unrelated person, who, in turn, subcontracts the performance of the sales activities to foreign sales agents. The sales activities performed by the foreign sales agents are considered to be performed on behalf of the FSC for purposes of meeting the requirements of section 924(d)(1)(A).

(2) *Proof of compliance.* If the FSC does not perform the activity itself, it must maintain records adequate to establish, with respect to each transaction or group of transactions, that the activity was performed and that the performance of such activity took place outside the United States. If the person who performed the activity on behalf of the FSC is an independent contractor, the FSC may rely upon a written declaration from that person stating that the activities were performed by that person on behalf of the FSC, and were performed outside the United States. An invoice or a receipt for payment will be considered to be such a written declaration if it specifies that the activities were performed outside the United States or specifies a particular place outside the United States where the activities were performed. If the person performing the activities on behalf of the FSC is a related person, the FSC must maintain records adequate to establish that the activities were actually performed and where the activities were performed. Such records may be stored with the related person provided that the FSC makes such records available to the Commissioner upon request.

(c) *Participation outside the United States in the sales portion of the transaction—(1) In general.* The requirement of section 924(d)(1)(A) is met with respect to the gross receipts of a FSC derived from any transaction if the FSC has participated outside the United States in the solicitation, the negotiation, or the making of the contract relating to such transaction (hereinafter described as “sales activities”), as provided in this paragraph (c). A sale need not occur in order that the solicitation or negotiation tests be satisfied. Once

the FSC has participated outside the United States in an activity that constitutes the solicitation, negotiation, or the making of the contract with respect to a transaction, any prior or subsequent activity by the FSC with respect to such transaction that would otherwise constitute the sales activity will be disregarded for purposes of determining whether the FSC has met the requirements of section 924(d)(1)(A). For example, if a FSC sells a product to a foreign customer by first meeting with the customer in New York to discuss the product and then by mailing to it from outside the United States a brochure describing the product, the prior meeting is disregarded and only the mailing is considered in determining whether there was solicitation outside the United States by the FSC with respect to the transaction which has occurred.

(2) *Solicitation (other than advertising).* For purposes of this paragraph (c), “solicitation” refers to any communication (by any method, including, but not limited to, telephone, telegraph, mail, or in person) by the FSC, at any time during the 12 month period (measured from the date the communication is mailed or transmitted) immediately preceding the execution of a contract relating to the transaction to a specific, targeted customer or potential customer, that specifically addresses the customer’s attention to the product or service which is the subject of the transaction. For purposes of paragraph (c)(2) of this section, communication by mail means depositing the communication in a mailbox. Except as provided in § 1.924(e)-1(a)(1) with respect to second mailings, activities that would otherwise constitute advertising (such as sending sales literature to a customer or potential customer) will be considered solicitation if the activities are directed at a specific, targeted customer or potential customer, and the costs of the activity are not taken into account as advertising under the foreign direct cost tests. Activities that would otherwise constitute sales promotion (such as a promotional meeting in person with a customer) will be considered to be solicitation if the activities are directed at a

specific, targeted customer or potential customer, and the costs of the activity are not taken into account as sales promotion under the foreign direct cost tests. Except as provided in § 1.924(e)-1(a)(1) with respect to second mailings, the same or similar activities cannot be considered both solicitation and advertising, or both solicitation and sales promotion, with respect to the same customer. Solicitation, however, may take place at the same time as, and in conjunction with, another sales activity. Additionally, it may take place with respect to any person, whether domestic or foreign, and whether or not related to the FSC.

(3) *Negotiation.* For purposes of this paragraph (c), “negotiation” refers to any communication by the FSC to a customer or potential customer aimed at an agreement on one or more of the terms of a transaction, including, but not limited to, price, credit terms, quantity, or time or manner of delivery. For purposes of this paragraph (c)(3), communication by mail has the same meaning as provided in paragraph (c)(2) of this section. Negotiation does not include the mere receipt of a communication from a customer (such as an order) that includes terms of a sale. Negotiation may take place at the same time as, and in conjunction with, another sales activity. Additionally, it may take place with respect to any person, whether domestic or foreign, and whether or not related to the FSC.

(4) *Making of a contract.* For purposes of this paragraph (c), “making of a contract” refers to performance by the FSC of any of the elements necessary to complete a sale, such as making an offer or accepting an offer. A requirements contract is considered an open offer to be accepted from time to time when the customer submits an order for a specified quantity. Thus, the acceptance of such an order will be considered the making of a contract. The written confirmation by the FSC to the customer of the acceptance of the open order will also be considered the making of a contract. Acceptance of an unsolicited bid or order is considered the “making of a contract” even if no solicitation or negotiation occurred with respect to the transaction. The written confirmation by the FSC to the cus-

tommer of an oral or written agreement which confirms variable contract terms, such as price, credit terms, quantity, or time or manner of delivery, or specifies (directly or by cross-reference) additional contract terms will be considered the making of a contract. A written confirmation is any confirmation expressed in writing, including a telegram, telex, or other similar written communication. The making of a contract may take place at the same time as, and in conjunction with, another sales activity. Additionally, it may take place with respect to any person, whether domestic or foreign, and whether or not related to the FSC.

(5) *Grouping transactions.* Generally, the sales activities under this paragraph (c) are to be applied on a transaction-by-transaction basis. By annual election of the FSC, however, any of the sales activities may be applied on the basis of a group as set forth in this paragraph (c)(5). Any groupings used must be supported by adequate documentation of performance of activities relating to the groupings used. An election by the FSC to group transactions must be made on its annual income tax return. The FSC, however, may amend its tax return to group in a manner different from that elected on its original return before the expiration of the statute of limitations.

(i) *Standards of groups.* A determination by a FSC as to a grouping will be accepted by a district director if such determination conforms to any of the following standards:

(A) *Product or product line groupings.* A product or product line grouping may be based upon either a recognized trade or industry usage, or upon a two digit major group (or on any inferior classification or combination of inferior classifications within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President. For taxable years beginning on or before February 19, 1987, any sales activity that is performed outside the United States with respect to any transaction covered by the product or product line grouping during the FSC’s taxable year shall

apply to all transactions covered by the product or product line. However, for taxable years beginning after February 19, 1987, the requirement of section 924(d)(1)(A) is met with respect to all transactions covered by the product or product line grouping only if the sales activities are performed outside the United States with respect to customers with sales representing either:

(i) 20 percent or more of the foreign trading gross receipts of the product or product line grouping during the current year or

(ii) 50 percent or more of the foreign trading gross receipts of the product or product line grouping for the prior year irrespective of whether any sales occurred within the current year to the prior year customers.

If during the prior taxable year, the controlled group of which the FSC is a member had a DISC or interest charge DISC, the FSC may use the 50 percent rule with respect to the preceding DISC or interest charge DISC year, substituting qualified export receipts for foreign trading gross receipts. A corporation which has not been treated in the prior year as a FSC, interest charge DISC, or DISC does not have to meet either the 20 percent test or the 50 percent test for the first year in which it is treated as a FSC.

(B) *Customer groupings.* A customer grouping includes all transactions of the FSC with a particular customer during the FSC's taxable year. Thus, any sales activity that is performed outside the United States with respect to any transaction with the customer during the taxable year shall apply to all transactions within the customer grouping.

(C) *Contract groupings.* A contract grouping includes all transactions of the FSC under a particular contract for a taxable year. Thus, any sales activity that is performed outside the United States with respect to any transaction under the contract will apply to all transactions under the contract for such taxable year. For long-term contracts between unrelated parties, the sales activities tests need be satisfied only once for the life of the contract. With respect to requirements contracts and long-term contracts between re-

lated parties, the sales activities test must be satisfied annually.

(D) *Product or product line groupings within customer or contract groupings.* Groupings may be based upon product or product line groupings within customer or contract groupings. If, however, the primary grouping is a customer or contract grouping, the 20 percent test set forth in subdivision (A) of this paragraph relating to product or product line grouping will not be applicable.

(ii) *Transactions included in a grouping.* A choice by a FSC to group transactions shall generally apply to all transactions within the scope of that grouping. The choice of a grouping, however, applies only to transactions covered by the grouping and, for transactions not encompassed by the grouping, the determinations may be made on a transaction-by-transaction basis or other grouping basis. For example, a FSC may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year. In addition, if a FSC applies sales activity rules on the basis of other types of groupings, such as all sales to a particular customer, transactions included in those other groupings shall be excluded from product groupings.

(iii) *Different groupings allowed for different purposes.* A choice by the FSC to group transactions may be made separately for each of the sales activities under section 924(d)(1)(A). Groupings used for purposes of section 924(d)(1)(A) will have no relationship to groupings used for other purposes, such as satisfying the foreign direct cost tests. This paragraph (c)(5) does not apply for purposes of section 925.

(6) *Examples.* The provisions of this paragraph (c) may be illustrated by the following examples:

Example 1. In November, a calendar year FSC mailed from its foreign office its catalog to a potential foreign customer. The catalog displayed numerous products along with a brief description and the price of each. In February of the following year, the FSC sold to the customer a product displayed in the catalog. Since the FSC communicated with the customer during the 12-

month period prior to the sale, although during the previous taxable year, the FSC participated outside the United States in the solicitation relating to the transaction.

Example 2. A FSC with a taxable year ending April 30, 1986, solicits customer X during that taxable year with respect to Product A. In the previous taxable year, the FSC sold product A to customers V, W, X, Y, Z, none of whom were customers in the taxable year ending April 30, 1986. The sales proceeds from sales to customer X represented 50 percent of the foreign trading gross receipts for the previous FSC year. The FSC meets the 50 percent test for product or product line grouping for the taxable year ending April 30, 1986. If the facts were changed so that there was not a FSC, DISC or interest charge DISC in the same controlled group in the previous taxable year, the single solicitation directed to any customer would qualify all transactions within the product group as meeting the solicitation requirement for that taxable year. For subsequent taxable years, the 50 percent test or the 20 percent test would be applicable.

Example 3. A FSC earns commissions on the sale of export property by its domestic related supplier to United States wholesalers for final sale to foreign customers. The related supplier receives an order from one of its United States wholesalers. The related supplier telephones the United States wholesaler to inform it of the new price and the probability of another price increase soon. The United States wholesaler orally agrees to the new price and the related supplier instructs the FSC to telex the wholesaler from its foreign office a confirmation that the product will be sold at the current new price. The written confirmation by the FSC of an oral agreement on a variable contract term constitutes the making of a contract. Thus, the requirements of section 924(d)(1)(A) are met with respect to the transaction relating to the product.

(d) *Satisfaction of either the 50-percent or the 85-percent foreign direct cost test—*

(1) *In general.* Section 924(d)(1)(B) requires, in order for the gross receipts of a transaction to qualify as foreign trading gross receipts, that the foreign direct costs incurred by the FSC attributable to the transaction equal or exceed 50 percent of the total direct costs incurred by the FSC attributable to the transaction. The direct costs are those costs attributable to activities described in the five categories of section 924(e). Section 924(d)(2) provides that, instead of satisfying the 50-percent foreign direct cost test of section 924(d)(1)(B), the FSC may incur foreign direct costs attributable to activities

described in each of two of those categories that equal or exceed 85 percent of the total direct costs incurred by the FSC attributable to the activity described in each of the two categories. If no direct costs are incurred by the FSC in a particular category, that category shall not be taken into account for purposes of determining satisfaction of either the 50-percent or the 85-percent foreign direct cost test. If any amount of direct costs is incurred in a particular category, that category shall be taken into account for purposes of the foreign direct costs tests.

(2) *Direct costs—(i) Definition of direct costs.* For purposes of section 924 (d), direct costs are those costs which are incidental to and necessary for the performance of any activity described in section 924(e). Direct costs include the cost of materials which are consumed in the performance of the activity, and the cost of labor which can be identified or associated directly with the performance of the activity (but only to the extent of wages, salaries, fees for professional services, and other amounts paid for personal services actually rendered, such as bonuses or compensation paid for services on the basis of a percentage of profits). Direct costs also include the allowable depreciation deduction for equipment or facilities (or the rental cost for use thereof) that can be specifically identified or associated with the activity, as well as the contract price of an activity performed on behalf of the FSC by a contractor. If costs of services or the use of facilities are only incidentally related to the performance of an activity described in section 924(e), only the incremental cost is considered to be identified directly with the activity. For example, supervisory, administrative, and general overhead expenses, such as telephone service, normally are not identified directly with particular activities described in section 924(e). The cost of a long distance telephone call made to arrange for delivery of export property, however, is identified directly with the activities described in section 924(e)(2). Direct costs for purposes of section 924(d) do not necessarily include all of the expenses taken into account for purposes of determining the taxable income of the

FSC or the combined taxable income of the FSC and its related supplier.

(ii) *Allocation of direct costs.* For purposes of this section only, if costs are identified with more than one activity (whether or not all of the activities are described in section 924(e)), the portion of the costs attributable to each activity shall be determined by allocating the costs among the activities in any manner that is consistently applied and, if applicable, that reasonably reflects relative costs that would be incurred by performing each activity independently. If costs of an activity are attributable to more than one transaction or grouping of transactions, the portion of the costs attributable to each transaction or grouping shall be determined by allocating the costs among the transactions or groupings in any manner that is consistently applied and, if applicable, that reasonably reflects relative costs that would be incurred by performing the activity independently with respect to each transaction or grouping.

(3) *Total direct costs.* The term “total direct costs” means all of the direct costs of any transaction attributable to activities described in any paragraph of section 924(e). For purposes of the 50-percent foreign direct cost test of section 924(d)(1)(B), total direct costs are determined based on the direct costs of all activities described in all of the paragraphs of section 924(e). For purposes of the 85-percent foreign direct cost test of section 924(d)(2), however, the total direct costs are determined separately for each paragraph of section 924(e). If more than one activity is included within a paragraph of section 924(e), direct costs must be incurred with respect to at least one activity listed in the paragraph. If costs are incurred with respect to more than one activity, all direct costs must be considered for purposes of satisfying the direct costs test.

(4) *Foreign direct costs.* The term “foreign direct costs” means the portion of the total direct costs of any transaction which is attributable to activities performed outside the United States. For purposes of the 50-percent foreign direct cost test, foreign direct costs are determined based on the direct costs of all activities described in

all of the paragraphs of section 924(e). For purposes of the 85-percent foreign direct cost test, however, foreign direct costs are determined separately for each paragraph of section 924(e).

(5) *Fifty percent foreign direct cost test.* To satisfy the requirement of section 924(d)(1)(B), the foreign direct costs incurred by the FSC attributable to the transaction must equal or exceed 50 percent of the total direct costs attributable to the transaction. This test looks to the cost of the activities described in section 924(e) on an aggregate basis; therefore, it is not necessary that the foreign direct costs of each activity, or of each paragraph of section 924(e), equal or exceed 50 percent of the total direct costs of that activity or paragraph.

(6) *Eighty-five percent foreign direct cost test—(i) General rule.* To satisfy the requirement of section 924(d)(2), the foreign direct costs of a transaction incurred by the FSC attributable to activities described in each of at least two paragraphs of section 924(e) must equal or exceed 85 percent of the total direct costs attributable to activities described in that paragraph. This test looks to costs of the activities on a paragraph-by-paragraph basis (but not on an activity-by-activity basis). As an example, the foreign direct costs of advertising and sales promotion are aggregated with each other for this purpose, but they are not aggregated with the foreign direct costs of transportation.

(ii) *Satisfaction of the 85-percent test.* If, after the FSC files its tax return indicating that it has satisfied the 85-percent foreign direct cost test with respect to each of at least two paragraphs of subsection 924(e) and a determination is made by the Commissioner that the foreign direct costs attributable to one or both of the two paragraphs of section 924(e) specified on the return did not equal or exceed 85 percent of the total direct costs attributable to such activities, the FSC may, nonetheless, satisfy the 85-percent foreign direct cost test if the foreign direct costs attributable to any two paragraphs of section 924(e) equal or exceed 85 percent of the total direct costs attributable to those other paragraphs.

(e) *Grouping transactions.* Generally, the foreign direct cost tests under paragraph (d) of this section are to be applied on a transaction-by-transaction basis. By annual election of the FSC, however, the foreign direct cost tests may be applied on a customer, contract or product or product line grouping basis. Any groupings used must be supported by adequate documentation of performance of activities and costs of activities relating to the groupings used. An election by the FSC to group transactions must be made on its annual income tax return. The FSC may, however, amend its tax return before the expiration of the statute of limitations under section 6501 of the Code to group in a manner different from that elected on its original return.

(1) *Standards for groupings.* A determination by a FSC as to a grouping will be accepted by the district director if such determination conforms to any of the following standards:

(i) *Product or product line groupings.* A product or product line grouping may be based either on a recognized trade or industry usage, or on a two digit major grouping (or on any inferior classification or combination of inferior classifications within a major grouping) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President.

(ii) *Customer groupings.* A customer grouping includes all transactions of the FSC with a particular customer during the FSC's taxable year.

(iii) *Contract groupings.* A contract grouping includes all transactions of the FSC under a particular contract, including a requirements contract. The tests will be applied to all transactions within a contract grouping during each taxable year of the FSC; however, by election of the FSC, all transactions under a contract that occur in the first or the last year of the contract may be included with, respectively, the next succeeding or the immediately preceding taxable year in applying these tests. For example, if with respect to transactions during the first calendar year of a 5-year contract, a calendar year FSC incurs direct costs attrib-

utable to the transactions of \$100X for advertising, all of which are foreign direct costs, and \$10X for processing of customer orders and for arranging for delivery, \$9X (or 90 percent of the total direct costs) of which are foreign direct costs, the FSC has satisfied the 85-percent foreign direct cost test with respect to those transactions for the taxable year. If with respect to transactions during the second year of the contract, the FSC only incurs \$18X of direct costs for processing of customer orders and arranging for delivery, \$15X (83.3 percent of the total direct costs) of which are foreign direct costs, the FSC may include the transactions from the first year of the contract to meet the 85-percent foreign direct cost test in the second taxable year. Thus, with respect to the transactions in the second year, the FSC satisfies the foreign direct costs test for advertising (because the entire \$100X of direct costs are foreign direct costs) and for processing of customer orders and arranging for delivery (because of the \$28X of direct costs, \$24X or 85.7 percent of the total direct costs are foreign direct costs). If, however, with respect to transactions in the third year, the FSC satisfies the foreign direct costs test, those transactions cannot be included with the transactions in the fourth year. The FSC may aggregate the direct costs in the fourth and fifth years in the same manner as for the first and second years as described above in order to satisfy the 85 percent foreign direct costs test.

(iv) *Product or product line groupings within customer or contract groupings.* Groupings may be based on product or product line groupings within customer or contract groupings.

(2) *Transactions included in a grouping.* An election by the FSC to group transactions shall generally apply to all transactions within the scope of that grouping. The election of a grouping, however, applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations may be made on a transaction-by-transaction basis or other grouping basis. For example, the FSC may elect a product grouping with respect to one product

§ 1.924(e)-1

26 CFR Ch. I (4-1-12 Edition)

and elect the transaction-by-transaction method for another product within the same taxable year. In addition, if a FSC is permitted to apply either the 50-percent or the 85-percent foreign direct cost test on the basis of other types of groupings, such as all transactions with respect to a particular customer, transactions included in those other groupings shall be excluded from product groupings.

(3) *Different groupings allowed for different purposes.* An election by the FSC to group transactions may be made separately for each of the activities relating to disposition of export property under section 924(d)(1)(B) or section 924(d)(2). Groupings used for purposes of section 924 will have no bearing on groupings for other purposes. This paragraph (e) does not apply for purposes of section 925.

(f) *Exception for foreign military property—(1) General rule.* The requirements of this section do not apply to any activities performed in connection with foreign military sales except those activities described in section 924(e). The FSC is deemed to have satisfied the requirements of section 924(d)(1)(A).

(2) *Example.* The principles of paragraph (f)(1) of this section may be illustrated by the following example:

Example. A FSC earns commissions on foreign military sales by its related supplier. All solicitation, negotiation, and contract making activities occur in the United States solely between the related supplier and the United States government. The property is delivered, title passes, and payment is made in the United States in accordance with standard United States government practices. The FSC incurs direct costs in the amount of \$155X to process the government's orders and arrange for delivery of the goods, all of which are foreign direct costs. In addition, it incurs foreign direct costs in the amount of \$250X for assembling and transmitting its final invoice to the government from outside the U.S. and foreign direct costs of \$200X associated with receiving payment from the related supplier in accordance with the rules of § 1.924(e)-1(d)(2)(iii). No other activities occur with respect to the foreign military sales. The FSC has satisfied the 85-percent foreign direct cost test and thus has foreign trading gross receipts with respect to the foreign military sales. The fact that the FSC did not participate outside the United States in any of the sales activities has no bearing on the qualification of

the receipts since the FSC is deemed to have met the requirements of section 924(d)(1)(A).

[T.D. 8125, 52 FR 5090, Feb. 19, 1987]

§ 1.924(e)-1 Activities relating to the disposition of export property.

(a) *Advertising and sales promotion.* For purposes of section 924(e), advertising and sales promotion are defined as follows.

(1) *Advertising—(i) Advertising defined—(A) General rule.* Advertising means the announcement or description of property or services described in section 924(a), in some medium of mass communication (such as radio, television, newspaper, trade journals, mass mailings, or billboards), in order to induce multiple customers or potential customers to buy or rent the property or services from the FSC or related supplier. Advertising is not required to be directed to the general public, but may be focused toward any group of export customers or potential export customers. Advertising except for the advertising described in § 1.924(e)-1(a)(1)(B) must describe one or more specific products or product lines (or services) and identify the product as a product offered by the FSC or related supplier. Advertising intended solely to build a favorable image of a company or group of companies is not included in this definition of advertising. Additionally, advertising primarily directed at customers or potential customers in the United States is not included in this definition of advertising, nor is advertising related to property or services not described in section 924(a).

(B) *Special rules for sales to distributors.* If the customer is a distributor (whether domestic or foreign, related or unrelated to the FSC), an expense that is incurred by the distributor and charged to the FSC or related supplier as a reduction in the purchase price or as a separate charge for an announcement or description described in paragraph (a)(1)(A) of this section to induce the distributor's customers, potential customers, or the ultimate users to buy or rent the property or services is advertising for these purposes (i) if the FSC incurs 20 percent or more of the total advertising costs of the distributor or (ii) if the FSC pays the

total charge of an advertisement either directly or indirectly. For these purposes, a distributor is anyone other than an end user or a final consumer. A FSC may incur direct advertising costs to a foreign end consumer even though the FSC sells to a U.S. distributor.

(ii) *Direct costs of advertising.* Direct costs of advertising include costs of transmitting, displaying, or distributing the advertising to customers or potential customers and the costs of printing in the case of sales literature, but do not include fees paid to an independent advertising agency to develop the announcement or description, translation costs, or costs of preparing the announcement or description for potential use as advertising. Direct costs of sending sales literature to customers or potential customers may be taken into account as advertising costs as long as the activity is not taken into account for purposes of the sales activity requirements of § 1.924(d)-1(c).

(iii) *Location of advertising—(A) General rule.* The location of advertising activity is the place to which the advertising is transmitted, displayed, distributed, mailed, or otherwise conveyed to the customers or potential customers (or in the case of advertising described in paragraph (a)(1)(B) of this section, the distributor's customers, or the ultimate users). For example, a television advertisement that is broadcast to a foreign country constitutes advertising activity outside the United States even though the broadcast signal originates in the United States. Therefore, the cost of that advertising activity is a foreign cost. The FSC may rely upon the distribution statistics of the publisher of print media or the broadcaster of broadcast media through which the advertising is distributed. If the distribution statistics show that 85 percent or more of the readership, radio listeners, or viewership are outside the United States, all direct costs of advertising are considered foreign direct costs of advertising.

(B) *Foreign editions of journals, magazines, etc.* Costs related to advertising in foreign English editions of U.S. publications as well as advertising in any publication in a foreign language are foreign direct costs.

(C) *United States editions.* Costs related to advertising in United States publications are not treated as direct costs even if the publication also has a foreign edition in English.

(iv) *Second mailings.* In general, direct costs of sending sales literature to customers may be treated as solicitation or advertising, but not both. A distinction may be made, however, between a first and second mailing so that one may be treated as advertising and the other may be treated as solicitation. To qualify under this second mailing rule, the two mailings must be generically different items such as a price list and a description of the product itself. An amended price list would not be distinguishable from an original price list and would, therefore, not constitute a second mailing.

(v) *Examples.* The principles of paragraph (a)(1) of this section may be illustrated by the following examples:

Example 1. The related supplier, under contract with a buy-sell FSC to advertise export product D on the "FSC's" behalf to its foreign unrelated customers, engaged a French advertising agency to develop an advertising campaign to induce French customers to buy the product. As a part of the advertising campaign, the agency places a one-page advertisement in a relevant French trade journal. The advertisement constitutes advertising within the meaning of paragraph (a)(1) of this section.

Example 2. A United States weekly magazine publishes, in addition to its United States edition, a Canadian edition in English and a Mexican edition in Spanish. A FSC incurs costs of \$200 X for a one-page display in each of the three editions for a total advertising cost of \$600 X. The \$200 X cost relating to the advertising in the United States edition is not a direct cost because it relates to United States sales. The total costs of \$400 X relating to advertising in the English language Canadian edition and the Spanish language Mexican edition are foreign direct costs.

Example 3. A FSC earns commissions on the sale of export product E by its domestic related supplier to United States distributors for resale to Canadian retail customers. The related supplier, under contract with the FSC to advertise product E, pays an amount equal to 1 percent of its annual gross receipts with respect to product E under a cooperative advertising arrangement with the distributor. The amount, which represents 20 percent of the total advertising costs for product E, is reimbursed by the FSC. The 20-

percent amount represents a significant portion of the total advertising costs and thus constitutes advertising within the meaning of paragraph (a)(1)(i) of this section.

