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Memorandum

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subject: Qualification for FSC benefits and ETI Exclusions

This legal advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether income from long-term sales and leases¹ qualifies for foreign sales corporation ("FSC") benefits under sections 921 through 927, extraterritorial income ("ETI") exclusions under sections 114 and 941 through 943, or neither.

CONCLUSION

Income from long-term sales and leases may qualify for FSC benefits or ETI exclusions depending on when the transaction was entered into and depending, in some cases, on whether such transaction was pursuant to a binding contract as described in certain binding contract rules. Numerous factors contribute to the determination of whether such income qualifies for FSC benefits, ETI exclusions, or neither. The discussion below explains the relevant effective dates, repeal dates, and

¹ The term "lease," as used in this memorandum, includes rentals, subleases, licenses, and sublicenses. See Temp. Treas. Reg. § 1.924(a)-1T(a)(2).

transition rules. The examples below illustrate the proper application of those provisions to various fact patterns.

FACTS

Generally, where all events associated with a sale or lease occur within a single taxable year, the determination of whether the FSC or ETI exclusion provisions apply to the transaction depends on which regime, if any, applied to the transaction. Questions have arisen, however, with respect to certain long-term sales and leases. For example, if a taxpayer enters into a sale or lease in Year1 and recognizes income from the transaction in Year2 (where the FSC provisions are in effect for Year1 and the ETI exclusion provisions are in effect for Year2), which regime applies to the transaction? Some Taxpayers have found the answer to this type of question difficult not only because of the multi-year aspect but also in light of the legislation that repealed the FSC and ETI exclusion provisions subject to transition rules. This memorandum addresses such questions.

LAW

Both the FSC and ETI exclusion provisions provide tax benefits with respect to foreign trading gross receipts. See generally I.R.C. §§ 114; 921-927; and 941-943. The FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (“ETI Act”) repealed the FSC provisions and enacted the ETI exclusion provisions. Pub. L. No. 106-519, 114 Stat. 2423, §§ 2 and 3 (2000). Section 5(a) of the ETI Act provides that the ETI exclusion provisions generally apply to “transactions after September 30, 2000” (“ETI effective date”). The legislative history further clarifies that the ETI exclusion provisions are “effective for transactions entered into after September 30, 2000.” (emphasis added). S. Rep. No. 104-416, p.20 (2000) (“ETI Report”); see also Rev. Proc. 2001-37, 2001-1 C.B. 1327, §§ 2.02 and 6.03. For purposes of the FSC and ETI exclusion provisions, “transaction” means any sale, exchange, or other disposition; lease or rental; and furnishing of services. I.R.C. §§ 927(d)(2)(A) and 943(b)(1).

Section 5(c)(1) of the ETI Act contains transition rules that delay the application of the ETI exclusion provisions to certain transactions notwithstanding the ETI effective date. Section 5(c)(1) of the ETI Act provides:

In the case of a FSC (as so defined) in existence on September 30, 2000, and at all times thereafter, the amendments made by this Act shall not apply to any transaction in the ordinary course of trade or business involving a FSC which occurs—

- (A) before January 1, 2002; or
- (B) after December 31, 2001, pursuant to a binding contract—

- (i) which is between the FSC (or any related person) and any person which is not a related person; and
- (ii) which is in effect on September 30, 2000, and all times thereafter.

For purposes of this paragraph, a binding contract shall include a purchase option, renewal option, or replacement option which is included in such contract and which is enforceable against the seller or lessor.

We refer to the section 5(c)(1)(B) transition rule involving binding contracts as the “FSC binding contract rule.” The FSC provisions, rather than the ETI exclusion provisions, apply to transactions to which the section 5(c)(1) transition rules apply. However, under section 5(c)(2) of the ETI Act, a taxpayer may elect out of the section 5(c)(1) transition rules.

Section 5(c)(2) allows a taxpayer to elect to apply the ETI exclusion provisions to any transaction that would have been subject to the FSC provisions by reason of section 5(c)(1) of the ETI Act. The section 5(c)(2) election applies on a transaction-by-transaction basis and is “effective for the taxable year for which made and all subsequent taxable years. . . .” See also Rev. Proc. 2001-37 at § 6.04.

