Docket No. 18-72451

In the

United States Court of Appeals

for the

Ninth Circuit

CELIA MAZZEI, et al.

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the United States Tax Court
Case Nos. 16702-09 and 16779-09
Hon. Michael B. Thornton for the Majority of the Tax Court

OPENING BRIEF OF APPELLANT

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I.
INTRODUCTION

> The tax credits were intended to generate investments … Yet the Commissioner in this case at bar proposes to use the reason Congress created the tax benefits as a ground for denying them.
>
> *Sacks v. Commissioner*, 69 F.3d 982, 992 (9th Cir. 1995)

When a taxpayer uses two tax-saving devices created by Congress to incentivize behavior the People's representatives have deemed worthy of tax breaks, can the Tax Court eliminate, by judicial fiction, the resulting tax benefits—because they worked too well?

That is the question before this Court, to which the First, Second, and Sixth Circuits have already answered "No." Therein, taxpayers employed congressionally-created entities—Domestic International Sales Corporations ("DISCs") and Roth IRA retirements plans—for tax benefits. Used together, the two structures worked too well, the Tax Court held. But the Sixth Circuit reversed: "Because Summa Holdings used the DISC and Roth IRAs for their congressionally sanctioned purpose—tax avoidance—the Commissioner had no basis for recharacterizing the transactions." (*Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779, 782 (6th Cir. 2017) ("Summa Holdings")).

The First Circuit also reversed the Tax Court, in *Benenson v. Commissioner*, 887 F.3d 511 (1st Cir. 2018) ("Benenson 1"), as did the Second Circuit in *Benenson*

v. Commissioner, 910 F.3d 690 (2nd Cir. 2018) ("Benenson 2"). "Some may call the Benensons' transaction clever. Others may call it unseemly. The sole question presented to us is whether the Commissioner has the power to call it a violation of the Tax Code. We hold that he does not." *Benenson 1*, *supra*, 887 F.3d at 523. [1]

DISCs were created by Congress to incentivize foreign sales of U.S. goods. (ER169:51, fn. 41).[2] When the European Union complained about DISCs, Congress replaced them with Foreign Sales Corporations ("FSCs"), modified to placate foreign trading partners but still employing tax incentives. (*Ibid*.). *It was conceded by the Commissioner in this case that there is no difference between FSCs and DISCs*. (ER169:87).

In *Summa* and the *Benenson* decisions, the taxpayers' Roth IRAs owned DISC stock and received DISC dividends, resulting in attractive tax savings.[3] Using a substance over form rationale, the Tax Court improperly redirected DISC dividends from the Roth IRAs to the taxpayers. Similarly, the Mazzei's Roth IRAs owned FSC stock and received FSC dividends. Having been reversed in *Summa*

[1] As used herein, *"Benenson 1"* refers to the First Circuit's decision; *"Benenson 2"* refers to the Second Circuit's decision; and "Benenson decisions" refer to both.

[2] As used herein, ER with a cite followed by a colon refers to the tab number in the Excerpts, and the ER page, except for the trial transcripts (Tabs 155-158), for which the citation is to the original reporter's transcript page number. If there is no colon, the number after ER is the page number of Tab Number 169.

[3] Allowable under the Code. *Benenson 2,* 910 F.3d at 694-695.

and the *Benenson* decisions, the Tax Court tried a new tack herein to reach the same result: a divided Tax Court—with the trial judge emphatically dissenting—found that the Mazzeis, not their Roth IRAs, were the "real" FSC stockholders. By ignoring the structure actually used by the Mazzeis, the Tax Court attempted through judicial fiction to avoid the holdings of *Summa* and the two *Benenson* decisions. As the deemed owners of the FSC stock, the Mazzeis "received" dividends and "overcontributed" to their respective Roth IRAs, resulting in an excise tax.

Was the Tax Court right? Or did it merely repackage a thrice-rejected position in different terms?

II.
JURISDICTIONAL STATEMENT

1. Lower Court Jurisdiction: The Tax Court had jurisdiction under 26 U.S.C. § 6214.[4]

2. Jurisdiction For The Court Of Appeals: This Court has jurisdiction and venue under Sections 7482(a)(1); 7482(b); and 7482(c).

3. Date of Entry of Judgment Appealed From: The Tax Court entered its decision on March 6, 2018. Petitioners timely filed a Motion for Reconsideration

[4] As used herein "Code," "I.R.C.", or "Internal Revenue Code" shall refer to United States Code Title 26, as from time to time amended; the term "Treas. Reg." or "Regulations" shall refer to Treasury Regulations, issued by the Treasury Department; the term "Section" shall refer to section(s) of the Code or Regulations, as contextually appropriate.

on April 4, 2018, pursuant to Tax Court Rule 161 (ERDKT:17), and a Motion to Vacate or Revise the decision on April 5, 2018, pursuant to Tax Court Rule 162 (ERDKT:17). Both Motions were denied on May 24, 2018. (ERDKT:17). U.S. Tax Court Rule 190 incorporates Federal Rule of Appellate Procedure 13(a)(1)(A), which provides that the time for filing an appeal from the Tax Court runs from the entry of the order denying those motions. Petitioners timely filed their Notice of Appeal to the U.S. Tax Court on August 22, 2018. (ERDKT:18).

4. Final Judgment: The Appeal is from a final judgment disposing of all parties' claims.

III.
STATUTORY AND REGULATORY AUTHORITIES

All relevant statutory and/or regulatory authorities appear in the Addendum to this Brief.

IV.
ISSUES PRESENTED

1. Whether the Tax Court erred in finding that FSC stock, held by Petitioners' Roth IRAs, actually belonged to Petitioners.

2. Whether the Tax Court incorrectly utilized valuation principles in determining ownership of stock.

3. Whether the Tax Court incorrectly utilized risk-benefit analyses in determining ownership of stock.

4. Whether the Tax Court incorrectly employed a substance analysis in determining ownership of stock.

5. Whether the Tax Court erred in disregarding Congressional purpose.

V.
STATEMENT OF THE CASE

A. Factual Background

This is the story of a small businessman who invented a device useful for pollution control and green technology. (ER156:185/18-21, 181/ 23-25). With his wife and daughter, who helped as a youngster (ER155:29/7-12), he started a small business in his garage (ER155:54/12-20; 115/1-2; ER169:6-7). Seeking new

markets, he began selling his devices overseas (ER169:7). Beset by foreign copies of his invention (ER138:68-71**)** he sought new marketing techniques (ER156:118/2-4, 9-12; 123/13-25; 124/1-6). He learned of an entity created by Congress—commonly called an "FSC"—designed to promote foreign sales through tax incentives. (ER30). For sound business reasons, he joined the FSC program, and as a direct result of participating in the program Western Growers mailed hundreds of flyers for him each year, from which he obtained business.[5] (ER155:49/16-22; ER156:132/1-25; 133/1,4, 148/2-149/4; ER138:13,72-73). At that time, retirement was not his concern. (ER156:135/10-16). The FSC provided helpful foreign marketing assistance. (ER156:132/1-24; 152/9-14). He little realized that he would become the subject of an IRS test case upon which the Government would spend, in one useless "expert" alone, more than the entire amount of tax due. (ER169:6-7; ER156:11/25-12/17)[6].

[5] Absent the tax benefits of the transaction, a decision by a business owner to spend $3,500 to have another company handle direct mailing of hundreds of brochures each year for four years to international recipients would be immune from attack under the business judgment rule. *See, e.g., FDIC v. Castetter*, 184 F.3d 1040, 1046 (9th Cir. 1999).

[6] The IRS spent $112,500 on a trial expert who had not reviewed or considered basic information—with a tax at issue of only $108,282.

1. The Statutory Entities at Issue

There are three entities relevant herein, all created by Congress: *Foreign Sales Corporations* ("FSCs") (ER169:8), *Roth IRA retirement plans* ("Roth IRAs") (ER9), and *Domestic International Sales Corporations* ("DISCs"). (ER169:51-52).

Roth IRAs: Created by Congress in the Taxpayer Relief Act of 1997,[7] Roth IRAs were funded by contributions from taxable income, which then accumulated tax free, along with accrued earnings, for tax-free distribution when the owner reached age 59-1/2. (ER169:19-20; I.R.C. §§ 408(A)(c)(1), 408(A)(d)(1)). This offered attractive tax advantages. (ER169:19). Contributions to Roth IRAs were and are subject to limitations. (ER169:20; *Paschall v. Commissioner,* 137 T.C. 8 (2011)).

DISCs: DISCs were a creation of Congress in 1971. (ER169:51-52). Designed to stimulate foreign sales of U.S. goods, a DISC's qualified export income was not subject to taxation while so held. (ER169:53; I.R.C. §§ 991-997). DISCs were largely replaced by Congress with FSCs after an international trade dispute. (ER169:10, 51-2, fn. 41).[8] While the operative entity in this case was not

[7] ER19-20; Public Law 105-34, § 302, 111 Stat. 825.

[8] *See also* Background and History of the Trade Dispute, Staff, Joint Committee on Taxation, July 26, 2002, pp. 2-3.

a DISC, case law reversing the Tax Court, in cases similar to the one herein, involved DISCs. (ER169:51-53). DISCs and FSCs are treated the same for excise tax purposes. (ER169:87).

FSCs: After DISCs were largely abandoned due to international pressure, FSCs were another Congressional attempt to promote through tax savings the foreign sales of U.S. goods. (ER169:51-2, fn. 41). To placate the international trade community, Congress required an FSC to be managed outside the U.S. (ER169:34, fn. 28). Congress provided tax advantages to incentivize foreign sales (ER169:29; 80-81)[9]. These included relaxed transfer pricing rules (ER169:30-31), with which Petitioners complied. (ER169:31, fn. 25).

For services related to export transactions, FSCs received commissions from U.S. firms. (ER169:32). Because the Congressional goal was trade promotion through tax incentives, the requirements were very loose: commissions were allowed even where services "were not, in substance, performed by the FSC." (ER169:32, 80-81). Further, an FSC's "exempt foreign trade income" was not subject to U.S. tax. (ER169:33). "In sum, section 925 allowed part of the income from an export transaction to be assigned to an FSC … resulting in an effective tax rate cut for foreign income." (ER169:34).

[9] ER80-81, from the dissent, describes some of the methods by which Congress promoted FSCs and DISCs.

For small taxpayers, such as the Mazzeis—who can remember how they earned every penny of the $108,000 at issue herein—Congress went further. If, like the Mazzeis, you could not afford the complexity and technical requirements of a regular FSC, Congress created "shared FSCs," in which multiple small companies could participate, each establishing a separate corporation within a small shared FSC. (Section 927(g)(3)). These Small FSCs were subject to even less regulation than large FSCs (Section 924(b)(2)(A)), and were designed to provide tax benefits to small exporters—with barely any legal formalities required of the Small FSC participant. (Section 922; Treas. Reg. Section 1.922-1).

FSCs, broadly exempted from ordinary business purpose requirements, had little business purpose other than tax savings. (ER169:81; Sections 924(a), 921-927; Temp. Reg. Section 1.925(a)-1T(a)(3)). Shared FSCs had fewer requirements still, a sort of dollar store FSC for small businesses. (Section 927(g)(2(A)). As created by Congress, they had virtually no substance whatever—except tax savings. (Section 922; Treas. Reg. Section 1.922-1; ER169:81).

A Roth IRA could own FSC stock, and an FSC's foreign trade income, received as a dividend, could, in theory, fund the retirement plan more rapidly than could contributions by FSC owners, who were subject to income restrictions. (ER169:20, 50-51). Thus, Code Sections 408A and 921-927, if combined, could result in attractive tax savings. (ER169:19, 33, 34). Indeed, other taxpayers had

utilized similar Code sections: their names were Clement Benenson, James Benenson, and Summa Holdings, Inc. (ER169:52-53)—along with *Hellweg*, Slaight, and *Ohsman*. Every single one of those taxpayers ultimately prevailed against attacks by the Commissioner. The Mazzeis had every reason to think they, too, would prevail—and the Tax Court trial judge who actually heard the evidence agreed, penning a pointed (and poignant) dissent when the Tax Court *en banc* took the case away from him and went a different direction.

2. Why the FSC Mattered to the Mazzeis

Petitioners marketed their products to foreign buyers (ER169:6-7) through their corporation, Injector Corp. (ER169:7). In 1998 they formed ALM Corp., which, in concert with Injector Corp., formed an LLC named Mazzei Injector Co. ("Injector Co."). (ER169:9-10).

Struggling against foreign copiers of Mazzei products, Petitioners decided in February of 1998 to participate in a small, shared FSC program offered by Western Growers Association, an agricultural trade association ("WGA"). (ER169:8, 10). They paid $3,500 to WGA to participate in the FSC. (ER156:132/3-8). WGA's program required the Mazzeis to have self-directed Roth Individual Retirement Accounts that would purchase stock in the shared FSC. (ER169:8-9). Angelo, Mary, and daughter Celia each established Roth IRA plans, into which each

contributed $2,000. (ER169:10, 20). Their contributions complied with Section 408A's income limits. (ER169:10).

Each Petitioner directed his/her IRA to buy 33-1/3 shares in FSC IV, one of WGA's Shared FSCs, at $5 per share (ER169:11), a total investment of $500 for 100 shares (ER169:11).[10] FSC IV properly qualified as a shared FSC with the I.R.S. (ER138:14-15). At the time of stock purchase, the parties agreed that if the FSC stock were sold, the sale price for all 500 shares would be $1. (ER169:45). Far from being an unrealistic stock price, this valuation recognized that the stock was entirely dependent on the creative input and management of Angelo Mazzei. (ER155:50/11-14).

Injector Co. contracted with FSC IV to pay commissions for export-related activities. (ER169:12). In accordance with Treas. Reg. § 1.925(a)-1T(d)(2), the FSC was not required to perform export-related activities (ER169:32), and payments to FSC IV were optional: other than certain mandatory payments for management and operational fees, Injector Co. was not required to pay anything to the FSC. (ER169:14; for the reasons why, *see* Dissent, *at* ER169:81).

Each quarter, Injector Co. reported its foreign sales to FSC IV. (ER169:15). Through its management company, the FSC then submitted to Injector Co. the

[10] BNA Portfolio Export Tax Incentives 934 2d, 68-69, "Shared FSCs", provides: "Participating exporters paid only for actual start-up costs (on the order of $500 per participant) and annual maintenance costs." This is what Mazzeis paid.

maximum commission allowable under Code section 925(b) and associated temporary Treasury Regulations, and invited payment. (ER169:15). FSC IV properly filed tax returns and paid taxes. (ER138:16-67). Over the course of four years, from 1998 to 2001, Injector Co. paid to the FSC a total of $558,555 (ER169:16)—in contrast to over $6.477 million received in *Benenson*. After reporting and paying taxes, the FSC paid $533,057 dividends to the Mazzeis' Roth IRAs (ER169:16).[11]

Employing a broad substance-over-form attack on the transaction, the Commissioner determined the Mazzeis had constructively received the dividends paid to their Roth IRAs and then "over contributed" them to their Roth IRAs, resulting in excise tax deficiencies and penalties (ER169:5-6). Despite its stated intent to decide *Mazzei* on a "narrower factual basis", the Tax Court utilized substance-over-form to find that stock, held *in form* by their Roth IRAs, was held, *in substance,* by the Mazzeis. (ER169:73).

B. Procedural History

On April 6, 2009, the Commissioner served Statutory Notices of Deficiency for tax years 2002 through 2007, asserting excise tax deficiencies against Angelo and Mary Mazzei of $67,590, section 6651(a)(1) penalties of $15,204, and section 6651(a)(2) penalties of $4,011. (ER1:30-31). Against Celia Mazzei, Respondent

[11] Petitioners do not concede the Tax Court's conclusion that these dividends were "excess contributions."

asserted excise tax deficiencies for tax years 2002 through 2007 of $40,692, section 6651(a)(1) penalties of $9,153, and section 6651(a)(2) penalties of $2,759. (ER1:2).

All three petitioned the Tax Court on July 13, 2009: Celia Mazzei in Docket No. 16702-09; Angelo and Mary Mazzei in Docket No. 16779-09. (ER1:1, 30). The cases were consolidated. (ERDKT:11). On December 14, 2012, all Petitioners moved for partial summary judgment, which was denied on April 1, 2014. (ERDKT:13-15).

The consolidated matters were tried on November 20, 2014 before the Hon. Mark Holmes. (ERDKT:16). On March 8, 2017, the Tax Court ordered Petitioners and Respondent to provide supplemental briefs on the impact of *Summa Holdings*, which reversed the Tax Court on issues similar to those in the Mazzei consolidated cases. (ERDKT:17). The Parties filed Briefs on March 29 and 30, 2017. (ERDKT:17). On March 5, 2018, the cases were ordered submitted to Judge Michael Thornton, who on the same date entered an Opinion denying Petitioners relief on the excise tax issue and granting them relief from penalties. (ERDKT:17). Eleven judges agreed with the decision, with five judges concurring. Trial Judge Mark V. Holmes dissented, with three judges joining different portions of the dissent.

On August 22, 2018, Petitioner's timely filed their Notice of Appeal. (ER180:2).

C. Rulings Presented For Review

Petitioners request review of the rulings that:

1. Petitioners, and not their Roth IRAs, were the owners, for Federal tax purposes, of the FSC stock;
2. FSC dividends were "in substance" income to Petitioners;
3. Petitioners "contributed" the dividend funds to their Roth IRAs; and
4. Petitioners are liable for excise taxes on "excess contributions to their Roth IRAs." (All on ER169:2).