Example 4. A FSC mails two items to each customer on its customer list within one taxable year. The first mailing consists of a price list which merely lists the various products by name and provides a price next to each product name. The second mailing consists of a brochure which fully describes and illustrates each product. The two mailings are generically different. Therefore, one mailing may be counted as advertising while the other mailing may be counted as solicitation.

(2) *Sales promotion*—(i) *Sales promotion defined.* Sales promotion means an appeal made in person to an export customer or potential export customer for the sale or rental of property or services described in section 924(a), made in the context of a trade show or customer meeting. A customer meeting means a periodic meeting (e.g., quarterly, semi-annual, or annual) in which 10 or more customers or potential customers are reasonably expected to attend. However, for taxable years beginning before February 19, 1987, a customer meeting may, at the option of the taxpayer, mean any meeting with a customer or potential customer regardless of the frequency of the meetings or the number of customers or potential customers in attendance. A meeting, show or event in the United States that is primarily aimed at the export of goods or services described in section 924(a) constitutes sales promotion. Sales promotion does not include an appeal made in the context of any meeting, show or event primarily aimed at U.S. customers or an appeal for the sale or rental of property or services not described in section 924(a). Whether any meeting, show or event is primarily aimed at U.S. customers or at the export of goods or services described in section 924(a) shall be determined by all of the facts and circumstances including the announced objective of the meeting, show or event; the attendees; the location of the meeting, show or event; and the product or special feature of the product.

(ii) *Direct costs of sales promotion.* Direct costs of sales promotion include costs such as rental of space at trade shows, payments to organizers or other

persons hired for the event, rental of display equipment and decorations for the event, and costs of maintaining a showroom. Direct costs of sales promotion also include costs for travel, meals, and lodging for direct sales people attending the event if these costs are paid by the FSC or related supplier. In the case of a customer meeting, direct costs of sales promotion include the costs of materials printed specifically for the meeting and the costs of travel, lodging, and food for both the direct sales people and customers or potential customers attending the meeting. Direct costs of sales promotion do not include the cost of salaries and commissions of direct sales people or the cost of discount coupons, samples of the product, or printed advertising materials that are used for general advertising as well as sales promotion.

(iii) *Location of sales promotion.* The location of sales promotion activity is the place where the trade show or customer meeting is held.

(iv) *Examples.* The principles of paragraph (a)(2)(i) of this section may be illustrated by the following examples:

Example 1. The related supplier sells various export products described in section 924(a) to its foreign customers. As a commission agent for the related supplier with respect to such sales, the FSC performs sales promotion. It contracts with the related supplier to serve as its agent for such purposes. To stimulate the sale of its export products, the related supplier conducts semi-annual meetings with the purchasing agents of its customers at its Kansas City headquarters. Ten or more purchasing agents are reasonably expected to attend each meeting. At such meetings, the purchasing agents see the related supplier's manufacturing facilities, visit with its executives, attend technical updates, and see new export products. These semi-annual customer meetings constitute sales promotion within the meaning of paragraph (a)(2)(i) of this section. Direct costs incurred with respect to the customer meetings are U.S. direct costs because the sales promotion activities occur within the United States.

Example 2. Assume the same facts as in *Example 1*, except that the related supplier exhibits products that only operate on 220 volts at a trade show in the United States. According to the trade show sponsors, the purpose of the show is to increase sales abroad of United States-manufactured products. Since

the products exhibited are designed for operation in foreign countries and the purpose of the trade show is to boost sales in those countries, the trade show held in the United States is primarily aimed at the export products described in section 924(a) and not at United States customers. Thus, the trade show constitutes sales promotion within the meaning of paragraph (a)(2)(i) of this section and the direct costs incurred in connection with the trade show are treated as United States direct costs.

(b) *Processing of customer orders and arranging for delivery of the export property.* For purposes of section 924(e), the processing of customer orders and the arranging for delivery of the export property are defined in paragraph (b)(1) and paragraph (b)(2), respectively, of this section. For taxable years beginning after February 19, 1987, if the FSC performs the activities of processing of customer orders and arranging for delivery of the export property and elects to group its transactions, it is considered to have performed the activities with respect to all transactions in the grouping elected by the FSC under §1.924(d)-1(e) during the taxable year if it performs the activities of processing of customer orders and arranging for delivery of the export property with respect to customers generating 20 percent or more of foreign trading gross receipts within the elected grouping.

(1) *Processing of customer orders—(i) Processing of customer orders defined.* The processing of customer orders means notification by the FSC to the related supplier of the order and of the requirements for delivery. The related supplier may have independent knowledge of the order and requirements for delivery. If the FSC does not have a related supplier, the processing of customer orders means communication with the customer by any method such as telephone, telegram, or mail to acknowledge receipt of the order and requirements for delivery. Once the related supplier has been notified by the FSC, or the customer has received an acknowledgement from the FSC, of the order and requirements for delivery, subsequent or prior communications with respect to an order (such as changes in quantity or prospective delivery date) are not included in the definition of processing of customer orders.

(ii) *Direct costs of processing customer orders.* Direct costs of processing of customer orders include salaries of clerical personnel and costs of telephone, telegram, mail, or other communication media (including the costs of operating transmission equipment).

(iii) *Location of processing of customer orders.* The location of this activity is the place where the communication is initiated by the FSC.

(iv) *Examples.* The principles of paragraph (b)(1) of this section may be illustrated by the following examples:

Example 1. A domestic related supplier, using a FSC as its commission agent on the sale of export property to foreign customers, receives an order from one of its foreign customers. Information concerning the receipt of such order and its requirements for delivery are transmitted to the FSC. The FSC from its office outside the United States notifies the related supplier of the order and the requirements for delivery by telex. This notification by the FSC to the related supplier constitutes the processing of the customer's order within the meaning of paragraph (b)(1)(i) of this section. In addition, its direct costs of processing the customer's order are foreign direct costs because the communication is initiated by the FSC from outside the United States.

Example 2. A domestic unrelated supplier manufactures a product which it sells to a buy-sell FSC located in Germany for resale to the FSC's German customers. Upon receiving an order from one of its customers, the FSC telephones the customer from its German office to acknowledge receipt of the order and the requirements for delivery. The acknowledgement constitutes the processing of the customer's order within the meaning of paragraph (b)(1)(i) of this section and the direct costs attributable thereto are foreign direct costs.

(2) *Arranging for delivery—(i) Arranging for delivery defined.* The arranging for delivery of export property means the taking of necessary steps to have the export property delivered to the customer in accordance with the requirements of the order. Arranging for delivery does not include preparation of shipping documents (*e.g.*, bill of lading) or the property for shipment (*i.e.*, packaging or crating), or shipment of property (*i.e.*, transportation). Arranging for delivery does include communications with a carrier or freight forwarder to provide transportation (as defined in §1.924(e)-1(c)(1), but without

regard to when the commission relationship for purposes of transportation begins) for the export property from the FSC or related supplier to the place where the customer takes possession of the property. Arranging for delivery also includes communications with the customer to notify the customer of the time and place of delivery. The carrier or freight forwarder and the customer may already have knowledge of the information communicated. If the FSC has communicated with the carrier or freight forwarder, where applicable, and the customer to notify it of the time and place of delivery, prior or subsequent communications to either about delivery are not included in the definition of arranging for delivery.

(ii) *Direct costs of arranging for delivery.* The direct costs of arranging for delivery include salaries of clerical personnel and costs of telephone, telegraph, mail, and other communications media, but do not include any actual shipping costs.

(iii) *Location of arranging for delivery.* The location of arranging for delivery activity is the place where the activity is initiated by the FSC.

(iv) *Examples.* The principles of paragraph (b)(2)(i) of this section may be illustrated by the following examples:

Example 1. A FSC earns commissions on the sale of export property by its domestic related supplier to foreign customers. The shipment term of all of the related supplier's sales is F.O.B. (Free on Board) its manufacturing plant in Gary, Indiana. Thus, there is no transportation as defined in § 1.924(e)-1(c)(1) with respect to its sales. From its shipping department at the plant, the related supplier telephones carriers to arrange for delivery. It also notifies the FSC by mail of the time and place of delivery of the customer's orders. The FSC from its office outside the United States transmits the received information to the customers. Because there is no transportation to be arranged, this communication alone by the FSC to the customers to notify them of the time and place of delivery constitutes arranging for delivery within the meaning of paragraph (b)(2)(i) of this section.

Example 2. Assume the same facts as in *Example 1*, except that the shipment term of all of the related supplier's sales is C.I.F. (Cost, Insurance, Freight) and that the commission relationship for transportation begins after the export property leaves the United States customs territory. The related supplier telephones a trucking firm and an overseas car-

rier from its plant in Gary, Indiana to ascertain information on transporting its property by truck to the docks, and by overseas carrier from the docks to the place where the customer takes possession. Upon receiving the necessary information, the related supplier electronically transmits to the FSC the shipping information and the time and place of delivery to the customer. In addition, it instructs the FSC to communicate the necessary shipping information to the carriers to ensure shipment and to notify the customer of the time and place of delivery. The FSC does both from its office located outside of the United States. The communications by the FSC to the carriers and the customer constitute arranging for delivery within the meaning of paragraph (b)(2)(i) of this section.

(c) *Transportation*—(1) *Transportation defined.* For purposes of section 924(e), transportation means moving or shipping the export property during the period when the FSC owns or is responsible for the property, or, if the FSC is acting as a commission agent, during the period when the related supplier owns or is responsible for the property but after the commission relationship for purposes of transportation begins (even if the relationship begins after the property leaves the U.S. customs territory). The FSC or related supplier is treated as responsible for the property when it either has title, bears the risk of loss, or insures the property during shipment. Since a commission FSC will not generally have title or bear the risk of loss, it will, nevertheless, satisfy the transportation test if the related supplier has either title, bears the risk of loss, or insures the property during shipment. Examples of methods of shipping which would qualify as transportation include F.O.B. (Free on Board) destination, C.I.F. (Cost, Insurance, Freight), Ex Ship, and Ex Quay, but do not include C. & F. (Cost and Freight) or F.O.B. shipping point.

(2) *Direct costs of transportation.* The direct costs of transportation include the expenses of shipping, such as fees paid to carriers and freight forwarders, costs of freight insurance, and documentation fees. With respect to fungible commodities, direct costs include only those costs incurred after the goods have been identified to a contract. Transportation costs do not include any of the costs of arranging for

delivery. The FSC is considered to engage in transportation activity whenever it pays the costs of shipping the export property and the property is shipped during the period when the FSC owns or is responsible for the property as provided in paragraph (c)(1) of this section. If the customer pays the shipping costs directly, the FSC is not considered to engage in transportation activity. If, however, the FSC pays the shipping costs, the ultimate transfer of those costs to the customer will not disqualify the FSC from engaging in transportation for purposes of section 924(e) regardless of whether the costs are included in the sale price of the export property or separately stated.

(3) *Location of transportation.* The location of transportation activity is the area over which the property is transported. Thus, the portion of total direct costs of transportation treated as foreign direct costs is the portion attributable to transportation outside the United States, determined on the basis of the ratio of mileage outside the U.S. customs territory to total mileage. For purposes of determining mileage outside U.S. customs territory, goods are treated as leaving U.S. customs territory when they have been tendered to an international carrier for shipment to a foreign location, as long as they are not removed from the custody of the carrier before they reach a point outside U.S. customs territory. The same rule for determining mileage outside the U.S. customs territory will apply to freight forwarders if (i) the forwarder has the risk of loss or is an insurer of the goods, and (ii) the property is shipped on a single bill of lading issued to the FSC or its agent as the shipper.

(4) *Examples.* The principles of paragraph (c) of this section may be illustrated by the following examples:

Example 1. A buy-sell FSC sells export property to a customer located in Canada. The contract between the FSC and the customer requires that the property be shipped F.O.B. its Canadian destination. Under this shipment term, the FSC holds title and bears the risk of loss until the property is tendered at its Canadian destination. Thus, it is responsible for the property during shipment. The FSC instructs its related supplier to ship the property from its manufacturing fa-

cilities in St. Louis. The related supplier negotiates two contracts, one for domestic transportation and the second for foreign transportation. A domestic trucking firm transports the property to the Canadian border where a Canadian trucking company is used to transport the property to its Canadian destination. The documentation fees and the fees for the two trucking firms are paid by the FSC. Because the FSC paid the costs of shipping and the property was shipped during the period when the FSC was responsible for the property, the FSC has engaged in transportation activity, the direct costs of which are the fees paid by the FSC. If 70 percent of the mileage from St. Louis to the Canadian destination is associated with the transportation from the Canadian border to the Canadian destination, 70 percent of the FSC's direct transportation costs are foreign direct costs. If, instead of using two trucking firms, the FSC had tendered the goods to a freight forwarder for shipment to a foreign location and the freight forwarder assumed the risk of loss for the goods and issued a single bill of lading, all of the fees paid by the FSC to the freight forwarder would be foreign direct costs.

Example 2. A related supplier sells export property to its foreign customer in Liverpool, England. The contract between the related supplier and the customer requires that the property be shipped C.I.F. Liverpool. The related supplier engages the FSC as its commission agent with respect to its sales to the customer, requiring the FSC to provide transportation to the customer. The FSC contracts with the related supplier to provide the transportation on behalf of the FSC. The commission agreement between the related supplier and the FSC provides that the FSC's responsibilities with respect to transportation of the export property begins after the property leaves the U.S. customs territory. The related supplier hires a domestic trucking firm to transport the shipment to a New York City port where it is loaded on a cargo ship destined for Liverpool at a total cost of \$3,000X, \$2,750X of which is allocable to mileage from the U.S. customs territory to Liverpool, England. Because the related supplier insures the property during shipment under C.I.F., the property is shipped during the period when the related supplier is treated as responsible for the property. Thus, the FSC, as the related supplier's commission agent, has satisfied the transportation test. In addition, because the FSC's responsibilities with respect to transportation begins when the property leaves U.S. customs territory, the FSC's payment of \$2,750X is a foreign direct cost of transportation. The remaining \$250X is not a direct cost of transportation to the FSC because the amount was expended before the commission relationship between the FSC and related supplier began.

Example 3. A FSC earns commissions on sales by the related supplier of export property, all of which falls within a single two-digit SIC group. The related supplier is under contract to the FSC to perform on the FSC's behalf all of the section 924(e) activities attributable to the sales. Of all of the sales made during the year, the FSC has no transportation costs with respect to the sales to customer R because the shipment term is F.O.B. the related supplier's Chicago plant. With respect to the sales to customer S, the FSC ships the property F.O.B. its destination and pays 100 percent of the transportation costs, all of which are foreign direct costs because the commission relationship for transportation begins outside the U.S. customs territory. For purposes of determining whether the FSC has satisfied the 85-percent foreign direct cost test for transportation, the FSC groups the sales by product. Because the transportation costs for sales to customer S are 100-percent foreign direct costs and because there are no transportation costs on sales to customer R, the FSC is considered to have met the 85-percent foreign direct cost test for transportation for all the sales in the single two-digit SIC group.

(d) *Determination and transmittal of a final invoice or statement of account and receipt of payment.* For purposes of section 924(e), the determination and transmittal of a final invoice or statement of account and the receipt of payment are defined as follows.

(1) *Determination and transmittal of a final invoice or statement of account—(i) Definitions—(A) In general.* The determination and transmittal of a final invoice or statement of account means the assembly of either a final invoice or statement of account and the forwarding of that document to the customer. A FSC may elect to send either final invoices or statements of account and disregard any costs of the alternative not elected. For taxable years beginning after February 19, 1987, a special grouping rule is provided. If the FSC assembles and forwards either a statement of account or a final invoice from outside the United States to customers with sales representing 50 percent of the current year foreign trading gross receipts within a product or product line grouping or to customers with sales representing 50 percent of the prior year foreign trading gross receipts within a product or product line grouping utilized for the current year, all other U.S. costs will be disregarded

and the FSC will be deemed to have no U.S. costs with respect to the determination and transmittal of a final invoice or statement of account. If, during the prior taxable year, the controlled group of which the FSC is a member had a DISC or interest charge DISC, the FSC may apply the 50 percent rule by taking into account the customers and sales of the DISC or interest charge DISC for the preceding taxable year. If no foreign trading gross receipts (or qualified export receipts for DISC purposes) were received in the prior year either by the FSC or by a DISC or interest charge DISC within the controlled group of which the FSC is a member, the FSC must apply the 50 percent rule taking into account customers and foreign trading gross receipts for the current year. In the event that the 50 percent rule is not satisfied, all costs associated with assembly and forwarding of the selected documents (invoices or statements of account) must be included in the costs attributable to activities described in section 924(e)(4).

(B) *Final invoice defined.* A final invoice is an invoice upon which payment is made by the customer. A final invoice must contain the customer's name or identifying number and, with respect to the transaction or transactions, the date, product or service, quantity, price, and amount due. In the alternative, a document will be acceptable as a final invoice even though it does not include all of the above listed information if the FSC establishes that the document is considered to be a final invoice under normal commercial practices. An invoice forwarded to the customer after payment has been tendered or received pursuant to a letter of credit as a receipt for payment satisfies this definition.

(C) *Statement of account defined.* A statement of account is any summary statement forwarded to a customer to inform of, or confirm, the status of transactions occurring within an accounting period during a taxable year that is not less than one month. A statement of account must contain, at a minimum, the customer's name or identifying number, date of the statement of account as of the last day of the accounting period covered by the

statement of account and the balance due (even if the balance due is zero). A single final invoice or statement of account can cover more than one transaction with one customer. In the alternative, a document will be accepted as a statement of account even though it does not include all of the above listed information if the FSC establishes that the document is considered a statement of account under normal commercial practice. For these purposes, a document will be considered to be a statement of account under normal commercial practices if it is sent to domestic as well as to export customers in order to inform the customers of the status of transactions during an accounting period. Additional information may be sent separately, such as summary statements forwarded to a related party for purposes of reconciling intercompany accounts for financial reporting requirements. If the information is sent separately, the direct costs associated with the assembly and forwarding of that information are not considered for purposes of section 924(d).

(D) *Assembly and forwarding defined.* Assembly means folding the documents (where applicable), filling envelopes, and addressing envelopes (if window envelopes are not used). Forwarding means mailing or delivery.

(ii) *Direct costs of determination and transmittal of final invoice or statement of account.* Direct costs of this activity include costs of office supplies, office equipment, clerical salaries and costs of mailing or other delivery services, if the costs can be identified or associated directly with the assembly and transmittal of a final invoice or statement of account. Costs of establishing a price, or of communicating prices or other billing information between the FSC and a related supplier are not direct costs of this activity. In addition, the costs of preparing and mailing the final invoices or statements of account to the FSC and the costs of accumulating and formatting data for invoicing or statements of account on computer discs, tapes, or some other storage media along with the costs of transmitting or transporting this data to the FSC are not direct costs of this activity.

(iii) *Location of determination and transmittal of a final invoice or statement of account.* For taxable years beginning before February 19, 1987, the location of this activity is the place where the final invoice or statement of account is assembled for forwarding to the customer or the place from which it is forwarded to the customer. Thus, the forwarding of the final invoice or statement of account from outside the United States is sufficient to source this activity outside the United States. For all other taxable years, the location of this activity is the place where the final invoice or statement of account is both assembled and forwarded to the customer.

(iv) *Examples.* The principles of paragraph (d)(1) of this section may be illustrated by the following examples, all of which apply to taxable years beginning on or after February 19, 1987.

Example 1. A related supplier sells export property to its foreign customers. The related supplier engages the FSC as its commission agent with respect to the sales, requiring the FSC to determine and transmit final invoices or statements of account to the customers with respect to the sales. Annually, the FSC assembles and forwards statements of account to customers representing 40 percent of current year export sales and 35 percent of prior year sales. The statements are sent from its office outside of the United States. The remaining statements of account are sent from the Albany, New York office of the related supplier. The statements are recognized in its industry as a statement of account. Although the statement does not contain all of the information described in §1.924(e)-1(d)(1)(i), it is sent to both domestic and foreign customers of the related supplier to inform the customer of the status of its transactions with the related supplier. The document qualifies as a statement of account under §1.924(e)-1(d)(1)(i); however, the 50 percent test set forth in §1.924(e)-1(d)-1(d)(1)(i)(A) is not satisfied. Therefore, the FSC must take into account all domestic direct costs attributable to assembly and forwarding of statements of account from its domestic office in determining whether the FSC has satisfied the direct costs test with respect to section 924(e)(4) and §924 (e)-1(d).

Example 2. Employees of a FSC, in the FSC's foreign office, fold and place in envelopes the sheet or sheets that constitute the final invoices provided by the related supplier. In addition, the employees address, affix postage to, and mail the envelopes.

These activities constitute the determination and transmittal of the final invoices within the meaning of paragraph (d)(1)(i) of this section and, because the final invoices are assembled and forwarded to the customers from outside the United States, all the direct costs of the activities are foreign direct costs.

Example 3. The related supplier sends to the FSC's foreign office a computer tape to be used to prepare a statement of account. A management company, working under contract with the FSC, transcribes the data to a piece of paper which is a statement of account for purposes of § 1.924(d)(1)(i), folds the document, and fills, affixes postage to, and mails the envelopes. Only the costs performed by the management company under contract with the FSC that constitute the assembly and forwarding of a statement of account under § 1.924(e)-1(d)(1)(i)(D) are direct costs. Therefore, the costs attributable to transcribing the data to a piece of paper are not direct costs for purposes of section 924(e)(4).

(2) *Receipt of payment*—(i) *Receipt of payment defined.* Receipt of payment means the crediting of the FSC's bank account by an amount which is not less than 1.83 percent of the gross receipts ("gross receipts amount") associated with the transaction. The FSC's bank account is not credited unless the FSC has the authority to withdraw the amount deposited. Where sales proceeds are factored or where payments from related foreign subsidiaries are netted against amounts owed to these foreign subsidiaries in an intercompany account, crediting of the FSC's bank account with no less than the gross receipts amount of the factoring proceeds or the proceeds, net of offsets, respectively, qualifies as receipt of payment. In addition, where a FSC is precluded from receiving a portion of the proceeds of the export transaction, the FSC may satisfy receipt of payment by receiving no less than the gross receipts amount of the remaining portion of the proceeds in its bank account. In the case of advance or progress payments, each payment constitutes a payment for receipt of payment purposes.

(ii) *Direct costs of receipt of payment.* Direct costs of receiving payment include the expenses of maintaining a bank account of the FSC in which payment is deposited, any fees or service charges incurred for converting the payment into U.S. currency, and any

transfer fees incurred with respect to the transfer of funds into and out of the FSC's bank account in accordance with the 35 calendar day rule in paragraph (d)(2)(iii) of this section. The transfer fees and the fees or service charges incurred for currency conversion are considered to be foreign direct costs of receiving payment; however, exchange losses are not costs of receiving payment.

(iii) *Location of receipt of payment.* The location of this activity is the office of the banking institution at which the account is maintained. If payment is made by the purchaser directly to the FSC or the related supplier in the United States, and the FSC or related supplier transfers the gross receipts amount associated with the transaction to a bank account of the FSC outside the United States after receipt of payment (i.e., cash, check, wire transfer, etc.), but no later than 35 calendar days after receipt of good funds (i.e., the clearance of the check) the FSC is considered to have received payment outside the United States. Therefore, all transfer fees and the costs of the foreign bank account are treated as foreign direct costs. The United States bank costs are disregarded. If, however, the related supplier does not transfer the gross receipts amount within 35 calendar days, United States bank costs are not disregarded and are domestic direct costs. In either case, the transfer costs, currency conversion charges, and foreign bank costs remain foreign direct costs. The preceding rules apply both to commission FSCs and buy-sell FSCs.

(iv) *Examples.* The principles of paragraph (d)(2) of this section may be illustrated by the following examples:

Example 1. A FSC earns commissions on sales of export property by its related supplier. The related supplier manufactures and sells its export property to its foreign subsidiaries for resale in their respective countries. From time to time, the foreign subsidiaries will return products to the related supplier for credit and, from time to time, the foreign subsidiaries purchase products in their respective countries and sell such products to the related supplier. These transactions result in various amounts being owed to the foreign subsidiaries. Each month the various inter-company obligations are reviewed. The result of such review of inter-

company indebtedness is a netting out of the various intercompany liabilities on the books, to the extent possible, and a flow of funds for the net obligation. Due to the nature of these transactions, the amounts owed by the foreign subsidiaries exceed the amounts which the related supplier owes to the foreign subsidiaries. The gross receipts amount (*i.e.*, 1.83 percent of this net amount) is credited to the FSC's bank account. This constitutes receipt of payment for purposes of paragraph (d)(2)(i) of this section.

Example 2. In a leveraged lease transaction, a FSC-lessor obtains purchase financing from a lending institution. The lending institution retains a security interest in the proceeds and requires that a portion of each rental payment be paid by the lessee directly to the lending institution. Since the FSC is precluded from receiving a portion of the proceeds of the export transaction, the FSC may satisfy the receipt of payment requirement by receiving the gross receipts amount with respect to the remaining proceeds.

Example 3. A buy-sell FSC sells its export property to a foreign customer and is paid by means of a "draw-down" letter of credit. Over a substantial period of time prior to delivery of the export property, amounts are advanced to the FSC under the letter of credit. At delivery, the remaining amount available is paid. Each payment made to the FSC constitutes a payment for receipt of payment purposes and thus the gross receipts amount related to each payment must be credited to the FSC's bank account.

Example 4. An FSC earns commissions on sales of export property by its related supplier. The related supplier regularly collects payments from its foreign customers in a San Francisco bank account and, after the San Francisco bank has collected on the checks, transfers, within 35 calendar days, the gross receipts amounts from its New York bank account to the FSC's bank account located outside the United States. The FSC incurred transfer fees of \$160X in addition to a fee of \$35X for the maintenance of the FSC's bank account outside the United States during the 35 calendar day period. The maintenance fee relating to the United States bank account for the 35 calendar day period is \$45X. The receipt of payment test is met because the gross receipts amounts are transferred after payment but within 35 calendar days to the FSC's bank account located outside the United States. The transfer fees of \$160X and the maintenance fee of \$35X relating to the FSC's foreign bank account are foreign direct costs. The \$45X maintenance fee related to the United States bank account is not a direct cost. If the gross receipts amounts had not been transferred to the FSC's foreign bank account within 35 calendar days, the \$45X maintenance fee related to the United States bank account would be considered a United States direct

cost. The transfer fee of \$160X and the maintenance fee of \$35X relating to the FSC's foreign bank account, however, would, nonetheless, be considered as foreign direct costs. The same funds received in San Francisco need not be transferred to the FSC's foreign bank account because money is fungible. For the same reason, the gross receipts amounts need not be transferred from the same bank account in which the payments are received.

