

Internal Revenue Service, Treasury

§ 1.925(a)-1T

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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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) |
| | <hr/> |
| Combined gross income | 450.00 |
| | <hr/> |
| Less: | |
| R's direct selling expenses | 50.00 |
| F's expenses | 295.00 |
| Apportionment of R's general and administrative expenses: | |
| R's total G/A expenses | 200.00 |
| Combined gross income | 450.00 |
| R's and F's total gross income (foreign and domestic) | 18,000.00 |
| Apportionment of G/A expenses: | |
| \$200×\$450/\$18,000 | 5.00 |
| | <hr/> |
| Total | (350.00) |
| | <hr/> |
| Combined taxable income | 100.00 |

| | |
|--|----------|
| The section 482 method—Transfer price to F and F's profit: | |
| Transfer price to F | \$690.00 |
| | <hr/> |
| F's profit: | |
| F's foreign trading gross receipts | 1,000.00 |
| | <hr/> |
| Less: | |
| F's cost of goods sold | 690.00 |
| F's expenses | 295.00 |
| | <hr/> |
| Total | (985.00) |
| | <hr/> |
| F's profit | 15.00 |

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

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F's profit—lesser of 1.83% of F's foreign trading gross receipts (\$18.30) or two times F's profit under the combined taxable income method (\$46.00) (See below) (Unless otherwise indicated, all examples in this section assume that the marginal costing method of § 1.925(b)-1T does not result in a higher profit than the profit under the full costing combined taxable income method) 18.30

Transfer price to F:
 F's foreign trading gross receipts 1,000.00
 Less:
 F's expenses 295.00
 F's profit 18.30
 Total (313.30)
 Transfer price 686.70

The combined taxable income method— F's profit and transfer price to F:
 F's profit—23% of combined taxable income (\$100) \$23.00
 Transfer price to F:
 F's foreign trading gross receipts 1,000.00
 Less:
 F's expenses 295.00
 F's profit 23.00
 Total (318.00)
 Transfer price 682.00

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

F's foreign trading gross receipts \$1,000.00
 F's costs of purchases (transfer price) (682.00)
 F's foreign trade income 318.00
 F's exempt foreign trade income $\$318 \times 15/23$ 207.39
 F's taxable income would be \$8.00, computed as follows:
 F's foreign trade income \$318.00
 F's exempt foreign trade income (207.39)

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

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

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

Combined taxable income:
 F's foreign trading gross receipts \$990.00
 R's cost of goods sold (550.00)
 Combined gross income 440.00
 Less:
 R's direct selling expenses 50.00
 R's apportioned G/A expenses:
 $\$200 \times \$440 / \$18,000$ 4.89
 F's expenses 295.00
 Total (349.89)
 Combined taxable income .. 90.11

The combined taxable income method—F's profit and transfer price to F:
 F's profit—23% of combined taxable income (\$90.11) \$20.73

Transfer price to F:
 F's foreign trading gross receipts 990.00
 Less:
 F's expenses 295.00
 F's profit 20.73
 Total (315.73)

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| | |
|---|----------|
| Transfer price | 674.27 |
| <hr/> | |
| 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 |
| <hr/> | |
| Transfer price to F: F's foreign trading gross receipts | 990.00 |
| <hr/> | |
| Less: | |
| F's expenses | 295.00 |
| F's profit | 18.12 |
| <hr/> | |
| Total | (313.12) |
| <hr/> | |
| Transfer price | 676.88 |
| <hr/> | |
| The section 482 method—Transfer price to F and F's profit: Transfer price to F | 690.00 |
| <hr/> | |
| F's profit: | |
| F's foreign trading gross receipts | 990.00 |
| <hr/> | |
| Less: | |
| F's cost of goods sold | 690.00 |
| F's expenses | 295.00 |
| <hr/> | |
| Total | (985.00) |
| <hr/> | |
| F's profit | 5.00 |

