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memorandum

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to: David Brodsky, Associate Area Counsel, CC:LM:F:BOS

from: Jacob Feldman, Special Counsel, CC:INTL

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subject: **Sale of Export Property for Use by the United States Government**

This Chief Counsel Advice responds to your request for non-taxpayer specific guidance regarding the captioned subject. In accordance with I.R.C. 6110(k)(3), Chief Counsel Advice may not be used or cited as precedent.

I. ISSUE

Whether the sale of national defense weaponry, military systems, and similar equipment -- that qualifies as export property under section 927(a) of the foreign sales corporation ("FSC") provisions -- for use by the United States or any instrumentality thereof (the "U.S. government") violates section 924(f)(1)(A)(ii).

II. CONCLUSION

The sale of national defense systems and military equipment that qualifies as export property under section 927(a) of the FSC provisions for use by the U.S. government does not violate section 924(f)(1)(A)(ii) where the purchase of such property is made pursuant to an administrative or discretionary decision of the U.S. government, rather than a law or regulation that prohibits the purchase of foreign-made property. In addition, section 924(f)(1)(A)(ii) is not violated where a law or regulation encourages or favors procurement of domestic-made goods (but does not prohibit the procurement of foreign-made goods). Finally, section 924(f)(1)(A)(ii) is not violated where a law or regulation that requires the purchase of domestic-made goods is negated by a waiver.

III. FACTS

The U.S. government uses national defense weaponry, military systems, and similar equipment ("military products"). Because of national security interests, trade issues, and other concerns, the U.S. government often awards procurement contracts for military products to domestic companies. These domestic companies often manufacture military products within the United States. We understand that critical facts pertaining to this general fact pattern -- as well as the relevance of certain national security, procurement, and other provisions -- vary from case to case. In some cases, military products satisfy the definition of export property in section 927(a), and the manufacturers of those products have claimed FSC benefits under section 921(a).

IV. LAW

Generally, a foreign sales corporation ("FSC") may claim a partial exemption from income tax with respect to foreign trading gross receipts ("FTGR") from the sale of export property (as defined in section 927(a)). I.R.C. §§ 921 through 927. Under section 924(f)(1)(A)(ii), gross receipts from a sale of export property that would otherwise qualify as FTGR under section 924(a)(1) do not qualify as FTGR if the export property is "for use by the United States or any instrumentality thereof and such use of export property . . . is required by law or regulation." Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i) elaborates:

> Foreign trading gross receipts of a FSC do not include [otherwise qualifying] gross receipts . . . if a sale . . . of export property . . . is for use by the United States or an instrumentality thereof in any case in which any law or regulation requires in any manner the purchase . . . of property manufactured, produced, grown, or extracted in the United States. . . . For example, a sale by a FSC of export property to the Department of Defense for use outside the United States would not produce foreign trading gross receipts for the FSC if the Department of Defense purchased the property from appropriated funds subject to either any provision of the Department of Defense Federal Acquisition Regulations Supplement (48 CFR Chapter 2) or any appropriations act for the Department of Defense for the applicable year if the regulations or appropriations act requires

> that the items purchased must have been grown, reprocessed, reused, or produced in the United States. The Department of Defense's regulations do not require that items purchased by the Department for resale in post or base exchanges and commissary stores located on United States military installations in foreign countries be items grown, reprocessed, reused or produced in the United States. Therefore, receipts arising from the sale by a FSC to those post or base exchanges and commissary stores will not be excluded from the definition of foreign trading gross receipts by this paragraph (g)(4). (Emphasis added).[1]

Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(iii)(B) provides an exception to the government-sale exclusion rule "if the purchase is pursuant to . . . [a] program (whether bilateral or unilateral) under which sales to the United States government are open to international competitive bidding."

V. ANALYSIS

Section 924(f)(1)(A)(ii) provides that gross receipts that would otherwise qualify as FTGR do not constitute FTGR if (1) the export property that gave rise to the gross receipts is used by the U.S. government and (2) the U.S. government was required by law or regulation to use export property. Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i) restates the statutory rule in such a way that seems to broaden the statutory definition by describing a requirement "in any manner." Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i).

Our analysis and consideration of several specific cases involving the interpretation of section 924(f)(1)(A)(ii) and Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i) has revealed that the cases in this area may be highly fact-dependent. As a result, we believe that an attempt to provide an interpretation of these provisions that addresses each and every case involving this issue would be inappropriate. However, this memorandum provides some guidance on this issue that may be helpful in some cases.

The words "in any manner" in Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i) raise the question of how broadly the terms "law or regulation" should be construed. For example, a broad construction might result in the characterization of administrative and discretionary decisions as laws or regulations. A narrow construction might result in a definition of "law or regulation" that includes only Federal statutes and regulations.

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[1] We note that section 924(f)(1)(A)(ii) refers to "use" of export property required by law or regulation while Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i) refers to the required "purchase" of property manufactured, produced, grown, or extracted in the United States. In our view, the regulatory language is not inconsistent with the statutory language.

After careful consideration of this interpretive problem, we believe that it is inappropriate to treat an administrative or discretionary decision (or a series of such decisions) as a law or regulation for purposes of section 924(f)(1)(A)(ii) and Temp. Treas. Reg. § 1.924(a)-1T(g)(4)(i). That the decision to use domestic-made goods is made pursuant to a law or regulation does not mean that the use of such goods is required by law or regulation. Although we have concluded that the effect of the words "in any manner" may broaden the meaning of the terms "law or regulation" to include more than only Federal statutes and regulations, we believe that including administrative and discretionary decisions within that definition would be an over-broad interpretation of the phrase "in any manner."