(e) *Assumption of credit risk*—(1) *Assumption of credit risk defined.* For purposes of section 924(e), the assumption of credit risk means bearing the economic risk of nonpayment with respect to a transaction. If the FSC is acting as a commission agent for the related supplier, this risk is borne by the FSC if the commission contract transfers the costs of the economic risk of nonpayment with respect to the transaction from the related supplier to the FSC. The FSC may elect on its annual return to bear the economic risk of nonpayment with respect to its transactions during a taxable year by either—

(i) Assuming the risk of a bad debt in accordance with the rules of paragraph (e)(4)(i) of this section,

(ii) Obtaining insurance to cover nonpayment,

(iii) Investigating credit of a customer or a potential customer,

(iv) Factoring trade receivables, or

(v) Selling by means of letters of credit or banker's acceptances.

Only the alternative elected to be performed by the FSC during a taxable year is relevant for purposes of section 924(d). For example, if a buy-sell FSC elects to bear the economic risk of nonpayment with respect to its transaction during a taxable year by assuming the risk of a bad debt in accordance with the rules of paragraph (e)(4)(i) of this section, and also factors the transaction's trade receivables, only the direct costs of assuming the risk of a bad debt are relevant for purposes of section 924(d). For purposes of this paragraph, a potential customer is an unrelated person who is engaged in the purchase or sale of export property on whom an investigation is performed, but with whom no export sales contract is executed.

(2) *Direct costs of assumption of credit risk.* (i) With respect to assuming the risk of a bad debt, the direct costs of

the assumption of credit risk in the case of a buy-sell FSC include debts that become uncollectible and charges taken into account in determining additions to bad debt reserves of the FSC. In the case of a commission FSC, the direct costs of the assumption of credit risk include the assumption of the debts and charges of the related supplier attributable to export sales that are allowed as deductions under section 166.

(ii) With respect to insurance, the direct costs of the assumption of credit risk are the costs of obtaining insurance against the risk of nonpayment. Qualifying insurance must be obtained from an unrelated insurer and must cover the risk of nonpayment due to default and bankruptcy by the purchaser. Insurance obtained from a related insurer, or insurance that covers default and bankruptcy due to risks of war or political unrest without covering ordinary default or bankruptcy is not sufficient.

(iii) With respect to investigating credit, the direct costs of assumption of credit risk are the external costs of investigating credit for customers or potential customers, including costs of membership in a credit agency or association for that purpose (but not the costs of approving credit by an internal credit agency).

(iv) With respect to factoring trade receivables, the direct costs of assumption of credit risk are the costs of factoring trade receivables of related and unrelated customers (*e.g.* the amount of the discount and the fees relating to factoring).

(v) With respect to letters of credit or banker's acceptances, the direct costs of assumption of credit risk are the costs of letters of credit or banker's acceptances and the documentary collection costs.

(3) *Location of assumption of credit risk.* The location of the activity of assumption of credit risk is the location of the customer or obligor whose payment is at risk, except that the location of investigating credit is the location of the credit agency or association performing the investigation. A foreign branch of a United States corporation and a foreign office of the United States government are not foreign obli-

gors for purposes of this test. A foreign branch of a United States credit investigation agency or association, however, is treated as located outside the United States.

(4) *Special rules—(i) Assuming the risk of a bad debt—(A) In general.* If a FSC chooses to bear the economic risk of nonpayment by assuming the risk of a bad debt with respect to a transaction or grouping of transactions and an actual bad debt loss on a foreign trading gross receipt is not incurred in any three consecutive years, the FSC will be deemed to have performed this activity during the first two years of the three year period. For the third year, the FSC will not be deemed to have performed this activity and must satisfy the 85 percent foreign direct costs test by satisfying any two paragraphs included within section 924(e) other than assumption of credit risk activity under section 924(e)(5). An actual bad debt loss will only satisfy the activity test with respect to a single three consecutive year period.

(B) *Example.* The principles of this paragraph may be illustrated by the following example:

Example. In year 1, a related supplier of a commission FSC incurs a bad debt with respect to foreign trading gross receipts owed by a foreign obligor. This expense is the only bad debt incurred with respect to foreign trading gross receipts in year 1. Therefore, the direct costs for the bearing of the economic risk of nonpayment for year 1 are all foreign direct costs and the 85-percent test is satisfied. In year 2, the FSC incurs a bad debt with respect to a U.S. broker/consolidator. The direct costs for year 2 are U.S. direct costs and, therefore, the 85-percent test is not satisfied. No bad debt is incurred in year 3. Because a bad debt with respect to a foreign obligor is incurred in year 1, the FSC is deemed to have satisfied the economic risk of nonpayment for each of years 1, 2 and 3.

(ii) *Grouping with respect to other risk activities.* For taxable years beginning after February 19, 1987, if a FSC elects to bear the economic risk of nonpayment by performing one of the activities described in paragraph (e) of this section and elects to group transactions, it is considered to have performed the elected activity with respect to all transactions within the

group during the taxable year if it performs the activity in accordance with the following rules. If a FSC elects to factor trade receivables, at least 20 percent of the face amount of a group's receivables must be factored. If a FSC elects to sell by means of letters of credit or banker's acceptances, a fee must be incurred with respect to 20 percent of the foreign trading gross receipts attributable to sales within the group. If the FSC elects to obtain insurance to cover nonpayment, 20 percent of the face amount of receivables attributable to sales included in the §1.924(d)-1(e) grouping elected by the FSC must be insured. If a FSC elects to investigate credit of customers or potential customers, 20 percent of new or potential customers for which a credit investigation is performed must be investigated.

[T.D. 8125, 52 FR 5094, Feb. 19, 1987]

§ 1.925(a)-1 Transfer pricing rules for FSCs.

(a)-(c)(7) [Reserved]. For further guidance, see §1.925(a)-1T(a) through (c)(7).

(c)(8) *Grouping transactions.* (i) The determinations under this section are to be made on a transaction-by-transaction basis. However, at the annual choice made by the related supplier if the administrative pricing methods are used, some or all of these determinations may be made on the basis of groups consisting of products or product lines. The election to group transactions shall be evidenced on Schedule P of the FSC's U.S. income tax return for the taxable year. No untimely or amended returns filed later than one year after the due date of the FSC's timely filed (including extensions) U.S. income tax return will be allowed to elect to group, to change a grouping basis, or to change from a grouping basis to a transaction-by-transaction basis (collectively "grouping redeterminations"). The rule of the previous sentence is applicable to taxable years beginning after December 31, 1999. For any taxable year beginning before January 1, 2000, a grouping redetermination may be made no later than the due date of the FSC's timely filed (including extensions) U.S. income tax return for the FSC's first taxable year begin-

ning on or after January 1, 2000. Notwithstanding the time limits for filing grouping redeterminations otherwise specified in the previous three sentences, a grouping redetermination may be made at any time during the one-year period commencing upon notification of the related supplier by the Internal Revenue Service of an examination, provided that both the FSC and the related supplier agree to extend their respective statutes of limitations for assessment by one year. In addition, any grouping redeterminations made under this paragraph must meet the requirements under §1.925(a)-1T(e)(4) with respect to redeterminations other than grouping. The language "or grouping of transactions" is removed from the fourth sentence of §1.925(a)-1T(e)(4), applicable to taxable years beginning after December 31, 1997. See also §1.925(b)-1T(b)(3)(i).

(c)(8)(ii)-(f) [Reserved]. For further guidance, see §1.925(a)-1T(c)(8)(ii) through (f).

(g) *Effective date.* The provisions of this section apply on or after March 2, 2001.

[T.D. 8944, 66 FR 13428, Mar. 6, 2001]

§ 1.925(a)-1T Temporary regulations; transfer pricing rules for FSCs.

(a) *Scope*—(1) *Transfer pricing rules.* In the case of a transaction described in paragraph (b) of this section, section 925 permits a related party to a FSC to determine the allowable transfer price charged the FSC (or commission paid to the FSC) by its choice of the three transfer pricing methods described in paragraphs (c)(2), (3), and (4) of this section: The "1.83 percent" gross receipts method and the "23 percent" combined taxable income method (the administrative pricing rules) of section 925(a)(1) and (2), respectively, and the section 482 method of section 925(a)(3). (Any further reference to a FSC in this section shall include a small FSC unless indicated otherwise.) Subject to the special no-loss rule of §1.925(a)-1T(e)(1)(iii), any, or all, of the transfer pricing methods may be used in the same taxable year of the FSC for separate transactions (or separate groups of

transactions). If either of the administrative pricing methods (the gross receipts method or combined taxable income method) is applied to a transaction, the Commissioner may not make distributions, apportionments, or allocations as provided by section 482 and the regulations under that section. The transfer price charged the FSC (or the commission paid to the FSC) on a transaction with a person that is not a related party to the FSC may be determined in any manner agreed to by the FSC and that person. However, the Commissioner will use special scrutiny to determine whether a person selling export property to a FSC (or paying a commission to a FSC) is a related party to the FSC with respect to a transaction if the FSC earns a profit on the transaction in excess of the profit it would have earned had the administrative pricing rules applied to the transaction.

(2) *Special rules.* For rules as to certain “incomplete transactions” and for computing full costing combined taxable income, see paragraphs (c)(5) and (6) of this section. For a special rule as to cooperatives and computation of their combined taxable incomes, see paragraph (c)(7) of this section. Grouping of transactions for purposes of applying the administrative pricing method chosen is provided for by paragraph (c)(8) of this section.

The rules in paragraph (c) of this section are directly applicable only in the case of sales or exchanges of export property to a FSC for resale, and are applicable by analogy to leases, commissions, and services as provided in paragraph (d) of this section. For a rule providing for the recovery of the FSC’s costs in an overall loss situation, see paragraph (e)(1)(i) of this section. Paragraph (e)(2) of this section provides for the applicability of section 482 to resales by the FSC to related persons or to sales between related persons prior to the sale to the FSC. Paragraph (e)(3) of this section provides for the creation of receivables if the transfer price, rental payment, commission or payment for services rendered is not paid by the due date of the FSC’s income tax return for the taxable year under section 6072(b), including extensions provided for by section 6081. Provisions

for the subsequent determination and further adjustment to the relevant amounts are set forth in paragraphs (e)(4) and (5) of this section. Paragraph (f) of this section has several examples illustrating the provisions of this section. Section 1.925(b)-1T prescribes the marginal costing rules authorized by section 925(b)(2). Section 1.927(d)-2T provides definitions of related supplier and related party.

(3) *Performance of substantial economic functions*—(i) *Administrative pricing methods.* The application of the administrative pricing methods of section 925 (a)(1) and (2) does not depend on the extent to which the FSC performs substantial economic functions beyond those required by section 925(c). See paragraph (b)(2)(ii) of this section and § 1.924(a)-1T(i)(1).

(ii) *Section 482 method.* In order to apply the section 482 method of section 925(a)(3), the arm’s length standards of section 482 and the regulations under that section must be satisfied. In applying the standards of section 482, all of the rules of section 482 will apply. Thus, if the FSC would not be recognized as a separate entity, it would also not be recognized on application of the section 482 method. Similarly, if a FSC performs no substantial economic function with respect to a transaction, no income will be allocable to the FSC under the section 482 method. See § 1.924(a)-1T(i)(2). If a related supplier performs services under contract with a FSC, the FSC will not be deemed to have performed substantial economic functions for purposes of the section 482 method unless it compensates the related supplier under the provisions of § 1.482-2(b)(1) through (7). See § 1.925(a)-1T(c)(6)(ii) for the applicability of the regulations under section 482 in determination of the FSC’s profit under the administrative pricing methods.

(b) *Transactions to which section 925 applies*—(1) *In general.* The transfer pricing methods of section 925 (the administrative pricing methods and the section 482 method) will apply, generally, only if a transaction, or group of transactions, gives rise to foreign trading gross receipts (within the meaning of section 924(a) and § 1.924(a)-1T) to the FSC (or small FSC, as defined in section 922(b) and § 1.921-2(b)

(Q&A3)). However, the transfer pricing methods will apply as well if the FSC is acting as commission agent for a related supplier with regard to a transaction, or group of transactions, on which the related supplier is the principal if the transaction, or group of transactions, would have resulted in foreign trading gross receipts had the FSC been the principal.

(2) *Application of the transfer pricing rules*—(i) *Section 482 method.* The section 482 transfer pricing method may be applied to any transaction between a related supplier and a FSC if the requirements of paragraph (a)(3)(ii) of this section have been met.

(ii) *Administrative pricing methods.* The administrative pricing methods may be applied in situations in which the FSC is either the principal or commission agent on the transaction, or group of transactions, only if the requirements of section 925(c) are met. Section 925(c) requires that the FSC performs all the activities described in subsections (d)(1)(A) and (e) of section 924 that are attributable to a particular transaction, or group of transactions. The FSC need not perform any activities with respect to a particular transaction merely to comply with section 925(c) if that activity would not have been performed but for the requirements of that subsection. The FSC need not perform all of the activities outside the United States. None of the activities need be performed outside the United States by a small FSC. Rather than the FSC itself performing the activities required by section 925(c), another person under contract, written or oral, directly or indirectly, with the FSC may perform the activities (see §1.924(d)-1(b)). If a related supplier is performing the required activities on behalf of the FSC with regard to a transaction, or group of transactions, the requirements of section 925(c) will be met if the FSC pays the related supplier an amount equal to the direct and indirect expenses related to the required activities. See paragraph (c)(6)(ii) of this section for the amount of compensation due the related supplier. The payment made to the related supplier must be reflected on the FSC's books and must be taken into account in computing the FSC's

and related supplier's combined taxable income. If it is determined that the related supplier was not compensated for all the expenses related to the required activities or if the entire payment is not reflected on the FSC's books or in computing combined taxable income, the administrative pricing methods may be used but proper adjustments will be made to the FSC's and related supplier's books or income. At the election of the FSC and related supplier, the requirements of section 925(c) will be deemed to have been met if the related supplier is paid by the FSC an amount equal to all of the costs under paragraph (c)(6)(iii)(D) of this section (limited by paragraph (c)(6)(ii) of this section) related to the export sale, other than expenses relating to activities performed directly by the FSC or by a person other than the related supplier, and if that payment is reflected on the FSC's books and in computing the FSC's and related supplier's combined taxable income on the transaction, or group of transactions. If it is determined that the related supplier was not compensated for all its expenses or if the entire payment is not reflected on the FSC's books or in computing combined taxable income, the administrative pricing methods may be used but proper adjustments will be made to the FSC's and related supplier's books or income. All activities that are performed in connection with foreign military sales are considered to be performed by the FSC, or under contract with the FSC, if they are performed by the United States government even though the United States government has not contracted for the performance of those activities. All actual costs incurred by the FSC and related supplier in connection with the performance of those activities must be taken into account, however, in determining the combined taxable income of the FSC and related supplier.

(iii) *Allowable transactions for purposes of the administrative pricing methods.* If the required performance of activities has been met, the administrative pricing methods may be applied to a transaction between a related supplier and a FSC only in the following circumstances.

§ 1.925(a)-1T

26 CFR Ch. I (4-1-12 Edition)

(A) The related supplier sells export property (as defined in section 927(a) and § 1.927(a)-1T) to the FSC for resale or the FSC acts as a commission agent for the related supplier on sales by the related supplier of export property to third parties, whether or not related parties. For purposes of this section, references to sales include references to exchanges or other dispositions.

(B) The related supplier leases export property to the FSC for sublease for a comparable period with comparable terms of payment, or the FSC acts as commission agent for the related supplier on leases of export property by the related supplier, to third parties whether or not related parties.

(C) Services are furnished by a FSC as principal or by a related supplier if a FSC is a commission agent for the related supplier which are related and subsidiary to any sale or lease by the FSC, acting as principal or commission agent, of export property under subdivision (iii)(A) and (B) of this paragraph.

(D) Engineering or architectural services for construction projects located (or proposed for location) outside of the United States are furnished by the FSC if the FSC is acting as principal, or by the related supplier if the FSC is a commission agent for the related supplier, with respect to the furnishing of the services to a third party whether or not a related party.

(E) The FSC acting as principal, or the related supplier where the FSC is a commission agent, furnishes managerial services in furtherance of the production of foreign trading gross receipts of an unrelated FSC or the production of qualified export receipts of an unrelated interest charge DISC.

This subdivision (iii)(E) shall not apply for any taxable year unless at least 50 percent of the gross receipts for such taxable year of the FSC or of the related supplier, whichever party furnishes the managerial services, is derived from activities described in subdivision (iii)(A), (B), or (C) of this paragraph.

(c) *Transfer price for sales of export property*—(1) *In general.* Under this paragraph, rules are prescribed for computing the allowable price for a transfer from a related supplier to a

FSC in the case of a sale, described in paragraph (b)(2)(iii)(A) of this section, of export property.

(2) *The “1.83 percent” gross receipts method.* Under the gross receipts method of pricing, described in section 925(a)(1), the transfer price for a sale by the related supplier to the FSC is the price as a result of which the profit derived by the FSC from the sale will not exceed 1.83 percent of the foreign trading gross receipts of the FSC derived from the sale of the export property. Pursuant to section 925(d), the amount of profit derived by the FSC under this method may not exceed twice the amount of profit determined under, at the related supplier’s election, either the combined taxable income method of § 1.925(a)-1T(c)(3) or the marginal costing rules of § 1.925(b)-1T. For FSC taxable years beginning after December 31, 1986, if the related supplier elects to determine twice the profit determined under the combined taxable income method using the marginal costing rules, because of the no-loss rule of § 1.925(a)-1T(e)(1)(i), the profit that may be earned by the FSC is limited to 100% of the full costing combined taxable income as determined under § 1.925(a)-1T(c)(3) and (6). Interest or carrying charges with respect to the sale are not foreign trading gross receipts.

(3) *The “23 percent” combined taxable income method.* Under the combined taxable income method of pricing, described in section 925(a)(2), the transfer price for a sale by the related supplier to the FSC is the price as a result of which the profit derived by the FSC from the sale will not exceed 23 percent of the full costing combined taxable income (as defined in paragraph (c)(6) of this section) of the FSC and the related supplier attributable to the foreign trading gross receipts from such sale.

(4) *Section 482 method.* If the methods of paragraph (c)(2) and (3) of this section are inapplicable to a sale or if the related supplier does not choose to use them, the transfer price for a sale by the related supplier to the FSC is to be determined on the basis of the sales price actually charged but subject to the rules provided by section 482 and the regulations for that section and by § 1.925(a)-1T(a)(3)(ii).

(5) *Incomplete transactions.* (i) For purposes of the gross receipts and combined taxable income methods, if export property which the FSC purchased from the related supplier is not resold by the FSC before the close of either the FSC's taxable year or the taxable year of the related supplier during which the export property was purchased by the FSC from the related supplier, then—

(A) The transfer price of the export property sold by the FSC during that year shall be computed separately from the transfer price of the export property not sold by the FSC during that year.

(B) With respect to the export property not sold by the FSC during that year, the transfer price paid by the FSC for that year shall be the related supplier's cost of goods sold (see paragraph (c)(6)(iii)(C) of this section) with respect to the property.

(C) For the subsequent taxable year during which the export property is resold by the FSC, an additional amount shall be paid by the FSC (to be treated as income for the later year in which it is received or accrued by the related supplier) equal to the excess of the amount which would have been the transfer price under this section had the transfer to the FSC by the related supplier and the resale by the FSC taken place during the taxable year of the FSC during which it resold the property over the amount already paid under subdivision (B) of this paragraph.

(D) The time and manner of payment of transfer prices required by subdivisions (i)(B) and (C) of this paragraph shall be determined under paragraphs (e)(3), (4) and (5) of this section.

(ii) For purposes of this paragraph, a FSC may determine the year in which it received property from a related supplier and the year in which it resells property in accordance with the method of identifying goods in its inventory properly used under section 471 or section 472 (relating respectively to the general rule for inventories and to the rule for LIFO inventories). Transportation expense of the related supplier in connection with a transaction to which this paragraph applies shall be treated as an item of cost of goods sold with respect to the property if the re-

lated supplier includes the cost of intracompany transportation between its branches, divisions, plants, or other units in its cost of goods sold (see paragraph (c)(6)(iii)(C) of this section).

(6) *Full costing combined taxable income—(i) In general.* For purposes of section 925 and this section, if a FSC is the principal on the sale of export property, the full costing combined taxable income of the FSC and its related supplier from the sale is the excess of the foreign trading gross receipts of the FSC from the sale over the total costs of the FSC and related supplier including the related supplier's cost of goods sold and its and the FSC's noninventoriable costs (see § 1.471-11(c)(2)(ii)) which relate to the foreign trading gross receipts. Interest or carrying charges with respect to the sale are not foreign trading gross receipts.

(ii) *Section 482 applicability.* Combined taxable income under this paragraph shall be determined after taking into account under paragraph (e)(2) of this section all adjustments required by section 482 with respect to transactions to which the section is applicable. If a related supplier performs services under contract with a FSC, the FSC shall compensate the related supplier an arm's length amount under the provisions of § 1.482-2(b) (1) through (6). Section 1.482-2(b)(7), which provides that an arm's length charge shall not be deemed equal to costs or deductions with respect to services which are an integral part of the business activity of either the member rendering the services (*i.e.*, the related supplier) or the member receiving the benefit of the services (*i.e.*, the FSC), shall not apply if the administrative pricing methods of section 925(a)(1) and (2) are used to compute the FSC's profit and if the related supplier is the person rendering the services. Section 1.482-2(b)(7) shall apply, however, if a related person other than the related supplier is the person rendering the services or if the section 482 method of section 925(a)(3) is used to compute the FSC's profit. See § 1.925(a)-1T(a)(3)(ii). For a special rule for computation of combined taxable income where the related supplier is a qualified cooperative shareholder

of the FSC, see paragraph (c)(7) of this section.

(iii) *Rules for determination of gross receipts and total costs.* In determining the gross receipts of the FSC and the total costs of the FSC and related supplier which relate to such gross receipts, the rules set forth in subdivisions (iii)(A) through (E) of this paragraph shall apply.

(A) Subject to the provisions of subdivisions (iii)(B) through (E) of this paragraph, the methods of accounting used by the FSC and related supplier to compute their taxable incomes will be accepted for purposes of determining the amounts of items of income and expense (including depreciation) and the taxable year for which those items are taken into account.

(B) A FSC may, generally, choose any method of accounting permissible under section 446(c) and the regulations under that section. However, if a FSC is a member of a controlled group (as defined in section 927(d)(4) and § 1.924(a)-1T(h)), the FSC may not choose a method of accounting which, when applied to transactions between the FSC and other members of the controlled group, will result in a material distortion of the income of the FSC or of any other member of the controlled group. Changes in the method of accounting of a FSC are subject to the requirements of section 446(e) and the regulations under that section.

(C) Cost of goods sold shall be determined in accordance with the provisions of § 1.61-3. See sections 471 and 472 and the regulations thereunder with respect to inventories. With respect to property to which an election under section 631 applies (relating to cutting of timber considered as a sale or exchange), cost of goods sold shall be determined by applying § 1.631-1 (d)(3) and (e) (relating to fair market value as of the beginning of the taxable year of the standing timber cut during the year considered as its cost).

(D) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are the expenses, losses, and deductions definitely related, and therefore allocated and apportioned thereto, and a ratable part of any other expenses, losses, or deductions which

are not definitely related to any class of gross income, determined in a manner consistent with the rules set forth in § 1.861-8. The deduction for depletion allowed by section 611 relates to gross receipts from sales of export property and shall be taken into account in computing the combined taxable income of the FSC and its related supplier.

(7) *Cooperatives and combined taxable income method.* If a qualified cooperative, as defined in section 1381(a), sells export property to a FSC of which it is a shareholder, the combined taxable income of the FSC and the cooperative shall be computed without taking into account deductions allowed under section 1382 (b) and (c) for patronage dividends, per-unit retain allocations and nonpatronage distributions. The FSC and cooperative must take into account, however, when computing combined taxable income, the cooperative's cost of goods sold, or cost of purchases.

(8) *Grouping transactions.* (i) [Reserved]. For further guidance, see § 1.925(a)-1(c)(8)(i).

(ii) A determination by the related supplier as to a product or a product line will be accepted by a district director if such determination conforms to either of the following standards: Recognized trade or industry usage, or the two-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President. A product shall be included in only one product line for purposes of this section if a product otherwise falls within more than one product line classification.

(iii) A choice by the related supplier to group transactions for a taxable year on a product or product line basis shall apply to all transactions with respect to that product or product line consummated during the taxable year. However, the choice of a product or product line grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are to be made on a transaction-by-transaction basis. For example, the

related supplier may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year. Sale transactions may not be grouped, however, with lease transactions.

(iv) For purposes of this section, transactions involving military property, as defined in section 923(a)(5) and § 1.923-1T(b)(3)(ii), may be grouped only with other military property included within the same product or product line grouping determined under the standards of subdivision (8)(ii) of this paragraph. Non-military property included within a product or product line grouping which includes military property may be grouped, at the election of the related supplier, under the general grouping rules of subdivisions (i) through (iii) of this paragraph.

(v) A special grouping rule applies to agricultural and horticultural products sold to the FSC by a qualified cooperative if the FSC satisfies the requirements of section 923(a)(4). Section 923(a)(4) increases the amount of the FSC's exempt foreign trade income with regard to sales of these products, see § 1.923-1T(b)(2). This special grouping rule provides that if the related supplier elects to group those products that no other export property may be included within that group. Export property which would have been grouped under the general grouping rules of subdivisions (i) through (iii) of this paragraph with the export property covered by this special grouping rule may be grouped, however, at the election of the related supplier, under the general grouping rules.