VI.
SUMMARY OF ARGUMENT

FSCs and DISCs are treated the same for excise tax purposes. (ER169:87*)*. Using a Congressionally-sanctioned small shared FSC (ER155:62/24-25; 63/1) , Petitioners did what the First, Second, and Sixth Circuits allowed in *Summa* and the *Benenson* decisions, where a DISC was involved and where the Tax Court's imposition of excise taxes was reversed.

The decision herein reaches the same result reversed in *Summa* and the *Benenson* decisions, but by a more circuitous judicial process: instead of

shamming the entire transaction, the Tax Court erroneously held that the Mazzeis' Roth IRAs were not the real holders of the FSC stock they purchased, and reassigned the stock to Mazzeis—thus imposing excise taxes, as in *Summa* and *Benenson.*

The Tax Court accomplishes this result by the following errors:

1. Employing general substance-over-form stock valuation principles to issuance of stock in a shared FSC that was created by Congress to have no substance whatever. (I.R.C. Section 922; Treas. Reg. Section 1.922-11),
2. Improperly applying risk-benefit analyses to issuance of stock by a Congressionally-created FSC that was intended to generate tax savings between related parties.
3. Reversing Reformation principles recognized in the Ninth Circuit.
4. Improperly ignoring the legislative purpose of FSCs and Roth IRAs.

VII.
DISCUSSION

A. Standard of Review

Tax Court findings of fact are reviewed for clear error, while its application of law is reviewed *do novo.* *Newman v. Commissioner*, 909 F.2d 159, 162 (2d

Cir.1990). Application of substance over form to a transaction is a legal conclusion and not a question of fact. "The general characterization of a transaction for tax purposes is a question of law subject to review." *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995); *Frank Lyon Co. v. U.S.*, 435 U.S. 561, 581 fn. 16 (1978). "We review the lower court's characterization of a transaction *de novo…" Bank of N.Y.Mellon v. Commissioner,* 801 F.3d 104, 112 (2d Cir. 2015).

B. The Mazzei Transaction Worked Under the Code

The Mazzeis engaged in the following transactions:

1. Their company, Injector Co., enrolled in WGA's Shared FSC program. (ER169:10, 34 fn. 28).
2. Each Petitioner formed a Roth IRA in accordance with the WGA program. (ER169:10).
3. Their Roth IRAs purchased the shared FSC stock. (ER169:10-11)[12].
4. The FSC received annual commissions from Injector Co. (ER169:15-16).
5. The FSC paid income taxes as required. (ER169:16, 35-36).

[12] The Tax Court agrees that a Roth IRA may own FSC stock: "respondent has not disputed that Roth IRAs may sometimes own FSC stock, and nothing in our holding today suggests otherwise." (ER 55)

6. The FSC paid annual dividends to Petitioners' Roth IRAs. (ER169:16).

Each of the above followed the Code, and no facial attack under either the FSC or Roth IRA statutes was possible—or even attempted. (ER169:10-17, 87; ER139:1-3). That is an important point, since both transactions utilized Congressionally-mandated favorable tax treatment: *first*, for foreign sales income earned by exports, and *second*, the accumulation of tax free money in Roth IRAs. Nor was the Commissioner able to use any of the modern common law doctrines (e.g., economic substance, step transaction, and the like) to rid himself of these symbiotic tax benefits.

This reality left the Tax Court with only one way of denying the Mazzeis the their Congressionally-intended benefits: the use of an ancient common law principle from which the modern common law doctrines were derived. The continued viability of the substance over form principal[13] notwithstanding, the Tax Court used it (while claiming they didn't) to frustrate the Congressional intent behind both FSCs and Roth IRAs.

[13] Substance over form, a judicially created interpretive tool, is more amorphous than the doctrines that grew out of it, such as business purpose. (Linda Jellum, "Codifying and 'Miscodifying' Judicial Anti-Abuse Tax Doctrines", 33 Va. L. Rev. 579, 596 (2014)).

Did the Tax Court finally get it right, after being thrice reversed by three different Circuits on the same issue? The Mazzeis respectfully submit that it did not.

C. Comity Suggests Following The *Summa* And *Benenson* Decisions

Where an issue is before a Circuit Court of Appeals, deference is to be given to a prior decision of a sister court ruling on the same issue, to promote uniformity.

> Comity is not a rule of law, but one of practice, convenience, and expediency … it has a substantial value in securing uniformity of decision, and discouraging repeated litigation of the same question. *Mast, Foos & Co. v. Stover,* 177 U.S. 485, 488 (1900).

This rule is especially important in Federal tax cases.

> Uniformity of decisions among the circuits is vitally important on issues concerning the administration of tax laws. Thus the tax decisions of other circuits should be followed unless they are demonstrably erroneous … *Popov v. Commissioner,* 246 F.3d 1190, 1195 (9th Cir., 2001).

While *Summa* and *Benenson* involved DISCs, FSCs and DISCs are identical for excise Tax purposes. (ER169:87 & ER166:1,4,14(fn)). The issues have factual "similarities." *Benenson 1,* 887 F. 3d at 522, fn. 10.

> Bearing in mind the interest in … sparing the Supreme Court the burden of taking cases merely to resolve conflicts between the circuits, we give respectful

> consideration to the decisions of other courts of appeals and follow them whenever we can. *Colby v. J.C. Penney,* 811 F.2d 1119, 1123 (7th Cir. 1987)

As set forth below, there is no reason for this Circuit to split with its sister Circuits.

D. Recharacterization Of FSC Stock Ownership Was Improper

> "The sole issue we decide today is who *in substance* owned this FSC—petitioners or their Roth IRAs." (ER169:74).

Since the Mazzeis complied with the relevant statutes, the next question is whether they violated Congressional intent, such that the form of their actual transaction should be ignored in favor of its perceived "substance." They did not.

The Congressional objective for DISCs and FSCs was promotion of foreign sales of U.S. goods. Sections 924(a), 921-927, 245(c); *Jet Research, Inc. v. Commissioner*, 1990 Tax Ct. Memo LEXIS 508, at *30. As such, neither FSCs nor DISCs needed a business purpose: their only purpose was tax reduction—or, to use the language of the Sixth Circuit, "tax avoidance." *Summa,* 848 F.3d at 786; ER169:87. Requirements for a small shared FSC were even less; they were created by Congress to have virtually no substance whatever, and were merely book entries in which 25 accounts shared a single FSC. Section 922; Treas. Reg. Section 1.922-1.

To effectively promote foreign sales, tax reduction had to be available to the exporter (*Summa,* 848 F.3d at 782), and the Regulations recognized ownership of FSC stock by related parties. Treas. Reg. Section 1.922-1(f); *see also* ER169:29. Thus, an FSC transaction was anything but "arms-length." Indeed, when Respondent's expert witness opined that the stock purchase price was "not consistent with arms-length levels," Judge Holmes ordered that reference stricken. (ER157:221/5-16).

Under case law as foundational as *Helvering v. Horst,* 311 U.S. 112 (1940), investment income is attributable to the owner of the investment. As owners of the FSC stock, Petitioners' Roth IRAs were the proper recipients of dividend income derived therefrom. In an effort to avoid this obvious conclusion, the Tax Court determined that the stock purchase price "did not reflect the substance of the related-party transaction." (ER169:76).

The Tax Court's recourse to this rationale is understandable—if unavailing. It was hardly their first choice: on facts identical for purposes of the outcome, the Tax Court has already been reversed by the First, Second and Sixth Circuits, where the taxpayers' Roth IRAs purchased stock of a DISC, from which they received dividend payments. (*Summa, Benenson 1,* and *Benenson 2).*[14] As with the

[14] The Tax Court seeks to limit application of *Summa* because it involved a DISC rather than a FSC, "a related but different issue" (ER169:51), and because the Roth IRA payment issue in *Benenson* had not yet been decided. But the

Mazzeis, these investment earnings could allow Roth IRA accounts to grow more rapidly than was possible from their holders' limited annual contributions. Section 408A(c); *Paschall v. Commissioner,* 137 T.C. 8 (2011).

In *Summa*, the Sixth Circuit reversed the Tax Court for using substance over form to "undo transactions that the terms of the code expressly authorize." (*Summa,* 848 F.3d at 782). The Benensons used "a congressionally innovated corporation – a 'domestic international sales corporation' (DISC) … to transfer money from their family-owned company to their sons' Roth Individual Retirement Accounts." *Id.* at 781. Combining the tax advantages of a DISC with those of Roth IRAs provided tax benefits described in the Sixth Circuit's colorful language:

> At this point, one can begin to see why the owner of a Roth IRA might add shares of a DISC to his account. The owner of a closely held export company could transfer money from the export company to the DISC, as the statute encourages, and pay some (or all) of that money as a dividend to its shareholders, allowing the money to enter the Roth IRA and grow there. (*Id.* , at 783).

The Sixth Circuit held that neither the Commissioner nor the Tax Court were entitled to re-write something Congress had intentionally created:

Benenson appeals in both the First and Second Circuits have now also reversed the Tax Court, and the Commissioner conceded at trial that there were no differences between DISCs and FSCs for purposes of the outcome of this case. (ER169:87; ER166:1,4,14(fn))

> Congress created the DISC … for the purpose of lowering taxes. And Congress created Roth IRAs … for the purpose of lowering taxes. That these laws allow taxpayers to sidestep the Roth IRA contribution limits may be an unintended consequence … but it is a text-driven consequence no less. (*Id.*, at 790).

The taxpayers in *Summa* followed the Code (*Id.* at 784, 790), as did the Mazzeis,[15] but the Tax Court "applied the substance over form doctrine, to recharacterize the transactions as dividends from Summa Holdings to the Benensons, followed by excess Roth IRA contributions." (*Id.* at 782). That ultimate result is also what happened to the Petitioners herein – but by a different route of judicial reasoning.

The *Mazzei* case had been tried and was under consideration by the Tax Court when *Summa* was decided, and that Court ordered additional briefing on the issue (ER169:87), which Respondent and Petitioner provided. Notably, the Commissioner expressly did not argue or ask the Tax Court to decide the issue on the basis it ultimately used; far from it, the Commissioner conceded that FSCs were identical to DISCs for purposes of applying *Summa Holdings* and instead urged the Tax Court to revisit the Commissioner's loss in the Sixth Circuit by holding that substance over form did invalidate the transaction—in the hope this Court would split with its sister circuit. A year later, on March 5, 2018, the Tax

[15] ER169:93.

Court gave the Commissioner that result, albeit by means of a slightly different analysis. *Mazzei v. Commissioner* 150 T.C. No. 7 (2018).

In so doing, the *Mazzei* Court seeks to distinguish *Summa* because the *Summa* taxpayers used DISCs, while Mazzei's used a FSC. (ER169:53). But that is a distinction the Commissioner expressly rejected, conceding they are identical for purposes of this case—and the distinctions the Tax Court tries to draw are highly technical, trending towards invisible: DISCs paid unrelated business income tax on their payments to a Roth IRA, while FSCs paid a corporate-level tax.[16] In any event, the Tax Court dismissed the differences as unimportant to its ultimate analysis, which clearly was intended to avoid a repeat of *Summa:*

> [W]e are not concerned with the ownership of FSCs in general; our concern is whether, on the particular facts and circumstances of these cases, petitioners' Roth IRAs owned the FSC *in substance*. (ER169:54-55, emph. suppl.)

Having been reversed by the Sixth Circuit for employing substance over form on facts legally identical to those herein, the Tax Court attempted to avoid using substance over form—by invoking substance over form, under the guise of "a narrower factual basis: "We conclude on the basis of facts in the record that

[16] All of which is explained, in esoteric terms, in Treas. Reg. Section 1.921-2(c), Q & A.

petitioners, and not their Roth IRAs, were the substantive owners of the FSC stock at all times." (ER169:22-23).

Whatever the Tax Court's "factual basis" may have been, its legal vehicle was the same broad application of substance over form that was resoundingly rejected by the First, Second, and Sixth Circuits. Despite its announced intention of narrowing the analysis, the Tax Court did exactly what the Commissioner asked, and dismantled Petitioners' transactions as thoroughly as it had failed to do in *Summa*—by acknowledging Petitioners' FSC and Roth IRA entities, then determining that FSC stock owned *in form* by Petitioners' Roth IRAs was held, *in substance,* by Petitioners.

> [W]e do not disregard, sham, ignore, or otherwise challenge the reality of the FSC or the Roth IRAs as such under the Code. Instead, we examine the purchase, by the Roth IRAs, of the FSC stock. (ER169:59)

So…the Tax Court is not using substance over form to sham the entities, because the Sixth Circuit said that frustrated Congressional intent. It is, instead, using substance over form to sham the purchase of the FSC stock by the Mazzeis' Roth IRAs—so it can frustrate Congressional intent. Is that distinction even possible? The Congressional goal was to promote foreign sales of U.S. goods through tax advantages. Sections 921-927. To accomplish this, FSC stock needed to be owned by those personally interested in the tax benefits an FSC provided,

resulting in related party transactions. Treas. Reg. Section 1.922-1(f) recognized this, allowing FSC ownership by such family-related entities as an estate and the beneficiaries of a trust.

Ownership of an FSC by the supplier whose goods it promoted was explicitly allowed.[17] In *Ford Motor Co. v. United States,* 132 Fed. Cl. 104 (2017), Ford was the acknowledged owner of a large FSC that it formed. When Ford argued, on motion for summary judgment, that Ford and its FSC were substantially the same company (and hence entitled to interest netting), the Commissioner argued that the FSC was a viable separate entity, Ford's ownership notwithstanding, and the Court of Claims agreed. (*Id.* at 112).

Similarly, FSC stock herein was owned by related parties—just as the Code and Regulations allowed. To sham its stock ownership is, in essence, to sham the entity—and substance over form may not even apply to DISCs or FSCs:

> Congress has itself elevated form over substance … by allowing exporters 'commission' deductions for payments that lack the economic substance generally associated with commissions, *i.e.,* some service rendered by the payees. (*Benenson 2*, 910 F.3d at 695)

Given the Code-created relationship between an FSC and its related stockholder(s), and given that the Commissioner conceded in the Tax Court that

[17] *Benenson 2,* 887 F.3d at 694.

FSCs are identical to DISCs, the Mazzeis submit it is similarly inappropriate to use substance over form to reassign FSC stock ownership.

Roth IRAs were similarly provided tax incentives to promote a policy goal:[18] they could earn investment income. "Congress has made clear that corporations and other entities, including IRAs, may own shares in DISCs. 26 U.S.C. §§ 246(d), 995(g)." (*Summa,* 848 F.3d at 782). "[I]f only through a maze of cross-references, section 995(g) does allow both traditional and Roth IRAs to own DISCs, see secs. 401(a), 408(a), 408A(a), 501(a), 511, and Congress hasn't decided to change it." (ER169:83). Since FSCs are treated the same as DISCs for these purposes (ER169:87), the *Summa* Court's reasoning applies to FSCs as well.

A Roth IRA that owned FSC stock could receive investment income greater than the IRA holder's limited annual contribution. Congress can hardly have been unaware of this potential interaction. Roth IRAs were part of the Taxpayer Relief Act of 1997, by which time FSCs had been around for 13 years—since the Deficit Reduction Act of 1984. DISCs had been around for 26 (Revenue Act of 1971, Pub. L. No. 92-178). "We assume Congress is aware of existing law when it passes legislation." *Miles v. Apex Marine Corp.,* 498 U.S. 19, 32 (1990). As the Dissent points out, "Congress hasn't decided to change it." (ER170:83, fn. 6).

[18] "[T]he committee believes some individuals would be more likely to save if funds set aside in a tax-favored account could be withdrawn without tax after a reasonable holding period…" H.R. Rep. 105-148, at 337.

Against this, the Tax Court argues that "There was no discernable legislative purpose to allow taxpayers to use FSCs to defeat the contribution limits for Roth IRAs, as petitioners seek to do." (ER170:57). How so?

> (1) " The Code does not explicitly or implicitly authorize Roth IRAs' purchase on these facts." (ER60).[19]

Perhaps not, but *neither does it prohibit such a purchase*. As pointed out above, a Congressional prohibition after all these years was inevitable—*if* that's what Congress intended. Yet nowhere do the Code or Regulations prohibit Roth IRA purchase of FSC stock on "these" or any other facts. That is telling. "[D]espite its active history of legislating in these areas, Congress has not placed any further limits on transactions like the Benensons'." (*Benenson,* 887 F.3d at 521). Nor did Congress prohibit what the Mazzeis did.

While the Tax Court found no "textual evidence" that a "discrepancy between substance and form … should be ignored" (ER169:60), it is easy in discussing tax policy for even experts to get lost in the weeds. Petitioners respectfully submit that in its desire to achieve what it believed to be the preferred tax result, the Tax Court missed something seen by the First, Second and Sixth Circuits: the whole purpose of an FSC was tax incentives, to promote foreign sales

[19] The Tax Court conceded Roth IRAs could own FSC stock. (ER169:55)

of U.S. goods—which worked best if the result was to maximize benefits from exports (*Benenson 2 ,* 910 F.3d at 694).