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

tributable 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) |
| <hr/> | |
| Combined gross income | 85.00 |
| <hr/> | |
| Less: | |
| R's direct selling expenses | 18.00 |
| R's apportioned G/A expenses: \$120×\$85/\$5,100 | 2.00 |
| F's expenses | 50.00 |
| <hr/> | |
| Total | (70.00) |
| <hr/> | |
| Combined taxable income | 15.00 |

| | |
|--|---------|
| <i>The combined taxable income method—F's profit:</i> | |
| F's profit—23% of combined taxable income (\$15) | \$ 3.45 |

| | |
|---|--------|
| <i>The gross receipts method—F's profit:</i> | |
| F's profit—lesser of 1.83% of F's foreign trading gross receipts (\$3.66) or two times F's profit under the combined taxable income method (\$6.90) | \$3.66 |

| | |
|---|----------|
| <i>The section 482 method—F's profit:</i> | |
| F's foreign trading gross receipts | 200.00 |
| <hr/> | |
| Less: | |
| F's cost of goods sold | 157.00 |
| F's expenses | 50.00 |
| <hr/> | |
| Total | (207.00) |
| <hr/> | |
| F's profit (loss) | (7.00) |

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

| | |
|--|-----------|
| <i>Transfer price to F:</i> | |
| F's foreign trading gross receipts | \$ 200.00 |
| Less: | |
| F's expenses | 50.00 |

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| | |
|----------------------|---------|
| F's profit | 3.66 |
| Total | (53.66) |
| Transfer price | 146.34 |

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

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) | (30.00) |

Under paragraph (e)(1)(i) of this section, F is permitted to recover its expenses attributable to the sale (\$290) even though such re-

covery 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 | 660.00 |

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 | 10.00 |

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

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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 ... | <u>350.00</u> |
| 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) | <u>18,000.00</u> |
| Apportionment of G/A expenses: | |
| \$200×\$350/\$18,000 | 3.89 |
| Total | <u>(303.89)</u> |

| | |
|-------------------------------|--------------|
| Combined taxable income | <u>46.11</u> |
|-------------------------------|--------------|

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

| | |
|----------------------------------|---------------|
| Combined taxable income: | |
| R's gross receipts from the sale | \$1,000.00 |
| R's cost of goods sold | (650.00) |
| Combined gross income | <u>350.00</u> |
| Less: | |
| F's expenses | (303.89) |
| Combined taxable income .. | <u>46.11</u> |

| | |
|---|----------------|
| The combined taxable income method—F's profit: | |
| F's profit—23% of combined taxable income (\$46.11) | <u>\$10.61</u> |

| | |
|---|----------------|
| The gross receipts method—F's profit: | |
| F's profit—lesser of 1.83% of R's gross receipts (\$18.30) or two times F's profit under the combined taxable income method (\$21.22) | <u>\$18.30</u> |

If the election provided for in paragraph (b)(2)(ii) of this section is not made, F may receive a commission from R in the amount of \$268.30, computed as follows:

| | |
|----------------------|---------------|
| F's expenses | \$250.00 |
| F's profit | 18.30 |
| F's commission | <u>268.30</u> |

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

| | |
|---|--------------|
| F's foreign trade income | \$268.30 |
| F's exempt foreign trade income | (174.98) |
| F's non-exempt foreign trade income | <u>93.32</u> |

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Less:

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

Of F's total expenses, \$163.05 (\$250×\$174.98/\$268.30) are allocated to F's exempt foreign trade income and are disallowed for purposes of computing F's taxable income.

If R and F make the election provided for in paragraph (b)(2)(ii) of this section, F may receive a commission from R in the amount of \$322.19, computed as follows:

| | |
|----------------------|---------------|
| F's expenses | \$303.89 |
| F's profit | 18.30 |
| F's commission | <u>322.19</u> |

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

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

Of F's total expenses, \$198.19 (\$303.89×\$112.07/\$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 | <u>350.00</u> |
| Less: | |
| R's direct selling expenses | 60.00 |
| R's apportioned G/A expenses | 3.89 |
| F's expenses | 250.00 |
| | <u>(313.89)</u> |
| Combined taxable income | <u>36.11</u> |

| | |
|---|-------------|
| The combined taxable income method—F's profit: | |
| F's profit—23% of combined taxable income (\$36.11) | <u>8.31</u> |

| | |
|--|--------------|
| The gross receipts method—F's profit: | |
| F's profit—lesser of 1.83% of R's gross receipts (\$ 18.30) or two times F's profit under the combined taxable income method (\$16.62) | <u>16.62</u> |