(vi) For rules as to grouping certain related and subsidiary services, see paragraph (d)(3)(ii) of this section.

(vii) If there is more than one FSC (or more than one small FSC) within a controlled group of corporations, the same grouping of transactions, if any, must be used by all FSCs (or small FSCs) within the controlled group. If the same grouping of transactions is required by this subdivision, and if grouping is elected, the same transfer pricing method must be used to determine each FSC's (or small FSC's) taxable income with respect to that grouping.

(viii) The product or product line groups that are established for purposes of determining combined taxable income may be different from the groups that are established with regard to economic processes (see § 1.924(d)-1(e)).

(d) *Rules under section 925(a)(1) and (2) for transactions other than sales by a FSC.* The following rules are prescribed for purposes of applying the gross receipts method or combined taxable income method to transactions other than sales by a FSC.

(1) *Leases.* In the case of a lease of export property by a related supplier to a FSC for sublease by the FSC, the amount of rent the FSC must pay to the related supplier shall be computed in a manner consistent with the rules in paragraph (c) of this section for computing the transfer price in the case of sales and resales of export property under the gross receipts method or combined taxable income method. Transactions may not be so grouped on a product or product line basis under the rules of paragraph (c)(8) of this section as to combine in any one group of transactions both lease transactions and sale transactions.

(2) *Commissions.* If any transaction to which section 925 applies is handled on a commission basis for a related supplier by a FSC and if commissions paid to the FSC give rise to gross receipts to the related supplier which would have been foreign trading gross receipts under section 924(a) had the FSC made the sale directly then—

(i) The administrative pricing methods of section 925(a)(1) and (2) may be used to determine the FSC's commission income only if the requirements of section 925(c) (relating to activities that must be performed in order to use the administrative pricing methods) are met, see § 1.925(a)-1T(b)(2)(ii).

(ii) The amount of the income that may be earned by the FSC in any year is the amount, computed in a manner consistent with paragraph (c) of this section, which the FSC would have been permitted to earn under the gross receipts method, the combined taxable income method, or the section 482 method if the related supplier had sold (or leased) the property or service to the FSC and the FSC had in turn sold

(or subleased) to a third party, whether or not a related party.

(iii) The combined taxable income of a FSC and the related supplier from the transaction is the excess of the related supplier's gross receipts from the transaction which would have been foreign trading gross receipts had the sale been made by the FSC directly over the related supplier's and the FSC's total costs, excluding the commission paid or payable to the FSC, but including the related supplier's cost of goods sold and its and the FSC's noninventoriable costs (see § 1.471-11(c)(2)(ii)) which relate to the gross receipts from the transaction. The related supplier's gross receipts for purposes of the administrative pricing methods shall be reduced by carrying charges, if any, as computed under § 1.927(d)-1(a)(Q&A2). These carrying charges shall remain income of the related supplier.

(iv) The maximum commission the FSC may charge the related supplier is the amount of income determined under subdivisions (ii) and (iii) of this paragraph plus the FSC's total costs for the transaction as determined under paragraph (c)(6) of this section.

(3) *Receipts from services*—(i) *Related and subsidiary services attributable to the year of the export transaction.* The gross receipts for related and subsidiary services described in paragraph (b)(2)(iii)(C) of this section shall be treated as part of the receipts from the export transaction to which such services are related and subsidiary, but only if, under the arrangement between the FSC and its related supplier and the accounting method otherwise employed by the FSC, the income from such services is includible for the same taxable year as income from such export transaction.

(ii) *Other services.* Income from the performance of related and subsidiary services will be treated as a separate type of income if subdivision (i) of this paragraph does not apply. Income from the performance of engineering and architectural services and certain managerial services, as defined in paragraphs (b)(2)(iii)(D) and (E), respectively, of this section, will in all situations be treated as separate types of income. If this subdivision (ii) applies, the amount of taxable income which

the FSC may derive for any taxable year shall be determined under the arrangement between the FSC and its related supplier and shall be computed in a manner consistent with the rules in paragraph (c) of this section for computing the transfer price in the case of sales for resale of export property under the transfer pricing rules of section 925. Related and subsidiary services to which the above subdivision (i) of this paragraph does not apply may be grouped, under the rules for grouping of transactions in paragraph (c)(8) of this section, with the products or product lines to which they are related and subsidiary, so long as the grouping of services chosen is consistent with the grouping of products or product lines chosen for the taxable year in which either the products or product lines were sold or in which payment for the services is received or accrued. Grouping of transactions shall not be allowed with respect to the determination of taxable income which the FSC may derive from services described in paragraph (b)(2)(iii)(D) or (E) of this section whether performed by the FSC or by the related supplier. Those determinations shall be made only on a transaction-by-transaction basis.

(e) *Special rules for applying paragraphs (c) and (d) of this section—(1) Limitation on FSC income (“no loss” rules).* (i) If there is a combined loss on a transaction or group of transactions, a FSC may not earn a profit under either the combined taxable income method or the gross receipts method. Also, for FSC taxable years beginning after December 31, 1986, in applying the gross receipts method, the FSC's profit may not exceed 100% of full costing combined taxable income determined under the full costing method of § 1.925(a)-1T(c)(3) and (6). This rule prevents pricing at a loss to the related supplier. The related supplier may in all situations set a transfer price or rental payment or pay a commission in an amount that will allow the FSC to recover an amount not in excess of its costs, if any, even if to do so would create, or increase, a loss in the related supplier.

(ii) For purposes of determining whether a combined loss exists, the basis for grouping transactions chosen

by the related supplier under paragraph (c)(8) of this section for the taxable year shall apply.

(iii) If a FSC recognizes income while the related supplier recognizes a loss on a sale transaction under the section 482 method, neither the combined taxable income method nor the gross receipts method may be used by the FSC and related supplier (or by a FSC in the same controlled group and the related supplier) for any other sale transaction, or group of sale transactions, during a year which fall within the same three digit Standard Industrial Classification as the subject sale transaction. The reason for this rule is to prevent the segregation of transactions for the purposes of allowing the related supplier to recognize a loss on the subject transactions, while allowing the FSC to earn a profit under the administrative pricing methods on other transactions within the same three digit Standard Industrial Classification.

(2) *Relationship to section 482.* In applying the administrative pricing methods, it may be necessary to first take into account the price of a transfer (or other transaction) between the related supplier (or FSC) and a related party which is subject to the arm's length standard of section 482. Thus, for example, if a related supplier sells to a FSC export property which the related supplier purchased from related parties, the costs taken into account in computing the combined taxable income of the FSC and the related supplier are determined after any necessary adjustment under section 482 of the price paid by the related supplier to the related parties. In applying section 482 to a transfer by a FSC to a related party, the parties are treated as if they were a single entity carrying on all the functions performed by the FSC and the related supplier with respect to the transaction. The FSC shall be allowed to receive under the section 482 standard the amount the related supplier would have received had there been no FSC.

(3) *Creation of receivables.* (i) If the amount of the transfer price or rental payment actually charged by a related supplier to a FSC or the sales commission actually charged by a FSC to a related supplier has not been paid, an ac-

count receivable and payable will be deemed created as of the due date under section 6072(b), including extensions provided for under section 6081, of the FSC's tax return for the taxable year of the FSC during which a transaction to which section 925 is applicable occurs. The receivable and payable will be in an amount equal to the difference between the amount of the transfer price or rental payment or commission determined under section 925 and this section and the amount (if any) actually paid or received. For example, a calendar year FSC's related supplier paid the FSC on July 1, 1985, a commission of \$50 on the sale of export property. On September 15, 1986, the extended due date of the FSC's income tax return for taxable year 1985, the related supplier determined that the commission should have been \$60. The additional \$10 of commission had not been paid. Accordingly, an interest-bearing payable to the FSC from the related supplier in the amount of \$10 was created as of September 15, 1986. A \$10 interest bearing receivable was also created on the FSC's books.

(ii) An indebtedness arising under the above subdivision (i) shall bear interest at an arm's length rate, computed in the manner provided by § 1.482-2(a)(2), from the due date under section 6072(b), including extensions provided for under section 6081, of the FSC's tax return for the taxable year of the FSC in which the transaction occurred which gave rise to the indebtedness to the date of payment of the indebtedness. The interest so computed shall be accrued and included in the taxable income of the person to whom the indebtedness is owed for each taxable year during which the indebtedness is unpaid if that person is an accrual basis taxpayer or when the interest is paid if a cash basis taxpayer. Because the transactions covered by this subdivision are between the related supplier and FSC, the carrying charges provisions of § 1.927(d)-1(a) do not apply.

(iii) Payment of dividends, transfer prices, rents, commissions, service fees, receivables, or payables may be in the form of money, property, sales discount, or an accounting entry offsetting the amount due the related supplier, or FSC, whichever applies,

against an existing debt of the other party to the transaction. This provision does not eliminate the requirement that actual cash payments be made by the related supplier to a commission FSC if the receipt of payment test of section 924(e)(4) is used to meet the foreign economic process requirements of section 924(d). The offset accounting entries must be clearly identified in both the related supplier's and FSC's books of account.

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

(5) *Procedure for adjustments to redeterminations.* (i) If a redetermination under paragraph (e)(4) of this section is made of the transfer price, rental payment or commission for a transaction, or group of transactions, the person

who was underpaid under this redetermination shall establish (or be deemed to have established), at the date of the redetermination, an account receivable from the person with whom it engaged in the transaction equal to the difference between the amounts as redetermined and the amounts (if any) previously paid and received, plus the amount (if any) of the account receivable determined under paragraph (e)(3) of this section that remains unpaid. A corresponding account payable will be established by the person who underpaid the amount due.

(ii) An account receivable established in accordance with the above subdivision (5)(i) of this paragraph shall bear interest at an arm's length rate, computed in the manner provided by § 1.482-2(a)(2), from the day after the date the account receivable is deemed established to the date of payment. The interest so computed shall be accrued and included in the taxable income for each taxable year during which the account receivable is outstanding of an accrual basis taxpayer or when paid if a cash basis taxpayer.

(iii) In lieu of establishing an account receivable in accordance with the above subdivision (5)(i) of this paragraph for all or part of an amount due a related supplier, the related supplier and FSC are permitted to treat all or part of any current or prior distribution which was made by the FSC as an additional payment of transfer price or rental payment or repayment of commission (and not as a distribution) made as of the date the distribution was made. Any additional amount arising on the redetermination due the related supplier after this treatment shall be represented by an account receivable established under the above subdivision (5)(i) of this paragraph. To the extent that a distribution is so treated under this subdivision (5)(iii), it shall cease to qualify as a distribution for any Federal income tax purpose. If all or part of any distribution made to a shareholder other than the related supplier is recharacterized under this subdivision (5)(iii), the related supplier shall establish an account receivable from that shareholder for the amount so recharacterized. The

Internal Revenue Service, Treasury

§ 1.925(a)-1T

Commissioner may prescribe by Revenue Procedure conditions and procedures that must be met in order to obtain the relief provided by this subdivision (5)(iii).

(iv) The procedure for adjustments to transfer price provided by this paragraph does not apply to incomplete transactions described in paragraph (c)(5) of this section. Such procedure will, however, be applied to any such transaction with respect to the taxable year in which the transaction is completed.

(f) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. In 1985, F, a FSC, purchases export property from R, a domestic manufacturer of export property A. R is F's related supplier. The sale from R to F is made under a written agreement which provides that the transfer price between R and F shall be that price which allocates to F the maximum amount permitted to be received under the transfer pricing rules of section 925. F resells property A in 1985 to an unrelated purchaser for \$1,000. The terms of the sales contract between F and the unrelated purchaser provide that payment of the \$1,000 sales price will be made within 90 days after sale. The purchaser pays the entire sales price within 60 days. F incurs indirect and direct expenses in the amount of \$260 attributable to the sale which relate to the activities and functions referred to in section 924 (c), (d) and (e). In addition, F incurs additional expenses attributable to the sale in the amount of \$35. R's cost of goods sold attributable to the export property is \$550. R incurred direct selling expenses in connection with the sale of \$50. R's deductible general and administrative expenses allocable to all gross income are \$200. Apportionment of those supportive expenses on the basis of gross income does not result in a material distortion of income and is a reasonable method of apportionment. R's direct selling expenses and its general and administrative expenses were not required to be incurred by F. R's gross income from sources other than the transaction is \$17,550 resulting in total gross income of R and F (excluding the transfer price paid by F) of \$18,000 (\$450 plus \$17,550). For purposes of this example, it is assumed that if R sold the export property to F for \$690, the price could be justified as satisfying the standards of section 482. Under these facts, F may earn, under the combined taxable income method, the more favorable of the three transfer pricing rules, a profit of \$23 on the sale. (Unless otherwise indicated, all examples in this section assume that the marginal costing method of § 1.925(b)-1T does not result in a higher

profit than the profit under the full costing combined taxable income method of paragraphs (c)(3) and (6) of this section.) F's profit and the transfer price to F from the transaction, using the administrative pricing methods, and F's profit if the transfer price is determined under section 482, would be as follows:

Combined taxable income:	
F's foreign trading gross receipts	\$1,000.00
R's cost of goods sold	(550.00)
Combined gross income	450.00
Less:	
R's direct selling expenses	50.00
F's expenses	295.00
Apportionment of R's general and administrative expenses:	
R's total G/A expenses	200.00
Combined gross income	450.00
R's and F's total gross income (foreign and domestic)	18,000.00
Apportionment of G/A expenses:	
\$200×\$450/\$18,000	5.00
Total	(350.00)
Combined taxable income	100.00
The section 482 method—Transfer price to F and F's profit:	
Transfer price to F	\$690.00
F's profit:	
F's foreign trading gross receipts	1,000.00
Less:	
F's cost of goods sold	690.00
F's expenses	295.00
Total	(985.00)
F's profit	15.00
The gross receipts method—	
F's profit and transfer price to F:	
F's profit—lesser of 1.83% of F's foreign trading gross receipts (\$18.30) or two times F's profit under the combined taxable income method (\$46.00) (See below) (Unless otherwise indicated, all examples in this section assume that the marginal costing method of § 1.925(b)-1T does not result in a higher profit than the profit under the full costing combined taxable income method) ...	
	18.30
Transfer price to F:	
F's foreign trading gross receipts	1,000.00
Less:	
F's expenses	295.00
F's profit	18.30
Total	(313.30)
Transfer price	686.70
The combined taxable income method—F's profit and transfer price to F:	
F's profit—23% of combined taxable income (\$100)	
	\$23.00

§ 1.925(a)-1T

26 CFR Ch. I (4-1-12 Edition)

Transfer price to F:	
F's foreign trading gross receipts	1,000.00
Less:	
F's expenses	295.00
F's profit	23.00
Total	(318.00)
Transfer price	682.00

With a profit of \$23 under the most favorable of the transfer pricing methods, F's exempt foreign trade income under section 923 would be \$207.39, computed as follows:

F's foreign trading gross receipts	\$1,000.00
F's costs of purchases (transfer price)	(682.00)
F's foreign trade income	318.00
F's exempt foreign trade income $\$318 \times 15/23$	207.39

F's taxable income would be \$8.00, computed as follows:

F's foreign trade income	\$318.00
F's exempt foreign trade income	(207.39)
F's non-exempt foreign trade income	110.61
Less:	
F's expenses allocable to non-exempt foreign trade income $\$295 \times \$110.61 / \$318$	(102.61)
F's taxable income	8.00

Of F's total expenses, \$192.39 ($\$295 \times \$207.39 / \318) are allocated to F's exempt foreign trade income and are disallowed for purposes of computing F's taxable income.

Example 2. Assume the same facts as in *Example 1* except that the purchaser pays the entire sales price 96 days after delivery, well beyond the 60 day period in which payment must be made to avoid recharacterization of part of the contract price as carrying charges. Therefore, the contract price of \$1,000 includes \$10 of carrying charges, assuming a discount rate of 10%. See § 1.927(d)-1(a) (Q & A2) for computation method for determining amount of carrying charges. Under these facts, F may earn, under the combined taxable income method, the most favorable of the three transfer pricing rules, a profit of \$20.73 on the sale. F's profit and the transfer price to F under the transfer pricing rules, assuming that a carrying charge is incurred, would be as follows:

Combined taxable income:	
F's foreign trading gross receipts	\$990.00
R's cost of goods sold	(550.00)
Combined gross income	440.00
Less:	
R's direct selling expenses	50.00
R's apportioned G/A expenses:	
$\$200 \times \$440 / \$18,000$	4.89
F's expenses	295.00

Total	(349.89)
Combined taxable income	90.11
The combined taxable income method—F's profit and transfer price to F:	
F's profit—23% of combined taxable income (\$90.11)	\$20.73
Transfer price to F:	
F's foreign trading gross receipts	990.00
Less:	
F's expenses	295.00
F's profit	20.73
Total	(315.73)
Transfer price	674.27

The gross receipts method—F's profit and transfer price to F:

F's profit—lesser of 1.83% of F's foreign trading gross receipts (\$18.12) or two times F's profit under the combined taxable income method (\$41.46)	\$18.12
---	---------

Transfer price to F: F's foreign trading gross receipts	990.00
Less:	
F's expenses	295.00
F's profit	18.12
Total	(313.12)
Transfer price	676.88

The section 482 method—Transfer price to F and F's profit:	
Transfer price to F	690.00
F's profit:	
F's foreign trading gross receipts	990.00
Less:	
F's cost of goods sold	690.00
F's expenses	295.00
Total	(985.00)
F's profit	5.00

Example 3. R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, a FSC for the taxable year. During 1985, R produces and sells a product line of export property to F for \$157, a price which can be justified as satisfying the arm's length price standard of section 482. The sale from R to F is made under a written agreement which provides that the transfer price between R and F shall be that price which allocates to F the maximum amount permitted to be received under the transfer pricing rules of section 925. F resells the export property for \$200. R's cost of goods sold attributable to the export property is \$115 so that the combined gross income from the sale of the export property is \$85 (*i.e.*, \$200 minus \$115). R incurs \$18 in direct selling expenses in connection with the sale of the property. R's deductible general and administrative expenses allocable to all

Internal Revenue Service, Treasury

§ 1.925(a)-1T

gross income are \$120. R's direct selling and its general and administrative expenses were not required to be incurred by F. R's gross income from sources other than the transaction is \$5,015 resulting in total gross income of R and F (excluding the transfer price paid by F) of \$5,100 (*i.e.*, \$85 plus \$5,015). F incurs \$50 in direct and indirect expenses attributable to resale of the export property. Of those expenses, \$45 relate to activities and functions referred to in section 924 (c), (d) and (e). The maximum profit which F may earn with respect to the product line is \$3.66, computed as follows:

Combined taxable income:	
F's foreign trading gross receipts	\$200.00
R's cost of goods sold	(115.00)
Combined gross income	85.00
Less:	
R's direct selling expenses	18.00
R's apportioned G/A expenses: \$120×\$85/\$5,100	2.00
F's expenses	50.00
Total	(70.00)
Combined taxable income	15.00
<i>The combined taxable income method—F's profit:</i>	
F's profit—23% of combined taxable income (\$15)	\$ 3.45
<i>The gross receipts method—F's profit:</i>	
F's profit—lesser of 1.83% of F's foreign trading gross receipts (\$3.66) or two times F's profit under the combined taxable income method (\$6.90)	\$3.66
<i>The section 482 method—F's profit:</i>	
F's foreign trading gross receipts	200.00
Less:	
F's cost of goods sold	157.00
F's expenses	50.00
Total	(207.00)
F's profit (loss)	(7.00)

Since the gross receipts method results in a greater profit to F (\$3.66) than does either the combined taxable income method (\$3.45) or the section 482 method (a loss of \$7), and does not exceed twice the profit under the combined taxable income method, F may earn a maximum profit of \$3.66. Accordingly, the transfer price from R to F may be readjusted as long as the transfer price is not readjusted below \$146.34, computed as follows:

<i>Transfer price to F:</i>	
F's foreign trading gross receipts	\$ 200.00
Less:	
F's expenses	50.00
F's profit	3.66
Total	(53.66)
Transfer price	146.34

Example 4. R and F are fiscal year May 31 year-end taxpayers. R, a domestic manufacturing company, owns all the stock of F, a FSC for the taxable year. During August of 1987, R produces and sells 100 units of export property A to F under a written agreement which provides that the transfer price between R and F shall be that price which allocates to F the maximum profit permitted to be received under the transfer pricing rules of section 925. Thereafter, the 100 units are resold for export by F for \$950. R's cost of goods sold attributable to the 100 units is \$650. R incurs costs, both direct and indirect, in the amount of \$270 with regard to activities and functions referred to in section 924 (c), (d) and (e) which it was under contract with F to perform for F. R's direct selling expenses are \$40. Those expenses were not required to be incurred by F. For purposes of this example, assume that R has no general and administrative expenses other than those relating to the section 924 (c), (d) and (e) activities and functions. F incurs expenses in the amount of \$290 attributable to the resale which relate to the activities and functions referred to in section 924 (c), (d) and (e). Of that amount, \$270 was paid to R under contract to perform the activities in section 924. The remaining \$20 was paid to independent contractors. R chooses not to apply the section 482 transfer pricing method to determine F's profit on the transaction. F may not earn any income under either the gross receipts (see the special no-loss rule of paragraph (e)(1)(i) of this section) or the combined taxable income administrative pricing methods with respect to resale of the 100 units because there is a combined loss of \$(30) on the transaction, computed as follows:

<i>Combined taxable income:</i>	
F's foreign trading gross receipts	\$ 950.00
R's cost of goods sold	(650.00)
Combined gross income	300.00
Less:	
R's direct selling expenses	40.00
F's expenses	290.00
Total	(330.00)
Combined taxable income (loss)	(30.00)

Under paragraph (e)(1)(i) of this section, F is permitted to recover its expenses attributable to the sale (\$290) even though such recovery results in a loss or increased loss to the related supplier. Accordingly, the transfer price from R to F may be readjusted as long as the transfer price is not readjusted below \$660, computed as follows:

<i>Transfer price to F:</i>	
F's foreign trading gross receipts	\$950.00
Less:	
F's expenses	(290.00)

§ 1.925(a)-1T

26 CFR Ch. I (4-1-12 Edition)

Transfer price	660.00
	<u>660.00</u>

Example 5. Assume the same facts as in *Example 4* except that F performs the section 924 (c), (d) and (e) activities and functions and that R chooses to apply the section 482 transfer pricing method. Under the standards of section 482, a transfer price from R to F of \$650 is an arm's length price. Accordingly, the transfer price to F and F's profit on the subsequent resale of product A (\$10) are as follows:

The section 482 method—Transfer price to F and F's profit:	
Transfer price to F	\$650.00
	<u>650.00</u>
F's profit:	
F's foreign trading gross receipts	950.00
F's cost of purchases	(650.00)
	<u>300.00</u>
F's gross income	300.00
	<u>300.00</u>
Less:	
F's expenses	(290.00)
	<u>10.00</u>
F's profit	10.00
	<u>10.00</u>

This sale of product A results in a loss to R of \$40 (transfer price of \$650 less R's cost of goods sold of \$650 and direct selling expenses of \$40). Since R chose to use the section 482 transfer pricing method on this loss transaction, under the special no loss rule of paragraph (e)(1)(iii) of this section, the administrative pricing methods of section 925(a)(1) and (2) may not be used for any other sale transactions, or group of sale transactions, during the same year of other products which fall within the same three digit Standard Industrial Classification as product A. F's profit, if any, on these sales must be computed under the section 482 transfer pricing method.