Congress saw this as well, by not prohibiting a tax synergy it is assumed to have understood when Roth IRA legislation was passed after creation of both DISCs and FSCs. So did the Treasury Secretary, in issuing Regulations that neither prohibited such a foreseeable transaction nor "explicitly or implicitly" constrained a Roth IRA's purchase of FSC stock, almost certainly to be held by related parties. (Treas. Regs. Section 1.922-1(f)). Even the Tax Court recognized that under Section 925 the exporter and the FSC would be related parties. (ER170:41).[20]

In sum, the Tax Court arbitrarily divides Petitioners' transaction into three segments: sale of stock, contracts with Injector Co., and dividends to its shareholders. Parts 1 and 3 of that supposedly had no application in the "statutes or associated regulations." (ER170:36). Thus, the Tax Court reasons, there is no violation of Congressional intent in its Decision. But to accept that premise, one must take seriously the notion that the FSC's commission payments from Injector Co. (acceptable to the Tax Court) were unrelated to its sales agreements with Injector Co. (unacceptable). Or that payments of dividends, by a Code-created

[20] Section 925(a), referring to Section 482.

corporation to its foreseeably related stockholder, were somehow irrelevant to the Code (and hence also unacceptable).

The Tax Court's reasoning is dependent on "substance doctrines." (ER169:37) But this requires one to assume that Congressional purpose does not reach to such basics as stock issuance in the very structure Congress authorized. In its zeal to correct what it believes to be an unacceptable tax result, the Tax Court has strayed deep into territory the *Summa* and *Benenson* courts avoided.

> Whether there is legislative history that shows anyone intended FSCs and Roth IRAs to work so well together for taxpayers like the Mazzeis shouldn't matter. Substance-over-form principles don't give courts free rein to choose results that fit their view of good tax policy. (ER169:103).

Exactly.

E. Congressional Inaction Militates Against Disturbing Symbiotic Use of Roth IRAs and FSCs

Nor is it likely the symbiotic benefits were unintended. While Congress was creating vehicles to benefit exporters, it also created vehicles by which taxpayers could better assure a reasonable income in their retirement years. Individual Retirement Accounts were created by Congress in 1974 as part of the Employee Retirement Income Security Act. As part of the Taxpayer Relief Act of 1997, Congress created the Roth IRA.

Both DISCs and IRAs have existed side by side from 1974 to the present. Roth IRAs, FSCs, and DISCs existed simultaneously from 1997 onward. Throughout this period, the Commissioner bitterly disputed an IRA's ownership of stock in DISCs/FSCs. In *Swanson v. Commissioner*, 106 T.C. 76 (1996), the Tax Court held that an IRA's purchase of original issue stock in an FSC was appropriate.

Far from taking this into account and limiting IRA/Roth IRA ownership of FSCs/DISCs/ETIs/IC DISCs, Congress did nothing a year later when it enacted section 408A. Nor was *Swanson* the last effort by the Commissioner to unhorse an IRA or Roth IRA from an FSC investment. The issue arose again in *Ohsman v. Commissioner*, T.C. Memo. 2011-98, where the Tax Court (again) held that Roth IRA ownership of a DISC is not Congressionally forbidden. *Id*. at * 5-6; *Hellweg v. Commissioner*, T.C. Memo. 2011-58, at *30.

After decades of the Commissioner's tireless efforts to attack the tax benefits inherent in IRA/Roth IRA ownership of the various export-subsidy regimes enacted by Congress, and with full knowledge of the competing public policy imperatives, Congress has still done *nothing* to prohibit an IRA or Roth IRA from owning a FSC, DISC, or IC-DISC. A simple amendment to Section 408 could have accomplished that goal—if Congress desired to do so. Instead, a Roth IRA is

still not prohibited by either statutory or regulatory law from investing in a tax-advantaged foreign sales entity.

As such, this Court must presume that Congress intentionally failed to act. (*See, e.g., Caminetti v. U.S.*, 252 U.S. 470, 487-488 (1917) (prior case interpreting phrase "must be presumed to have been known to Congress when it enacted the law here involved.")

F. The Tax Court's Analysis is Deeply Flawed

Instead of yielding to these realities and the weight of appellate authority, the Tax Court instead attacked a tax result it found objectionable by acknowledging the existence of an FSC, but then rejecting the way Roth IRAs purchased its stock. That makes about as much sense as acknowledging the existence of a child and then—because one disagrees with her motives—concluding that the mother is "in substance" a different person altogether. In service of this bizarre conclusion, the Tax Court employs risk/benefit and valuation analyses, unsupported by any authority remotely relevant to the FSC's unique Congressional construct or by any cogent valuation theory.

1. *The Tax Court Improperly Employed Risk/Benefit and Valuation Tests To Reassign FSC Ownership*

In finding against the Mazzeis, the Tax Court faced formidable challenges.

1. The Tax Court's recharacterizations of the *Summa* and *Benenson* transactions were reversed because "No court has used this power to override statutory provisions whose only function is enable tax savings…" (*Summa,* 848 F.3d at 789). *But in reassigning FSC stock to Petitioners herein, the Tax Court has effectively done that.*

2. "The Code authorizes companies to create DISCs as shell corporations … that have no substance at all." (*Summa,* 848 F.3d 786). Shared FSCs had even less substance. (Code Section 922; Treas. Reg. Section 1.922-1). *How is substance analysis proper in determining stock ownership in a shell that Congress mandates has no substance?*

3. "The point of these entities *is* tax avoidance. The Commissioner cannot place ad hoc limits on them by invoking a statutory purpose … that has little relevance to the text-driven function of these portions of the Code." (*Summa,* 848 F.3d at 789). *How can the Tax Court fault the Mazzeis for employing a tax avoidance vehicle created by Congress?*

4. Likewise, the purpose of Roth IRAs is "lowering taxes." (*Id.* at 789; Section 408A). *How is it improper to use a Roth IRA with a FSC—when that entity was created by Congress in 1984, and its predecessor*

DISC dates back to the early 1970s? If Congress thought the two should not be used together it has had ample opportunity to say so in the multiple amendments to the Roth IRA statutes since then.

5. The tax synergy between Roth IRAs and DISCs "may be an unintended consequence of Congress's legislative actions, but it is a text-driven consequence no less." (*Id.* at 790). As pointed out in Section VII.E, above, this results were far more likely intended by Congress.

G. The Tax Court's Conclusions Cannot Withstand Legislative History

Facing repeated reversal, the Tax Court reached a fork in the judicial road: "it is evident that the payments from the FSC were dividends to someone – either to petitioners or to their Roth IRAs." (ER169:38). Take one fork, and Roth IRAs would provide tax relief; take the other, and the tax burden would fall on the Mazzeis.

The Tax Court took the second, via two steps: *First*, conclude the FSC was an income-producing asset. (ER169:40). *Second*, determine the "real" owners of the FSC's income were the Mazzeis. (ER169:40, 50).

Petitioners respectfully submit that both steps were wrong.

1. The FSC Was Not An "Income-Producing" Entity

In determining that the FSC produced income, the Tax Court utilized *Commissioner v. Banks,* a 2005 Supreme Court case having nothing to do with statutorily-created FSCs. *Banks* involved civil rights litigants who recovered judgment and paid, but did not report as income, their attorney fees. The Supreme Court held that Mr. Banks had retained dominion and control over the funds, resulting in attribution of income to him. *Commissioner v. Banks*, 543 U.S. 426, 434 (2005).

Citing *Banks,* the Tax Court determined that "In petitioners' cases, the 'income-generating asset' was the FSC" (ER169:40). How so? The FSC had zero right to any income unless and until such income was allocated to it by Injector Co. Without that income, the allocation of which was entirely discretionary with the Mazzeis, the FSC was totally worthless.

And as a matter of law, the FSC, as created by Congress, was a tax saving vehicle that served as an intended conduit for funds earned by another entity and statutorily deemed to be of non-U.S. origin:

> Exempt foreign trade income of a FSC shall be treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States. (Section 921(a)).

This is why "A DISC … does not generate the income which it enters on its books." *Addison v. Commissioner,* 90 T.C. 1207, 1221 (1988). Similarly, FSC receipts from the "sale, exchange, or other disposition of export property" were considered "foreign trading gross receipts." Section 924(a)(1). Section 925's complex transfer pricing rules allowed part of the income from an export transaction to be assigned to an FSC. Section 925(a)(1) & (2). But did that assignment make a Small FSC an income *producing* entity?[21]

The Small FSC herein (ER169:34, fn. 28), was subject to reduced requirements. Receipts in excess of $5,000,000 would "not be taken into account in determining the exempt foreign trade income." Section 924(b)(2)(B). It was exempt from the requirements of Sections 924(d) and 924(e). In connection with transfer pricing rules, "None of the activities need be performed outside the United States by a small FSC." Treas. Reg. § 1.925(a)-1T(b)(2)(ii). Thus, small shared FSCs had even less business purpose than regular FSCs (Section 922, Treas. Reg. Section 1.922-1), which were "barely-there entities through which businesses

[21] Yes, this is tax minutiae, and yes, Mazzeis are aware that "Corporate tax planning involves abstruse transactions that generalist appellate courts are ill-equipped to untangle." *Hewlett-Packard v. Commissioner,* 875 F.3d 494, 497 (9th Cir. 2017). But before this Court disagrees with three other Circuits, such intricacies are important: simply put, when Congress says the entity earns no income, courts are bound to accept that as true. The Tax Court's failure to do so is reversible error *per se.*

could funnel 'foreign trading gross receipts' to largely escape corporate-level tax." (ER169:81).[22]

As the majority admits, Congress had created an entity entitled to receive:

> a 'commission' for services (relating to an export transaction) that were not, in substance, performed by the FSC … the FSC and its related supplier were allowed to set and pay a commission for services that might not actually have been rendered… (ER169:32).

So was the Small FSC herein really an income-producing asset? Significant parts of its "income" (if any) were excluded under the Tax Code as foreign source income "not effectively connected with the conduct of a trade or business in the United States." Section 921(a). Nor was it required to perform any services justifying payment of income. Sections 921-927. Under *Block, Polowniak* and *Repetto* (which the Tax Court cites in support of its position, discussed *infra*), it would have been disregarded as a sham. *But it wasn't a sham, and only because Congress said so.*

An FSC was never judged by the same criteria applied to a typical business, since its sole business function was tax reduction (Sections 245(c), 925; Treas. Reg. Section 1.925(a)-1T(a)(3)). It needed no basis in economic reality, and

[22] Judge Holmes' thoughts are worth sober reflection: he previously worked at the International Trade Commission and was personally familiar with the history of FSCs. (ER156:167/3-25 & 168/1-5).

existed solely to promote foreign trade, using tax benefits as the incentive. "Congress created the DISC program specifically to provide a tax incentive … to 'increase our exports and improve an unfavorable balance of payments.'" (*LeCroy Research v. Commissioner*, 751 F.2d 123, 124 (2d Cir., 1984); *Benenson 2,* 910 F.3d at 694-5). Yet the Tax Court addresses FSC stock issuance as if substance analyses were somehow appropriate.

Against the Dissent's argument that a FSC was never an income-generating asset and that Injector Co. was the only entity generating income through the foreign sale of its products (ER169:90), the Majority argues that the *dividends* remitted by the FSC were "income." (ER169:40, fn. 34). But that argument defies the whole point of a FSC: its "congressionally sanctioned" flow of funds existed solely to reduce Injector Co.'s "effective tax rate on exports." (ER169:90).

As such, the money coming into the FSC fails under *Banks*: income cannot be attributed where there is, legally, no income.

2. The Tax Court's Stock Ownership Analyses Were Flawed

> [T]he Commissioner had no basis for recharacterizing the transactions and no basis for recharacterizing the law's application to them. We reverse. (*Benenson 2,* 920 F.3d at 783, emph. in orig.).

If one gets by Step One, *Banks* and *Benenson* impose a second obstacle: ownership of FSC stock must somehow be re-assigned from the Roth IRAs to Petitioners. The Tax Court does this by determining that in purchasing the FSC stock: (a) The Roth IRAs undertook no risk (ER169:43); (b) The Roth IRAs could expect no benefits (ER169:47); and (c) The stock purchase price was too cheap (ER169:49). All three fail under the very precedent the Tax Court cites.

a. "Risk" Was Improperly Used To Recharacterize Stock Ownership

In *Benenson 1*, the First Circuit rejected the argument that the Roth IRAs assumed insufficient risk.

> [T]o the extent that risk was required, it came from reliance on the DISC. The benefit of James III and Clement's Roth IRAs is necessarily tied, at least initially, to the success and profitability of Summa Holdings' export companies … Without DISC commissions, the Benensons' Roth IRAs would received no dividends. (887 F.3d at 522).

So followed the Second Circuit in rejecting the risk argument:

> Although the Commissioner argued the IRAs had assumed no investment risk … the degree to which the Roth IRAs would benefit from owning JC Holding depended on the success of Summa's export subsidiaries. (*Benenson 2*, 910 F.3d at 700).

As in *Benenson*, the Mazzei's FSC was entirely dependent on Angelo Mazzei's management. (ER155:50/11-24; ER156:131/13-23). Nevertheless, the

Tax Court pursues the risk/benefit approach by citing a line of sales/leaseback cases in which the issue was whether the risks and benefits of a transaction justified a tax *deduction*, such as depreciation or interest costs. Each cited case also hinged on whether tax benefits were the only benefits present.

But those cases don't fit: here, deductions are not an issue, and for FSCs, tax benefits were the Congressional goal. (*Lyon v. United States*, 435 U.S. 561, 572 (1978) (the Court's "real and substantial risk" holding was limited to the facts: whether the risks and benefits of a transaction justified a tax *deduction* such as depreciation—not the issue here); *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995) (reversing the Tax Court because Sacks assumed the risk of a rise or fall in energy prices in connection with his water heaters, thus legitimating his transaction); *Casebeer v. Commissioner*, 909 F.2d 1360 (9th Cir. 1990) (taxpayers dabbling in computer sales and leasebacks were denied depreciation and interest *deductions* because the transaction lacked economic substance)).

Notably, in *Sacks,* the Tax Court had previously held against the taxpayer, saying his only motive was tax reduction. This Court disagreed:

> **The tax credits were intended to generate investments in alternate energy technologies that would not otherwise be made** because of their low profitability. (*Id.* at 992, emph. suppl.)

In other words, there (as here) Congress had intentionally created tax benefits to promote a public policy. In *Sacks*, it was alternate energy; in *Mazzei,* it was marketing of green technology in foreign commerce (ER156:181/23-25). Relying on this inapt sale-leaseback authority, the Tax Court concluded the Mazzeis' Roth IRAs could not have legitimately owned the FSC stock because they "were exposed to no risk" (ER169:43) and, for variation, "were never exposed to appreciable economic risk." (ER169:45, f/n 36)

But how is risk relevant to purchase of stock where: (1) the Code and Regulations require no business purpose (Sections 921-927), (2) under the Code, the only foreseeable risk is that the related parent company may fail, and (3) where shares will foreseeably be held by family members or family trusts? (Treas. Reg. Sec. 1.922).

While instructive in a normal tax-loss case, risk/benefit arguments ring tinny where, "to the extent that risk was required, it came from reliance" on a Congressionally-sanctioned U.S. exporter (*Benenson 1,* 887 F.3d at 522).

b. Benefit Analyses Were Improperly Used To Recharacterize Stock Ownership

The Tax Court reasons that "no independent holder of the FSC stock could realistically have expected to receive any benefit." (ER169:49). With respect, this

is a creative attempt to shoehorn "traditional sham analysis" into a situation where it does not fit. As structured by Congress, FSC shares were certain to never have an "independent holder" because—as the Tax Court admits—there was no benefit from FSC stock absent its relation with the related exporter.

The purpose of Sections 921-927, stimulation of foreign trade by tax avoidance, was useful only if realized by the U.S. seller with an incentive to participate in a FSC. As such, Congress created a structure in which the holder(s) of FSC stock would *not* be an "independent holder." *Ford v. U.S.,* 132 Fed. Cl. at 112. Similarly, the Regulations expressly allowed family (or family entity) ownership of FSC stock. Treas. Reg. Section 1.922-1(f). Ownership of FSC stock by an "independent holder" was never contemplated; the Mazzeis did only what Congress expected.

The Tax Court determined the Mazzeis' tax benefits were disproportional to their investment (ER49), and suggested that the Ninth Circuit's "two pronged analysis" should determine whether their transactions "had any *practical* effects other than the creation of tax losses." (ER169:25; *Reddam v. Commissioner* 755 F.3d 1051, 1060 (9th Cir. 2014), emph. in orig.). There, John Paul Reddam bought into a KPMG program ("OPIS") engineered "to avoid U.S. regulatory rules that limit the amount of financing permissible in securities transactions." *Id.* at 1053. His plan was so "byzantine" the Ninth Circuit wisely offered a "Simplified

Overview of Reddam's OPIS Transaction." *Id.* at 1054, 1055. The end result was a claimed loss of $50,200,000, "tax benefits not contemplated by a reasonable application of the language and purpose of the Code…" *Id.* at 1057.

But a KPMG program "to avoid U.S. regulatory rules" is hardly relevant where the taxpayers admittedly followed the Code and reached a "text driven consequence." (ER169:87; *Summa,* 848 F.3d at 790).

Here, the "practical effects" of FSCs *were* tax losses for the Government, explicitly designed to subsidize foreign trade. Section 924(a). For that reason, sham analysis, appropriately employed in *Reddam,* was rejected in *Summa,* where taxpayers employed Congressionally-created "shell corporations … that have no substance at all." (884 F.3d at 786).