The American Jobs Creation Act of 2004 (“AJCA”) generally repealed the ETI exclusion provisions. Pub. L. No. 108-357, 118 Stat. 1418, § 101(a) and (b). Section 101(c) of the AJCA provides that the general repeal of the ETI exclusion provisions “shall apply to transactions after December 31, 2004” (“ETI repeal date”). Two transition rules apply. One is a two-year phase-out of the ETI exclusion:

- (d) TRANSITIONAL RULE FOR 2005 and 2006.--
 - (1) IN GENERAL.--In the case of transactions during 2005 or 2006, the amount includible in gross income by reason of the amendments made by this section shall not exceed the applicable percentage of the amount which would have been so included but for this subsection.
 - (2) APPLICABLE PERCENTAGE.--For purposes of paragraph (1), the applicable percentage shall be as follows:
 - (A) For 2005, the applicable percentage shall be 20 percent.
 - (B) For 2006, the applicable percentage shall

be 40 percent.

AJCA, § 101(d). Thus, for transactions entered into during 2005 and 2006, taxpayers may claim 80% and 60%, respectively, of the ETI exclusions that would have been permitted but for the repeal (“phase-out rule”) with respect to the income recognized during those calendar years. Id.

The AJCA also contains a binding contract rule that is materially similar to the FSC binding contract rule and provides:

(f) BINDING CONTRACTS.--The amendments made by this section shall not apply to any transaction in the ordinary course of a trade or business which occurs pursuant to a binding contract--

(1) which is between the taxpayer and a person who is not a related person (as defined in section 943(b)(3) of such Code, as in effect on the day before the date of the enactment of this Act), and

(2) which is in effect on September 17, 2003, and at all times thereafter.

For purposes of this subsection, a binding contract shall include a purchase option, renewal option, or replacement option which is included in such contract and which is enforceable against the seller or lessor.

AJCA, § 101(f). We refer to the section 101(f) transition rule as the “ETI binding contract rule.” Section 101 of the AJCA does not apply to transactions to which the ETI binding contract rule applies. In other words, the ETI exclusion provisions are not repealed or phased out with respect to such transactions. Thus, just as the FSC binding contract rule allows the FSC provisions to continue to apply to certain transactions, the ETI binding contract rule allows the ETI exclusion provisions to continue to apply to certain transactions. We refer to the FSC and ETI binding contract rules collectively as the “binding contract rules.” The binding contract rules apply on a transaction-by-transaction basis.

The Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”) repealed the binding contract rules. Pub. L. No. 109-222, 120 Stat. 345, §513 (2006). Section 513 of TIPRA provides:

(a) FSC PROVISIONS. Paragraph (1) of

section 5(c) of the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 is amended by striking “which occurs—“ and all that follows and inserting “which occurs before January 1, 2002.”.

(b) ETI PROVISIONS. Section 101 of the American Jobs Creation Act of 2004 is amended by striking subsection (f).

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

TIPRA was enacted on May 17, 2006. Thus, the repeal of the binding contract rules is effective for taxable years beginning after May 17, 2006 (“TIPRA repeal date”). Id. at 22-23.

ANALYSIS

I. ETI Act – Repeal of the FSC Provisions

The Service interprets the ETI effective date such that the FSC provisions generally apply to transactions entered into before October 1, 2000, and the ETI exclusion provisions generally apply to transactions entered into after September 30, 2000. This interpretation of the ETI effective date is explicitly supported by the legislative history to the ETI Act. ETI Report, p. 20. The determination of when a sale or lease² is entered into within the meaning of section 5(a) of the ETI Act requires an analysis of the surrounding facts and circumstances on a case-by-case basis.

II. AJCA – Repeal of the ETI Exclusion Provisions

The Service interprets the ETI repeal date consistently with the ETI effective date because the language of section 101(c) of the AJCA is materially similar to the language of section 5(a) of the ETI Act. Thus, the determination of when sales and leases are entered into within the meaning of section 101(c) of the AJCA requires an analysis of the surrounding facts and circumstances on a case-by-case basis. In contrast to the ETI effective date and ETI repeal date, which apply on a transaction-by-transaction basis, the Service interprets the phase-out rule as applying to income recognized during the 2005 and 2006 calendar years from transactions entered into during those years.

² This memorandum does not address services in large part because the Service has not encountered disputes involving services. No inference should be drawn regarding the treatment of services under the FSC or ETI exclusion provisions.

III. TIPRA – Repeal of the Binding Contract Rules

The TIPRA repeal date repeals the binding contract rules for taxable years that begin after May 17, 2006. Because the binding contract rules apply on a transaction-by-transaction basis, we interpret the TIPRA repeal date as repealing the binding contract rules prospectively, on a transaction-by-transaction basis, for transactions entered into during a taxable year that begins after May 17, 2006. In other words, the binding contract rules apply to certain transactions, but only if such transactions are not entered into in a taxable year that begins after May 17, 2006.