Example 6. R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, a FSC for the taxable year. During 1985, R manufactures 100 units of export property A. R enters into a written agreement with F whereby F is granted a sales franchise with respect to export property A and F will receive commissions with respect to these exports equal to the maximum amount permitted to be received under the administrative pricing rules of section 925 (a)(1) and (2). Thereafter, the 100 units are sold for export by R for \$1,000. The total sales price of \$1,000 was paid by the purchaser to R within 60 days of the sales transaction. The entire \$1,000 would have been foreign trading gross receipts had F been the principal on the sale. R's cost of goods sold attributable to the 100 units is \$650. R's direct selling expenses so attributable are \$50. R's deductible general and administrative expenses, other than those attributable to the section 924 (c), (d) and (e) activities and functions, allocable to all gross income are \$200. Apportionment of

those supportive expenses on the basis of gross income does not result in a material distortion of income and is a reasonable method of apportionment. R's direct selling expenses and the portion of the general and administrative expenses not relating to the activities and functions referred to in section 924 (c), (d) and (e) were not required to be incurred by F. R's gross income from sources other than the transaction is \$17,650 resulting in total gross income of \$18,000 (\$350 plus \$17,650). R and a related person perform on F's behalf the activities and functions referred to in section 924 (c), (d) and (e). In performing these activities, R and the related person incurred expenses, both direct and indirect, of \$200 and \$45, respectively. F pays \$200 to R under contract and \$50 to the related person. The maximum profit which F may earn under the franchise pursuant to the administrative pricing rules is \$18.30, computed as follows:

Combined taxable income:	
R's gross receipts from the sale	\$1,000.00
R's cost of goods sold	(650.00)
	<u>350.00</u>
Combined gross income	350.00
Less:	
R's direct selling expenses	50.00
F's expenses	250.00
	<u>300.00</u>
Apportionment of R's general and administrative expenses:	
R's total G/A expenses	200.00
Combined gross income	350.00
R's and F's total gross income (foreign and domestic)	18,000.00
	<u>18,000.00</u>
Apportionment of G/A expenses:	
\$200×\$350/\$18,000	3.89
Total	(303.89)
	<u>(303.89)</u>
Combined taxable income	46.11
	<u>46.11</u>

As reflected in the above computation, F included on its books \$200 of expenses related to the section 924 activities and performed by R on behalf of F. R incurred \$253.89 of expenses. These expenses were reflected on its books. Under paragraph (b)(2)(ii) of this section, R and F may elect to include all of the expenses related to the export sales on F's books. This will satisfy the requirements of section 925(c) without requiring an allocation of the expenses between R and F. Under this election, as reflected in the following computation, combined taxable income will still be \$46.11 but, as reflected in a later part of this example, the commission due F will be increased by \$253.89:

Combined taxable income:	
R's gross receipts from the sale	\$1,000.00
R's cost of goods sold	(650.00)
	<u>350.00</u>
Combined gross income	350.00
Less:	
F's expenses	(303.89)
	<u>(303.89)</u>

Internal Revenue Service, Treasury

§ 1.925(a)-1T

Combined taxable income	46.11
<hr/>	
The combined taxable income method—F's profit:	
F's profit—23% of combined taxable income (\$46.11)	\$10.61
<hr/>	
The gross receipts method—F's profit:	
F's profit—lesser of 1.83% of R's gross receipts (\$18.30) or two times F's profit under the combined taxable income method (\$21.22)	\$18.30
<hr/>	
If the election provided for in paragraph (b)(2)(ii) of this section is not made, F may receive a commission from R in the amount of \$268.30, computed as follows:	
F's expenses	\$250.00
F's profit	18.30
<hr/>	
F's commission	268.30

This \$268.30 is F's foreign trade income. F's exempt foreign trade income is \$174.98 (\$268.30×15/23). F's taxable income is \$6.37, computed as follows:

F's foreign trade income	\$268.30
F's exempt foreign trade income	(174.98)
<hr/>	
F's non-exempt foreign trade income	93.32
<hr/>	
Less:	
F's expenses allocable to non-exempt foreign trade income \$250×93.32/\$268.30	(86.95)
<hr/>	
F's taxable income	6.37

Of F's total expenses, \$163.05 (\$250×\$174.98/\$268.30) are allocated to F's exempt foreign trade income and are disallowed for purposes of computing F's taxable income. If R and F make the election provided for in paragraph (b)(2)(ii) of this section, F may receive a commission from R in the amount of \$322.19, computed as follows:

F's expenses	\$303.89
F's profit	18.30
<hr/>	
F's commission	322.19

With this election, this \$322.19 is F's foreign trade income. F's exempt foreign trade income is \$210.12 (\$322.19×15/23). F's taxable income is still \$6.37, computed as follows:

F's foreign trade income	\$322.19
F's exempt foreign trade income	(210.12)
<hr/>	
F's non-exempt foreign trade income	112.07
<hr/>	
Less:	
F's expenses allocable to non-exempt foreign trade income \$303.89×\$112.07/\$322.19	(105.70)
<hr/>	
F's taxable income	6.37

Of F's total expenses, \$198.19 (\$303.89×\$210.12/\$322.19) are allocated to F's exempt foreign trade income and are disallowed for purposes of computing F's taxable income.

Example 7. Assume the same facts as in *Example 6* except that R's direct selling expenses are \$60. The profit which F may earn under the franchise pursuant to the adminis-

trative pricing rules is \$16.62, computed as follows:

Combined taxable income:	
R's gross receipts from the sale	\$1,000.00
R's cost of goods sold	(650.00)
<hr/>	
Combined gross income	350.00
<hr/>	
Less:	
R's direct selling expenses	60.00
R's apportioned G/A expenses	3.89
F's expenses	250.00
<hr/>	
Combined taxable income	(313.89)
<hr/>	
Combined taxable income	36.11
<hr/>	
The combined taxable income method—F's profit:	
F's profit—23% of combined taxable income (\$36.11)	8.31
<hr/>	
The gross receipts method—F's profit:	
F's profit—lesser of 1.83% of R's gross receipts (\$ 18.30) or two times F's profit under the combined taxable income method (\$16.62)	16.62

F may receive a commission from R in the amount of \$266.62, computed as follows:

F's expenses	\$250.00
F's profit	16.62
<hr/>	
F's commission	266.62

If the election provided for in paragraph (b)(2)(ii) of this section is made by R and F, the profit which F may earn under the franchise pursuant to the administrative pricing rules will remain at \$16.62 but will be computed as follows:

Combined taxable income:	
R's gross receipts from the sale	\$1,000.00
R's cost of goods sold	(650.00)
<hr/>	
Combined gross income	350.00
<hr/>	
Less: F's expenses	(313.89)
<hr/>	
Combined taxable income	36.11
<hr/>	
The combined taxable income method—F's profit:	
F's profit—23% of combined taxable income (\$36.11)	8.31
<hr/>	
The gross receipts method—F's profit:	
F's profit—lesser of 1.83% of R's gross receipts (\$18.30) or two times F's profit under the combined taxable income method (\$16.62)	16.62
<hr/>	
F may receive a commission from R in the amount of \$330.51, computed as follows:	
F's expenses	313.89
F's profit	16.62
<hr/>	
F's commission	330.51

As illustrated by *Example 6*, F's exempt taxable income and taxable income will be the same regardless of which method is used to compute F's commission.

§ 1.925(a)-1T

26 CFR Ch. I (4-1-12 Edition)

Example 8. Assume the same facts as in *Example 6* except that F's expenses are \$300. With this assumption, there is a combined loss of \$(3.89) on the transaction under the full costing combined taxable income method, computed as follows:

Combined taxable income:	
R's gross receipts from the sale	\$1,000.00
R's cost of goods sold	(650.00)
Combined gross income	350.00
Less:	
R's direct selling expenses	50.00
R's apportioned G/A expenses	3.89
F's expenses	300.00
	(353.89)
Combined taxable income (loss)	(3.89)

Since there is a combined loss, F will not have a profit under the full costing combined taxable income method. However, for purposes of this example, it is assumed that under the marginal costing rules of §1.925(b)-1T the maximum combined taxable income is \$75 and the overall profit percentage limitation is \$30. Accordingly, F's profit would be \$6.90 (23% of \$30) under the marginal costing rules. F's profit under the gross receipts method will be \$13.80 (1.83% of \$1,000 limited by section 925(d) to two times the profit determined under marginal costing). The commission F may receive from R is \$313.80. Had all of the expenses been reflected on F's books pursuant to the election of paragraph (b)(2)(ii) of this section, F's commission would have been \$367.69.

Example 9. Assume the same facts as in *Example 6* except that F's expenses are \$300 and that the transaction occurred in 1987. F will not earn a profit under the sales franchise pursuant to the administrative pricing rules. This is shown by the following computation:

Combined taxable income:	
R's gross receipts from the sale	\$1,000.00
R's cost of goods sold	(650.00)
Combined gross income	350.00
Less:	
R's direct selling expenses	50.00
R's apportioned G/A expenses	3.89
F's expenses	300.00
	(353.89)
Combined taxable income (loss)	(3.89)

F will not have a profit under the full costing combined taxable income method since there is a combined loss of \$(3.89). Also, F will not have a profit under the gross receipts method due to section 925(d) and the special no loss rule of paragraph (e)(1)(i) of this section. In addition, F will not have a profit under the marginal costing rules be-

cause the profit may not exceed full costing combined taxable income, see §1.925 (b)-1T(b)(4). Although F may not earn a profit, it is entitled to recoup its expenses. Therefore, the commission F may receive from R is \$300.00. R will bear the entire loss. Had all of the expenses been reflected on F's books pursuant to the election of paragraph (b)(2)(ii) of this section, F's commission would have been \$353.89.

Example 10. Assume the same facts as in *Example 6* except that R receives total payment of the sale price of \$1,000 on the 96th day after delivery, well beyond the 60 day period in which payment must be made to avoid recharacterization of part of the contract price as carrying charges. Therefore, the contract price of \$1,000 includes \$10 of carrying charges, assuming a discount rate of 10%. See §1.927(d)-1 (a) (Q & A2) for computation method for determining amount of carrying charges. This \$10 of carrying charges is R's income. The profit which F may earn under the franchise pursuant to the administrative pricing rules is \$16.66, computed as follows (the election of paragraph (b)(2)(ii) of this section is not made by R and F):

Combined taxable income:	
R's gross receipts from the sale	\$990.00
R's cost of goods sold	(650.00)
Combined gross income	340.00
Less:	
R's direct selling expenses	50.00
R's apportioned G/A expenses:	
\$200×\$340/\$18,000	3.78
F's expenses	250.00
Total	(303.78)
Combined taxable income	36.22

The combined taxable income method—F's profit: F's profit—23% of combined taxable income (\$36.22)

\$8.33

The gross receipts method—F's profit: F's profit—lesser of 1.83% of R's gross receipts (\$18.12) or two times F's profit under the combined taxable income method (\$16.66)

\$16.66

F may receive a commission from R in the amount of \$266.66, computed as follows:

F's expenses	\$250.00
F's profit	16.66
F's commission	266.66

Example 11. Assume the same facts as in *Example 6*. In addition, assume that R also manufactures products K, L, M, N, and P all of which are export property as defined in section 927(a). Product K is military property as defined in section 923(a)(5) and §1.923-1T(b)(3)(ii). Assume further that products A, L, and P are included within product line X and that products K, L, M, and N are included within product line W. R has entered

Internal Revenue Service, Treasury

§ 1.925(a)-1T

into a written agreement with F under which F is granted a sales franchise with respect to exporting the products. Under this agreement, F will receive commissions with respect to those exports equal to the maximum amount permitted to be received under the administrative pricing rules. The table set forth below details F's foreign trading gross receipts, R's cost of goods sold and R's and F's expenses allocable and apportioned under §1.861-8 to the sale of products A, L, M, N, and P. For purposes of this example, it is assumed that R does not incur any general and administrative expenses. Because of the special grouping rule of paragraph (c)(8)(ii) of this section, product L may be included for purposes of the administrative pricing rules in only one product line, at the option of R. Also for these purposes, product K, which is military property, may not be grouped with products L, M, and N. See paragraph (c)(8)(iv) of this section. Under these facts, F will have profits under the franchise agreement from the sale of products A, L, M, N, and P and may receive commissions from R relating to the sale of those products, assum-

ing the election of paragraph (b)(2)(ii) of this section is not made, in the following amounts:

	Profit	F's Expenses	Commissions
Product Line X (products A and P)	\$36.34	\$490.00	\$526.34
Product Line W (products L, M, and N)	\$40.48	\$421.00	\$461.48

On the sale of product K, R received gross receipts of \$150. R's cost of goods sold was \$130. R's and F's expenses allocable to product K totaled \$10 (\$7 of R's expenses and \$3 of F's). Under the gross receipts method, F earned a profit of \$2.75 (1.83% of \$150) and \$2.30 under the combined taxable income method. F may receive a commission, assuming the election of paragraph (b)(2)(ii) of this section is made by R and F, from R in the amount of \$12.75, computed as follows:

F's expenses	\$10.00
F's profit	2.75
F's commission	\$12.75

	Product A	Product L	Product M	Product N	Product P	Total
Product Line X						
Combined Taxable Income						
R's GR From sale	\$1,000				\$1,000	\$2,000
R's cost of goods sold	(650)				(650)	(1,300)
Combined gross income	350				350	700
Less:						
R's expenses	50				81	131
F's expenses	250				240	490
Total	(300)				(321)	(621)
Combined taxable income (loss)	\$50				\$29	\$79
23% of CTI	\$11.50				\$6.67	\$18.17
1.83% of GR from sale	\$18.30				\$13.34	\$36.34
Product Line W						
Combined Taxable Income						
R's GR from sale		\$1,000	\$625	\$1,800		\$3,425
R's cost of goods sold		(650)	(445)	(1,600)		(2,695)
Combined gross income		350	180	200		730
Less:						
R's expenses		81	70	70		221
F's expenses		230	60	131		421
Total		(311)	(130)	(201)		(642)
Combined taxable income (loss)		\$39	\$50	\$(1)		\$88
23% of CTI		\$8.97	\$11.50	\$0		\$20.24
1.83% of GR From sale		\$17.94	\$11.44	\$0		\$40.48

Example 12. R and F are calendar year taxpayers. R owns all the stock of F, an FSC for the taxable year. During 1985, R purchases

§ 1.925(a)-1T

26 CFR Ch. I (4-1-12 Edition)

100 units of export property A from B, an unrelated domestic manufacturing company for \$850. R's direct selling expenses so attributable are \$20. R enters into a written agreement with F whereby F is granted a sales franchise with respect to export product A and F will receive commissions with respect to these exports equal to the maximum amount permitted to be received under the administrative pricing rules of section 925. Thereafter, the 100 units are sold for export by R for \$1,050. R factors the trade receivable to unrelated person X for \$1,000. Under § 1.924(a)-1T(g)(7), total gross receipts for purposes of computing R's and F's combined taxable income is \$1,000 (total receipts (\$1,050) less the discount (\$50)). This \$1,000 would have been foreign trading gross receipts had F been the principal on the sale. For purposes of this example, it is assumed that R did not incur any general and administrative expenses. F incurs expenses in the amount of \$110, all of which were performed by R under contract to F. The profit which F may earn under the franchise pursuant to the administrative pricing rules is \$9.20 computed as follows:

Combined taxable income:	
R's gross receipts from the sale	\$1,000.00
R's cost of goods sold	(850.00)
	<u>150.00</u>
Less:	
R's direct selling expenses	20.00
F's expenses	110.00
	<u>130.00</u>
Combined taxable income	<u>\$20.00</u>
The combined taxable income method—F's profit:	
F's profit—23% of combined taxable income (\$20)	<u>\$4.60</u>
The gross receipts method—F's profit:	
F's profit—lesser of 1.83% of R's gross receipts (\$18.30) or two times F's profit under the combined taxable income, method (\$9.20)	<u>\$9.20</u>
F may receive a commission from R in the amount of \$119.20, computed as follows (the election of § 1.925(a)-1T(b)(2)(ii) has not been made):	
F's expenses	\$110.00
F's profit	9.20
	<u>\$119.20</u>

Example 13. R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, an FSC for the taxable year. During March 1985, R manufactures office equipment, export property within the definition of section 927(a)(1), which it leases on April 1, 1985, to F for a term of 1 year at a monthly rental of \$1,000, a rent which satisfies the standard of arm's length rental under section 482. F subleases the

product on April 1, 1985, for a term of 1 year at a monthly rental of \$1,200. R's cost for the product leased is \$40,000. R's other deductible expenses attributable to the product are \$200, all of which are incurred in 1985. Those expenses were not incurred under contract to F. F's expenses attributable to sublease of the export property are \$1,150, all of which are incurred in 1985 directly by F. R depreciates the property on a straight line basis, using a half-year convention, assuming a 10 year recovery period (see section 168(f)(2)(C), § 1.48-1(g)). The profit which F may earn with respect to the transaction is \$1,483.50 for 1985 and \$600 for 1986, computed as follows:

COMPUTATION FOR 1985	
Combined taxable income:	
F's sublease rental receipts for year (\$1,200 × 9 months)	\$10,800.00
Less:	
R's depreciation (((\$40,000 × 1/10) × 9/12) ..	3,000.00
R's expenses	200.00
F's expense	1,150.00
	<u>(4,350.00)</u>
Combined taxable income	<u>6,450.00</u>
The combined taxable income method—F's profit:	
F's profit—23% of combined taxable income (\$6,450)	<u>\$1,483.50</u>
The gross receipts method—F's profit:	
F's profit—lesser of 1.83% of F's foreign trading gross receipts (\$197.64) or two times F's profit under the combined taxable income method (\$2,967)	<u>\$197.64</u>
The section 482 method—F's profit:	
F's sublease rental receipts for year	\$10,800.00
Less:	
F's lease rental payments for year	9,000.00
F's expenses	1,150.00
	<u>(10,150.00)</u>
F's profit	<u>650.00</u>

Since the combined taxable income method results in greater profit to F (\$1,483.50) than does either the gross receipts method (\$197.64) or the section 482 method (\$650), F may earn a profit of \$1,483.50 for 1985. Accordingly, the monthly rental payable by F to R for 1985 may be readjusted as long as the monthly rental payable is not readjusted below \$907.39, computed as follows:

Monthly rental payable by F to R for 1985:	
F's sublease rental receipts for year	\$10,800.00
Less:	
F's expenses	1,150.00
F's profit	1,483.50
	<u>(2,633.50)</u>
Rental payable for 1985	<u>8,166.50</u>

Internal Revenue Service, Treasury

§ 1.925(b)-1T

Rental payable each month (\$8,166.50/9 months)	\$907.39
<hr/>	
COMPUTATION FOR 1986	
<i>Combined taxable income:</i>	
F's sublease rental receipts for year (\$1,200 × 3 months)	\$3,600.00
Less:	
R's depreciation (((\$40,000 × 1/10) × 3/12) ...	(1,000.00)
Combined taxable income	2,600.00
<hr/>	
<i>The combined taxable income method—F's profit:</i>	
F's profit—23% of combined taxable income (\$2,600)	598.00
<hr/>	
<i>The gross receipts method—F's profit:</i>	
F's profit—lesser of 1.83% of F's foreign trading gross receipts (\$3,600) or two times F's profit under the combined taxable income method (\$1,196)	65.88
<hr/>	
<i>The section 482 method—F's profit:</i>	
F's sublease rental receipts for year	\$3,600.00
Less:	
F's lease rental payments for year	(3,000.00)
F's profit	600.00
<hr/>	

Since the section 482 method results in a greater profit to F (\$600) than does either the combined taxable income method (\$598) or the gross receipts method (\$65.88), F may earn a profit of \$600 for 1986. Accordingly, the monthly rental payable by F to R for 1986 may be readjusted as long as the monthly rental payable is not readjusted below \$1,000, computed as follows:

<i>Monthly rental payable by F to R for 1986:</i>	
F's sublease rental receipts for year	\$3,600.00
Less:	
F's profit	(600.00)
Rental payable for 1986	3,000.00
<hr/>	
Rental payable for each month (\$3,000/3 months)	1,000.00
<hr/>	

(g) *Effective date.* The provisions of this section and § 1.925(b)-1T apply with respect to taxable year ending after December 31, 1984, except that a corporation may not be a FSC for any taxable year beginning before January 1, 1985.

[T.D. 8126, 52 FR 6443, Mar. 3, 1987, as amended by T.D. 8764, 63 FR 10306, Mar. 3, 1998; T.D. 8944, 66 FR 13426, Mar. 6, 2001]

§ 1.925(b)-1T Temporary regulations; marginal costing rules.

(a) *In general.* This section prescribes the marginal costing rules authorized by section 925(b)(2). If under paragraph

(c)(1) of this section a FSC is treated for its taxable year as seeking to establish or maintain a foreign market for sales of an item, product, or product line of export property (as defined in § 1.927(a)-1T) from which foreign trading gross receipts (as defined in § 1.924(a)-1T) are derived, the marginal costing rules prescribed in paragraph (b) of this section may be applied at the related supplier's election to compute combined taxable income of the FSC and related supplier derived from those sales. (Any further reference to a FSC in this section shall include a small FSC unless indicated otherwise.) The combined taxable income determined under these marginal costing rules may be used to determine whether the "twice the amount determined under the combined taxable income method" limitation for the 1.83% of gross receipts test of section 925(d) has been met.

For FSC taxable years beginning after December 31, 1986, if the marginal costing rules are used to determine the section 925(d) limitation, the FSC may not earn more than 100% of full costing combined taxable income determined under the full costing combined taxable income method of § 1.925(a)-1T(c)(3) and (6). The marginal costing rules may be applied even if the related supplier does not manufacture, produce, grow, or extract the export property sold. The marginal costing rules do not apply to sales of export property which in the hands of a purchaser related under section 954(d)(3) to the seller give rise to foreign base company sales income as described in section 954(d) unless, for the purchaser's year in which it resells the export property, section 954(b)(3)(A) is applicable or that income is under the exceptions in section 954(b)(4). In addition, the marginal costing rules do not apply to leases of property or to the performances of any services even if they are related and subsidiary services (as defined in § 1.924(a)-1T(d) and § 1.925(a)-1T(b)(2)(iii)(C)).

(b) *Marginal costing rules—(1) In general.* Marginal costing is a method under which only direct production costs of producing a particular item, product, or product line are taken into account for purposes of computing the

combined taxable income of the FSC and its related supplier under section 925(a)(2). The costs to be taken into account are the related supplier's direct material and labor costs (as defined in § 1.471-11(b)(2)(i)). Costs which are incurred by the FSC and which are not taken into account in computing combined taxable income are deductible by the FSC only to the extent of the FSC's non-foreign trade income. If the related supplier is not the manufacturer or producer of the export property that is sold, the related supplier's purchase price shall be taken into account.

(2) *Overall profit percentage limitation.* Under marginal costing, the combined taxable income of the FSC and its related supplier may not exceed the overall profit percentage (determined under paragraph (c)(2) of this section) multiplied by the FSC's foreign trading gross receipts if the FSC is the principal on the sale (or the related supplier's gross receipts if the FSC is a commission agent) from the sale of export property.

(3) *Grouping of transactions.* (i) In general, for purposes of this section, an item, product, or product line is the item or group consisting of the product or product line pursuant to § 1.925(a)-1T(c)(8) used by the taxpayer for purposes of applying the full costing combined taxable income method of § 1.925(a)-1T(c)(3) and (6).

(ii) However, for purposes of determining the overall profit percentage under paragraph (c)(2) of this section, any product or product line grouping permissible under § 1.925(a)-1T(c)(8) may be used at the annual choice of the FSC even though it may not be the same item or grouping referred to in subdivision (i) of this paragraph as long as the grouping chosen for determining the overall profit percentage is at least as broad as the grouping referred to in the above subdivision (i) of this paragraph. A product may be included for this purpose, however, in only one product group even though under the grouping rules it would otherwise fall in more than one group. Thus, the marginal costing rules will not apply with respect to any regrouping if the regrouping does not include any product (or products) that was included in the

group for purposes of the full costing method.

(4) *Application of limitation on FSC income ("no loss" rules).* The marginal costing rules of this section will not apply if there is a combined loss of the related supplier and the FSC determined in accordance with paragraph (b)(1) of this section. In addition, for FSC taxable years beginning after December 31, 1986, the profit determined under the marginal costing method may be allowed to the FSC only to the extent it does not exceed the FSC's and the related supplier's full costing combined taxable income determined under the full costing combined taxable income method of § 1.925(a)-1T(c)(3) and (6). This rule prevents pricing at a loss to the related supplier. If either of these "no loss" rules apply, the related supplier may nonetheless charge a transfer price or pay a commission in an amount that will allow the FSC to recover an amount not in excess of its full costs, if any, even if to do so would create or increase a loss in the related supplier. The effect of these no-loss rules and of the overall profit percentage limitation of paragraph (c)(2) of this section is that the FSC's profit under these marginal costing rules is limited to the lesser of the following:

(i) 23% of maximum combined taxable income determined under the marginal costing rules,

(ii) 23% of the overall profit percentage limitation, or

(iii) For FSC taxable years beginning after December 31, 1986, 100% of the full costing combined taxable income determined under the full costing combined taxable income method of § 1.925(a)-1T(c)(3) and (6).

(c) *Definitions—(1) Establishing or maintaining a foreign market.* A FSC shall be treated for its taxable year as seeking to establish or maintain a foreign market with respect to sales of an item, product, or product line of export property from which foreign trading gross receipts are derived if the combined taxable income computed under paragraph (b) of this section is greater than the full costing combined taxable income computed under the full costing combined taxable income method of § 1.925(a)-1T(c)(3) and (6).

(2) *Overall profit percentage.* (i) For purposes of this section, the overall profit percentage for a taxable year of the FSC for a product or product line is the percentage which—

(A) The combined taxable income of the FSC and its related supplier from the sale of export property plus all other taxable income of its related supplier from all sales (domestic and foreign) of such product or product line during the FSC's taxable year, computed under the full costing method, is of

(B) The total gross receipts (determined under § 1.927(b)-1T) of the FSC and related supplier from all sales of the product or product line.

(ii) At the annual option of the related supplier, the overall profit percentage for the FSC's taxable year for all products and product lines may be determined by aggregating the amounts described in subdivisions (i)(A) and (B) of this paragraph of the FSC, and all domestic members of the controlled group (as defined in section 927(d)(4) and § 1.924(a)-1T(h)) of which the FSC is a member, for the FSC's taxable year and for taxable years of the members ending with or within the FSC's taxable year.

(iii) For purposes of determining the amounts in subdivisions (i) and (ii) of this paragraph, a sale of property between a FSC and its related supplier or between domestic members of the controlled group shall be taken into account only during the FSC's taxable year (or taxable year of the member ending within the FSC's taxable year) during which the property is ultimately sold to a person which is not related to the FSC or if related, is a foreign person that is not a FSC.

(3) *Full costing method.* For purposes of section 925 and this section, the term "full costing combined taxable income method" is the method for determining full costing combined taxable income set forth in § 1.925(a)-1T(c)(3) and (6).