An interpretation of "law or regulation" that includes such decisions would improperly disregard the meaning of the term "required." An administrative or discretionary decision to restrict procurement to domestic-made goods, where procurement of foreign-made goods would have been legally permissible, does not rise to the level of "required by law or regulation" described in section 924(f)(1)(A)(ii). In short, we construe "law or regulation" as referring to legal authority that affirmatively requires the purchase of domestic-made goods (or prohibits the purchase of foreign-made goods) where such legal authority has not been waived. Applying this interpretive approach, we also conclude that laws or regulations that encourage or favor procurement of domestic-made goods (but do not require the purchase of domestic-made goods or prohibit the procurement of foreign-made goods) do not rise to the level of "required by law or regulation."

The following examples illustrate our position:

Example 1

An appropriations act provides funding specifically for the purchase of military products manufactured in the United States. In this scenario, sellers of the military products identified in the appropriations act are denied FSC benefits under section 924(f)(1)(A)(ii).

Example 2

Federal provision R generally restricts the location of specified materials and technologies to the United States. However, Federal provision R allows for a waiver of the restriction under certain circumstances.[2] For purposes of national defense, the U.S. government purchases military products that contain materials and technologies restricted to the United States by Federal provision R. Absent inclusion in the

[2] An example of such a provision is the Arms Export Control Act and the regulations thereunder, which generally prohibit the export of certain articles, services, and technical data but also permit export licenses to be granted for such items. 22 U.S.C. §§ 2751 et seq., Pub. L. No. 90-629, 82 Stat. 1321 (1968); 22 C.F.R. §§ 121.1 et seq.

purchased military products of those particular materials and technologies (which render the purchased military products technologically superior to any other military products of the same type), the U.S. government would not have purchased those particular military products.

Situation A: If the restriction is not waived, and manufacture of the military products using the restricted materials and technologies occurs entirely within the United States, sellers of the military products containing the restricted materials and technologies are denied FSC benefits under section 924(f)(1)(A)(ii).

Situation B: If the restriction is not waived, and manufacture of the military products using the restricted materials and technologies occurs predominantly within the United States, the National Office should be consulted regarding the applicability of section 924(f)(1)(A)(ii).

Situation C: If the restriction is waived, and manufacture of the military products using the formerly restricted materials and technologies occurs predominantly outside the United States, Federal provision R does not constitute a law or regulation described in section 924(f)(1)(A)(ii).

Situation D: If the restriction is waived, and manufacture of the military products using the formerly restricted materials and technologies occurs predominantly inside the United States, Federal provision R does not constitute a law or regulation described in section 924(f)(1)(A)(ii).

Example 3

A Federal regulation promulgated under a certain statute (“Regulation1”) prohibits the purchase by the U.S. government of military product X manufactured outside the United States. A Federal regulation promulgated under a different statute (“Regulation2”) waives the Regulation1 prohibition with respect to manufacture of military product X in foreign country Y. The U.S. government purchases (for its own use) 100 units of military product X that were manufactured in the United States. Even though Regulation1, standing alone, limits U.S. government purchases of military product X to domestic-made items, the Regulation2 waiver for manufacture in foreign country Y negates the requirement of domestic manufacture contained in the Regulation1. Therefore, in this scenario, FSC benefits are not denied to the seller of military product X under section 924(f)(1)(A)(ii).

Example 4

The U.S. government wants to purchase 100 units of a military product for its own use outside the United States. Rather than using standard competitive bidding procedures to award the procurement contract, the U.S. government decides, for national security

reasons, to award the contract to a company that has manufacturing facilities only in the United States and does not contract outside the United States. In this scenario, even though the administrative decision to forego competitive bidding precluded the possibility of foreign manufacture as a practical matter, FSC benefits are not denied to the seller of the military products under section 924(f)(1)(A)(ii) because the purchase of domestic-made goods resulted from an administrative decision and was not required by law or regulation.

Example 5

The U.S. government solicits bids for a contract to manufacture military products. A price preference provision – for example, the Buy American Act[3] or the Balance of Payments Program[4] -- discourages purchases of foreign-made goods for use by the U.S. government by artificially increasing bids from foreign companies by a fixed percentage of the actual price. The contract is awarded to a company that manufactures only within the United States. This situation does not involve a requirement by law or regulation that domestic-made goods be purchased. Either a qualifying low bid from a foreign manufacturer or a lack of satisfactory domestic manufacturers could result in the purchase of foreign-made products. Therefore, FSC benefits would not be denied by section 924(f)(1)(A)(ii) because of the Buy American Act, the Balance of Payments Program, or a similar price preference.[5]

We recommend that the Field and Examination apply the considerations described in this memorandum in determining whether to pursue cases involving the application of section 924(f)(1)(A)(ii) to sales of military products.

Please call CC:INTL branch 6 at if you have any further questions.

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[3] 41 U.S.C. §§ 10a et seq., Pub. L. No. 72-428, 47 Stat. 1520 (1933).

[4] 48 C.F.R. §§ 25.300 et seq., 48 Fed. Reg. 42,278 (Sept. 19, 1983).

[5] An exception to the Buy American Act and Balance of Payments Program provides that artificial increases to bids from foreign companies do not apply to acquisitions of military products made in specified countries such as certain members of the North Atlantic Treaty Organization. 48 C.F.R. § 225.872-1(a). However, companies organized in such specified countries have, in some cases, been prohibited entirely from bidding on acquisition contracts for certain specified military products. See, e.g., 48 C.F.R. § 225.105 and 48 C.F.R. § 225.7405 (1990)). Because those prohibitions prevent bids from certain foreign companies but do not preclude the possibility of foreign manufacture either by domestic companies or by non-prohibited foreign companies, we believe such a prohibition would not change the outcome in this example.