Similarly, Roth IRAs employed tax incentives for the social purpose of incentivizing retirement savings. (H.R. Rep. 105-148, at 337). Traditional substance over form and sham transaction analyses do not fit the unique structure of a Roth IRA buying stock in a FSC—even though the entity was related, as the Regulations allowed. (ER169:55). The commissions received by an FSC, and therefore the dividends it paid its stockholders, did not arise from any classic "economic reality". Sections 245(c), 925; Temp. Treas. Reg. Section 1.925(a)-1T(a)(3). Combine an export subsidizing entity with an IRA, and tax benefits result. If this was objectionable, especially after 45 years of peaceful coexistence

in the Code, Congress alone can provide the remedy – "and Congress hasn't decided to change it." (ER169:83).

Traditional benefit analyses hardly justify reassigning stock ownership where the relationships between an FSC, its contracting exporter, and its shareholder(s) were statutorily structured in a way designed to result in exactly what happened here.[23]

c. The Tax Court Employed Flawed Valuation Analyses

Respondent proffered valuation expert Ken Nunes ("Nunez" in the trial transcript) (ER157:210/8-13), who at trial admitted that in order to have value, an asset must be saleable to a willing buyer (ER157:283/15-19). He failed to determine, however, whether the FSC herein could be legally sold to anyone. In fact, it could not: Section 7.1 of the Shareholders' agreement provided that "None of the issued and outstanding shares of stock of the company, nor any interest in them, may be sold, assigned, pledged, or otherwise transferred" (ER138:3-11), which Nunes failed to consider (ER157:283/20-25, 284/1-3) Yet the Tax Court based its stock valuation analysis on hypothetical third-party owners, without

[23] Treas. Reg. Section 1.922-1(f), which reduces the requirements for Small FSCs, being a prime example.

acknowledging that there could be no third party owners or buyers of the FSC other than the Mazzeis.

Ironically, the Commissioner never wished to make stock value the issue: "Respondent's not attempting to challenge the value of the FSC shares." (ER157:230/23-25). *Yet valuation of the FSC stock was a major factor in the Tax Court's decision to re-assign ownership*:

That is probably due, in some part, to the fact that the author of the majority opinion never heard the Commissioner's "expert" testify. Although that expert, Mr. Nunes, is not named in the Tax Court's Opinion, his flawed reasoning obviously was. Issues with that include:

- Nunes based his valuation forecast on an admitted error (ER157:266/16-25; 267/1-7).
- He valued Petitioners' S Corporation as a C corporation, did not know what the dividends received deduction is, and *did not know how a small shared FSC differed from a large FSC under Code sections 921-927.* (ER157:265/6-21).
- On four separate occasions Respondent failed to provide Nunes with critical information:

  (1) He was not provided historical financial data on Mazzei companies, and was instructed to use Feb. 1, 1998 as valuation date for Mazzei Injector

Co. (ER157-158). Events subsequent to the valuation date are inadmissible for valuation, and after-discovered facts should not be used. Treas. Reg. § 10.2031-1(b); *Ithaca Trust Co. v. U.S.*, 279 U.S. 151, 155 (1929). *Ex post facto* data is not a correct valuation method (RT241/17-21) and is contrary to Treasury Regulation 202031-1(b), Rev. Rule 59-60, and case law (ER157:243/9-19).

(2) Despite telling Respondent he needed historical data (RT241/25, 242/1-2), he made economic forecasts based only on 1998 data (RT239/4-8, 11-25)

(3) The Commissioner did not allow Nunes to interview Angelo Mazzei or reveal to him they had done so for two hours (ER157:250/14-20; 251/12-17; 255/14-19). As a result, Nunes erroneously based his economic forecast on assumptions that were in error (ER157:266/16-25; 267/1-7).

(4) Nunes was not shown an entire banker's box of data the Mazzeis had timely provided (ER157:235/24-25; 236/1-4; 237/3-6; 10-12; ER138:166-170, delivery receipt signed by IRS; 138:161-165, Response to Request for Production). Despite Nunes' claim (after examining the box) that it held only "two items that would have been helpful" (ER157:285/25-286/1), in reality the box contained important historical

information from 1996 through 1999 (ER158:328/13-25; 329/1-3), that would have been important in his valuation (ER157:240/8-15)

- In prior Tax Court cases he had never been deprived of historical data (ER157:241/8-16)
- Respondent instructed him not to consider minority discounts for a small family-owned company (ER157:271/4-6). Yet discount for lack of marketability should have been considered (*Estate of Maggos v. Comm'r,* T.C. Memo 2000-129, *51-*53). The benchmark for liquidity is three business days (Hon. David Laro & Shannon Pratt, BUS. VAL. & TAXES: PROCEDURE, LAW & PERSPEC TIVE, p. 285 (Wiley 2004). Tellingly, Nunes did not know this basic principle of business valuation. (ER157:270/13)

Perhaps that is why the judge who did hear the evidence did not buy into the Tax Court's factual findings as to substantive ownership. (*Compare* footnote 1, on ER169:77 ("As the trial judge in these cases, I…agree with his findings of facts (with one exception…"), *with* footnote 9, on ER169:88 ("If this is a finding of fact, it is one with which I as the trial judge, would disagree.")

To add insult to injury, the Commissioner *conceded* at trial that 1/3 of the FSC stock was worth $33.33 per share—and the Tax Court excluded the Mazzei's expert from testifying to value on that basis, deeming it "irrelevant" in light of the

concession. (ER156:189-ER157:208; ER138:74-160). Had this testimony been adduced, the Majority might well have reached a different result as to stock value, which is discussed next.

d. The Tax Court's "$1" Stock Valuation Was Chimerical

Having cited sale and leaseback cases for the proposition that the FSC stock purchase failed risk/benefit analysis, even at a customary $500 purchase price (BNA Portfolio Export Tax Incentives 934 2d, p. 69; ER169:45), the Tax Court then concluded that the purchase price was really only a mere $1:

> "The opinion of the Court focuses on the substance of a single step: the purported purchase of FSC stock by the Roth IRAs for the nominal price of $1…" (ER74).

With all due respect, that whimsical $1 conclusion defies logic, if one reflects for a moment on what Congress had designed. One cannot attack the way this transaction was structured without running headlong into the very reason it should be respected: as discussed above, shared FSCs were expressly created by Congress not to have substance, but to give a small exporter a competitive edge. (Section 922; Treas. Reg. Section 1.922-1; ER169:34). A small FSC was dependent on a U.S. supplier whose goods it could promote on the foreign market—and its shares had only nominal value without that supplier, which was foreseeably a small, family-owned corporation. Stock value in their shared FSC

was dependent on the skills of Angelo Mazzei (ER155:50/11-14), and a shareholders' agreement was made fixing the price of all FSC shares at $1 *only if* the shares were ever sold to someone else. (ER169:45).

Even though Respondent's trial expert never considered the shareholders' agreement in his valuation analysis (ER157:283/20-25, 284/1-3), and despite the fact that Respondent was "not attempting to challenge" FSC share value, the Tax Court focused on it, and adopted this contingent price—applicable only in the improbable event of a stock sale to a third party—as the actual sale value of the stock, concluding that the agreement "strongly suggests" the real purchase price was $1. Having thus reasoned, and ignoring the $3,500 fee Petitioners paid to WGA (ER156:132/9-17; ER138:1-3,12), the Tax Court concluded that $499 of the stock purchase price was actually "a fee for access to the FSC." (ER169:45-46).

In support of that conclusion, the Tax Court invoked *Hewlett-Packard v. Commissioner,* 875 F.3d 494, 499 (9th Cir., 2017). But *Hewlett-Packard* was a debt-equity case where a taxpayer's purported loss, in exercising a put option to sell its shares, was held to be a fee paid for a tax shelter, not allowable as a tax deduction.

How does this relate to *Mazzei?* It does not. As this Court colorfully put it, *Mazzei* is not a corporate debt-equity "borscht" (*Id.* at 496). Debt and equity have nothing to do with Petitioners' transaction. FSC stock would be utterly worthless

if separated from the exporting business with which it contracted. To envision FSC stock being routinely sold on the open market requires a degree of fictional creativity seldom seen outside Hollywood. (*See Benenson 2,* 910 F.3d at 694).

The Tax Court describes a "disconnect" between the claimed fair market value of FSC stock and its "related-party value" where Petitioners "controlled every aspect" of the transactions. (ER169:63). But FSC transactions were *inherently* related-party, explicitly recognized as such by the Code and Regulations.[24] The Tax Court concludes "there was no chance that commission payments would be made, in the absence of related-party control", and that FSC stock "had no fair market value" because "in the absence of related-party control … neither the FSC nor an independent holder of the FSC stock … could expect to receive anything." (ER169:64) Exactly. Without any anticipated stream of certain revenue, value does not lie. Pratt & Laro, *supra,* Chapter 11, Income Valuation Methods.

Under the Code, FSCs and their suppliers *were* related, and under the Regulations, FSC owners were *foreseeably* related. Nonetheless, harking back to Nunes' "arms-length" argument (ER157:219/7), the Tax Court opines that "the formal purchase price and contracts … were entered into without the benefit of

[24] Section 925 specifically cited Section 482, which defines related parties. Reg. Sections 1.922-1(f) amplifies this.

arm's-length pressure" (ER169:63), thus challenging whether those agreements justified "the tax treatment of the transactions…" (ER169:63-64).

This ignores textual reality. Because of Congressional exemption from most of the requirements imposed on large FSCs, the Mazzeis' shared FSC was, *in reality*, simply an ongoing book entry as one of 25 accounts maintained in the shared FSC. As such, their Roth IRAs reasonably paid only $500 for their ownership interest in what, by Congressional design, was a bookkeeping entry that existed solely to give a small exporter a tax break. The term "fair market value" is virtually meaningless in this context, and incorrectly assumes that FSC stock would be an open market commodity.

It never was, and failing to recognize how a small FSC's special characteristics impacted its contracts and stock issuance, the Tax Court relied on sales/leaseback caselaw unrelated to the textual issues herein.

H. Petitioners' Contracts Were Not 'Too Good To Be True' Nor Did They Exhibit Unwarranted "Common Control"

The real inference of the Tax Court's holding is that the Mazzeis' tax results should be reversed because they were too good to be true—even though prior taxpayers, using DISCs instead of FSCs, won on appeal. To get there, the Tax

Court found that the contracts between Injector Co. and the FSC exhibited unallowable common control, thus somehow tainting purchase of the FSC stock:

> [W]e conclude that the purchase of the FSC stock by the Roth IRAs, together with the contracts that were entered into in consideration of that purchase, created an untenable discrepancy between the form petitioners claimed and the related-party substance underlying their transaction. (ER169:60)

Utilizing provisions of the Code, Injector Co. and the FSC entered into agreements whereby: (1) FSC commissions would be agreed upon in order to provide "maximum federal income tax benefits"; and (2) Injector Co. retained the right to determine, prospectively or retrospectively, whether the FSC was entitled to a commission. (ER169:12, 48-49 fn. 38).[25] Under these facts, the Tax Court suggests, "no independent holder of the FSC stock could realistically have expected to receive any benefits…" (ER169:49).

The Tax Court reasons that while the Code may have contemplated a related-party relationship between the FSC and its supplier, no such protection extended to the buyer of FSC stock. (ER169:37). But that argument ignores both Treas. Reg. Sections 1.922-1(f), and the fact that the only way to achieve the Congressional goal of subsidizing foreign trade was for the FSC to be owned *by an interested party*. The Tax Court's reasoning was the same argument Ford Motor

[25] All of which was allowable by the Code. (Sections 921-927).

Company unsuccessfully made (132 Fed. Cl. at 110). There, as here, a related party owned the FSC, and the Commissioner successfully asserted the viability of the FSC rather than attacking its stock issuance to Ford.

Yet the Tax Court holds:

> No part of the FSC statutes and regulations states, or even implies, that purchases … of FSC stock, or any transactions at the shareholder level or between the FSC and its owners, are exempt from application of the substance doctrines…" (ER169:37)

That conclusion concedes that the only issue herein *is* the Tax Court's use of the substance over form principal, and also ignores the fact that ownership of FSC stock by family-owned Roth IRAs was foreseeable and recurrent, and Congress cannot have been unaware of the tax results: Roth IRAs were part of the Taxpayer Relief Act of 1997; FSCs had been around since the Deficit Reduction Act of 1984.

Confronted by these textual realities, the Tax Court relies on its conclusion that the FSC stock was bought for $1:

> In form, petitioners' Roth IRAs purchased FSC stock for $1 and the FSC simultaneously entered into a series of contracts with Injector Co. … the Roth IRAs effectively paid nothing for the FSC stock, put nothing at risk, and … could not have expected any benefits. From that nominal initial investment, Petitioners claim that their

> Roth IRAs earned dividends totaling $533,057 …" (ER169:49)[26]

"*Could not have expected any benefits?"* The benefits received by the Roth IRAs are what occasion this litigation.

"Put nothing at risk?"

> "Although the Commissioner argued the IRAs had assumed no investment risk … the degree to which the Roth IRAs would benefit from owning JC Holding depended on the success of Summa's export subsidiaries". (*Benenson 2* , 910 F.3d at 700).

I. The Tax Court Ignores The Supreme Court's Recognition Of Statutory Intent And Textual Primacy

Despite the Tax Court's attempt to decide only the issue of stock ownership, has this decision ignored Congressional intent?

The *Summa* and *Benenson* Courts recognized a danger: in its zeal to correct a perceived tax windfall, a court might be tempted – by whatever theory it chooses to employ – to re-write something intended by Congress.

A recently unanimous Supreme Court held:

> [I]t is never our job to rewrite a constitutionally valid statutory text under the banner of speculation about what

[26] The taxpayers in *Benenson* were upheld where their Roth IRAs received a total of $1,477,028 (*Benenson,* 887 F.3d at 515).

> Congress might have done … "We cannot replace the actual text with speculation as to Congress' intent." (*Henson v. Santander Consumer USA Inc.* 137 S. Ct. 1718, 1725 (2017), *quoting Magwood v. Patterson*, 561 U.S. 320, 334 (2010)

Similarly, the *Summa* Court recognized "the Supreme Court's textually respectful methods of statutory interpretation." *Summa,* 848 F.3d at 787. Substance over form should not "override statutory provisions whose only function is to enable tax savings." *Id.* at 789. Otherwise, "Before long, allegations of tax avoidance begin to look like efforts at text avoidance." (*Id*.) Travel too far down that judicial road, and one will miss the point Congress was trying to make—while usurping the exclusive province of the People's elected representatives.

Because the *Mazzei* transactions involve the interaction between two Code-created entities, each of which intentionally begets tax savings, and because these statutory issues challenge the Tax Court's substance over form analysis, it is worth reviewing how deeply the Supreme Court has deferred to the textual primacy of the Code.

1. *"Transactions with no non-tax purpose" Do Not Justify the Tax Court's Judicial Restructuring*

The Tax Court suggests that, absent a non-tax purpose, Petitioners' transaction should be judicially restructured. This was rejected in *Benenson 2,*910

F.3d at 700-701, and by the Supreme Court in *Cottage Savings v. Commissioner*. There, an S & L lender owned residential mortgage loans which had catastrophically declined in value when interest rates surged, and for which it could take an attractive tax loss. But reporting these losses would risk closure of the lender by the FHLB Board. To get around the problem, the Board concocted an arrangement where an S & L could avoid reporting its losses by exchanging its worthless mortgages with "substantially identical" mortgages held by another luckless S & L. After such an "exchange," neither S & L would be required by the Board to formally report its financial loss position. But they still could, and did, report huge tax losses. *Cottage Savings Ass'n. v. Commissioner,* 499 U.S. 554, 556-557 (1991).

The Commissioner attacked this administrative arrangement on the basis that the properties exchanged, all being residential mortgages, were "economic substitutes" and were not "materially different" properties, as required for recognition of loss by Code Section 1001(a). *Id.* at 565. Reversing the Sixth Circuit, the Supreme Court followed the pure text of the Code and the Board's administrative regulation, even though the result was a massive tax benefit: "the Commissioner's approach ill serves the goal of administrative convenience that underlies the realization requirement" and is "incompatible with the structure of

the Code." (*Id.* at 565-566). Even though there were significant tax benefits, the Supreme Court respected textual authority.

Summa and the *Benenson* decisions are similar. Both cases recognized Congressional intent and followed the language of the Code. "That these laws allow taxpayers to sidestep Roth IRA contribution limits or to earn more tax-advantaged money than they otherwise might have, may be an unintended consequence of Congress's legislative actions, but it is a text-driven consequence no less." (*Summa,* 848 F.3d at 790).

The *Mazzei* Court seeks to circumvent this result by "recognizing" the FSC and Roth IRAs, while destroying the transaction through a reassignment of FSC stock. In so doing, the Tax Court elevated its own feelings about *substance* over the *form* mandated by Congress. Nothing in the case law cited by the Tax Court, nor the old cases setting forth the substance over form principal, countenances such a result.

Here, the Code allowed deductions where the only purpose was a tax deduction. To cite, as the Tax Court has done, commercial substance-over-form cases that require a non-tax purpose is to impose on the shareholder of FSC stock a judicially-created exception to a Congressionally legislated valid tax purpose.