(d) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, a FSC for the taxable year. During 1985, R produces and

sells 100 units of export property A to F under a written agreement which provides that the transfer price between R and F shall be that price which allocates to F the maximum profit permitted to be received under the administrative pricing rules of section 925(a)(1) and (2). Thereafter, the 100 units are resold for export by F for \$950. R's cost of goods sold attributable to the 100 units is \$650 consisting in part of \$400 of direct materials and \$200 of direct labor. R incurs selling expenses directly attributable to the sale in the amount of \$100. Those expenses were not required to be incurred by F. For purposes of this example, it is assumed that R does not have general and administrative expenses that are not definitely allocable to any item of gross income. F's expenses attributable to the resale of the 100 units are \$120. For purposes of this example, R and F have gross receipts of \$4,000 from all domestic and foreign sales. R's total cost of goods sold and total expenses relating to its foreign and domestic sales are \$2,730 and \$450, respectively. Under full costing, the combined taxable income will be \$80, computed as follows:

Combined taxable income—full costing:	
F's foreign trading gross receipts	\$950.00
R's cost of goods sold	(650.00)
Combined gross income	300.00
Less:	
R's direct selling expenses	100.00
F's expenses	120.00
Total	(220.00)
Combined taxable income (loss)	80.00

F's profit under the full costing combined taxable income method is \$18.40, *i.e.*, 23% of full costing combined taxable income (\$80). F's profit under the gross receipts method will be \$17.39, *i.e.*, 1.83% of F's foreign trading gross receipts (\$950). However, under the marginal costing rules, F would have a profit attributable to the export sale in the amount of \$38.24, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of \$166.25). As shown by the computation below, the combined taxable income under marginal costing is limited to the overall profit percentage limitation (\$166.25) since that amount is less than the maximum combined taxable income amount (\$350):

Maximum combined taxable income (determined under paragraph (b)(1) of this section):	
F's foreign trading gross receipts	\$950.00
Less:	
R's direct materials	400.00
R's direct labor	200.00
Total	(600.00)
Maximum combined total income	350.00

§ 1.925(b)-1T

26 CFR Ch. I (4-1-12 Edition)

Overall profit percentage limitation calculation (determined under paragraph (c)(2) of this section):

Gross receipts of R and F from all domestic and foreign sales	\$4,000.00
R's cost of goods sold	(2,730.00)
Combined gross income	1,270.00
Less:	
R's expenses	450.00
F's expenses	120.00
Total	(570.00)
Total taxable income from all sales computed on a full costing method	700.00
<i>Overall profit percentage</i> (total taxable income (\$700) divided by total gross receipts (\$4,000)	17.5%
<i>Overall profit percentage limitation</i> Overall profit percentage times F's foreign trading gross receipts (17.5% times \$950.00)	\$166.25

The transfer price from R to F may be set at \$791.76, computed as follows:

Transfer price to F:	
F's foreign trading gross receipts	\$950.00
Less:	
F's expenses	120.00
F's profit	38.24
Total	(158.24)
Transfer price	791.76

Example 2. Assume the same facts as in *Example 1* except that F's expenses are \$170. Under full costing, the combined taxable income will be \$30, computed as follows:

Combined taxable income—full costing:

F's foreign trading gross receipts	\$950.00
R's cost of goods sold	(650.00)
Combined gross income	300.00
Less:	
R's expenses	100.00
F's expenses	170.00
Total	(270.00)
Combined taxable income (loss)	30.00

F's profit under the full costing combined taxable income method is \$6.90, *i.e.*, 23% of combined taxable income, \$30. Under the marginal costing rules, F may earn a profit attributable to the export sale in the amount of \$35.51, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of \$154.38). Had the transaction occurred in 1987, F would have had a profit attributable to the export sale under these marginal costing rules of only \$30, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of

\$154.38) limited, for FSC taxable years beginning after December 31, 1986, to combined taxable income determined under full costing (\$30), see paragraph (b)(4) of this section. F's profit under the gross receipts method will be \$17.39 *i.e.*, 1.83% of F's foreign trading gross receipts (\$950). The computations are as follows:

Maximum combined taxable income (determined under paragraph (b)(1) of this section):

F's foreign trading gross receipts	\$950.00
Less:	
R's direct materials	400.00
R's direct labor	200.00
Total	(600.00)
Maximum combined taxable income	350.00

Overall profit percentage limitation calculation (determined under paragraph (c)(2) of this section):

Gross receipts of R and F from all domestic and foreign sales	4,000.00
R's cost of goods sold	(2,730.00)
Combined gross income	1,270.00
Less:	
R's expenses	450.00
F's expenses	170.00
Total	(620.00)
Total taxable income from all sales computed on a full costing method	650.00
<i>Overall profit percentage</i> (total taxable income (\$650) divided by total gross receipts (\$4,000))	16.25%
<i>Overall profit percentage limitation</i> Overall profit percentage times F's foreign trading gross receipts (16.25% times \$950.00)	154.38

The transfer price from R to F may be set at \$744.49, computed as follows:

Transfer price to F:

F's foreign trading gross receipts	950.00
Less:	
F's expenses	170.00
F's profit	35.51
Total	(205.51)
Transfer price	744.49

Example 3. Assume the same facts as in *Example 1* except that the transaction occurs in 1987 and that F incurs expenses in the amount of \$250. Since a \$50 combined loss, as computed below, is incurred, F will not have any profit under either the full costing combined taxable income method, the gross receipts method or the marginal costing rules:

Combined taxable income—full costing:

F's foreign trading gross receipts	\$950.00
R's cost of goods sold	(650.00)
Combined gross income	300.00

Internal Revenue Service, Treasury

§ 1.925(b)-1T

Less:		
R's expenses	100.00	
F's expenses	250.00	
		<hr/>
Total	(350.00)	
		<hr/>
Combined taxable income (loss)	(50.00)	

The transfer price to R may be set at \$700 so that F may recover its expenses.

Example 4. R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, a FSC for the taxable year. During 1985, R manufactures export property A. R enters into a written agreement with F whereby F will receive a commission with respect to sales of export property A by R which result in gross receipts to R which would have been foreign trading gross receipts had F and not R been the principal on the sale. F will receive commissions with respect to such export sales equal to the maximum amount permitted to be received under the transfer pricing rules of section 925. The maximum commission may be earned by F under these marginal costing rules. In this example, R received \$950 from the sale of export property A. R's cost of goods sold for that property was \$620. R incurred direct selling expenses of \$20. Also, it is assumed that R incurred total general and administrative expenses, in addition to those incurred relating to its contract to perform on behalf of F the functions and activities of section 924 (c), (d) and (e), of \$50. R incurred direct and indirect expenses of \$130 in performing those functions and activities on behalf of F. During 1985, R had gross receipts from all domestic and foreign sales of \$3,500, total cost of goods sold and total expenses relating to the domestic and foreign sales of \$1,600 and \$259, respectively. The election provided for in § 1.925(a)-1T(b)(2)(ii) was not made by R and F.

Combined taxable income—full costing:

R's gross receipts from the sale of the export property	\$950.00	
R's cost of goods sold	(620.00)	
		<hr/>
Combined gross income	330.00	
Less:		
R's direct selling expenses	20.00	
F's expenses	130.00	
Apportionment of R's general and administrative expenses:		
R's total G/A expenses \$50		
Combined gross income 330		
R's total gross income 1,900		
Apportionment of G/A expenses $\$50 \times$ $\$330/\$1,900$		8.68
		<hr/>
Total	(158.68)	
		<hr/>
Combined taxable income (loss)	171.32	

Maximum combined taxable income (determined under paragraph (b)(1) of this section):

R's gross receipts from the sale of the export property	\$950.00
Less:	
R's direct materials	450.00
R's direct labor	100.00
	<hr/>
Total	(550.00)
	<hr/>
Maximum combined taxable income	400.00

Overall profit percentage limitation calculation (determined under paragraph (c)(2) of this section):

Gross receipts of R from all domestic and foreign sales	3,500.00
R's cost of goods sold	(1,600.00)
	<hr/>
Combined gross income	1,900.00
Less:	
R's total expenses	259.00
F's total expenses	130.00
	<hr/>
Total	(450.00)
	<hr/>
Total taxable income from all sales computed on a full costing method	1,511.00
	<hr/>
<i>Overall profit percentage</i> (total taxable income (\$1,511) divided by total gross receipts (\$3,500))	43.17%
	<hr/>
<i>Overall profit percentage limitation</i> Overall profit percentage times R's gross receipts from the sale of export property (i.e., 43.17% times \$950.00)	410.12
	<hr/>

Since the overall profit percentage limitation (\$410.12) is greater than the maximum combined taxable income (\$400), combined taxable income under marginal costing and for purposes of computing F's commission is limited to \$400. Under these marginal costing rules, F will have a profit attributable to the sale of \$92, i.e., 23% of combined taxable income as determined under the marginal costing rules (23% of \$400). Accordingly, the commission F receives from R is \$222, i.e., F's expenses (\$130) plus F's profit (\$92).

Example 5. Assume the same facts as in *Example 4*, except that R's gross receipts from the sale of export property which would have been foreign trading gross receipts had F been the principal on the sale are \$1,050 and gross receipts from all sales, domestic and foreign, remain at \$3,500. For purposes of applying the combined taxable income method, R and F may compute their combined taxable income attributable to the product line of export property under the marginal costing rules as follows:

Combined taxable income—full costing:

R's gross receipts from the sale of the export property	\$1,050.00
R's cost of goods sold	(620.00)
	<hr/>
Combined gross income	430.00

§ 1.926(a)-1

26 CFR Ch. I (4-1-12 Edition)

Less:	
R's direct selling expenses	20.00
F's expenses	130.00
Apportionment of R's G/A expenses \$50 × \$430/\$1,900	11.32
Total	(161.32)
Combined taxable income (loss)	268.68
<i>Maximum combined taxable income</i> (determined under paragraph (b)(1) of this section):	
R's gross receipts from the sale of export property	\$1,050.00
Less:	
R's direct materials	450.00
R's direct labor	100.00
Total	(550.00)
Maximum combined taxable income	500.00
<i>Overall profit percentage</i> (see example 4)	43.17%
<i>Overall profit percentage limitation</i> (determined under paragraph (c)(2) of this section) (R's gross receipts from sale (\$1,050.00) times the overall profit percentage (43.17%))	453.29

Since maximum combined taxable income (\$500) is greater than the overall profit percentage limitation (\$453.29), combined taxable income under marginal costing and for purposes of computing F's commission is limited to \$453.29. Under these marginal costing rules, F will have a profit attributable to the sales of \$104.26, *i.e.*, 23% of combined taxable income (23% of \$453.29). Accordingly, the commission F receives from R is \$234.26, *i.e.*, F's expenses (\$130) plus F's profit (\$104.26).

Example 6. Assume the same facts as in *Example 5*, except that F has expenses of \$140 and R's cost of goods sold for the export sale was \$900. R does not incur any direct selling expenses. Since cost of goods sold has increased by \$280, R's total gross income has been reduced from \$1,900 to \$1,620. For purposes of applying the combined taxable income method, R and F may compute their combined taxable income under the marginal costing rules as follows:

<i>Combined taxable income—full costing:</i>	
R's gross receipts from the sale of export property	\$1,050.00
R's cost of goods sold	(900.00)
Combined gross income	150.00
Less:	
F's expenses	140.00
Apportionment of R's G/A expenses \$50 × \$150/\$1,620	4.63
Total	(144.63)
Combined taxable income (loss)	5.37

<i>Maximum combined taxable income</i> (determined under paragraph (b)(1) of this section):	
R's gross receipts from the sale of export property	\$1,050.00
Less:	
R's direct materials	630.00
R's direct labor	200.00
Total	(830.00)
Maximum combined taxable income	220.00
<i>Overall profit percentage limitation calculation</i> (determined under paragraph (c)(2) of this section):	
Gross receipts of R and F from all domestic and foreign sales	\$3,500.00
R's cost of goods sold	(1,880.00)
Combined gross income	1,620.00
Less:	
R's total expenses	259.00
F's total expenses	140.00
Total	(399.00)
Total taxable income from all sales computed on a full costing method	\$1,221.00
<i>Overall profit percentage</i> (total taxable income (\$1,221) divided by total gross receipts (\$3,500))	34.89%
<i>Overall profit percentage limitation—overall profit percentage times R's gross receipts from the sale of export property (i.e., 34.89% times \$1,050)</i>	\$366.35

Since the overall profit percentage limitation (\$366.35) is greater than the maximum combined taxable income (\$220), combined taxable income under marginal costing and for purposes of computing F's commission is limited to \$220. Under these marginal costing rules, F will have a profit attributable to the sale of \$50.60, *i.e.*, 23% of combined taxable income as determined under the marginal costing rules (23% of \$220). If the transaction occurred in 1987, F's profit would be limited, however, by paragraph (b)(4) of this section to the full costing combined taxable income of \$5.37.

[T.D. 8126, 52 FR 6455, Mar. 3, 1987, as amended by T.D.8764, 63 FR 10306, Mar. 3, 1998; T.D. 8944, 66 FR 13429, Mar. 6, 2001]

§ 1.926(a)-1 Distributions to shareholders.

(a) *Treatment of distributions.* [Reserved]. For guidance, see § 1.926(a)-1T(a).

(b) *Order of distribution—(1) In general—(i) Distributions by a FSC received by a shareholder in a taxable year of the shareholder beginning before January 1, 1990.* Any actual distribution to a

shareholder by a FSC (all references to a FSC in this section shall include a small FSC and a former FSC) that is received by the shareholder in a taxable year of the shareholder beginning before January 1, 1990, and made out of earnings and profits shall be treated as made in the following order, to the extent thereof—

(A) Out of earnings and profits attributable to exempt foreign trade income determined solely because of operation of section 923(a)(4),

(B) Out of earnings and profits attributable to other exempt foreign trade income,

(C) Out of earnings and profits attributable to non-exempt foreign trade income determined under either of the administrative pricing methods of section 925(a)(1) or (2),

(D) Out of earnings and profits attributable to section 923(a)(2) non-exempt income, and

(E) Out of other earnings and profits.

(ii) *Distributions by a FSC received by a shareholder in a taxable year of the shareholder beginning after December 31, 1989.* Any actual distribution to a shareholder by a FSC that is received by the shareholder in a taxable year beginning after December 31, 1989, and that is made out of earnings and profits shall be treated as made in the following order, to the extent thereof—

(A) Out of earnings and profits attributable to exempt foreign trade income determined solely because of the operation of section 923(a)(4),

(B) Out of earnings and profits attributable to foreign trade income (other than exempt foreign trade income determined solely because of the operation of section 923(a)(4)) allocable to the marketing of agricultural or horticultural products (or the providing of related services) by a qualified cooperative which is a shareholder of the FSC,

(C) Out of earnings and profits attributable to non-exempt foreign trade income and other exempt foreign trade income determined under either of the administrative pricing methods of section 925(a)(1) and (2). Distributions out of this classification will be made on a pro rata basis so that 15/23 (16/23 with regard to distribution to a non-corporate shareholder) of each distribu-

tion will be out of earnings and profits attributable to exempt foreign trade income and the remainder will be out of earnings and profits attributable to non-exempt foreign trade income. To the extent the distributions are out of earnings and profits attributable to the disposition of, or services related to, military property, 7.5/23 (8/23 with regard to distributions to a non-corporate shareholder) of each distribution will be out of earnings and profits attributable to exempt foreign trade income and the remainder will be out of earnings and profits attributable to non-exempt foreign trade income,

(D) Out of earnings and profits attributable to other exempt foreign trade income determined under the transfer pricing method of section 925(a)(3),

(E) Out of earnings and profits attributable to section 923(a)(2) non-exempt income,

(F) Out of earnings and profits attributable to effectively connected income, as defined in section 245(c)(4)(B), and

(G) Out of other earnings and profits.
(2) *Determination of earnings and profits.* [Reserved]. For guidance, see § 1.926(a)-1T(b)(1).

(c) *Definition of “former FSC”.* [Reserved]. For guidance, see § 1.926(a)-1T(c).

(d) *Personal holding company income.* [Reserved]. For guidance, see § 1.926(a)-1T(d).

(e) *Sale of stock if section 1248 applies.* [Reserved]. For guidance, see § 1.926(a)-1T(e).

[T.D. 8340, 56 FR 11093, Mar. 15, 1991]

§ 1.926(a)-1T Temporary regulations; distributions to shareholders.

(a) *Treatment of distributions.* Any distribution by a FSC (or former FSC) to its shareholder with respect to its stock will be includible in the shareholder's gross income in accordance with the provisions of section 301. (Any further reference to a FSC in this section shall include a small FSC unless indicated otherwise.) See section 245(c) for treatment of distributions to domestic corporate shareholders of the FSC. If earnings and profits of a FSC (or former FSC) attributable to foreign trade income are distributed to a shareholder which is a foreign person

(or a nonresident alien individual), that distribution shall be treated as United States source income which is effectively connected with the conduct of a trade or business conducted through a permanent establishment of such shareholder within the United States. For this purpose, distributions to a foreign partnership, foreign trust, foreign estate or other foreign entities that would be treated as pass-through entities under U.S. law shall be treated as made directly to the partners of beneficiaries in proportion to their respective interest in the entity.

(b) *Order of distributions*—(1) *In general.* For guidance, see § 1.926(a)-1(b)(1).

(2) *Determination of earnings and profits.* For purposes of this section, the earnings and profits of a FSC (or former FSC) shall be the earnings and profits computed in accordance with the rules, where applicable, prescribed in § 1.964-1 (relating to determination of the earnings and profits of a foreign corporation) other than subsections (d) and (e) of that section.

(c) *Definition of “former FSC”.* Under section 926(c), the term “former FSC” refers to a corporation which is not a FSC for a taxable year but which was a FSC for a prior taxable year. However, a corporation is not a former FSC for a taxable year unless such corporation has, at the beginning of such taxable year, earnings and profits attributable to foreign trade income. A corporation which is a former FSC for a taxable year is a former FSC for all purposes of the Code.

(d) *Personal holding company income*—

(1) *Treatment of dividends.* Any amount includible in a shareholder’s gross income as a dividend with respect to the stock of a FSC (or former FSC) under paragraph (a) of this section shall be treated as a dividend for all purposes of the Code, except that that part of the dividend attributable to foreign trade income, other than an amount attributable to section 923(a)(2) non-exempt income, shall not be considered in applying the personal holding company and foreign personal holding company provisions (sections 541 through 547 and 551 through 558, respectively).

(2) *Look through option.* With regard to distributions from a FSC (or former FSC) which are not treated as personal

holding company income under paragraph (d)(1) of this section, the shareholder may, however, treat any amount of that distribution as an item of income described under section 543 (or section 553) (for example, rents) if it establishes to the satisfaction of the Commissioner that such amount is attributable to earnings and profits of the FSC derived from such item of income. For example, distributions from a FSC relating to section 923(a)(2) non-exempt income will be treated as dividends for purposes of the personal holding company provisions of sections 541 through 547 unless the look through option is elected. Under this option, if earnings and profits out of which those distributions are made are attributable to the lease of export property, the FSC shareholder may treat the distribution for purposes of the personal holding company provisions as rents rather than as dividends. This may be beneficial to the shareholder because rents are not considered under section 543(a)(2) as personal holding company income, if in general, rents constitute 50% or more of the shareholder’s adjusted ordinary gross income.

(e) *Sale of stock if section 1248 applies.* For purposes of section 1248, the earnings and profits of a FSC (or former FSC) shall not include earnings and profits attributable to foreign trade income.

[T.D. 8126, 52 FR 6458, Mar. 3, 1987, as amended by T.D. 8340, 56 FR 11093, Mar. 15, 1991]

§ 1.927(a)-1T Temporary regulations; definition of export property.

(a) *General rule.* Under section 927(a), except as otherwise provided with respect to excluded property in paragraphs (f), (g) and (h) of this section and with respect to certain short supply property in paragraph (i) of this section, export property is property in the hands of any person (whether or not a FSC) (any further reference to a FSC in this section shall include a small FSC unless indicated otherwise)—

(1) *U.S. manufactured, produced, grown or extracted.* Manufactured, produced, grown, or extracted in the United States by any person or persons other than a FSC (see paragraph (c) of this section),

(2) *Foreign use, consumption or disposition.* Held primarily for sale, lease or rental in the ordinary course of a trade or business by a FSC to a FSC or to any other person for direct use, consumption, or disposition outside the United States (see paragraph (d) of this section),

(3) *Foreign content.* Not more than 50 percent of the fair market value of which is attributable to articles imported into the United States (see paragraph (e) of this section), and

(4) *Non-related FSC purchaser or user.* Which is not sold, leased or rented by a FSC, or with a FSC as commission agent, to another FSC which is a member of the same controlled group (as defined in section 927(d)(4) and § 1.924(a)-1T(h)) as the FSC.

(b) *Services.* For purposes of this section, services (including the written communication of services in any form) are not export property. Whether an item is property or services shall be determined on the basis of the facts and circumstances attending the development and disposition of the item. Thus, for example, the preparation of a map of a particular construction site would constitute services and not export property, but standard maps prepared for sale to customers generally would not constitute services and would be export property if the requirements of this section were otherwise met.

(c) *Manufacture, production, growth, or extraction of property—(1) By a person other than a FSC.* Export property may be manufactured, produced, grown, or extracted in the United States by any person, provided that that person does not qualify as a FSC. Property held by a FSC which was manufactured, produced, grown or extracted by it at a time when it did not qualify as a FSC is not export property of the FSC. Property which sustains further manufacture, production or processing outside the United States prior to sale or lease by a person but after manufacture, production, processing or extraction in the United States will be considered as manufactured, produced, grown or extracted in the United States by that person only if the property is reimported into the United States for further manufacturing, pro-

duction or processing prior to final export sale. In order to be considered export property, the property manufactured, produced, grown or extracted in the United States must satisfy all of the provisions of section 927(a) and this section.

(2) *Manufactured, produced or processed.* For purposes of this section, property which is sold or leased by a person is considered to be manufactured, produced or processed by that person or by another person pursuant to a contract with that person if the property is manufactured or produced, as defined in § 1.954-3(a)(4). For purposes of this section, however, in determining if the 20% conversion test of § 1.954-3(a)(4)(iii) has been met, conversion costs include assembly and packaging costs but do not include the value of parts provided pursuant to a services contract as described in § 1.924(a)-1T(d)(3). In addition, for purposes of this section, the 20% conversion test is extended and applied to the export property's adjusted basis rather than to its cost of goods sold if it is leased or held for lease.

(d) *Foreign use, consumption or disposition—(1) In general.* (i) Under paragraph (a)(2) of this section, export property must be held primarily for the purpose of sale, lease or rental in the ordinary course of a trade or business, by a FSC to a FSC or to any other person, and the sale or lease must be for direct use, consumption, or disposition outside the United States. Thus, property cannot qualify as export property unless it is sold or leased for direct use, consumption, or disposition outside the United States. Property is sold or leased for direct use, consumption, or disposition outside the United States if the sale or lease satisfies the destination test described in subdivision (2) of this paragraph, the proof of compliance requirements described in subdivision (3) of this paragraph, and the use outside the United States test described in subdivision (4) of this paragraph.

(ii) *Factors not taken into account.* In determining whether property which is sold or leased to a FSC is sold or leased for direct use, consumption, or disposition outside the United States, the fact that the acquiring FSC holds the property in inventory or for lease prior to

the time it sells or leases it for direct use, consumption, or disposition outside the United States will not affect the characterization of the property as export property. Fungible export property must be physically segregated from non-export property at all times after purchase by or rental by a FSC or after the start of the commission relationship between the FSC and related supplier with regard to the export property. Non-fungible export property need not be physically segregated from non-export property.

(2) *Destination test.* (i) For purposes of paragraph (d)(1) of this section, the destination test of this paragraph is satisfied with respect to property sold or leased by a seller or lessor only if it is delivered by the seller or lessor (or an agent of the seller or lessor) regardless of the F.O.B. point or the place at which title passes or risk of loss shifts from the seller or lessor—

(A) Within the United States to a carrier or freight forwarder for ultimate delivery outside the United States to a purchaser or lessee (or to a subsequent purchaser or sublessee),

(B) Within the United States to a purchaser or lessee, if the property is ultimately delivered outside the United States (including delivery to a carrier or freight forwarder for delivery outside the United States) by the purchaser or lessee (or a subsequent purchaser or sublessee) within 1 year after the sale or lease,

(C) Within or outside the United States to a purchaser or lessee which, at the time of the sale or lease, is a FSC or an interest charge DISC and is not a member of the same controlled group as the seller or lessor,

(D) From the United States to the purchaser or lessee (or a subsequent purchaser or sublessee) at a point outside the United States by means of the seller's or lessor's own ship, aircraft, or other delivery vehicle, owned, leased, or chartered by the seller or lessor,

(E) Outside the United States to a purchaser or lessee from a warehouse, storage facility, or assembly site located outside the United States, if the property was previously shipped by the seller or lessor from the United States, or

(F) Outside the United States to a purchaser or lessee if the property was previously shipped by the seller or lessor from the United States and if the property is located outside the United States pursuant to a prior lease by the seller or lessor, and either (1) the prior lease terminated at the expiration of its term (or by the action of the prior lessee acting alone), (2) the sale occurred or the term of the subsequent lease began after the time at which the term of the prior lease would have expired, or (3) the lessee under the subsequent lease is not a related person with respect to the lessor and the prior lease was terminated by the action of the lessor (acting alone or together with the lessee).

(ii) For purposes of this paragraph (d)(2) (other than paragraphs (d)(2)(i)(C) and (F)(3)), any relationship between the seller or lessor and any purchaser, subsequent purchaser, lessee, or sublessee is immaterial.

(iii) In no event is the destination test of this paragraph (d)(2) satisfied with respect to property which is subject to any use (other than a resale or sublease), manufacture, assembly, or other processing (other than packaging) by any person between the time of the sale or lease by such seller or lessor and the delivery or ultimate delivery outside the United States described in this paragraph (d)(2).

(iv) If property is located outside the United States at the time it is purchased by a person or leased by a person as lessee, such property may be export property in the hands of such purchaser or lessee only if it is imported into the United States prior to its further sale or lease (including a sublease) outside the United States. Paragraphs (a)(3) and (e) of this section (relating to the 50 percent foreign content test) are applicable in determining whether such property is export property. Thus, for example, if such property is not subjected to manufacturing or production (as defined in paragraph (c) of this section) within the United States after such importation, it does not qualify as export property.

(3) *Proof of compliance with destination test*—(i) *Delivery outside the United States.* For purposes of paragraph (d)(2) of this section (other than subdivision

(i)(C) thereof), a seller or lessor shall establish ultimate delivery, use, or consumption of property outside the United States by providing—

(A) A facsimile or carbon copy of the export bill of lading issued by the carrier who delivers the property,

(B) A certificate of an agent or representative of the carrier disclosing delivery of the property outside the United States,

(C) A facsimile or carbon copy of the certificate of lading for the property executed by a customs officer of the country to which the property is delivered,

(D) If that country has no customs administration, a written statement by the person to whom delivery outside the United States was made,

(E) A facsimile or carbon copy of the Shipper's Export Declaration, a monthly shipper's summary declaration filed with the Bureau of Customs, or a magnetic tape filed in lieu of the Shipper's Export Declaration, covering the property, or

(F) Any other proof (including evidence as to the nature of the property or the nature of the property or the nature of the transaction) which establishes to the satisfaction of the Commissioner that the property was ultimately delivered, or directly sold, or directly consumed outside the United States within 1 year after the sale or lease.