IV. Examples

We intend the following examples to illustrate and clarify our position. For all examples, assume the transactions satisfied all the FSC requirements in sections 921 through 927 and all the ETI exclusion requirements in sections 114 and 941 through 943. Unless otherwise specified, references to ETI exclusions are to the exclusion amount allowable under section 114, not the reduced amounts allowable for 2005 and 2006 under section 101(d) of the AJCA.

Example 1a

In April 1998, the government of CountryX signed a letter of agreement (“LOA”) with the U.S. Department of Defense (“DoD”) to purchase a specified number of ProductY (“Original Sale”) with an option to purchase an additional specified number of ProductY (“Second Sale”). The option is a binding contract for purposes of the binding contract rules. In July 1998, Taxpayer executed ContractZ with the DoD whereby the DoD would purchase ProductY in accordance with the LOA on behalf of CountryX.

Actual deliveries of ProductY purchased in the Original Sale occurred during 2002, 2003, and 2004. Taxpayer recognized income under a long-term contract method of accounting from 1999 through 2004. As deliveries were made in 2002, 2003, and 2004, the DoD executed DD Forms 250 evidencing delivery and acceptance with respect to the Original Sale.

In 2001, CountryX/DoD exercised the option to purchase additional ProductY under ContractZ. Deliveries of the additional ProductY began in 2004 and will continue for several more years. Taxpayer recognized income in 2004 and will continue to do so for several more years with respect to the Second Sale. As deliveries are made in 2004 and afterward, the DoD executes DD Forms 250 evidencing delivery and acceptance with respect to the Second Sale.

Taxpayer may claim FSC benefits (but not ETI exclusions) with respect to all the income from the Original Sale because the sale was entered into before the ETI

Effective Date. If the Second Sale involves³ a FSC, Taxpayer may claim either FSC benefits under section 5(c)(1)(A) of the ETI Act or ETI exclusions under section 5(c)(2) of the ETI Act with respect to all the income from the Second Sale recognized in all taxable years. If the Second Sale does not involve a FSC, Taxpayer may claim ETI exclusions under section 5(a) of the ETI Act with respect to all the income from the Second Sale recognized in all taxable years.

Example 1b

Same facts as Example 1a except that the option was exercised in 2003.

Same results as Example 1a except that the justification for FSC benefits with respect to the Second Sale is section 5(c)(1)(B) of the ETI Act, not section 5(c)(1)(A).

Example 1c

Same facts as Example 1a except that the option was exercised on May 30, 2007, and deliveries with respect to the Second Sale begin in 2007.

Same results as Example 1a with respect to the Original Sale but no FSC benefits or ETI exclusions with respect to the Second Sale because the Second Sale was entered into on May 30, 2007 (i.e., after the TIPRA repeal date).

Example 2a

On January 1, 2001, Taxpayer (a calendar year taxpayer) entered into a three-year lease as lessor ("First Lease") with an option for the lessee to renew the lease for up to ten years at the end of the First Lease. Taxpayer recognized rental income under the First Lease for three years beginning in 2001. On January 1, 2004, the lessee exercised the renewal option for another 10-year lease ("Second Lease"), so Taxpayer will recognize rental income for ten years beginning in 2004. The option is a binding contract for purposes of the ETI binding contract rule.

If the First Lease involves a FSC, Taxpayer may claim either FSC benefits under section 5(c)(1)(A) of the ETI Act or ETI exclusions under section 5(c)(2) of the ETI Act with respect to all the income from the First Lease. If the First Lease does not involve a FSC, Taxpayer may claim ETI exclusions under section 5(a) of the ETI Act with respect to all the income from the First Lease. Taxpayer may claim ETI exclusions under section 5(a) of the ETI Act with respect to all the income from the Second Lease because the Second Lease was entered into before the ETI Repeal Date.

³ A sale or lease "involves" a FSC within the meaning of section 5(c) of the ETI Act if either the FSC is the seller or lessor in the transaction or the FSC is paid a commission by a related supplier with respect to a transaction in which the related supplier was the seller or lessor. See Temp. Treas. Reg. § 1.927(d)-2T(a) (for the definition of "related supplier"); see also I.R.C. § 925(b)(1) and Temp. Treas. Reg. § 1.925(a)-1T(d)(2) (for rules regarding commission FSCs).

Example 2b

Same facts as Example 2a except that the renewal option is exercised on January 1, 2005.

