

[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 8782

RIN 1545-AV90

Source Rules for Foreign Sales Corporation Transfer Pricing

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance to taxpayers who have made an election to be treated as a foreign sales corporation (FSC). The regulations clarify that the special source rule under section 927(e)(1) applies only to income of related suppliers from sales of export property giving rise to foreign trading gross receipts of a FSC.

DATES: Effective date. These regulations are effective March 3, 1998.

Applicability date. These regulations apply to taxable years beginning after December 31, 1997.

FOR FURTHER INFORMATION CONTACT: Elizabeth Beck (202) 874-1490 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

### **Background**

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 927 which was added by the Deficit Reduction Act of 1984, applicable for taxable years of foreign sales corporations beginning after December 31, 1984.

Temporary regulations (TD 8126) were published in the **Federal Register** (52 FR 6468) on March 3, 1987. These temporary regulations were amended by temporary regulations published in the **Federal Register** (63 FR 10305) as a Treasury decision (TD 8764) on March 3, 1998. On the same date, a notice of proposed rulemaking cross-referencing TD 8764 was published in the **Federal Register** (63 FR 10351). The proposed rule proposed changes to the grouping and source rules for foreign sales corporation transfer pricing. Comments responding to this notice were received. On June 24, 1998, a public hearing was held limited to the proposed changes to the grouping rules, since no hearing was requested with respect to the source rule. After consideration of all comments received, the proposed regulations regarding the source rule are adopted as revised by this Treasury decision.

#### **Explanation of Provisions**

##### **A. Current Temporary Regulations.**

Section 927(e)(1) provides that "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." Transactions giving rise to foreign trading gross receipts include qualifying

sales, leases, licenses and services. Because TD 8126 could be interpreted to apply the special foreign source limit only to sales of export property, §1.927(e)-1T was amended by TD 8764 to clarify that the regulation applies to any transaction giving rise to foreign trading gross receipts of a FSC, including but not limited to sales, leases, licenses and services. TD 8764 also made conforming changes, added special rules and gave examples regarding the special source rule.

B. Discussion of Comments

No comments were received on the special rules added in proposed §1.927(e)-1(a)(3)(ii). These rules clarify how the corresponding DISC transfer pricing rules are to be applied for purposes of the foreign source limit and are generally taxpayer favorable. No comments were received on Examples (1) and (3) set forth in proposed §1.927(e)-1(b). These examples illustrate how the limit is applied under different transfer pricing methods for sales transactions.

Comments received did suggest that the rule distinguish between the foreign source income limitation applicable to sales and the limitation applicable to other transactions giving rise to foreign trading gross receipts. In light of these comments, Treasury and the IRS believe that additional consideration should

be given to the appropriate scope of the special source rule of section 927(e)(1) and that the expanded special source rule should be withdrawn. Accordingly, the final regulation applies the special source rule only to sales of export property. Example (2) of the proposed regulation, which addressed a licensing transaction, has been removed.

### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in E.O. 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

### **Drafting Information**

The principal author of these regulations is Elizabeth Beck of the Office of the Associate Chief Counsel (International). Other personnel from the IRS and Treasury Department also participated in the development of these regulations.

**List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

**Adoption of Amendments to the Regulations**

Accordingly, 26 CFR Part 1 is amended as follows:

## PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for §1.927(e)-1T and adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.927(e)-1 also issued under 26 U.S.C. 927(e)(1). \* \* \*

**§1.927(e)-1T [Removed]**

Par. 2. Section 1.927(e)-1T is removed.

Par. 3. Section 1.927(e)-1 is added to read as follows:

§1.927(e)-1 Special sourcing rule.

(a) Source rules for related persons--(1) In general. The income of a person described in section 482 from a sale of export property giving rise to foreign trading gross receipts of a FSC that is treated as from sources outside the United States shall not exceed the amount that would be treated as foreign source income earned by such person if the pricing rule under section 994 that corresponds to the rule used under section 925 with respect to such transaction applied to such transaction. This special sourcing rule also applies if the FSC is acting as a commission agent for the related supplier with respect to the transaction described in the first sentence of this paragraph (a)(1) that gives rise to foreign trading gross receipts and the

transfer pricing rules of section 925 are used to determine the commission payable to the FSC. No limitation results under this section with respect to a transaction to which the section 482 pricing rule under section 925(a)(3) applies.