2. Tax Synergy Between Two Code Provisions Is Not Objectionable

The *Benenson* decisions recognized, as did *Summa,* that one tax incentive could legitimately potentiate another, resulting in benefits to the taxpayers. *Summa,* 848 F.3d at 782; *Benenson 1,* 887 F.3d at 523. "[W]e begin with a basic point: The Internal Revenue Code allowed Summa Holdings and the Benensons to do what they did." *Summa,* 848 F.3d at 784.

The Supreme Court agrees. In *Gitlitz v. Commissioner*, multiple sections of the Code produced a windfall for taxpayers who owned an insolvent Subchapter S corporation. Various sections of the Code allowed the corporation to enjoy discharge of indebtedness, but to exclude that discharge from gross income because of insolvency, while also allowing the shareholders to fully deduct the corporation's losses—resulting in a tax bonanza. 531 U.S. 206 (2001).

The Commissioner claimed the taxpayers had used interactive Code sections to achieve a double benefit unintended by Congress. Despite lower courts' concerns about a tax double windfall, the Supreme Court followed the literal wording of Section 108(b)(1): "Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern." *Id.* at 220; *accord Austin v. Commissioner,* T.C. Memo. 2017-69, 32, *quoting Summa* at 790 (the Tax Court allowed all the income from an S corporation to flow to an

employee stock ownership plan, creating potentially unintended tax benefits: "The Commissioner cannot fault taxpayers for making the most of the tax-minimizing opportunities Congress created."); *Caterpillar Tractor Co. v. U.S.*, 218 Ct. Cl. 517, 526-8 (1978) (earnings placed into DISC from another Congressionally-created foreign trade corporation created an allowable double tax benefit where, as here, the statute is unambiguous on its face … the Treasury has no power to supply an omission or create an exception not already in the statute … [and] Plaintiff fits solidly within the statute.)

3. The Tax Court Misused The Principle Of Reformation

Reformation of contracts has been broadly recognized by the Ninth Circuit. *Asarco LLC v. United Steel*, 910 F.3d 485, 498 (9th Cir. 2018) (allowing arbitrator to reform a contract, despite contractual prohibitions, so as "to make [the contract] reflect the terms the parties actually agreed upon."); *Caliber One v. Wade,* 491 F.3d 1079, 1083 (9th Cir. 2007) (reformation of mutual mistake); *Kelley v. Commissioner,* 45 F.3d 348, 352 (9th Cir., 1995) (upholding Tax Court authority to reform IRS Forms 872-A to reflect a date different from that argued by the taxpayers).

But *Kelley* is limited: Form 872-A is not a contract, but a unilateral waiver of defense by the taxpayer. *Bilski v. Commissioner,* 69 F.3d 64 (1995).

As seen in Ninth Circuit authority, reformation should be used to conform a transaction to the intent of the parties, not to rewrite the parties' intent to achieve a result. Herein the Tax Court has done just that. The parties' intent was clear: as between Mazzei's, their Roth IRAs, and WGA, everyone intended for the Roth IRAs to own the shared FSC stock. Instead of recognizing the parties' intent, the Tax Court arrived at a desired tax result and reformed the parties' intentions to achieve it. The Tax Court thus improperly inverts the reformation process by seeking a result and then changing the parties' clearly expressed intent.

J. The Tax Court Misapplies Substance-Over-Form Authority

> "[T]he substance-over-form doctrine is not something the Commissioner can use to pound every Roth-IRA transaction he doesn't like." *Block v. Commissioner*, T.C. Memo 2017-142, at *30.

1. 9th Circuit Authority is Miscited

With a view toward possible Ninth Circuit review (ER23), the Tax Court cites case law for the use of substance over form and/or the economic substance doctrine. Mazzeis respectfully submit that the cited authority is misapplied, both as to facts and issues.

Cooper v. Commissioner, 877 F.3d 1086 (9th Cir. 2017), cited at ER24, f/n 17, is fraught with Code violations such as incomplete transfer of patent rights and a meritless deduction of a "bad debt," not totally worthless and hence not

deductible under Section 166. But that has nothing to do with this case, where the Code was followed to a "T", to fulfil the Congressional mandate to create "effective rate reduction for export income" (ER169:61), through "commission payments … *between parties that are related.*..one of which is a qualifying FSC." (ER169:62, emph. suppl.). Issue FSC stock to a Roth IRA, and tax savings potentiated. (ER49-50). But that combination does not invoke *Cooper,* which relied upon Code violations that do not exist here. (ER169:87).

The other cases relied upon by the Tax Court are likewise inapt. *Harbor Bancorp v. Commissioner*, 115 F.3d 722 (9th Cir. 1997), cited at ER169:24 fn. 17, involved arbitrage bonds and sham dating of documents. *Stewart v. Commissioner*, 714 F.2d 977 (9th Cir. 1983), cited at ER169:24, fn. 17, involved condemnation proceedings and a sale of securities by the taxpayer to his controlled (non-FSC) corporation, which the Court held to be a mere conduit for sale of appreciated securities. Again, nothing close to these facts.

Far more on point is a pithy quote from *Stewart*:

> "There are circumstances, however, 'when form – and form alone – determine the tax consequences of a transaction', regardless of its underlying 'substance' or 'purpose'." (*Stewart,* 714 F.2d at 988).

This, the Mazzeis submit, is the issue the First, Second, and Sixth Circuits encountered, and which now confronts this Court: can the substance over form

principal be used to recharacterize stock ownership because two Congressionally-designed entities worked together too well? An analysis of what is paid for stock, and under what terms—while useful in cases such as *Cooper, Stewart,* and *Reddam*—ignores the careful structure, and practical effect, of what Congress created. FSCs and Roth IRAs were both intended by Congress to motivate behavior through tax benefits. Traditional substance over form analyses in the sale/leaseback cases cited by the Tax Court are inapposite to a Roth IRA buying stock in an entity which, under the Code, had no purpose except tax benefits.

Hence, the cited cases lead the Tax Court in a direction that is convenient, but with an untenable destination: the Tax Court cannot sham the ownership of a FSC's stock without thereby shamming the FSC. Where, as here, Congress has explicitly removed the requirement for economic substance, sham analysis is inappropriate—at least in the Sixth Circuit's opinion, which recognized "the 'sham' transaction doctrine" (*Summa,* 848 F.3d at 785), and then refused to apply it where "The Code authorizes companies to create DISCs as shell corporations … that have no substance at all." (*Id.* at 786, 789). So, too, fails business purpose and economic substance where the entity being purchased is, by Congressional design, "all form and no substance" (*Id.* at 786).[27]

[27] Similar to small, shared FSC's, Treas. Reg. § 1.994-1(a)(2) stated that "The application of section 994(a)(1) or (2) does not depend on the extent to which the DISC performs substantial economic functions…"

Petitioners chose to use FSCs and Roth IRAs in concert, and while the Tax Court believes "the Code does not explicitly or implicitly authorize the Roth IRAs' purchase on these facts" (ER169:60), *neither can the Tax Court cite any statutory prohibition thereof*.[28]

Appellate authority with respect to FSCs, DISCs, and Roth IRAs consists primarily of the three recent cases, each of which have reversed the Tax Court on both the result and the reasoning in *Mazzei*. Far from giving this Court a compelling reason to depart from its sister Circuits, the Tax Court has instead offered a partial repaint of the same, failed analysis—bolstered by inapt authority and ludicrous conclusions as to stock value. Since there is not a single case that agrees with the Tax Court's analysis, it falls back on old sale-leaseback cases that have nothing to do with the unique issue of using two Code-sanctioned transactions at the same time.

Ownership of FSC stock by another tax-advantaged entity, even where resulting tax savings potentiated each other, should not invalidate the Mazzeis transaction—not until Congress decides to remedy what the Tax Court perceived as a problem.[29]

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[28] "Federal Tax obligations are established entirely by statute" *Benenson 2,* 910 F.3d at 698.

[29] "If Congress sees DISC – Roth IRA transactions of this sort as unwise … it should fix the problem." *Summa,* 848 F.3d at 790.

In *Lazarus v. Commissioner,* affirmed by the Ninth Circuit, the Tax Court held that substance rather than form "is determinative of the tax consequences, *unless it appears from an examination of the statute that form is to govern.*" (*Lazarus v. Commissioner*, 58 T.C. 854, 864 (emph. suppl.), aff'd 513 F.2d 824 (9th Cir., 1975). While *Lazarus* was an estate and gift tax matter, it articulates the dispositive issue herein: under the Code, form governs.

2. Prior Tax Court Decisions Were Misapplied

The Tax Court cites several of its own cases where taxpayers did exactly that. But none of those involved FSCs, DISCs, or other Code-structured entities.

Block Developers, LLC v. Commissioner (T.C. Memo 2017-142) involved a domestic partnership, not a FSC, which engaged in no real business activity, and was created to funnel money to a Roth IRA. In *Polowniak v. Commissioner,* T.C. Memo 2016-13, taxpayers had their Roth IRAs purchase stock, not in an FSC but in a *domestic* corporation that was unable to demonstrate performance of any services in exchange for payments it received. Similarly, in *Repetto v. Commissioner* (T.C. Memo 2012-168) the taxpayers' Roth IRAs received payment for sham services completely unrelated to FSCs or DISCs (*Id.* at *28)—a fact noted by the Second Circuit (*Benenson 2,* 910 F.3d at 701).

In each cited case, the Tax Court disregarded corporations or LLCs that did nothing except serve as vehicles for getting money into Roth IRAs. But none of

them were FSCs. Not surprisingly, the *Summa* court agreed that the sham services found in *Repetto* were unjustified. 848 F.3d at 785-786. But in citing that in footnote 21, the Tax Court misses *Summa's* very next sentence: "But these economic-substance principles – which undergird the traditional use of the substance-over-form doctrine – do not give the Commissioner purchasing power here." (Id. at 786).

None of the cited Tax Court cases involved the unique issue of a Code-sanctioned entity that was required to have no economic purpose *other* than tax reduction. Yet construing them as being factually "similar," the Tax Court criticizes the "substance" of the *Mazzei* transaction. (ER169:28). Limiting the FSC provisions of the Code and Regulations, the Tax Court applies "normal substance principles to petitioners' transactions—*at least in deciding who actually owned the FSC stock.*" (ER29; emph. suppl.)[30]

VIII.
FINAL THOUGHTS

> Granting the government's proposition that these taxpayers have found a hole in the dike, we believe it one that calls for the application of the Congressional thumb, not the court's. (*Fabreeka Products v. Commissioner,* 294 F.2d 876, 879 (1st Cir. 1961)).

[30] The last phrase, italicized for emphasis, suggests at least some doubt in the Court's mind as to how broadly it can actually apply substance analysis herein.

There are occasions when, for reasons grounded in policy goals, Congress creates transactions that have no non-tax purpose. (*Cottage Savings Ass'n. v. Commissioner, supra*). There are even occasions where taxpayers employ two legislative provisions which, in combination, provide benefits Congress may not have foreseen, but which are available from the plain text of the Code. (*Gitlitz v. Commissioner, supra*). Here, the safest assumption is that after decades of inaction, the Congress was well aware of the benefits from the IRA/FSC interaction and consciously allowed them to remain. *Hall v. U.S.*, 566 U.S. 506, 516 (2012).

Against that, the Tax Court decided to take one last run at a concept that has failed spectacularly in every appellate court to consider it. In so doing, that Court ignored those holdings, the textual primacy of the Code, the faulty work product of Commissioner's "expert," and the Commissioner's repeatedly-stated litigation position of "not challenging stock valuation." The Tax Court thereby created a fictitious $1 stock purchase price, based on case law that is factually and legally inapposite.

Whether hiding behind the fig leaf of "stock ownership," or understood for what it really is—yet another "substance over form" attack on a transaction the Tax Court just doesn't like—the Tax Court's dislike of a perceived tax windfall does not justify the result herein, by whatever theory it is reached. If there really is a

hole in the tax revenue dike, the Congressional "thumb"—not the Tax Court's—should be applied.

WHEREFORE, premises considered, the Mazzeis respectfully ask this Court to reverse that portion of the Opinion and Decision of the United States Tax Court finding them liable for excise taxes.

Respectfully submitted,

Date: January 25, 2019

WALTON & WALTON, LLP

By: _____
Lewis R. Walton

By: _____
L. Richard Walton
Attorneys for Appellants

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

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UNITED STATES COURT OF APPEALS
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UNITED STATES COURT OF APPEALS
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Docket No. 18-72451

In the

United States Court of Appeals

for the

Ninth Circuit

CELIA MAZZEI, et al.

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the United States Tax Court
Case Nos. 16702-09 and 16779-09
Hon. Michael B. Thornton, for the Majority of the Tax Court

ADDENDUM OF AUTHORITY TO APPELLANTS' OPENING BRIEF

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26 USC 245(c) 1997

§ 245. Dividends received from certain foreign corporations.

(c) Certain dividends received from FSC.
(1) In general. In the case of a domestic corporation, there shall be allowed as a deduction an amount equal to--
(A) 100 percent of any dividend received from another corporation which is distributed out of earnings and profits attributable to foreign trade income for a period during which such other corporation was a FSC, and
(B) 70 percent (80 percent in the case of dividends from a 20-percent owned corporation as defined in section 243(c)(2)) of any dividend received from another corporation which is distributed out of earnings and profits attributable to effectively connected income received or accrued by such other corporation while such other corporation was a FSC.
(2) Exception for certain dividends. Paragraph (1) shall not apply to any dividend which is distributed out of earnings and profits attributable to foreign trade income which--
(A) is section 923(a)(2) nonexempt income (within the meaning of section 927(d)(6)), or
(B) would not, but for section 923(a)(4), be treated as exempt foreign trade income.
(3) No deduction under subsection (a) or (b). No deduction shall be allowable under subsection (a) or (b) with respect to any dividend which is distributed out of earnings and profits of a corporation accumulated while such corporation was a FSC.
(4) Definitions. For purposes of this subsection--
(A) Foreign trade income; exempt foreign trade income. The terms "foreign trade income" and "exempt foreign trade income" have the respective meanings given such terms by section 923.
(B) Effectively connected income. The term "effectively connected income" means any income which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States and is subject to tax under this chapter. Such term shall not include any foreign trade income.

26 USC § 408 1999

Portions of section 408 are reproduced below. The section is very detailed with many provisions such as employer/employee provisions, SIMPLE plans, investments in commodities, and other provisions not related to the issues herein, which are not reproduced here.

§ 408. Individual retirement accounts.

(a) Individual retirement account. For purposes of this section, the term "individual retirement account" means a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries, but only if the written governing instrument creating the trust meets the following requirements:
(1) Except in the case of a rollover contribution described in subsection (d)(3) in section 402(c), 403(a)(4), or 403(b)(8), no contribution will be accepted unless it is in cash, and contributions will not be accepted for the taxable year in excess of $ 2,000 on behalf of any individual.
(2) The trustee is a bank (as defined in subsection (n)) or such other person who demonstrates to the satisfaction of the Secretary that the manner in which such other person will administer the trust will be consistent with the requirements of this section.
(3) No part of the trust funds will be invested in life insurance contracts.
(4) The interest of an individual in the balance in his account is nonforfeitable.
(5) The assets of the trust will not be commingled with other property except in a common trust fund or common investment fund.
(6) Under regulations prescribed by the Secretary, rules similar to the rules of section 401(a)(9) and the incidental death benefit requirements of section 401(a) shall apply to the distribution of the entire interest of an individual for whose benefit the trust is maintained.
(b) Individual retirement annuity. For purposes of this section, the term "individual retirement annuity" means an annuity contract, or an endowment contract (as determined under regulations prescribed by the Secretary), issued by an insurance company which meets the following requirements:
(1) The contract is not transferable by the owner.
(2) Under the contract--
(A) the premiums are not fixed,
(B) the annual premium on behalf of any individual will not exceed $ 2000, and

(C) any refund of premiums will be applied before the close of the calendar year following the year of the refund toward the payment of future premiums or the purchase of additional benefits.
(3) Under regulations prescribed by the Secretary, rules similar to the rules of section 401(a)(9) and the incidental death benefit requirements of section 401(a) shall apply to the distribution of the entire interest of the owner.
(4) The entire interest of the owner is nonforfeitable.

Such term does not include such an annuity contract for any taxable year of the owner in which it is disqualified on the application of subsection (e) or for any subsequent taxable year. For purposes of this subsection, no contract shall be treated as an endowment contract if it matures later than the taxable year in which the individual in whose name such contract is purchased attains age 70 1/2 ; if it is not for the exclusive benefit of the individual in whose name it is purchased or his beneficiaries; or if the aggregate annual premiums under all such contracts purchased in the name of such individual for any taxable year exceed $ 2,000.

…

(d) Tax treatment of distributions.
(1) In general. Except as otherwise provided in this subsection, any amount paid or distributed out of an individual retirement plan shall be included in gross income by the payee or distributee, as the case may be, in the manner provided under section 72.
(2) Special rules for applying section 72. For purposes of applying section 72 to any amount described in paragraph (1)--
(A) all individual retirement plans shall be treated as 1 contract,
(B) all distributions during any taxable year shall be treated as 1 distribution, and
(C) the value of the contract, income on the contract, and investment in the contract shall be computed as of the close of the calendar year in which the taxable year begins.
For purposes of subparagraph (C), the value of the contract shall be increased by the amount of any distributions during the calendar year.