Same results as Example 2a except that the justification for ETI exclusions with respect to the Second Lease is section 101(f) of the AJCA (which reinstates section 5(a) of the ETI Act).

Example 2c

Same facts as Example 2a except that the First Lease is entered into on January 1, 2004, and the Second Lease is entered into on January 1, 2007.

Taxpayer may claim ETI exclusions under section 5(a) of the ETI Act with respect to all the income from the First Lease. Taxpayer may claim no FSC benefits or ETI exclusions with respect to any of the income from the Second Lease because the Second Lease was entered after the TIPRA repeal date.

Example 2d

Same facts as Example 2c except that Taxpayer's taxable year begins on March 1.

Same result as Example 2c with respect to the First Lease. Taxpayer may claim ETI exclusions with respect to all of the income from the Second Lease under section 101(f) of the AJCA because the Second Lease was entered into during a taxable year (March 1, 2006 – February 28, 2007) that began before the TIPRA repeal date.

Example 3a

On January 1, 2005, Seller (a calendar year taxpayer) and Buyer entered into a sale whereby Seller agreed to sell Buyer a specified amount of property at a specified price within ten years. Under its accrual method of accounting, Buyer recognizes sales income from the sale for ten years beginning in 2005. The sale is not pursuant to a binding contract for purposes of the binding contract rules.

Under section 101(d)(2) of the AJCA, Seller may claim ETI exclusions with respect to income from the sale recognized in 2005 and 2006. The ETI exclusion amount for 2005 is 80% of the amount otherwise permitted under section 114. The ETI exclusion amount for 2006 is 60% of the amount otherwise permitted under section 114. No ETI exclusions are permitted with respect to income from the sale recognized after 2006 because transactions entered into during the phase-out period generate ETI exclusions only with respect to income from the transaction recognized during the 2005

and 2006 calendar years and because a binding contract rule does not apply to override⁴ the rules for the phase-out period.

Example 3b

Same facts as Example 3a except that the sale is pursuant to a binding contract as described in the ETI binding contract rule.

All income from the sale qualifies for ETI exclusions under section 101(f) of the AJCA because section 513 of TIPRA did not repeal the ETI binding contract rule with respect to transactions entered into during taxable years that began on January 1, 2005.

Example 3c

Same facts as Example 3b except that the sale is entered into in 2006 and income recognition begins in 2006.

Same result as Example 3b.

Example 3d

Same facts as Example 3b except that income recognition begins in 2007.

Same result as example 3b.

Example 3e

Same facts as Example 3a except that Seller's taxable year begins on June 1; the sale is entered into on September 8, 2006; and income recognition begins in calendar year 2006.

Under section 101(d)(2)(B) of the AJCA, Seller may claim an ETI exclusion with respect to income from the sale recognized in 2006. The ETI exclusion amount for 2006 is 60% of the amount otherwise permitted under section 114. No ETI exclusions are permitted with respect to income from the sale recognized after 2006 because transactions entered into during the phase-out period generate ETI exclusions only with respect to income from the transaction recognized during the 2005 and 2006 calendar years and because a binding contract rule does not apply to override the rules for the phase-out period.

⁴ If a transaction is entered into during calendar 2005 or 2006 and the ETI binding contract rule applies, the taxpayer may claim full ETI exclusions under section 101(f) of the AJCA instead of limited ETI exclusions under section 101(d) of the AJCA as illustrated by Example 3b below.

Example 3f

Same facts as Example 3e except that the sale is pursuant to a binding contract as described in the ETI binding contract rule.

Same result as Example 3e because, under section 513(b) and (c) of TIPRA, the taxable year in which Seller entered into the sale began after the TIPRA repeal date.

Example 3g

Same facts as Example 3f except that Seller's taxable year begins on May 9.

All income from the sale qualifies for ETI exclusions under section 101(f) of the AJCA because the taxable year in which Seller entered into the sale began before the TIPRA repeal date.

Example 3h

Same facts as Example 3g except that the sale was entered into on February 7, 2007.

Same results as Example 3g.

Example 4

Taxpayer entered into a sale in 2002 (to which the FSC binding contract rule does not apply) and recognizes income from that sale every year through 2012. Taxpayer entered into another sale in 2008 and recognizes income from that sale in 2008. In 2008, Taxpayer may claim an ETI exclusion with respect to the income from the sale entered into in 2002 but cannot claim an ETI exclusion with respect to the income from the sale entered into in 2008.

Please call branch 6 at (202) 435-5265 if you have any further questions.