(ii) The requirements of subdivision (i)(A), (B), (C), or (E) of this paragraph will be considered satisfied even though the name of the ultimate consignee and the price paid for the goods is marked out provided that, in the case of a Shipper's Export Declaration or other document listed in subdivision (i)(E) of this paragraph or a document such as an export bill of lading, such document still indicates the country in which delivery to the ultimate consignee is to be made and, in the case of a certificate of an agent or representative of the carrier, that the document indicates that the property was delivered outside the United States.

(iii) A seller or lessor shall also establish the meeting of the requirement of paragraph (d)(2)(i) of this section (other than subdivision (i)(C) thereof), that the property was delivered outside

the United States without further use, manufacture, assembly, or other processing within the United States.

(iv) For purposes of paragraph (d)(2)(i)(C) of this section, a purchaser or lessee of property is deemed to qualify as a FSC or an interest charge DISC for its taxable year if the seller or lessor obtains from the purchaser or lessee a copy of the purchaser's or lessee's election to be treated as a FSC or interest charge DISC together with the purchaser's or lessee's sworn statement that the election has been timely filed with the Internal Revenue Service Center. The copy of the election and the sworn statement of the purchaser or lessee must be received by the seller or lessor within 6 months after the sale or lease. A purchaser or lessee is not treated as a FSC or interest charge DISC with respect to a sale or lease during a taxable year for which the purchaser or lessee does not qualify as a FSC or interest charge DISC if the seller or lessor does not believe or if a reasonable person would not believe at the time the sale or lease is made that the purchaser or lessee will qualify as a FSC or interest charge DISC for the taxable year.

(v) If a seller or lessor fails to provide proof of compliance with the destination test as required by this paragraph (d)(3), the property sold or leased is not export property.

(4) *Sales and leases of property for ultimate use in the United States*—(i) *In general.* For purposes of paragraph (d)(1) of this section, the use test in this paragraph (d)(4) is satisfied with respect to property which—

(A) Under subdivision (4)(ii) through (iv) of this paragraph is not sold for ultimate use in the United States, or

(B) Under subdivision (4)(v) of this paragraph is leased for ultimate use outside the United States.

(ii) *Sales of property for ultimate use in the United States.* For purposes of subdivision (4)(i) of this paragraph, a purchaser of property (including components, as defined in subdivision (4)(vii) of this paragraph) is deemed to use the property ultimately in the United States if any of the following conditions exist:

(A) The purchaser is a related party with respect to the seller and the purchaser ultimately uses the property, or a second product into which the property is incorporated as a component, in the United States.

(B) At the time of the sale, there is an agreement or understanding that the property, or a second product into which the property is incorporated as a component, will be ultimately used by the purchaser in the United States.

(C) At the time of the sale, a reasonable person would have believed that the property or the second product would be ultimately used by the purchaser in the United States unless, in the case of a sale of components, the fair market value of the components at the time of delivery to the purchaser constitutes less than 20 percent of the fair market value of the second product into which the components are incorporated (determined at the time of completion of the production, manufacture, or assembly of the second product).

For purposes of subdivision (4)(ii)(B) of this paragraph, there is an agreement or understanding that property will ultimately be used in the United States if, for example, a component is sold abroad under an express agreement with the foreign purchaser that the component is to be incorporated into a product to be sold back to the United States. As a further example, there would also be such an agreement or understanding if the foreign purchaser indicated at the time of the sale or previously that the component is to be incorporated into a product which is designed principally for the United States market. However, such an agreement or understanding does not result from the mere fact that a second product, into which components exported from the United States have been incorporated and which is sold on the world market, is sold in substantial quantities in the United States.

(iii) *Use in the United States.* For purposes of subdivision (4)(ii) of this paragraph, property (including components incorporated into a second product) is or would be ultimately used in the United States by the purchaser if, at any time within 3 years after the purchase of such property or components,

either the property is or the components (or the second product into which the components are incorporated) are resold by the purchaser for use by a subsequent purchaser within the United States or the purchaser or subsequent purchaser fails, for any period of 365 consecutive days, to use the property or second product predominantly outside the United States (as defined in subdivision (4)(vi) of this paragraph).

(iv) *Sales to retailers.* For purposes of subdivision (4)(ii)(C) of this paragraph, property sold to any person whose principal business consists of selling from inventory to retail customers at retail outlets outside the United States will be considered to be used predominantly outside the United States.

(v) *Leases of property for ultimate use outside the United States.* For purposes of subdivision (4)(i) of this paragraph, a lessee of property is deemed to use property ultimately outside the United States during a taxable year of the lessor if the property is used predominantly outside the United States (as defined in subdivision (4)(vi) of this paragraph) by the lessee during the portion of the lessor's taxable year which is included within the term of the lease. A determination as to whether the ultimate use of leased property satisfies the requirements of this subdivision is made for each taxable year of the lessor. Thus, leased property may be used predominantly outside the United States for a taxable year of the lessor (and thus, constitute export property if the remaining requirements of this section are met) even if the property is not used predominantly outside the United States in earlier taxable years or later taxable years of the lessor.

(vi) *Predominant use outside the United States.* For purposes of this paragraph (d)(4), property is used predominantly outside the United States for any period if, during that period, the property is located outside the United States more than 50 percent of the time. An aircraft, railroad rolling stock, vessel, motor vehicle, container, or other property used for transportation purposes is deemed to be used predominantly outside the United States for any period if, during that period, either

the property is located outside the United States more than 50 percent of the time or more than 50 percent of the miles traversed in the use of the property are traversed outside the United States. However, property is deemed to be within the United States at all times during which it is engaged in transport between any two points within the United States, except where the transport constitutes uninterrupted international air transportation within the meaning of section 4262(c)(3) and the regulations under that section (relating to tax on air transportation of persons). An orbiting satellite is deemed to be located outside the United States. For purposes of applying section 4262(c)(3) to this subdivision, the term "United States" includes the Commonwealth of Puerto Rico.

(vii) *Component.* For purposes of this paragraph (d)(4), a component is property which is (or is reasonably expected to be) incorporated into a second product by the purchaser of such component by means of production, manufacture, or assembly.

(e) *Foreign content of property—(1) The 50 percent test.* Under paragraph (a)(3) of this section, no more than 50 percent of the fair market value of export property may be attributable to the fair market value of articles which were imported into the United States. For purposes of this paragraph (e), articles imported into the United States are referred to as "foreign content." The fair market value of the foreign content of export property is computed in accordance with paragraph (e)(4) of this section. The fair market value of export property which is sold to a person who is not a related person with respect to the seller is the sale price for such property (not including interest, finance or carrying charges, or similar charges.)

(2) *Application of 50 percent test.* The 50 percent test is applied on an item-by-item basis. If, however, a person sells or leases a large volume of substantially identical export property in a taxable year and if all of that property contains substantially identical foreign content in substantially the same proportion, the person may determine the portion of foreign content

contained in that property on an aggregate basis.

(3) *Parts and services.* If, at the time property is sold or leased the seller or lessor agrees to furnish parts pursuant to a services contract (as provided in § 1.924(a)-1T(d)(3)) and the price for the parts is not separately stated, the 50 percent test is applied on an aggregate basis to the property and parts. If the price for the parts is separately stated, the 50 percent test is applied separately to the property and to the parts.

(4) *Computation of foreign content—(i) Valuation.* For purposes of applying the 50 percent test, it is necessary to determine the fair market value of all articles which constitutes foreign content of the property being tested to determine if it is export property. The fair market value of the imported articles is determined as of the time the articles are imported into the United States.

(A) *General rule.* Except as provided in paragraph (e)(4)(i)(B), the fair market value of the imported articles which constitutes foreign content is their appraised value, as determined under section 403 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with their importation. The appraised value of the articles is the full dutiable value of the articles, determined, however, without regard to any special provision in the United States tariff laws which would result in a lower dutiable value.

(B) *Special election.* If all or a portion of the imported article was originally manufactured, produced, grown, or extracted in the United States, the taxpayer may elect to determine the fair market value of the imported articles which constitutes foreign content under the provisions of this paragraph (e)(4)(i)(B) if the property is subjected to manufacturing or production (as defined in paragraph (c) of this section) within the United States after importation. A taxpayer making the election under this paragraph may determine the fair market value of the imported articles which constitutes foreign content to be the fair market value of the imported articles reduced by the fair market value at the time of the initial export of the portion of the property that was manufactured, produced, grown, or extracted in the United

States. The taxpayer must establish the fair market value of the imported articles and of the portion of the property manufactured, produced, grown, or extracted in the United States at the time of the initial export in accordance with subdivision (4)(ii)(B) of this paragraph.

(ii) *Evidence of fair market value*—(A) *General rule.* For purposes of subdivision (4)(i)(A) of this paragraph, the fair market value of the imported articles is their appraised value, which may be evidenced by the customs invoice issued on the importation of such articles into the United States. If the holder of the articles is not the importer (or a related person with respect to the importer), the appraised value of the articles may be evidenced by a certificate based upon information contained in the customs invoice and furnished to the holder by the person from whom the articles (or property incorporating the articles) were purchased. If a customs invoice or certificate described in the preceding sentences is not available to a person purchasing property, the person shall establish that no more than 50 percent of the fair market value of such property is attributable to the fair market value of articles which were imported into the United States.

(B) *Special election.* For purposes of the special election set forth in subdivision (4)(i)(B) of this paragraph, if the initial export is made to a controlled person within the meaning of section 482, the fair market value of the imported articles and of the portion of the articles that are manufactured, produced, grown, or extracted within the United States shall be established by the taxpayer in accordance with the rules under section 482 and the regulations under that section. If the initial export is not made to a controlled person, the fair market value must be established by the taxpayer under the facts and circumstances.

(iii) *Interchangeable component articles.* (A) If identical or similar component articles can be incorporated interchangeably into property and a person acquires component articles that are imported into the United States and other component articles that are not

imported into the United States, the determination whether imported component articles were incorporated in the property that is exported from the United States shall be made on a substitution basis as in the case of the rules relating to drawback accounts under the customs laws. See section 313(b) of the Tariff Act of 1930, as amended (19 U.S.C. 1313(b)).

(B) The provisions of subdivision (4)(iii)(A) of this paragraph may be illustrated by the following example:

Example. Assume that a manufacturer produces a total of 20,000 electronic devices. The manufacturer exports 5,000 of the devices and subsequently sells 11,000 of the devices to a FSC which exports the 11,000 devices. The major single component article in each device is a tube which represents 60 percent of the fair market value of the device at the time the device is sold by the manufacturer. The manufacturer imports 8,000 of the tubes and produces the remaining 12,000 tubes. For purposes of this subdivision, in accordance with the substitution principle used in the customs drawback laws, the 5,000 devices exported by the manufacturer are each treated as containing an imported tube because the devices were exported prior to the sale to the FSC. The remaining 3,000 imported tubes are treated as being contained in the first 3,000 devices purchased and exported by the FSC. Thus, since the 50 percent test is not met with respect to the first 3,000 devices purchased and exported by the FSC, those devices are not export property. The remaining 8,000 devices purchased and exported by the FSC are treated as containing tubes produced in the United States, and those devices are export property (if they otherwise meet the requirements of this section).

(f) *Excluded property*—(1) *In general.* Notwithstanding any other provision of this section, the following property is not export property—

(i) Property described in subdivision (2) of this paragraph (relating to property leased to a member of controlled group).

(ii) Property described in subdivision (3) of this paragraph (relating to certain types of intangible property).

(iii) Products described in paragraph (g) of this section (relating to oil and gas products), and

(iv) Products described in paragraph (h) of this section (relating to certain export controlled products).

(2) *Property leased to member of controlled group*—(i) *In general.* Property

leased to a person (whether or not a FSC) which is a member of the same controlled group as the lessor constitutes export property for any period of time only if during the period—

(A) The property is held for sublease, or is subleased, by the person to a third person for the ultimate use of the third person;

(B) The third person is not a member of the same controlled group; and

(C) The property is used predominantly outside the United States by the third person.

(ii) *Predominant use.* The provisions of paragraph (d)(4)(vi) of this section apply in determining under subdivision (2)(i)(C) of this paragraph whether the property is used predominantly outside the United States by the third person.

(iii) *Leasing rule.* For purposes of this paragraph (f)(2), leased property is deemed to be ultimately used by a member of the same controlled group as the lessor if such property is leased to a person which is not a member of the controlled group but which subleases the property to a person which is a member of the controlled group. Thus, for example, if X, a FSC for the taxable year, leases a movie film to Y, a foreign corporation which is not a member of the same controlled group as X, and Y then subleases the film to persons which are members of the controlled group for showing to the general public, the film is not export property. On the other hand, if X, a FSC for the taxable year, leases a movie film to Z, a foreign corporation which is a member of the same controlled group as X, and Z then subleases the film to Y, another foreign corporation, which is not a member of the same controlled group for showing to the general public, the film is not disqualified from being export property.

(iv) *Certain copyrights.* With respect to a copyright which is not excluded by subdivision (3) of this paragraph from being export property, the ultimate use of the property is the sale or exhibition of the property to the general public. Thus, if A, a FSC for the taxable year, leases recording tapes to B, a foreign corporation which is a member of the same controlled group as A, and if B makes records from the recording tape and sells the records to C, another for-

eign corporation, which is not a member of the same controlled group, for sale by C to the general public, the recording tape is not disqualified under this paragraph from being export property, notwithstanding the leasing of the recording tape by A to a member of the same controlled group, since the ultimate use of the tape is the sale of the records (*i.e.*, property produced from the recording tape).

(3) *Intangible property.* Export property does not include any patent, invention, model, design, formula, or process, whether or not patented, or any copyright (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademark, tradebrand, franchise, or other like property. Although a copyright such as a copyright on a book or computer software does not constitute export property, a copyrighted article (such as a book or standardized, mass marketed computer software) if not accompanied by a right to reproduce for external use is export property if the requirements of this section are otherwise satisfied. Computer software referred to in the preceding sentence may be on any medium, including, but not limited to, magnetic tape, punched cards, disks, semi-conductor chips and circuit boards. A license of a master recording tape for reproduction outside the United States is not disqualified under this paragraph from being export property.

(g) *Oil and gas*—(1) *In general.* Under section 927(a)(2)(C), export property does not include oil or gas (or any primary product thereof).

(2) *Primary product from oil or gas.* A primary product from oil or gas is not export property. For purposes of this paragraph—

(i) *Primary product from oil.* The term “primary product from oil” means crude oil and all products derived from the destructive distillation of crude oil, including—

- (A) Volatile products,
- (B) Light oils such as motor fuel and kerosene,
- (C) Distillates such as naphtha,
- (D) Lubricating oils,
- (E) Greases and waxes, and
- (F) Residues such as fuel oil.

For purposes of this paragraph, a product or commodity derived from shale oil which would be a primary product from oil if derived from crude oil is considered a primary product from oil.

(ii) *Primary product from gas.* The term “primary product from gas” means all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including—

- (A) Natural gas,
- (B) Condensates,
- (C) Liquefied petroleum gases such as ethane, propane, and butane, and
- (D) Liquid products such as natural gasoline.

(iii) *Primary products and changing technology.* The primary products from oil or gas described in subdivisions (2)(i) and (ii) of this paragraph and the processes described in those subdivisions are not intended to represent either the only primary products from oil or gas, or the only processes from which primary products may be derived under existing and future technologies. For example, petroleum coke, although not derived from the destructive distillation of crude oil, is a primary product from oil derived from an existing technology.

(iv) *Non-primary products.* For purposes of this paragraph, petrochemicals, medicinal products, insecticides and alcohols are not considered primary products from oil or gas.

(h) *Export controlled products—(1) In general.* Section 927(a)(2)(D) provides that an export controlled product is not export property. A product or commodity may be an export controlled product at one time but not an export controlled product at another time. For purposes of this paragraph, a product or commodity is an “export controlled product” at a particular time if at that time the export of such product or commodity is prohibited or curtailed under section 7(a) of the Export Administration Act of 1979, to effectuate the policy relating to the protection of the domestic economy set forth in paragraph (2)(C) of section 3 of the Export Administration Act of 1979. That policy is to use export controls to the extent necessary to protect the domestic economy from the excessive

drain of scarce materials and to reduce the serious inflationary impact of foreign demand.

(2) *Products considered export controlled products—(i) In general.* For purposes of this paragraph, an export controlled product is a product or commodity, which is subject to short supply export controls under 15 CFR part 377. A product or commodity is considered an export controlled product for the duration of each control period which applies to such product or commodity. A control period of a product or commodity begins on and includes the initial control date (as defined in subdivision (2)(ii) of this paragraph) and ends on and includes the final control date (as defined in subdivision (2)(iii) of this paragraph).

(ii) *Initial control date.* The initial control date of a product or commodity which is subject to short supply export controls is the effective date stated in the regulations to 15 CFR part 377 which subjects the product or commodity to short supply export controls. If there is no effective date stated in these regulations, the initial control date of the product or commodity will be thirty days after the effective date of the regulations which subject the product or commodity to short supply export controls.

(iii) *Final control date.* The final control date of a product or commodity is the effective date stated in the regulations to 15 CFR part 377 which removes the product or commodity from short supply export controls. If there is no effective date stated in those regulations, the final control date of the product or commodity is the date which is thirty days after the effective date of the regulations which remove the product or commodity from short supply export control.

(iv) *Expiration of Export Administration Act.* An initial control date and final control date cannot occur after the expiration date of the Export Administration Act under the authority of which the short supply export controls were issued.

(3) *Effective dates—(i) Products controlled on January 1, 1985.* If a product or commodity was subject to short supply export controls on January 1, 1985, this

paragraph shall apply to all sales, exchanges, other dispositions, or leases of the product or commodity made after January 1, 1985, by the FSC or by the FSC's related supplier if the FSC is the commission agent on the transaction.

(ii) *Products first controlled after January 1, 1985.* If a product or commodity becomes subject to short supply export controls after January 1, 1985, this paragraph applies to sales, exchanges, other dispositions, or leases of such product or commodity made on or after the initial control date of such product or commodity, and to owning such product or commodity on or after such date.

(iii) *Date of sales, exchange, lease, or other disposition.* For purposes of this paragraph (h)(3), the date of sale, exchange, or other disposition of a product or commodity is the date as of which title to such product or commodity passes. The date of a lease is the date as of which the lessee takes possession of a product or commodity. The accounting method of a person is not determinative of the date of sale, exchange, other disposition, or lease.

(i) *Property in short supply.* If the President determines that the supply of any property which is otherwise export property as defined in this section is insufficient to meet the requirements of the domestic economy, he may by Executive Order designate such property as in short supply. Any property so designated will be treated under section 927(a)(3) as property which is not export property during the period beginning with the date specified in such Executive Order and ending with the date specified in an Executive Order setting forth the President's determination that such property is no longer in short supply.

[T.D. 8126, 52 FR 6459, Mar. 3, 1987]

**§ 1.927(b)-1T Temporary regulations;
Definition of gross receipts.**

(a) *General rule.* Under section 927(b), for purposes of sections 921 through 927, the gross receipts of a person for a taxable year are—

(1) *Business income.* The total amounts received or accrued by the person from the sale or lease of property held primarily for sale or lease in

the ordinary course of a trade or business, and

(2) *Other income.* Gross income recognized from whatever source derived, such as, for example, from—

(i) The furnishing of services (whether or not related to the sale or lease of property described in subdivision (1) of this paragraph),

(ii) Dividends and interest (including tax exempt interest),

(iii) The sale at a gain of any property not described in subdivision (1) of this paragraph, and

(iv) Commission transactions to the extent described in paragraph (e) of this section.

(b) *Non-gross receipts items.* For purposes of paragraph (a) of this section, gross receipts do not include amounts received or accrued by a person from—

(1) *Loan transactions.* The proceeds of a loan or of the repayment of a loan, or

(2) *Non-taxable transactions.* A receipt of property in a transaction to which section 118 (relating to contribution to capital) or section 1032 (relating to exchange of stock for property) applies.

(c) *Non-reduction of total amounts.* For purposes of paragraph (a) of this section, the total amounts received or accrued by a person are not reduced by costs of goods sold, expenses, losses, a deduction for dividends received, or any other deductible amounts. The total amounts received or accrued by a person are reduced by returns and allowances.

(d) *Method of accounting.* For purposes of paragraph (a) of this section, the total amounts received or accrued by a person shall be determined under the method of accounting used in computing its taxable income. If, for example, a FSC receives advance or installment payments for the sale or lease of property described in paragraph (a)(1) of this section, for the furnishing of services, or which represent recognized gain from the sale of property not described in paragraph (a)(1) of this section, any amount of such advance payments is considered to be gross receipts of the FSC for the taxable year for which such amount is included in the gross income of the FSC.

(e) *Commission transactions—(1) In general—(i) With a related supplier.* In the case of transactions which give rise

to a commission from the FSC's related supplier on the sale or lease of property or the furnishing of services by a principal, the FSC's gross income from all such transactions is the commission paid or payable to the FSC by the related supplier. The FSC's gross receipts for purposes of computing its profit under the administrative pricing methods of section 925(a)(1) and (2) shall be the gross receipts (other than gross receipts which would not be foreign trading gross receipts had they been received by the FSC) derived by the related supplier from the sale or lease of the property or from the furnishing of services, with respect to which the commissions are derived. Also, in determining whether the 50% test in section 924(a) has been met, the relevant gross receipts are the gross receipts of the related supplier.

(ii) *With an unrelated principal.* In the case of transactions which give rise to a commission from an unrelated principal to a FSC on the sale or lease of property or the furnishing of services by a principal, the amount recognized by the FSC as gross income from all such transactions shall be the commission received from the principal.

(2) *Selective commission arrangements—*

(i) *In general.* A commission arrangement between the FSC and its related supplier may provide that the FSC will not be the related supplier's commission agent with respect to sales or leases of export property, or the furnishing of services, which do not result in foreign trading gross receipts. In addition, the commission agreement may provide that the FSC will not be the related supplier's commission agent on transactions which would result in a loss to the related supplier under the transfer pricing rules of section 925(a). In a buy-sell FSC situation, selective commission arrangements are not applicable. Determination of which transactions fall within the selective commission arrangement may be made up to the due date under section 6072(b), including extensions provided for under section 6081, of the FSC's income tax return for the taxable year of the FSC during which a transaction occurs.

(ii) *Example.* The treatment of a selective commission arrangement may

be illustrated by the following example:

Example. A calendar year commission FSC ("F") entered into a selective commission arrangement with related supplier RS which provided that F will not be RS's commission agent on transactions which would result in a loss to RS under the transfer pricing rules of section 925(a). During 1987, RS sold three different articles of export property A, B and C, all of which fall within the same three digit Standard Industrial Classification. In July of 1988, while preparing the FSC's 1987 income tax return, RS determined that the sale of export property A resulted in a loss to RS under the section 482 method of section 925(a)(3) and that applying that method to the sales of export property B and C resulted in only a small amount of income to both RS and F. In addition, RS determined that grouping export property B and C, while excluding export property A from the grouping, resulted in the highest profit to F under the combined taxable income administrative pricing method of section 925(a)(2). Using the same grouping, the gross receipts method of section 925(a)(1) would result in a lower profit to F. Under the special no-loss rule of § 1.925(a)-1T(e)(1)(iii), RS would be prohibited from using the combined taxable income administrative pricing method to determine F's profit for the grouping of export property B and C if it used the section 482 method on the sale of export property A. This results because there was a loss to RS on the sale of export property A. Under the selective commission arrangement, RS could exercise its option and exclude the sale of export property A. Since F is no longer deemed to have been operating as RS's commission agent on that sale, the combined taxable income method may be used to compute F's profit on the grouping of the sales of export property B and C.

(f) *Example.* The definition of gross receipts under this section may be illustrated by the following example:

Example. During 1985, M, a related supplier of N, is engaged in the manufacture of machines in the United States. N, a calendar year FSC, is engaged in the sale and lease of such machines in foreign countries. N furnishes services which are related and subsidiary to its sale and lease of those machines. N also acts as a commission agent in foreign countries for Z, an unrelated supplier, with respect to Z's sale of products. N receives dividends on stock owned by it, interest on loans, and proceeds from sales of business assets located outside the United States resulting in recognized gains and losses. N's gross receipts for 1985 are \$3,550, computed on the basis of the additional facts assumed in the table below:

Internal Revenue Service, Treasury

§ 1.927(d)-1

N's sales receipts for machines manufactured by M (without reduction for cost of goods sold and selling expenses)	\$1,500
N's lease receipts for machines manufactured by M (without reduction for depreciation and leasing expenses)	500
N's gross income from related and subsidiary services for machines manufactured by M (without reduction for service expenses)	400
N's sales receipts for products manufactured by Z (without reduction for Z's cost of goods sold, commissions on sales and commission sales expenses)	550
Dividends received by N	150
Interest received by N	200
Proceeds received by N representing recognized gain (but not losses) for sales of business assets located outside the United States	250
N's gross receipts	3,550

[T.D. 8126, 52 FR 6464, Mar. 3, 1987]

§ 1.927(d)-1 Other definitions.

(a) Carrying Charges.

Q-1. Under what circumstances is the sales price of property or services sold by a FSC or a related supplier considered to include carrying charges as defined in subdivision (ii)(B)(I) of Q&A-9 of §1.921-2?