…

(e) Tax treatment of accounts and annuities.
(1) Exemption from tax. Any individual retirement account is exempt from taxation under this subtitle unless such account has ceased to be an individual retirement account by reason of paragraph (2) or (3). Notwithstanding the

preceding sentence, any such account is subject to the taxes imposed by section 511 (relating to imposition of tax on unrelated business income of charitable, etc. organizations).

...

(j) Increase in maximum limitations for simplified employee pensions. In the case of any simplified employee pension, subsections (a)(1) and (b)(2) of this section shall be applied by increasing the $ 2,000 amounts contained therein by the amount of the limitation in effect under section 415(c)(1)(A).

26 USC 408A 1998

§ 408A. Roth IRAs.

(a) General rule. Except as provided in this section, a Roth IRA shall be treated for purposes of this title in the same manner as an individual retirement plan.
(b) Roth IRA. For purposes of this title, the term "Roth IRA" means an individual retirement plan (as defined in section 7701(a)(37)) which is designated (in such manner as the Secretary may prescribe) at the time of establishment of the plan as a Roth IRA. Such designation shall be made in such manner as the Secretary may prescribe.
(c) Treatment of contributions.
(1) No deduction allowed. No deduction shall be allowed under section 219 for a contribution to a Roth IRA.
(2) Contribution limit. The aggregate amount of contributions for any taxable year to all Roth IRAs maintained for the benefit of an individual shall not exceed the excess (if any) of--
(A) the maximum amount allowable as a deduction under section 219 with respect to such individual for such taxable year (computed without regard to subsection (d)(1) or (g) of such section), over
(B) the aggregate amount of contributions for such taxable year to all other individual retirement plans (other than Roth IRAs) maintained for the benefit of the individual.
(3) Limits based on modified adjusted gross income.
(A) Dollar limit. The amount determined under paragraph (2) for any taxable year shall not exceed an amount equal to the amount determined under paragraph (2)(A) for such taxable year, reduced (but not below zero) by the amount which bears the same ratio to such amount as--
(i) the excess of--
(I) the taxpayer's adjusted gross income for such taxable year, over
(II) the applicable dollar amount, bears to
(ii) $ 15,000 ($ 10,000 in the case of a joint return or a married individual filing a separate return).

The rules of subparagraphs (B) and (C) of section 219(g)(2) shall apply to any reduction under this subparagraph.

Rollover, conversion, and surviving spouse provisions not included

26 USC § 482

§ 482. Allocation of income and deductions among taxpayers.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 367(d)(4) [26 USCS § 367(d)(4)]), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible. For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.

26 USC § 921, 1998

§ 921. Exempt foreign trade income excluded from gross income.

(a) Exclusion. Exempt foreign trade income of a FSC shall be treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States.
(b) Proportionate allocation of deductions to exempt foreign trade income. Any deductions of the FSC properly apportioned and allocated to the foreign trade income derived by a FSC from any transaction shall be allocated between--
(1) the exempt foreign trade income derived from such transaction, and
(2) the foreign trade income (other than exempt foreign trade income) derived from such transaction, on a proportionate basis.
(c) Denial of credits. Notwithstanding any other provision of this chapter, no credit (other than a credit allowable under section 27(a), 33, or 34) shall be allowed under this chapter to any FSC.
(d) Foreign trade income, investment income, and carrying charges treated as effectively connected with United States business. For purposes of this chapter--
(1) all foreign trade income of a FSC other than--
(A) exempt foreign trade income, and
(B) section 923(a)(2) non-exempt income,
(2) all interest, dividends, royalties, and other investment income received or accrued by a FSC, and
(3) all carrying charges received or accrued by a FSC,

shall be treated as income effectively connected with a trade or business conducted through a permanent establishment of such corporation within the United States. Income described in paragraph (1) shall be treated as derived from sources within the United States.

26 USC § 922 1999

§ 922. FSC defined.

(a) FSC defined. For purposes of this title, the term "FSC" means any corporation--

(1) which--

(A) was created or organized--

(i) under the laws of any foreign country which meets the requirements of section 927(e)(3), or

(ii) under the laws applicable to any possession of the United States,

(B) has no more than 25 shareholders at any time during the taxable year,

(C) does not have any preferred stock outstanding at any time during the taxable year,

(D) during the taxable year--

(i) maintains an office located outside the United States in a foreign country which meets the requirements of section 927(e)(3) or in any possession of the United States,

(ii) maintains a set of the permanent books of account (including invoices) of such corporation at such office, and

(iii) maintains at a location within the United States the records which such corporation is required to keep under section 6001,

(E) at all times during the taxable year, has a board of directors which includes at least one individual who is not a resident of the United States, and

(F) is not a member, at any time during the taxable year, of any controlled group of corporations of which a DISC is a member, and

(2) which has made an election (at the time and in the manner provided in section 927(f)(1)) which is in effect for the taxable year to be treated as a FSC.

(b) Small FSC defined. For purposes of this title, a FSC is a small FSC with respect to any taxable year if--

(1) such corporation has made an election (at the time and in the manner provided in section 927(f)(1)) which is in effect for the taxable year to be treated as a small FSC, and

(2) such corporation is not a member, at any time during the taxable year, of a controlled group of corporations which includes a FSC unless such other FSC has also made an election under paragraph (1) which is in effect for such year.

§26 USC § 923 1999

§ 923. Exempt foreign trade income.

(a) Exempt foreign trade income. For purposes of this subpart--
(1) In general. The term "exempt foreign trade income" means the aggregate amount of all foreign trade income of a FSC for the taxable year which is described in paragraph (2) or (3).
(2) Income determined without regard to administrative pricing rules. In the case of any transaction to which paragraph (3) does not apply, 32 percent of the foreign trade income derived from such transaction shall be treated as described in this paragraph. For purposes of the preceding sentence, foreign trade income shall not include any income properly allocable to excluded property described in subparagraph (B) of section 927(a)(2) (relating to intangibles).
(3) Income determined with regard to administrative pricing rules. In the case of any transaction with respect to which paragraph (1) or (2) of section 925(a) (or the corresponding provisions of the regulations prescribed under section 925(b)) applies, 16/23 of the foreign trade income derived from such transaction shall be treated as described in this paragraph.
(4) Special rule for foreign trade income allocable to a cooperative.
(A) In general. In any case in which a qualified cooperative is a shareholder of a FSC, paragraph (3) shall be applied with respect to that portion of the foreign trade income of such FSC for any taxable year which is properly allocable to the marketing of agricultural or horticultural products (or the providing ofrelated services) by such cooperative by substituting "100 percent" for "16/23".
(B) Paragraph only to apply to amounts FSC distributes. Subparagraph (A) shall not apply for any taxable year unless the FSC distributes to the qualified cooperative the amount which (but for such subparagraph) would not be treated as exempt foreign trade income. Any distribution under this subparagraph for any taxable year--
(i) shall be made before the due date for filing the return of tax for such taxable year, but
(ii) shall be treated as made on the last day of such taxable year.
(5) Special rule for military property. Under regulations prescribed by the Secretary, that portion of the foreign trading gross receipts of the FSC for the taxable year attributable to the disposition of, or services relating to, military property (within the meaning of section 995(b)(3)(B)) which may be treated as exempt foreign trade income shall equal 50 percent of the amount which (but for this paragraph) would be treated as exempt foreign trade income.

(6) Cross reference. For reduction in amount of exempt foreign trade income, see section 291(a)(4).

(b) Foreign trade income defined. For purposes of this subpart, the term "foreign trade income" means the gross income of a FSC attributable to foreign trading gross receipts.

26 USC § 924 1999

§ 924. Foreign trading gross receipts.

(a) In general. Except as otherwise provided in this section, for purposes of this subpart, the term "foreign trading gross receipts" means the gross receipts of any FSC which are--

(1) from the sale, exchange, or other disposition of export property,

(2) from the lease or rental of export property for use by the lessee outside the United States,

(3) for services which are related and subsidiary to--

(A) any sale, exchange, or other disposition of export property by such corporation, or

(B) any lease or rental of export property described in paragraph (2) by such corporation,

(4) for engineering or architectural services for construction projects located (or proposed for location) outside the United States, or

(5) for the performance of managerial services for an unrelated FSC or DISC in furtherance of the production of foreign trading gross receipts described in paragraph (1), (2), or (3).

Paragraph (5) shall not apply to a FSC for any taxable year unless at least 50 percent of its gross receipts for such taxable year is derived from activities described in paragraph (1), (2), or (3).

(b) Foreign management and foreign economic process requirements.

(1) In general. Except as provided in paragraph (2)--

(A) a FSC shall be treated as having foreign trading gross receipts for the taxable year only if the management of such corporation during such taxable year takes place outside the United States as required by subsection (c), and

(B) 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 required by subsection (d).

(2) Exception for small FSC.

(A) In general. Paragraph (1) shall not apply with respect to any small FSC.

(B) Limitation on amount of foreign trading gross receipts of small FSC taken into account.

(i) In general. Any foreign trading gross receipts of a small FSC for the taxable year which exceed $ 5,000,000 shall not be taken into account in determining the exempt foreign trade income of such corporation and shall not be taken into account under any other provision of this subpart.

(ii) Allocation of limitation. If the foreign trading gross receipts of a small FSC exceed the limitation of clause (i), the corporation may allocate such limitation among such gross receipts in such manner as it may select (at such time and in such manner as may be prescribed in regulations).
(iii) Receipts of controlled group aggregated. For purposes of applying clauses (i) and (ii), all small FSC's which are members of the same controlled group of corporations shall be treated as a single corporation.
(iv) Allocation of limitation among members of controlled group. The limitation under clause (i) shall be allocated among the foreign trading gross receipts of small FSC's which are members of the same controlled group of corporations in a manner provided in regulations prescribed by the Secretary.
(c) Requirement that FSC be managed outside the United States. The management of a FSC meets the requirements of this subsection for the taxable year if--
(1) all meetings of the board of directors of the corporation, and all meetings of the shareholders of the corporation, are outside the United States,
(2) the principal bank account of the corporation is maintained in a foreign country which meets the requirements of section 927(e)(3) or in a possession of the United States at all times during the taxable year, and
(3) all dividends, legal and accounting fees, and salaries of officers and members of the board of directors of the corporation disbursed during the taxable year are disbursed out of bank accounts of the corporation maintained outside the United States.
(d) Requirement that economic processes take place outside the United States.
(1) In general. The requirements of this subsection are met with respect to the gross receipts of a FSC derived from any transaction if--
(A) such corporation (or any person acting under a contract with such corporation) has participated outside the United States in the solicitation (other than advertising), the negotiation, or the making of the contract relating to such transaction, and
(B) the foreign direct costs incurred by the FSC attributable to the transaction equal or exceed 50 percent of the total direct costs attributable to the transaction.
(2) Alternative 85-percent test. A corporation shall be treated as satisfying the requirements of paragraph (1)(B) with respect to any transaction if, with respect to each of at least 2 paragraphs of subsection (e), the foreign direct costs incurred by such corporation attributable to activities described in such paragraph equal or exceed 85 percent of the total direct costs attributable to activities described in such paragraph.
(3) Definitions. For purposes of this subsection--
(A) Total direct costs. The term "total direct costs" means, with respect to any transaction, the total direct costs incurred by the FSC attributable to activities

described in subsection (e) performed at any location by the FSC or any person acting under a contract with such FSC.
(B) Foreign direct costs. The term "foreign direct costs" means, with respect to any transaction, the portion of the total direct costs which are attributable to activities performed outside the United States.
(4) Rules for commissions, etc. The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection and subsection (e) in the case of commissions, rentals, and furnishing of services.
(e) Activities relating to disposition of export property. The activities referred to in subsection (d) are--
(1) advertising and sales promotion,
(2) the processing of customer orders and the arranging for delivery of the export property,
(3) transportation from the time of acquisition by the FSC (or, in the case of a commission relationship, from the beginning of such relationship for such transaction) to the delivery to the customer,
(4) the determination and transmittal of a final invoice or statement of account and the receipt of payment, and
(5) the assumption of credit risk.
(f) Certain receipts not included in foreign trading gross receipts.
(1) Certain receipts excluded on basis of use; subsidized receipts and receipts from related parties excluded. The term "foreign trading gross receipts" shall not include receipts of a FSC from a transaction if--
(A) the export property or services--
(i) are for ultimate use in the United States, or
(ii) are for use by the United States or any instrumentality thereof and such use of export property or services is required by law or regulation,
(B) such transaction is accomplished by a subsidy granted by the United States or any instrumentality thereof, or
(C) such receipts are from another FSC which is a member of the same controlled group of corporations of which such corporation is a member.
In the case of gross receipts of a FSC from a transaction involving any property, subparagraph (C) shall not apply if such FSC (and all other FSC's which are members of the same controlled group and which receive gross receipts from a transaction involving such property) do not use the pricing rules under paragraph (1) of section 925(a) (or the corresponding provisions of the regulations prescribed under section 925(b)) with respect to any transaction involving such property.
(2) Investment income; carrying charges. The term "foreign trading gross receipts" shall not include any investment income or carrying charges.

26 USC § 925 1999

§ 925. Transfer pricing rules.

(a) In general. In the case of a sale of export property to a FSC by a person described in section 482, the taxable income of such FSC and such person shall be based upon a transfer price which would allow such FSC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount which does not exceed the greatest of--
(1) 1.83 percent of the foreign trading gross receipts derived from the sale of such property by such FSC,
(2) 23 percent of the combined taxable income of such FSC and such person which is attributable to the foreign trading gross receipts derived from the sale of such property by such FSC, or
(3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482).

Paragraphs (1) and (2) shall apply only if the FSC meets the requirements of subsection (c) with respect to the sale.

(b) Rules for commissions, rentals, and marginal costing. The Secretary shall prescribe regulations setting forth--
(1) rules which are consistent with the rules set forth in subsection (a) for the application of this section in the case of commissions, rentals, and other income, and
(2) rules for the allocation of expenditures in computing combined taxable income under subsection (a)(2) in those cases where a FSC is seeking to establish or maintain a market for export property.
(c) Requirements for use of administrative pricing rules. A sale by a FSC meets the requirements of this subsection if--
(1) all of the activities described in section 924(e) attributable to such sale, and
(2) all of the activities relating to the solicitation (other than advertising), negotiation, and making of the contract for such sale,

have been performed by such FSC (or by another person acting under a contract with such FSC).

(d) Limitation on gross receipts pricing rule. The amount determined under subsection (a)(1) with respect to any transaction shall not exceed 2 times the

amount which would be determined under subsection (a)(2) with respect to such transaction.

(e) Taxable income. For purposes of this section, the taxable income of a FSC shall be determined without regard to section 921.

(f) Special rule for cooperatives. In any case in which a qualified cooperative sells export property to a FSC, in computing the combined taxable income of such FSC and such organization for purposes of subsection (a)(2), there shall not be taken into account any deduction allowable under subsection (b) or (c) of section 1382 (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

26 USC 926 1999

§ 926. Distributions to shareholders.

(a) Distributions made first out of foreign trade income. For purposes of this title, any distribution to a shareholder of a FSC by such FSC which is made out of earnings and profits shall be treated as made--

(1) first, out of earnings and profits attributable to foreign trade income, to the extent thereof, and

(2) then, out of any other earnings and profits.

(b) Distributions by FSC to nonresident aliens and foreign corporations treated as United States connected. For purposes of this title, any distribution by a FSC which is made out of earnings and profits attributable to foreign trade income to any shareholder of such corporation which is a foreign corporation or a nonresident alien individual shall be treated as a distribution--

(1) which is effectively connected with the conduct of a trade or business conducted through a permanent establishment of such shareholder within the United States, and

(2) of income which is derived from sources within the United States.

(c) FSC includes former FSC. For purposes of this section, the term "FSC" includes a former FSC.

26 USC § 927 1999

§ 927. Other definitions and special rules.

(a) Export property. For purposes of this subpart--
(1) In general. The term "export property" means property--
(A) manufactured, produced, grown, or extracted in the United States by a person other than a FSC,
(B) held primarily for sale, lease, or rental, in the ordinary course of trade or business, by, or to, a FSC, for direct use, consumption, or disposition outside the United States, and
(C) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States.

For purposes of subparagraph (C), the fair market value of any article imported into the United States shall be its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation.
(2) Excluded property. The term "export property" shall not include--
(A) property leased or rented by a FSC for use by any member of a controlled group of corporations of which such FSC is a member,
(B) patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, and other than computer software (whether or not patented), for commercial or home use), good will, trademarks, trade brands, franchises, or other like property,
(C) oil or gas (or any primary product thereof),
(D) products the export of which is prohibited or curtailed to effectuate the policy set forth in paragraph (2)(C) of section 3 of the Export Administration Act of 1979 (relating to the protection of the domestic economy), or
(E) any unprocessed timber which is a softwood.

For purposes of subparagraph (E), the term "unprocessed timber" means any log, cant, or similar form of timber.
(3) Property in short supply. If the President determines that the supply of any property described in paragraph (1) is insufficient to meet the requirements of the domestic economy, he may by Executive order designate the property as in short supply. Any property so designated shall not be treated as export property during the period beginning with the date specified in the Executive order and ending with the date specified in an Executive order setting forth the President's determination that the property is no longer in short supply.