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 | <u>266.62</u> |

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 | <u>350.00</u> |
| Less: F's expenses | (313.89) |
| Combined taxable income | <u>36.11</u> |

| | |
|---|-------------|
| The combined taxable income method—F's profit: | |
| F's profit—23% of combined taxable income (\$36.11) | <u>8.31</u> |

| | |
|---|--------------|
| The gross receipts method—F's profit: | |
| F's profit—lesser of 1.83% of R's gross receipts (\$18.30) or two times F's profit under the combined taxable income method (\$16.62) | <u>16.62</u> |

| | |
|---|---------------|
| 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 | <u>330.51</u> |

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 | \$1,000.00 |
| R's cost of goods sold | (650.00) |
| Combined gross income | <u>350.00</u> |
| Less: | |
| R's direct selling expenses | 50.00 |
| R's apportioned G/A expenses | 3.89 |
| F's expenses | 300.00 |
| | <u>(353.89)</u> |

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Combined taxable income (loss) (3.89)

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

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

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

F will not have a profit under the full costing combined taxable income method since there is a combined loss of \$(3.89). Also, F will not have a profit under the gross receipts method due to section 925(d) and the special no loss rule of paragraph (e)(1)(i) of this section. In addition, F will not have a profit under the marginal costing rules 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×\$340/\$18,000 | 3.78 |
| F's expenses | 250.00 |
| Total | (303.78) |
| Combined taxable income | 36.22 |

The combined taxable income method—
F's profit: F's profit—23% of combined taxable income (\$36.22) \$8.33

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

F may receive a commission from R in the amount of \$266.66, computed as follows:
F's expenses \$250.00
F's profit 16.66
F's commission 266.66

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

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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 Ex-penses | Com-mis-sions |
|---|---------|---------------|---------------|
| Product Line X (products A and P) | \$36.34 | \$490.00 | \$526.34 |
| Product Line W (products L, M, and N) | \$40.48 | \$421.00 | \$461.48 |

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

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

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

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

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§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) |
| | <hr/> |
| | 150.00 |
| Less: | |
| R's direct selling expenses | 20.00 |
| F's expenses | 110.00 |
| | <hr/> |
| Total | 130.00 |
| Combined taxable income | <hr/> |
| | \$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) | \$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 |
| | <hr/> |
| 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 deductible

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

COMPUTATION FOR 1985

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

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:

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| | |
|---|-------------|
| 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

| | |
|--|------------|
| <i>Combined taxable income:</i> | |
| 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 1/12) | (1,000.00) |
| Combined taxable income .. | 2,600.00 |

| | |
|---|--------|
| <i>The combined taxable income method—F's profit:</i> | |
| F's profit—23% of combined taxable income (\$2,600) | 598.00 |

| | |
|--|-------|
| <i>The gross receipts method—F's profit:</i> | |
| F's profit—lesser of 1.83% of F's foreign trading gross receipts (\$3,600) or two times F's profit under the combined taxable income method (\$1,196) .. | 65.88 |

| | |
|---|------------|
| <i>The section 482 method—F's profit:</i> | |
| F's sublease rental receipts for year | \$3,600.00 |
| Less: | |
| F's lease rental payments for year | (3,000.00) |
| F's profit | 600.00 |

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

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

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

[T.D. 8126, 52 FR 6443, Mar. 3, 1987, as amended by T.D. 8764, 63 FR 10306, Mar. 3, 1998; T.D. 8944, 66 FR 13428, Mar. 6, 2001]

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

(a) *In general.* This section prescribes the marginal costing rules authorized by section 925(b)(2). If under paragraph (c)(1) of this section a FSC is treated for its taxable year as seeking to establish or maintain a foreign market for sales of an item, product, or product line of export property (as defined in § 1.927(a)-1T) from which foreign trading gross receipts (as defined in § 1.924(a)-1T) are derived, the marginal costing rules prescribed in paragraph (b) of this section may be applied at the related supplier's election to compute combined taxable income of the FSC and related supplier derived from those sales. (Any further reference to a FSC in this section shall include a small FSC unless indicated otherwise.) The combined taxable income determined under these marginal costing rules may be used to determine whether the "twice the amount determined under the combined taxable income method" limitation for the 1.83% of gross receipts test of section 925(d) has been met.

For FSC taxable years beginning after December 31, 1986, if the marginal costing rules are used to determine the section 925(d) limitation, the FSC may not earn more than 100% of full costing combined taxable income determined