(2) Grouping of transactions. If, for purposes of determining the FSC's profits under the administrative pricing rules of sections 925(a)(1) and (2), grouping of transactions under §1.925(a)-1T(c)(8) was elected, the same grouping shall be used for making the determinations under the special sourcing rule in this section.

(3) Corresponding DISC pricing rules--(i) In general. For purposes of this section--

(A) The DISC gross receipts pricing rule of section 994(a)(1) corresponds to the gross receipts pricing rule of section 925(a)(1);

(B) The DISC combined taxable income pricing rule of section 994(a)(2) corresponds to the combined taxable income pricing rule of section 925(a)(2); and

(C) The DISC section 482 pricing rule of section 994(a)(3) corresponds to the section 482 pricing rule of section 925(a)(3).

(ii) Special rules. For purposes of this section--

(A) The DISC pricing rules of section 994(a)(1) and (2) shall be determined without regard to export promotion expenses;

(B) Qualified export receipts under section 994(a)(1) and (2) shall be deemed to be an amount equal to the foreign trading gross receipts arising from the transaction; and

(C) Combined taxable income for purposes of section 994(a)(2) shall be deemed to be an amount equal to the combined taxable income for purposes of section 925(a)(2) arising from the transaction.

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

Example 1. (i) R and F are calendar year taxpayers. R, a domestic manufacturing company, owns all the stock of F, which is a FSC acting as a commission agent for R. For the taxable year, R and F used the combined taxable income pricing rule of section 925(a)(2). For the taxable year, the combined taxable income of R and F is \$100 from the sale of export property, as defined in section 927(a), manufactured by R using production assets located in the United States. Title to the export property passed outside of the United States.

(ii) Under section 925(a)(2), 23 percent of the \$100 combined taxable income of R and F (\$23) is allocated to F and the remaining \$77 is allocated to R. Absent the special sourcing rule, under section 863(b) the \$77 income allocated to R would be sourced \$38.50 U.S. source and \$38.50 foreign source. Under the special sourcing rule, the amount of foreign source income earned by a related supplier of a FSC shall not exceed the amount that would result if the corresponding DISC pricing rule applied. The DISC combined taxable income pricing rule of section 994(a)(2) corresponds to the combined taxable income pricing rule of section 925(a)(2). Under section 994(a)(2), \$50 of the combined taxable income ( $\$100 \times .50$ ) would be allocated to the DISC and the remaining \$50 would be allocated to the related supplier. Under section 863(b), the \$50 income allocated to the DISC's related supplier would be sourced \$25 U.S. source and \$25 foreign source. Accordingly, under the special sourcing rule, the foreign source income of R shall not exceed \$25.

Example 2. (i) Assume the same facts as in Example 1 except that R and F used the gross receipts pricing rule of section 925(a)(1). In addition, for the taxable year foreign trading gross receipts derived from the sale of the export property are \$2,000.

(ii) Under section 925(a)(1), 1.83 percent of the \$2,000 foreign trading gross receipts (\$36.60) is allocated to F and the \$63.40 remaining combined taxable income ( $\$100 - \$36.60$ ) is allocated to R. Absent the special sourcing rule, under section 863(b) the \$63.40 income allocated to R would be sourced \$31.70

U.S. source and \$31.70 foreign source. Under the special sourcing rule, the amount of foreign source income earned by a related supplier of a FSC shall not exceed the amount that would result if the corresponding DISC pricing rule applied. The DISC gross receipts pricing rule of section 994(a)(1) corresponds to the gross receipts pricing rule of section 925(a)(1). Under section 994(a)(1), \$80 ( $\$2,000 \times .04$ ) would be allocated to the DISC and the \$20 remaining combined taxable income would be allocated to the related supplier. Under section 863(b), the \$20 income allocated to the DISC's related supplier would be sourced \$10 U.S. source and \$10 foreign source. Accordingly, under the special sourcing rule, the foreign source income of R shall not exceed \$10.

(c) Effective date. The rules of this section are applicable to taxable years beginning after December 31, 1997.

Deputy Commissioner of Internal Revenue

Approved:

Assistant Secretary of the Treasury