(4) Qualified cooperative. The term "qualified cooperative" means any organization to which part I of subchapter T applies which is engaged in the marketing of agricultural or horticultural products.
(b) Gross receipts.
(1) In general. For purposes of this subpart, the term "gross receipts" means--
(A) the total receipts from the sale, lease, or rental of property held primarily for sale, lease, or rental in the ordinary course of trade or business, and
(B) gross income from all other sources.
(2) Gross receipts taken into account in case of commissions. In the case of commissions on the sale, lease, or rental of property, the amount taken into account for purposes of this subpart as gross receipts shall be the gross receipts on the sale, lease, or rental of the property on which such commissions arose.
(c) Investment income. For purposes of this subpart, the term "investment income" means--
(1) dividends,
(2) interest,
(3) royalties,
(4) annuities,
(5) rents (other than rents from the lease or rental of export property for use by the lessee outside of the United States),
(6) gains from the sale or exchange of stock or securities,
(7) gains from futures 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),
(8) amounts includible in computing the taxable income of the corporation under part I of subchapter J, and
(9) gains from the sale or other disposition of any interest in an estate or trust.
(d) Other definitions. For purposes of this subpart--
(1) Carrying charges. The term "carrying charges" means--
(A) carrying charges, and
(B) under regulations prescribed by the Secretary, any amount in excess of the price for an immediate cash sale and any other unstated interest.
(2) Transaction.
(A) In general. The term "transaction" means--
(i) any sale, exchange, or other disposition,
(ii) any lease or rental, and
(iii) any furnishing of services.
(B) Grouping of transactions. To the extent provided in regulations, any provision of this subpart which, but for this subparagraph, would be applied on a transaction-

by-transaction basis may be applied by the taxpayer on the basis of groups of transactions based on product lines or recognized industry or trade usage. Such regulations may permit different groupings for different purposes.
(3) United States defined. The term "United States" includes the Commonwealth of Puerto Rico.
(4) Controlled group of corporations. The term "controlled group of corporations" has the meaning given to such term by section 1563(a), except that--
(A) "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears therein, and
(B) section 1563(b) shall not apply.
(5) Possessions. The term "possession of the United States" means Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Virgin Islands of the United States.
(6) Section 923(A)(2) non-exempt income. The term "section 923(a)(2) non-exempt income" means any foreign trade income from a transaction with respect to which paragraph (1) or (2) of section 925(a) does not apply and which is not exempt foreign trade income. Such term shall not include any income which is effectively connected with the conduct of a trade or business within the United States (determined without regard to this subpart).
(e) Special rules.
(1) Source rules for related persons. Under regulations, the income of a person described in section 482 from a transaction giving rise to foreign trading gross receipts of a FSC which is treated as from sources outside the United States shall not exceed the amount which would be treated as foreign source income earned by such person if the pricing rule under section 994 which corresponds to the rule used under section 925 with respect to such transaction applied to such transaction.
(2) Participation in international boycotts, etc. Under regulations prescribed by the Secretary, the exempt foreign trade income of a FSC for any taxable year shall be limited under rules similar to the rules of clauses (ii) and (iii) of section 995(b)(1)(F).
(3) Exchange of information requirements. For purposes of this title, the term "FSC" shall not include any corporation which was created or organized under the laws of any foreign country unless there is in effect between such country and the United States--
(A) a bilateral or multilateral agreement described in section 274(h)(6)(C) (determined by treating any reference to a beneficiary country as being a reference to any foreign country and by applying such section without regard to clause (ii) thereof), or
(B) an income tax treaty which contains an exchange of information program--

(i) which the Secretary certifies (and has not revoked such certification) is satisfactory in practice for purposes of this title, and
(ii) to which the FSC is subject.
(4) Disallowance of treaty benefits. Any corporation electing to be treated as a FSC under subsection (f)(1) may not claim any benefits under any income tax treaty between the United States and any foreign country.
(5) Coordination with possessions taxation.
(A) Exemption. No tax shall be imposed by any possession of the United States on any foreign trade income derived before January 1, 1987. The preceding sentence shall not apply to any income attributable to the sale of property or the performance of services for ultimate use, consumption, or disposition within the possession.
(B) Clarification that possession may exempt certain income from tax. Nothing in any provision of law shall be construed as prohibiting any possession of the United States from exempting from tax any foreign trade income of a FSC or any other income of a FSC described in paragraph (2) or (3) of section 921(d).
(C) No cover over of taxes imposed on FSC. Nothing in any provision of law shall be construed as requiring any tax imposed by this title on a FSC to be covered over (or otherwise transferred) to any possession of the United States.
(f) Election of status as FSC (and as small FSC).
(1) Election.
(A) Time for making. An election by a corporation under section 922(a)(2) to be treated as a FSC, and an election under section 922(b)(1) to be a small FSC, shall be made by such corporation for a taxable year at any time during the 90-day period immediately preceding the beginning of the taxable year, except that the Secretary may give his consent to the making of an election at such other times as he may designate.
(B) Manner of election. An election under subparagraph (A) shall be made in such manner as the Secretary shall prescribe and shall be valid only if all persons who are shareholders in such corporation on the first day of the first taxable year for which such election is effective consent to such election.
(2) Effect of election. If a corporation makes an election under paragraph (1), then the provisions of this subpart shall apply to such corporation for the taxable year of the corporation for which made and for all succeeding taxable years.
(3) Termination of election.
(A) Revocation. An election under this subsection made by any corporation may be terminated by revocation of such election for any taxable year of the corporation after the first taxable year of the corporation for which the election is effective. A termination under this paragraph shall be effective with respect to such election--

(i) for the taxable year in which made, if made at any time during the first 90 days of such taxable year, or
(ii) for the taxable year following the taxable year in which made, if made after the close of such 90 days, and

for all succeeding taxable years of the corporation. Such termination shall be made in such manner as the Secretary shall prescribe by regulations.
(B) Continued failure to be a FSC. If a corporation is not a FSC for each of any 5 consecutive taxable years of the corporation for which an election under this subsection is effective, the election to be a FSC shall be terminated and not be in effect for any taxable year of the corporation after such 5th year.
(g) Treatment of shared FSC's.
(1) In general. Except as provided in paragraph (2), each separate account referred to in paragraph (3) maintained by a shared FSC shall be treated as a separate corporation for purposes of this subpart.
(2) Certain requirements applied at shared FSC level. Paragraph (1) shall not apply--
(A) for purposes of--
(i) subparagraphs (A), (B), (D), and (E) of section 922(a)(1),
(ii) paragraph (2) of section 922(a),
(iii) subsections (b), (c), and (e) of section 924, and
(iv) subsection (f) of this section, and
(B) for such other purposes as the Secretary may by regulations prescribe.
(3) Shared FSC. For purposes of this subsection, the term "shared FSC" means any corporation if--
(A) such corporation maintains a separate account for transactions with each shareholder (and persons related to such shareholder),
(B) distributions to each shareholder are based on the amounts in the separate account maintained with respect to such shareholder, and
(C) such corporation meets such other requirements as the Secretary may by regulations prescribe.

26 CFR 1.921-2 1998

§ 1.921-2 Foreign Sales Corporation--General Rules.

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-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.

(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.

26 CFR 1.922-1 (Treas Reg 1990)

§ 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 msut 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 compnay) 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 satisified 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 subdivison (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 idenfitying 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 coporation be considered to satisfy the requirement of section 922(a)(1)(D)(iii) that it maintain the records it is required to keep under section 6001 at a location within the United States?

A -- 16. A corporation will be considered to satify 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.

Statutory Authority

AUTHORITY:

Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805

26 CFR 1.925(a)-1T (Treas. Reg. 1998)

§ 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.

(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 subdivisions (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 related 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) 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 timely filed U.S. income tax return (including extensions thereof) for the taxable year. No untimely or amended returns 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. The rules of the previous two sentences of this paragraph (c)(8)(i) are applicable to taxable years beginning after December 31, 1997. For any taxable year beginning before January 1, 1998, for which a redetermination is otherwise permissible under paragraph (e)(4) of this section as in effect for taxable years beginning before January 1, 1998, a redetermination of grouping of transactions cannot be made later than the due date of the FSC's timely filed U.S. income tax return (including extensions thereof) for the FSC's first taxable year beginning after December 31, 1997. The language "or grouping of transactions" is removed from the fourth sentence of paragraph (e)(4) of this section, applicable to taxable years beginning after December 31, 1997.

(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 account 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 suppler may not redetermine that the FSC was operating as a commission FSC rather than a buy-sell FSC, and vice versa. For the election to group transactions for purposes of applying the administrative pricing methods, see paragraph (c)(8)(i) of this section.

(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 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 X $450/$18,000	5.00
Total	(350.00)
Combined taxable income	
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	
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

Transfer price to F:	
F's foreign trading gross receipts	1,000.00
Less:	

F's expenses	295.00
F's profit	
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 $31815/23

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 X $110.61/$318	(102.61)
F's taxable income	

Of F's total expenses, $ 192.39 ($ 295 x $ 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	
Less:	

R's direct selling expenses	50.00
R's apportioned G/A expenses:	
$200 X $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	

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	
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	

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 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 X $85/$5,100	2.00
F's expenses	50.00
Total	(70.00)
Combined taxable income	15.00
The combined taxable income method -- F's profit:	
F's profit -- 23% of combined taxable income ($15)	$ 3.45
The gross receipts method -- F's profit:	
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

The section 482 method -- F's profit:	
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)	

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:

Transfer price to F:	
F's foreign trading gross receipts	$ 200.00
Less:	
F's expenses	50.00
F's profit	3.66
Total	(53.66)

]

Transfer price

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:

Combined taxable income:	
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)	

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:

Transfer price to F:	
F's foreign trading gross receipts	$ 950.00
Less:	
F's expenses	(290.00)
Transfer price	

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
F's profit:	
F's foreign trading gross receipts	950.00
F's cost of purchases	(650.00)
F's gross income	300.00

Less:	
F's expenses	(290.00)

F's profit	

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)
Combined gross income	350.00
Less:	
R's direct selling expenses	50.00
F's expenses	250.00
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
Apportionment of G/A expenses:	
$200 X $350/$ 18,000	3.89
Total	(303.89)
Combined taxable income	

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)
Combined gross income	350.00
Less:	
F's expenses	(303.89)
Combined taxable income	

The combined taxable income method -- F's profit:

F's profit -- 23% of combined taxable income ($46.11)	$ 10.61

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

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

Of F's total expenses, $ 163.05 ($ 250 x $ 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

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 X 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	
F's non-exempt foreign trade income	112.07
Less:	
F's expenses allocable to non-exempt foreign trade income $303.89 X $112.07/$322.19	(105.70)

F's taxable income	6.37

Of F's total expenses, $198.19 ($303.89 X $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 administrative 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)

Combined gross income	350.00
Less:	
R's direct selling expenses	60.00
R's apportioned G/A expenses	3.89
F's expenses	250.00

	(313.89)
Combined taxable income	
The combined taxable income method -- F's profit:	
F's profit -- 23% of combined taxable income ($36.11)	8.31
The gross receipts method -- F's profit:	
F's profit -- lesser of 1.83% of R's gross receipts ($ 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

F's commission	

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)

Combined gross income	350.00
Less: F's expenses	(313.89)
Combined taxable income	36.11

The combined taxable income method -- F's profit:	
F's profit -- 23% of combined taxable income ($36.11)	8.31
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 $330.51,

computed as follows:	
F's expenses	313.89
F's profit	16.62

F's commission	

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.

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	
R's cost of goods sold	
Combined gross income	
Less:	
R's direct selling expenses	
R's apportioned G/A expenses	
F's expenses	
Combined taxable income (loss)	

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)	

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 because 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 X $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)	
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 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, assuming 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
	12.75

F's commission

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 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)
		150.00
Less:		
R's direct selling expenses		20.00
F's expenses		110.00
Total		130.00
Combined taxable income		$20.00
The combined taxable income method -- F's profit:		
F's profit -- 23% of combined taxable income ($20)		$ 4.60
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	
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
F's commission	$119.20	

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

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
Total		(2,633.50)
Rental payable for 1985		8,166.50
Rental payable each month ($8,166.50/9 months)	$907.39	

Computation for 1986

Combined taxable income:	
F's sublease rental receipts for year ($1,200 x 3 months)	$ 3,600.00
Less:	
R's depreciation (($40,000 x 1/10) x 3/12)	(1,000.00)
Combined taxable income	2,600.00
The combined taxable income method -- F's profit:	
F's profit -- 23% of combined taxable income ($2,600)	598.00

The gross receipts method -- F's profit:

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

The section 482 method -- F's profit:

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.

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:
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:

Monthly rental payable by F to R for 1986:

F's sublease rental receipts for year	$ 3,600.00
Less:	
F's profit	(600.00)
Rental payable for 1986	3,000.00
Rental payable for each month ($3,000/3 months)	$1,000.

26 CFR 1.994-1(a)(2)

§ 1.994-1 Inter-company pricing rules for DISC's.

(2) Performance of substantial economic functions. The application of section 994(a)(1) or (2) [26 USCS § 994(a)(1) or (2)] does not depend on the extent to which the DISC performs substantial economic functions (except with respect to export promotion expenses). See paragraph (1) of § 1.993-1.
(3) Related party and related supplier. For the purposes of this section --
(i) The term "related party" means a person which is owned or controlled directly or indirectly by the same interests as the DISC within the meaning of section 482 [26 USCS § 482] and § 1.482-1(a).
(ii) The term "related supplier" means a related party which singly engages in a transaction directly with the DISC which is subject to the rules of section 994 [26 USCS § 994] and this section. However, a DISC may have different related suppliers with respect to different transactions. If, for example, X owns all the stock of Y, a corporation, and of Z, a DISC, and sells a product to Y which is resold to Z, only Y is the related supplier of Z, and, thus, only the resale from Y to Z is subject to section 994 [26 USCS § 994] and this section. If, however, X sells directly to Z and Y also sells directly to Z, then, as to the transactions involving direct sales to Z, each of X and Y is a related supplier of Z.

Joint Committee on Taxation Background and History of the Trade Dispute

BACKGROUND AND HISTORY OF THE TRADE DISPUTE RELATING TO THE PRIOR-LAW FOREIGN SALES CORPORATION PROVISIONS AND THE PRESENT-LAW EXCLUSION FOR EXTRATERRITORIAL INCOME AND A DESCRIPTION OF THESE RULES

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on July 30, 2002

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

July 26, 2002
JCX-83-02

CONTENTS

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides background and history relating to the European Union's actions to challenge the legality under international trade agreements of the prior-law foreign sales corporation ("FSC") rules and the present-law extraterritorial income ("ETI") rules (as well as predecessor rules), and the current status of the trade dispute over the ETI rules before the World Trade Organization ("WTO"). The document also provides summary descriptions of the FSC and ETI rules.

[1] This document may be cited as follows: Joint Committee on Taxation, *Background and History of the Trade Dispute Relating to the Prior-Law Foreign Sales Corporation Provisions and the Present-Law Exclusion for Extraterritorial Income and a Description of These Rules*, (JCX-83-02), July 26, 2002.

A. Overview

Like many other countries, the United States has long provided export-related benefits under its tax law. In the United States, for most of the last two decades, these benefits were provided under the FSC regime. In 2000, the European Union ("EU") succeeded in having the FSC regime declared a prohibited export subsidy by the WTO. In response to this WTO ruling, the United States repealed the FSC rules and enacted the ETI regime. The EU immediately challenged the ETI regime in the WTO, and in January of 2002, a WTO Appellate Body held that the ETI regime also constituted a prohibited export subsidy under the relevant trade agreements. The EU is seeking authorization from a WTO arbitration panel to impose over $4 billion in trade sanctions. The WTO arbitration panel is expected to issue a decision on this matter soon. The United States is currently deciding how it will respond to these latest developments.

B. Background and History of the Trade Dispute Over the FSC and ETI Regimes

The "DISC" dispute and enactment of the FSC regime

Prior to the enactment of the FSC regime, the United States provided a different system of export-related tax benefits, which applied to certain export-intensive corporations known as "domestic international sales corporations" ("DISCs").[2] Under this regime, DISCs were incorporated as domestic corporations, but DISC income was exempt from corporate income tax, and the shareholder-level tax on that income was in part deferred. Shortly after the DISC regime's enactment in 1971, certain signatories to the General Agreement on Tariffs and Trade ("GATT") challenged the regime as a prohibited export subsidy. In 1976, a GATT panel sustained these challenges, as well as U.S. challenges to certain export tax incentives provided by France, Belgium, and the Netherlands. These rulings of the panel proved controversial and remained unadopted by the relevant signatory countries for a number of years.

In 1981, without conceding that the DISC regime violated the GATT, the United States agreed to adopt the general findings of the GATT panel, subject to a 1981 GATT Council Decision (the "1981 Understanding"), which was understood to qualify those findings. The 1981 Understanding had three main components: (1) GATT signatories are not required to tax export income that is attributable to economic processes occurring outside their territorial limits; (2) "arm's length" transfer pricing principles should be observed in transactions between exporting enterprises and related foreign buyers; and (3) the GATT does not prohibit the adoption of measures to avoid the double taxation of foreign-source income.