A-1. (i) The proceeds received from a sale of export property by a FSC or a related supplier (or the amount paid for services rendered or from rental of export property) may include carrying charges if any part of the sale proceeds (or service or rental payment) is paid after the end of the normal payment period. If the export property is sold or leased by, or if the services are rendered by, the FSC, the entire carrying charges amount as determined in Q&A-2 of this section will be the income of the FSC. If, however, the FSC is the commission agent of a related supplier on these transactions, the carrying charges amount so determined is income of the related supplier. The commission payable to the FSC will be computed by reducing the related supplier's gross receipts from the transaction by the amount of the carrying charges. No carrying charges will be assessed on the commissions paid by the related supplier to the FSC. The carrying charges provisions, likewise, do not apply to any other transaction that does not give rise to foreign trading gross receipts.

(ii) The normal payment period for a sale transaction is 60 days from the earlier of date of sale or date of ex-

change of property under the contract. For this purpose, the date of sale will be the date the sale is recorded on the seller's books of account under its normal accounting method. The date the transaction was recorded on the seller's books of account shall be disregarded if recording is delayed in order to delay the start of the normal payment period. In these circumstances, the earlier of the date of the contract or date of exchange of property will be deemed the date of sale. For related and subsidiary services that are not separately stated from the sale or lease transaction, the earlier of the date of the sale or date the export property is delivered to the purchaser is the applicable date. For related and subsidiary services which are separately stated from the sale or lease transaction and for other services, such as engineering and architectural services, the normal payment period is 60 days from the earlier of the date payment is due for the services or the date services under the contract are completed. The date of completion of a services contract is the date of final approval of the services by the recipient. With regard to transactions involving the lease or rental of export property, the normal payment period will begin on the date the rental payment is due under the lease. The date the normal payment period begins under this subdivision (ii) will be the same whether or not the transaction is with a related person.

(iii) The carrying charges are computed for the period beginning with the first day after the end of the normal payment period and ending with the date of payment. A FSC may elect at any time prior to the close of the statute of limitations of section 6501(a) for the FSC taxable year to treat the final date of payment stated in the contract as the date of payment if—

(A) The contracts for all transactions completed during the taxable year require that payment be received within the normal payment period,

(B) No more than 20% of transactions for which final payment is received in the taxable year involve payment after the end of the normal payment period. For FSC taxable years beginning after March 3, 1987, the 20% test will apply

only to the dollar value of the transactions and not to the number of transactions. For prior taxable years, the 20% test will apply to either the dollar value of the transactions or to the number of transactions. The special grouping rules applicable to determination of the FSC's profit under the administrative pricing rules of section 925 may be applied to this elective provision. Accordingly, transactions may be grouped into product or product-line groupings to determine whether 20% or less of the dollar value (or number of transactions, if applicable) of the grouped transactions involve payment after the end of the normal payment period.

Q-2. How are carrying charges as defined in subdivision (ii)(B)(I) of Q&A 9 of § 1.921-9 computed?

A-2. If carrying charges as defined in subdivision (ii)(B)(I) of Q&A 9 of § 1.921-9 are considered to be included in the sale price of property income or rental payment services, the amount of the carrying charges is equal to the amount in subdivision (i) of this answer if the contract provides for stated interest or the amount in subdivisions (ii) or (iii) of this answer, whichever is applicable, if the contract does not so provide.

(i) If a contract provides for stated interest beginning on the day after the end of the normal payment period, carrying charges will accrue only if the stated interest rate is less than the short-term, monthly Federal rate as of the day after the end of normal payment period and then only to the extent the stated interest is less than the short-term, monthly Federal rate. The short-term, monthly Federal rate is that rate as determined for purposes of section 1274(d) and which is published in the Internal Revenue Bulletin. Carrying charges will not accrue, however, unless payments are made after the end of the normal payment period.

(ii) If a contract for a transaction does not provide for stated interest, and if the taxpayer does not elect the method described in subdivision (iii) of this answer, the amount of carrying charges is equal to the excess of—

(A) The amount of the sales price of property, services income or rental payment that is unpaid on the day

after the end of the normal payment period, over

(B) The present value, as of the day after the end of the normal payment period, of all payments that are required to be made under the contract and that are unpaid on the day after the end of the normal payment period. The amount of the sales price of property, service income or rental payment is the amount under the contract whether it be the sales price, amount paid for services or the rental amount determined as of the actual payment date unless a FSC makes the election provided under subdivision (iii) of Q&A 1. If a FSC makes the election provided under subdivision (III) of Q&A 1, the amount of the sales price is the sales price, services income or rental payment under the contract determined as of the final payment date stated in the contract. All payments that are required to be made under the contract include the stated sales price, services income or rental payment as well as stated amounts of interest and carrying charges. The discount rate for the present value computation is simple interest at the short-term monthly Federal rate published in the Internal Revenue Bulletin, determined as of the day after the end of the normal payment period. The present value of a payment is calculated as follows:

$$P = S \frac{1}{(1 + (i \times t))}$$

P=present value of a payment that is required and unpaid after the end of the normal payment period

S=amount of a payment that is required and unpaid after the end of the normal payment period

i=the short-term monthly Federal rate

t=the number of days after the end of the normal payment period and before date of payment divided by 365.

If a sale is made, or if services are completed, or if rent is due under a lease in a taxable year and the required date of payment is in a later taxable year, carrying charges for the first taxable year are computed for the number of days after the end of the normal payment period and before the end of the taxable year. For the following taxable year, carrying charges are computed for the number of days after the beginning of

the taxable year and before the date of payment.

(iii) At the election of the taxpayer, the amount of carrying charges may be determined under the method described in this subdivision (iii). If the taxpayer elects this method, it must be used for all applicable transactions within the taxable year of the FSC. If this optional method is used, the computation of carrying charges must be made separately for transactions involving related persons and for those transactions involving unrelated persons. In addition, the computation of carrying charges must be made separately for each of the five types of income of the FSC (or of the related supplier if the related supplier is the principal on the transaction) listed in subparagraph (1) through (5) of section 924(a). These groupings are separate and distinct from the groupings that are established for purposes of determining the FSC's profit on the export transactions. The optional method allowed in this subdivision provides that the amount of carrying charges for a taxable year of a FSC (or related supplier if the related supplier is the principal on the export transaction) is computed using the average of receivables of unrelated persons (or of related persons) and the average time those receivables are outstanding. Receivables are included in this computation only if they are from transactions on which foreign trading gross receipts, as defined in section 924(a), are received by the FSC (or which are received by a related supplier of a FSC and which would have been foreign trading gross receipts had they been received by the FSC). Carrying charges are calculated under this method as follows:

$$CC=(AR) (I/365) (X) (Y)$$

CC=Carrying charges

AR=Average monthly receivables balance for the taxable year

I=The average short-term, monthly Federal rate for the year

X=The number of times receivables turn over in the year

Y=The number of days the average receivables are outstanding over 60 days.

This optional method is illustrated in *Example 5* in subdivision (v) of this answer.

(iv) The computation of carrying charges under this answer 2 applies only to the determination of carrying charges under subdivision (ii)(B)(I) of Q&A 9 of §1.921-2 and does not apply to the determination of any other unstated interest or for any other purpose.

(v) The following examples illustrate the computation of carrying charges under this section:

Example 1. On January 1, 1985, a FSC sells export property for \$10,000. The export property is delivered to the purchaser on January 10, 1985. The terms of the contract require payment within 90 days after sale. The normal payment period is 60 days. The FSC does not make an election under subdivision (iii) of Q&A. The contract does not require the payment of any interest or carrying charges. The purchaser pays the entire sales price on March 1, 1985. The sales price is not considered to include any carrying charges because the purchase paid the entire sales price within the normal payment period.

Example 2. The facts are the same as in example 1 except that the purchaser pays the entire sales price on April 6, 1985, 96 days after the earlier of the date of sale or date of delivery (*i.e.*, January 1, 1985). Therefore, the sales price is considered to include carrying charges computed as follows:

Step 1: Determines the short-term monthly Federal rate as of the earlier of date of sale or date of delivery. For purposes of this example, the rate is 10%.

Step 2: Determine the fraction of the year represented by the number of days after 60 days and before date of payment. In this example, the number of days beyond 60 is 96-60=36, which is divided by 365

$$\frac{36 \text{ days}}{365 \text{ days}} = .099 \text{ fraction of the year}$$

Step 3: Using the short-term monthly Federal rate and the fraction of the year, compute the present value of the payment.

$$P = S \frac{1}{(1 + (i \times t))}$$

$$P = \$10,000 \frac{1}{(1 + (.10 \sqrt{.099}))}$$

P=\$10,000 (.99)

P=\$9,900

Step 4: Using the present value of all payments, compute the carrying charges.

Carrying Charges=Sales Price less Present Value.

\$10,000	Sales Price
-9,900	Present Value
\$100	Carrying charges

Example 3. On October 15, 1985, F, a FSC, leases export property to X for one month with a total rental due of \$20,000. Under the terms of the lease, A agreed to pay F \$10,000 on October 15, 1985, and the remaining \$10,000 on January 15, 1986. The contract does not require the payment of any interest or carrying charges. The second \$10,000 payment is made on January 3, 1986. This payment does not include any carrying charges because X paid the \$10,000 before the start of the normal payment period.

Example 4. On October 15, 1985, F, a FSC, leases export property to X, for one month with a total amount due under the lease of \$10,000, payable on October 15, 1985. X delays payment until January 19, 1986, which was 96 days after the start of the normal payment period. The 60 day normal payment period terminated on December 14, 1985. Therefore, the lease payment is considered to include carrying charges of \$100 computed in the same manner as in *Example 2*. Of this \$100, 17/36, or \$47.22, is carrying charges for 1985 (*i.e.*, 17 days in December), and 19/36, or \$52.78, is carrying charges for 1986.

Example 5. During 1986, F, a FSC, sold on account export properties A and B to related and unrelated persons.

(A) *Unrelated persons.* During 1986, the sales on account to unrelated persons totaled \$6,000. On the last day of each of the months of 1986, F had total receivables from unrelated persons from sales of export properties A and B, as follows:

January 31	\$1,400
February 28	1,400
March 31	1,000
April 30	1,000
May 31	1,200
June 30	1,300
July 31	1,000
August 31	1,300
September 30	1,500
October 31	1,100
November 30	1,200
December 31	1,000
	14,400

Carrying charges for 1986 with unrelated persons under the optional method of subdivision (iii) of this answer will be \$19.23, computed as follows:

Step 1: Determine the average short-term, monthly Federal rate for the year. For purposes of this example, the rate is assumed to be 9%.

Step 2: Determine the average receivables for the year. This average is calculated by totaling the end of the month receivables balance of each month of the year and dividing by twelve. In this example, the average

monthly receivables balance is \$1,200, calculated as follows:

$$\$1,200 = \$14,400 / 12$$

Step 3: Determine the number of times the receivables turn over during the year. This is calculated by dividing the sales on account for the year by the average monthly receivables balance for the year. For purposes of this example, receivables turned over 5 times for 1986, computed as follows:

$$5 = \frac{\$6,000}{\$1,200}$$

Step 4: Determine the number of days the average receivables are outstanding in excess of 60 days. In this example, there are 13 receivable days in excess of 60 days, computed as follows:

$$13 \text{ days} = \left(\frac{365}{5} \right) - 60 \text{ days}$$

Step 5: The amount of carrying charges, \$19.23, is calculated by using the following equation:

$$CC = (AR) (I/365) (X)(Y)$$

CC=Carrying charges

AR=Average monthly receivables balance for the taxable year (step 2)

I=The average short-term monthly Federal rate for the year (step 1)

X=The number of times receivables turn over in the year (step 3)

Y=The number of days the average receivables are outstanding over 60 days (step 4).

$$CC = \$19.23 = (\$1,200) (.09/365) (5) (13)$$

(B) *Related persons.* Carrying charges, if any, on the sales on account to related persons must be computed separately using this optional method.

Q-3. Is a discount from the sales price of property or services for prompt payment considered to be stated carrying charges as defined in subdivision (ii)(A) of Q&A 9 of § 1.921-2?

A-3. No.

Q-4. Is the receipt of an arm's length factoring payment from an unrelated person considered a payment of the sales proceeds for purposes of determining whether payment is made within the normal payment period and the possible imposition of carrying charges?

A-4. Yes.

[T.D. 8127, 52 FR 6473, Mar. 3, 1987]

§ 1.927(d)-2T Temporary regulations; definitions and special rules relating to Foreign Sales Corporation.

(a) *Definition of related supplier.* For purposes of sections 921 through 927 and the regulations under those sections,

the term “related supplier” means a related party which directly supplies to a FSC any property or services which the FSC disposes of in a transaction producing foreign trading gross receipts, or a related party which uses the FSC as a commission agent in the disposition of any property or services producing foreign trading gross receipts. A FSC may have different related suppliers with respect to different transactions. If, for example, X owns all the stock of Y, a corporation, and of F, a FSC, and X sells a product to Y which is resold to F, only Y is the related supplier of F. If, however, X sells directly to F and Y also sells directly to F, then, as to the transactions involving direct sales to F, each of X and Y is a related supplier of F.

(b) *Definition of related party.* The term “related party” means a person which is owned or controlled directly or indirectly by the same interests as the FSC within the meaning of section 482 and § 1.482-1(a).

[T.D. 8126, 52 FR 6465, Mar. 3, 1987]

§ 1.927(e)-1 Special sourcing rule.

(a) *Source rules for related persons*—(1) *In general.* The income of a person described in section 482 from a sale of export property giving rise to foreign trading gross receipts of a FSC that is treated as from sources outside the United States shall not exceed the amount that would be treated as foreign source income earned by such person if the pricing rule under section 994 that corresponds to the rule used under section 925 with respect to such transaction applied to such transaction. This special sourcing rule also applies if the FSC is acting as a commission agent for the related supplier with respect to the transaction described in the first sentence of this paragraph (a)(1) that gives rise to foreign trading gross receipts and the transfer pricing rules of section 925 are used to determine the commission payable to the FSC. No limitation results under this section with respect to a transaction to which the section 482 pricing rule under section 925(a)(3) applies.

(2) *Grouping of transactions.* If, for purposes of determining the FSC’s profits under the administrative pricing rules of sections 925(a) (1) and (2),

grouping of transactions under § 1.925(a)-1T(c)(8) was elected, the same grouping shall be used for making the determinations under the special sourcing rule in this section.

(3) *Corresponding DISC pricing rules*—(i) *In general.* For purposes of this section—

(A) The DISC gross receipts pricing rule of section 994(a)(1) corresponds to the gross receipts pricing rule of section 925(a)(1);

(B) The DISC combined taxable income pricing rule of section 994(a)(2) corresponds to the combined taxable income pricing rule of section 925(a)(2); and

(C) The DISC section 482 pricing rule of section 994(a)(3) corresponds to the section 482 pricing rule of section 925(a)(3).

(ii) *Special rules.* For purposes of this section—

(A) The DISC pricing rules of section 994(a)(1) and (2) shall be determined without regard to export promotion expenses;

(B) Qualified export receipts under section 994(a)(1) and

(2) shall be deemed to be an amount equal to the foreign trading gross receipts arising from the transaction; and

(C) Combined taxable income for purposes of section 994(a)(2) shall be deemed to be an amount equal to the combined taxable income for purposes of section 925(a)(2) arising from the transaction.

(b) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. (i) R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, which is a FSC acting as a commission agent for R. For the taxable year, R and F used the combined taxable income pricing rule of section 925(a)(2). For the taxable year, the combined taxable income of R and F is \$100 from the sale of export property, as defined in section 927(a), manufactured by R using production assets located in the United States. Title to the export property passed outside of the United States.

(ii) Under section 925(a)(2), 23 percent of the \$100 combined taxable income of R and F (\$23) is allocated to F and the remaining \$77 is allocated to R. Absent the special sourcing rule, under section 863(b) the \$77 income allocated to R would be sourced \$38.50 U.S.

source and \$38.50 foreign source. Under the special sourcing rule, the amount of foreign source income earned by a related supplier of a FSC shall not exceed the amount that would result if the corresponding DISC pricing rule applied. The DISC combined taxable income pricing rule of section 994(a)(2) corresponds to the combined taxable income pricing rule of section 925(a)(2). Under section 994(a)(2), \$50 of the combined taxable income ($\$100 \times .50$) would be allocated to the DISC and the remaining \$50 would be allocated to the related supplier. Under section 863(b), the \$50 income allocated to the DISC's related supplier would be sourced \$25 U.S. source and \$25 foreign source. Accordingly, under the special sourcing rule, the foreign source income of R shall not exceed \$25.

Example 2. (i) Assume the same facts as in *Example 1* except that R and F used the gross receipts pricing rule of section 925(a)(1). In addition, for the taxable year foreign trading gross receipts derived from the sale of the export property are \$2,000.

(ii) Under section 925(a)(1), 1.83 percent of the \$2,000 foreign trading gross receipts (\$36.60) is allocated to F and the \$63.40 remaining combined taxable income ($\$100 - \36.60) is allocated to R. Absent the special sourcing rule, under section 863(b) the \$63.40 income allocated to R would be sourced \$31.70 U.S. source and \$31.70 foreign source. Under the special sourcing rule, the amount of foreign source income earned by a related supplier of a FSC shall not exceed the amount that would result if the corresponding DISC pricing rule applied. The DISC gross receipts pricing rule of section 994(a)(1) corresponds to the gross receipts pricing rule of section 925(a)(1). Under section 994(a)(1), \$80 ($\$2,000 \times .04$) would be allocated to the DISC and the \$20 remaining combined taxable income would be allocated to the related supplier. Under section 863(b), the \$20 income allocated to the DISC's related supplier would be sourced \$10 U.S. source and \$10 foreign source. Accordingly, under the special sourcing rule, the foreign source income of R shall not exceed \$10.

(c) *Effective date.* The rules of this section are applicable to taxable years beginning after December 31, 1997.

[T.D. 8782, 63 FR 50144, Sept. 21, 1998]

§ 1.927(e)-2T Temporary regulations; effect of boycott participation on FSC and small FSC benefits.

(a) *International boycott factor.* If the FSC (or small FSC) or any member of the FSC's (or small FSC's) controlled group participates in or cooperates with an international boycott within the meaning of section 999, the FSC's (or small FSC's) exempt foreign trade

income as determined under section 923 (a) shall be reduced by an amount equal to the product of the FSC's (or small FSC's) exempt foreign trade income multiplied by the international boycott factor determined under section 999. The amount of the reduction will be considered as non-exempt foreign trade income.

(b) *Specifically attributable taxes and income method.* If the taxpayer clearly demonstrates that the income earned for the taxable year is attributable to specific operations, then in lieu of applying the international boycott factor for such taxable year, the amount of the exempt foreign trade income as determined under section 923(a) that will be reduced by this section shall be the amount specifically attributable to the operations in which there was participation in or cooperation with an international boycott under section 999(b)(1). The amount of the reduction will be considered as non-exempt foreign trade income.

[T.D. 8126, 52 FR 6465, Mar. 3, 1987]

§ 1.927(f)-1 Election and termination of status as a Foreign Sales Corporation.

(a) *Election of status as a FSC or a small FSC.*

Q-1. What is the effect of an election by a corporation to be treated as a FSC or small FSC?

A-1. A valid election to be treated as a FSC or a small FSC applies to the taxable year of the corporation for which made and remains in effect for all succeeding taxable years in which the corporation qualifies to be a FSC unless revoked by the corporation or unless the corporation fails for five consecutive years to qualify as a FSC (in case of a FSC election) or as a small FSC (in case of a small FSC election).

Q-2. Can a corporation established prior to January 1, 1985 be treated as a FSC or a small FSC prior to making a FSC or a small FSC election?

A-2. A corporation cannot be treated as a FSC or a small FSC until it has made a FSC or a small FSC election. An election made within the first 90 days of 1985 relates back to January 1, 1985 unless the taxpayer indicates otherwise.

Q-3. If a shareholder who has not consented to a FSC or small FSC election transfers some or all of its shares before or during the first taxable year for which the election is made, may the holder of the transferred shares consent to the election?

A-3. A holder of the transferred shares may consent to a FSC or small FSC election under the circumstances described in §1.922-2(c)(1). The rules contained in §1.992-(c) shall apply to the consent by a holder of transferred shares.

Q-4. If a shareholder who has consented to a FSC or a small FSC election transfers some or all of its shares before the first taxable year for which the election is made, must the holder of the transferred shares consent to the election?

A-4. Yes. Consent must be made by any recipient of such shares on or before the 90th day after the first day of such first taxable year. If such recipient fails to file his consent on or before such 90th day, and extension of time for filing such consent may be granted in the manner, and subject to the conditions, described in paragraph (b)(3) of §1.992-2.

Q-5. May an election of a corporation to be a FSC or a small FSC be effective as of a time other than the start of the corporation's taxable year?

A-5. No.

Q-6. If a fiscal year foreign corporation was in existence on December 31, 1984, must it wait until the first day of its taxable year beginning after January 1, 1985, to elect FSC status?

A-6. No. If a fiscal year foreign corporation was in existence on December 31, 1984, its taxable year will be deemed to have terminated on that date if the foreign corporation elects FSC status to be effective January 1, 1985. An income tax return will be required for any short years created by the deemed closing of the taxable year unless the corporation is relieved from the necessity of making a return by section 6012 and the regulations under that section. If the corporation's taxable year is deemed closed by operation of this regulation, the filing date of tax returns for the short taxable year ended on December 31, 1984, will be automatically extended until May 18, 1987.

Q-7. What is the effect of an election to be treated as a FSC or as a small FSC if the corporation or any other member of the controlled group has in effect an election to be treated as an interest charge DISC?

A-7. The interest charge DISC election shall be treated as revoked for all purposes under the Code as of the date the FSC election is effective. An affirmative revocation of the DISC election is unnecessary. The FSC election shall take effect. As long as the FSC election remains in effect, neither the corporation nor any other member of the controlled group is permitted to elect to be treated as an interest charge DISC for any taxable year including any part of a taxable year during which the corporation's FSC election continues to be effective.

Q-8. What is the effect of an election to be treated as a small FSC if the corporation or any other member of the controlled group has in effect an election to be treated as a FSC?

A-8. As long as a FSC election remains in effect, neither the corporation nor any other member of the controlled group is permitted to elect to be treated as a small FSC for any taxable year including any part of a taxable year during which a FSC election continues to be effective. Any FSC within the controlled group must affirmatively revoke its FSC election for a taxable year including any part of a taxable year for which small FSC status is elected.

Q-9. What is the effect of an election to be treated as a FSC if the corporation or any other member of the controlled group has in effect an election to be treated as a small FSC?

A-9. As long as a small FSC election remains in effect, neither the corporation nor any other member of the controlled group is permitted to elect to be treated as a FSC for any taxable year including any part of the taxable year during which a small FSC election continues to be effective. Any small FSC within the controlled group must affirmatively revoke its small FSC election for a taxable year including any part of a taxable year for which FSC status is elected. An election to be treated as a small FSC is permitted if the corporation or any other member

of the controlled group has in effect an election to be treated as a small FSC. For a special rule providing for conversion of a small FSC to a FSC within one taxable year, see § 1.921-1T(b)(1) (Q&A-1).

(b) *Termination of election of status as a FSC or a small FSC.*

Q-10. How is the status of a corporation as a FSC or as a small FSC terminated?

A-10. The status of a corporation as a FSC or as a small FSC is terminated through revocation or by its continued failure to be a FSC.

Q-11. For what taxable year may a corporation revoke its election to be treated as a FSC or as a small FSC?

A-11. A corporation may revoke its election to be treated as a FSC or as a small FSC for any taxable year of the corporation after the first taxable year for which the election is effective.

Q-12. When must a corporation revoke a FSC or a small FSC election if revocation is to be effective for the taxable year in which revocation takes place?

A-12. If a corporation files a statement revoking its election to be treated as a FSC or as a small FSC during the first 90 days of a taxable year (other than the first taxable year for which such election is effective), such revocation will be effective for such taxable year and all taxable years thereafter. If the corporation files a statement revoking its election to be treated as a FSC or a small FSC after the first 90 days of a taxable year, the revocation will be effective for all taxable years following such taxable year.

Q-13. Can a FSC change its status to a small FSC, or can a small FSC change its status to a FSC as of a date other than the first day of a taxable year?

A-13. No. Since a revocation of an election to be a FSC or a small FSC is effective only for entire taxable year, a corporation's change between FSC and small FSC status is effective as of the first day of a taxable year.

Q-14. How may a corporation revoke an election by a corporation to be treated as a FSC or a small FSC?

A-14. A corporation may revoke its election by filing a statement that the corporation revokes its election under

section 922(a) to be treated as a FSC or under section 922(b) to be treated as a small FSC. Such statement shall indicate the corporation's name, address, employer identification number, and the first taxable year of the corporation for which the revocation is to be effective. The statement shall be signed by any person authorized to sign a corporate return under section 6062. Such revocation shall be filed with the Service Center with which the corporation filed its return.

Q-15. What if the effect is a corporation that has elected to be treated as a FSC or a small FSC fails to qualify as a FSC because it does not meet the requirements of section 922 for a taxable year?

A-15. If a corporation that has elected to be treated as a FSC or a small FSC does not qualify as a FSC or a small FSC for a taxable year, the corporation will not be treated as a FSC or a small FSC for the taxable year. However, the failure of a corporation to qualify to be treated as a FSC or a small FSC for a taxable year does not terminate the election of the corporation to be treated as FSC or a small FSC unless the corporation does not qualify under section 922 for each of 5 consecutive taxable years, as provided in Q&A 16 of this section.

Q-16. Under what circumstances is the FSC or small FSC election terminated for continued failure to be a FSC?

A-16. If a corporation that has elected to be treated as a FSC or a small FSC does not qualify under section 922 to be treated as a FSC or small FSC for each of 5 consecutive taxable years, such election terminates and will not be effective for any taxable year after such fifth taxable year. Such termination will be effective automatically without notice to such corporation or to the Internal Revenue Service.

[T.D. 8127, 52 FR 6475, Mar. 3, 1987]

POSSESSIONS OF THE UNITED STATES

§ 1.931-1 Exclusion of certain income from sources within Guam, American Samoa, or the Northern Mariana Islands.

(a) *General rule.* (1) An individual (whether a United States citizen or an