A debate subsequently ensued as to whether the DISC regime violated the GATT, as interpreted in light of the 1981 Understanding. The European Communities ("EC") argued that the DISC regime constituted an illegal export subsidy because it provided tax benefits for export income earned within the United States. The United States defended the regime on the grounds

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[2] Another export incentive in turn preceded the DISC regime -- under provisions enacted in 1962, controlled foreign corporations that qualified as "export trade corporations" were permitted to reduce their subpart F income by the amount of certain export trade income.

that, as applied to exports, it merely approximated the effect of a territorial tax system of the kind commonly used by European countries, which in turn was considered acceptable under the 1981 Understanding. A majority of GATT Council members sided with the EC and urged the United States to bring the DISC regime into compliance with the GATT. In addition, the EC took steps toward seeking approval for the imposition of trade sanctions against the United States, and other signatories indicated that they would seek compensation from the United States. In late 1982, the United States made a commitment to the GATT Council to develop legislation that would address these concerns, and in early 1983, the President set forth a proposal to replace the DISC regime with a new system that was thought to be GATT-compliant (without conceding that the DISC regime was not GATT-compliant).

In 1984, the Congress enacted legislation along the general lines proposed by the President, creating the FSC regime. Unlike the DISC regime, the FSC regime provided tax benefits for export-related income earned by foreign corporations that were required to have a foreign presence and to perform export-related activities outside the United States. Transfer pricing principles were also set forth for the measurement of FSC income. In light of these features, which caused the FSC regime to emulate more closely certain aspects of an exemption-method territorial tax system, the FSC regime was thought to fall directly within the terms of the 1981 Understanding.

The FSC regime had been in existence for approximately 14 years when the EU brought a case against it in the WTO in mid-1998.

The FSC dispute and enactment of the ETI regime

In 1999, a WTO panel agreed with the EU that the FSC regime constituted a prohibited export subsidy under the relevant WTO agreements, and in early 2000, a WTO Appellate Body upheld that finding. The rulings held that the FSC rules constituted a subsidy because under those rules the government refrained from collecting revenue that was "otherwise due"; the rulings held that this subsidy was prohibited because it was export-contingent. The EU also expressed additional objections to the FSC regime that were not addressed by the WTO -- specifically, that the FSC transfer pricing rules were not "arm's length," and that the FSC regime encouraged the use of tax havens.

In an effort to comply with these rulings (and to address the additional concerns raised by the EU), in late 2000 the United States repealed the FSC regime and enacted the ETI regime.

Under the ETI regime, an exclusion from gross income applies with respect to "extraterritorial income," which is a taxpayer's gross income attributable to "foreign trading gross receipts." This income is eligible for the exclusion to the extent that it is "qualifying foreign trade income." Qualifying foreign trade income is the amount of gross income that, if excluded, would result in a reduction of taxable income by the greatest of (1) 1.2 percent of the foreign trading gross receipts derived by the taxpayer from the transaction, (2) 15 percent of the

[JOINT COMMITTEE PRINT]

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GENERAL EXPLANATION

OF THE

REVENUE PROVISIONS OF THE

DEFICIT REDUCTION ACT OF 1984

(H.R. 4170, 98TH CONGRESS;
PUBLIC LAW 98-369)

Prepared by the Staff

OF the

JOINT COMMITTEE ON TAXATION

DECEMBER 31, 1984

[JOINT COMMITTEE PRINT]

GENERAL EXPLANATION

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U.S. GOVERNMENT PRINTING OFFICE

Taxation of International Income

The Act reforms numerous provisions of the Code concerning the taxation of income earned abroad by U.S. residents and the taxation of U.S.-source income earned by foreign investors.

The Act reforms the rules governing transfers of appreciated property to foreign corporations; in particular, the tax-free transfer of intangibles to foreign corporations. The Act also prevents improper use of the foreign tax credit to reduce U.S. taxes on U.S.-source income.

Under prior law, interest paid by a U.S. borrower to a foreign lender was generally subject to a 30-percent withholding tax. Some U.S. borrowers argued that treaty arrangements allowed them to borrow funds from foreigners free of the withholding tax. The Act eliminates the 30-percent tax on certain portfolio interest received

by foreigners, and gives Treasury regulatory authority to prevent tax avoidance by U.S. residents receiving such interest.

Under prior law, the use of a Domestic International Sales Corporation (DISC) allowed deferral of corporate income tax on a portion of export-related income. The DISC system of taxation was an irritant in trade negotiations. The Act creates a new system of taxing the export income of foreign sales corporations (FSCs). The FSC system of taxation was designed to comply with the letter and spirit of the General Agreement on Trade and Tariffs (GATT) code, and to be revenue neutral compared to the DISC system.

H.R. 2014

A BILL TO PROVIDE FOR RECONCILIATION PURSUANT TO SUBSECTIONS (b)(2) AND (d) OF SECTION 105 OF THE CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1998

together with

ADDITIONAL AND DISSENTING VIEWS

June 24, 1997.--Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

REVENUE RECONCILIATION ACT OF 1997

105th Congress Report
HOUSE OF REPRESENTATIVES
1st Session 105-148

REVENUE RECONCILIATION ACT OF 1997

R E P O R T

of the

COMMITTEE ON THE BUDGET

HOUSE OF REPRESENTATIVES

to accompany

H.R. 2014

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June 24, 1997.--Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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Reasons for Change

The Committee is concerned about the national savings rate, and believes that individuals should be encouraged to save. The Committee believes that the ability to make deductible contributions to an IRA is a significant savings incentive. However, this incentive is not available to all taxpayers under present law. Further, the present-law income thresholds for IRA deductions are not indexed for inflation so that fewer Americans will be eligible to make a deductible IRA contribution each year, and the amount of the maximum contribution is declining in real terms over time. The

Committee believes it is appropriate to encourage individual saving and that tax-favored savings vehicles should be available to more individuals.

In addition, the Committee believes that some individuals would be more likely to save if funds set aside in a tax-favored account could be withdrawn without tax after a reasonable holding period for retirement or certain special purposes. Some taxpayers may find such a vehicle more suitable for their savings needs.

The Committee believes that providing an incentive to save for certain special purposes is appropriate. The Committee believes that many Americans may have difficulty saving enough to purchase a home. Home ownership is a fundamental part of the American dream.

bution. A U.S. shareholder in a PFIC that is a QEF must currently include in gross income its pro rata share of the PFIC's total E&P, subject to an election to defer payment of tax on that income until a distribution from the company or a disposition of the stock, with an appropriate interest charge.[592]

A foreign corporation is considered to be a PFIC if at least 75% of its gross income for the taxable year is passive income, or at least 50% in value of its assets for the taxable year produce or are held for the production of passive income.[593] Passive income is generally defined as FPHC income for Subpart F purposes but excludes income derived by bona fide banks and insurance companies. The PFIC rules, however, do not contain a provision similar to § 951(e), which insulates a portion of an FSC's FTI from application of the Subpart F rules. It thus appears that the PFIC rules could have applied to an FSC.

4. Treaty Benefits

A corporation that elected FSC treatment could not claim the benefits of a tax treaty between the United States and any foreign country.[594]

Observation: This rule did not prevent U.S. shareholders of FSCs incorporated in a treaty jurisdiction from attempting to claim the reduction of the rate of the withholding tax on dividend and interest payments to the U.S. shareholders.[595] It was, nevertheless, unwise to incorporate an FSC in a jurisdiction that might impose such taxes (which generally were not creditable under the FSC rules).

5. Application of Alternative Minimum Tax

It is not entirely clear from the language of § 55,[596] or from the legislative history of the Tax Reform Act of 1986, whether the revised alternative minimum tax (AMT) provisions could properly be applied to an FSC.

Receiving dividends from an FSC could increase the tax liability of a shareholder of the FSC in a year in which the shareholder was subject to AMT. The dividend was not a tax preference item. Rather, in computing a shareholder's adjusted current earnings (ACE) adjustment, the DRD was not allowed to the extent of the portion of the dividend attributable to exempt FSC income.[597] Thus, 15/23 of the FSC dividend amount was added back as an ACE adjustment.[598]

6. Gains from Sales or Exchanges of FSC Stock

Section 1248 provides that a U.S. shareholder owning at least 10% of the voting stock of a foreign corporation will be taxed at ordinary income rates on the portion of any gain recognized on the sale or exchange of such stock (the gain to be included in income as a dividend), to the extent of the foreign corporation's E&P (attributable to such stock) accumulated while the stock was held by the U.S. shareholder and while the foreign corporation was a CFC.

Because the FSC often was a CFC, this provision might apply when its stock was transferred. Under § 1248(d)(6), as in effect before amendment on December 29, 2007, by P.L. 110-172, the E&P of an FSC attributable to FTI was excluded from E&P for purposes of determining a possible gain under § 1248. However, investment income, carrying charges, and all other income of the FSC will be included in the E&P of the FSC for this purpose.

Observation: The Tax Reform Act of 1986 amended § 1248(d) to provide that E&P attributable to former § 923(a)(2) nonexempt income should not be excluded when determining the E&P of an FSC under § 1248. The Joint Committee Report explained that this amendment was intended to subject the earnings of an FSC that would be taxable upon distribution to ordinary income treatment under § 1248. However, because the typical FSC distributed all of its income on an annual basis, it generally would not have a value over its basis.

7. International Boycotts, Bribes, Kickbacks to Foreign Officials

Former § 927(e)(2) provided that the Secretary of the Treasury was to prescribe regulations limiting the FTI earned by an FSC that participated in or cooperated with an international boycott (as defined in § 999(b)(3)).[599] In addition, an FSC's exempt FTI was limited to the extent that any illegal bribe, kickback, or other payment was made to an official, employee, or agent of a government. The statute did not define how regulations should limit an FSC's exempt FTI. Under rules in § 995(b)(1)(F) and explained in Regs. § 1.995-2(a) and (b) relative to DISCs, shareholders were imputed constructive dividends of pro rata shares of DISC income earned while the DISC participated in an international boycott, and the sum of any illegal bribes, kickbacks, or other payments paid by or on behalf of a DISC to an official or employee of a government. This had the effect of ending the deferral on those earnings.

I. Shared FSCs

1. Background

Shared or multiple ownership FSCs had their origins in the DISC rules. In 1973, however, the IRS effectively killed shared

[592] §§ 1291, 1293, 1294. A QEF is a PFIC that properly elects that status for a taxable year and complies with requirements to determine the ordinary earnings and net capital gain of the company for the taxable year, ascertain the ownership of its outstanding stock, and ascertain any other information necessary to carry out the purposes of the PFIC rules. § 1295(a).

[593] § 1296(a), (b). Because it was not intended to treat as PFICs foreign corporations that own subsidiaries primarily engaged in active business operations, a look-through rule provides that, for the purpose of applying the income or asset test to a corporate shareholder, a proportionate part of the income and assets of a 25% owned subsidiary is attributed to the corporate shareholder. § 1296(c). Furthermore, a corporation starting an active business can avoid, under certain conditions, PFIC classification where the income or asset test would otherwise be met. § 1297(b)(2), (3).

[594] Former § 927(e)(4).

[595] *See* Granwell & Rosensweig, "An Analysis of the Foreign Sales Corporation Provisions and Rules," 28 *Tax Notes* 1265, 1290 (1985).

[596] As amended by P.L. 99-514 (the 1986 TRA).

[597] Regs. § 1.56(g)-1(d)(2).

[598] Under the ETI regime, excludible ETI was not added back as an ACE (adjusted current earnings) adjustment by express regulatory mandate (i.e., § 56(g)(4)(B)(i) specifically states that "[the AMT provisions] shall not apply in the case of any amount excluded from gross income under section 108 (or the corresponding provisions of prior law) or under section 114.") This represented a benefit that was not previously available under the FSC regime. The American Jobs Creation Act of 2004, however, repealed the ETI provisions, including § 54(g)(4)(B)(i). As such, there was a question during the transition period whether the ACE adjustment benefit was still in effect.

[599] The list of Countries Requiring Cooperation With an International Boycott is published periodically in the *Federal Register*. It determined that "the following countries may require participation in, or cooperation with, an international boycott (within the meaning of section 999(b)(3) of the Internal Revenue Code of 1986): Kuwait, Lebanon, Libya, Qatar, Saudi Arabia, Syria, United Arab Emirates, and Yemen. Iraq is not included in this list, but its status with respect to future lists remains under review by the Department of the Treasury."

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DISCs when it ruled that a multiple ownership DISC that operated on a so-called business use basis — with a shareholder receiving back in the form of dividends what it paid to the DISC as buy-sell profits or commission income — effectively had separate classes of stock, even though in form the articles only provided for one class of common voting stock.[600]

When Congress converted the DISC into the FSC in 1984, it in effect overruled the 1973 revenue ruling by providing that an FSC could have separate classes of stock. The Boren Bill, which was the Senate-side version of the FSC legislation, authorized regulations that ultimately would make multiple-ownership FSCs a reality. Hence, a number of small unrelated exporters might set up an FSC to handle their export sales. Each exporter was issued a different class of common stock, which paid dividends in proportion to the exports marketed by the owner of that class through the FSC. A number of states, enterprise zones, trade associations, and the like sponsored shared FSCs for exporters. The initial costs of creating a shared FSC were incurred by the sponsoring entity. Participating exporters paid only for actual start-up costs (on the order of $500 per participant) and annual maintenance costs. Because of the economies of scale, participation in shared FSCs could be less expensive than exclusive ownership of an FSC.

The Securities and Exchange Commission, as well as several state securities authorities, determined that interests in a state-sponsored shared FSC would not be viewed as securities. Among other things, it was determined that the stock purchased by an exporter-shareholder appeared to be in the nature of a membership fee rather than an investment.

To be attractive, a shared FSC should have guarded against loss of commercial privacy, crossover of liabilities from one exporter to another, and interruption of regular customer and banking relationships. These issues had to be addressed under the laws of the qualifying jurisdiction, and were best handled in the drafting of the underlying articles of incorporation, bylaws, and shareholders' agreement. The law and regulations of the local jurisdiction needed to be accommodating; Barbados and Jamaica, for example, acted to accommodate shared FSCs.

2. Tax Treatment

Former § 927(g) prescribed the treatment of shared FSCs. Former § 927(g) was added in the Technical and Miscellaneous Revenue Act of 1988 and was effective as if included in the FSC enabling legislation.[601] Its provisions effectively treated a shared FSC as a wholly owned solo FSC except for the following enumerated provisions:

1. Incorporation in a qualifying jurisdiction (former § 922(a)(1)(A))

2. 25-shareholder limit (former § 922(a)(1)(B))

3. Foreign office requirements (former § 922(a)(1)(D))

4. Nonresident board member (former § 922 (A)(1)(E))

5. Election requirement (former § 922(a)(2))

6. Foreign management (former § 924(b)–(c))

7. Election procedures (former § 927(f)).

Thus, what could generally be categorized as the FSC threshold and foreign management tests were generally satisfied at the shared FSC level by a shared FSC manager. All the other FSC provisions such as foreign economic process requirements, administrative pricing, grouping rules, etc., applied in the shared FSC environment exactly as they did in a solo FSC environment. For an FSC to be characterized as a shared FSC, the books and records of the FSC had to be segregated by shareholder, to reflect business used by the shareholder. This separate accounting requirement was also generally performed by the shared FSC manager.[602]

J. Special Rules

1. Qualified Cooperatives

a. In General

The FSC provisions included special rules regarding the taxation of the export of agricultural products through a "qualified cooperative." The statute defined a qualified cooperative as "any organization to which part I of subchapter T applies, which was engaged in the marketing of agricultural or horticultural products."[603] Generally, a qualified cooperative was a farmers' cooperative that qualified under § 521.[604]

b. Administrative Pricing Rules

When a qualified cooperative sold export property to an FSC, the CTI of the transaction was computed without taking into account "patronage dividends,[605] "per-unit retain allocations,"[606] and certain "deductions for non-patronage distributions"[607] under § 1382 (relating to the taxable income of cooperatives).[608] The Finance Committee and the Joint Committee stated that, as a result of this special rule, the cooperative was not required to distribute the income attributable to exempt FTI (generally 15/23 of FTI) to benefit from the exemption from corporate-level tax on this income.[609] Because under § 521 cooperatives were tax-exempt at the corporate

[600] Rev. Rul. 73-442, 1973-2 C.B. 296.

[601] P.L. 100-647, § 1012(bb)(8)(A).

[602] State taxation of shared FSCs, while not a subject of this Appendix A, presented interesting issues. In some instances, participation in a shared FSC could help to avoid state taxation properly. *See* Richards, Saxon & Bruce, "State Taxation of FSCs and Tax Planning Opportunities in Delaware," 39 *Tax Exec.* 289 (Spring 1987).

[603] Former § 927(a)(4).

[604] Section 1381(a)(1) refers to § 521.

[605] The term "patronage dividend" is defined as an amount paid to a patron by a cooperative which satisfies the following three conditions: (i) it is paid on the basis of the quantity of value of business done with or for the patron; (ii) there is a valid, enforceable, and preexisting written obligation to pay that amount; and (iii) the amount is determined by reference to the net earnings of the cooperative organization from business done with or for its patrons. *See* § 1388(a).

[606] The term "per-unit retain allocations" refers to amounts allocated to and retained by a cooperative from patrons without reference to the net earnings of the cooperative, pursuant to an agreement between the cooperative and the patron. *See* § 1388(f).

[607] Deductions for non-patronage distributions include: (i) amounts paid during the taxable years as dividends of capital stock (*see* § 1382 (c)(i)); (ii) distributions to patrons of earnings derived from business done for the United States or any of its agencies or from sources other than patronage (*see* § 1382(c)(2)(A)); and (iii) distributions and redemptions of nonqualified written notices of allocation (*see* § 1382(c)(2)(B)).

[608] Former § 925(f).

[609] S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess., 653 (1984); J. Comm.

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