

**UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF OHIO
WESTERN DIVISION**

**The Proctor & Gamble Company,
et al.,**

Plaintiffs,

-V-

**Case No. 1:05-cv-00355
Judge Michael H. Watson**

United States of America,

Defendant.

OPINION AND ORDER

Plaintiffs seek a refund of taxes paid pursuant to assessments by the Internal Revenue Service ("Service"). This matter is before the Court on the parties' cross-motions for summary judgment on the Foreign Sales Corporation ("FSC") advance payment transaction ("APT") issue. The parties have reached a settlement on the other substantive issues in this case. The Court heard oral argument on this issue on July 11, 2007. For the reasons that follow, the Court grants the government's motion for summary judgment and denies plaintiffs' summary judgment motion.

I. Facts

Plaintiffs are Proctor & Gamble Company ("P&G") and related entities. P&G is a large corporation headquartered in Cincinnati, Ohio. P&G, *inter alia*, manufactures and distributes numerous well-known brands of consumer products, such as Crest

toothpaste and Ivory soap.

During the 2000 tax period, P&G owned 100% of the outstanding stock of both Proctor & Gamble Canada ("P&G Canada") and Proctor & Gamble Distributing Company ("P&G Distributing"). P&G Distributing owned 100% of the outstanding stock of Proctor & Gamble FSC, Inc. (Barbados)("P&G FSC"). P&G FSC is a FSC within the meaning of the Tax Code. P&G, P&G Canada, and P&G FSC file separate tax returns.

In the Spring of 2000, Deloitte & Touche LPP ("Deloitte & Touche") contacted P&G's tax department about several tax strategies, one of which involved an advance payment transaction ("APT") with a FSC. Deloitte & Touche made a Power Point presentation about the advance payment strategy to P&G's tax department during a luncheon at the Banker's Club in Cincinnati on May 11, 2000. P&G decided to adopt the APT strategy.

The APT involved two advance payments for the sale of consumer products manufactured by P&G: one for the sale of goods from P&G to P&G FSC and another for the sale of goods from P&G FSC to P&G Canada. The advance payments were to be made before the end of the 2000 Tax Period, by June 30, 2000. The goods were to be delivered in the 2001 Tax Period.

Advance Payment No. 1 was from P&G Canada to P&G FSC in the amount of \$374,790,000 on June 29, 2000. The government does not challenge Advance Payment No. 1.

Advance Payment No. 2 was from P&G FSC to P&G in the amount of \$288,588,300 on June 29 or 30, 2000. P&G FSC transferred the remaining \$86,201,700 to P&G in the form of an interest free loan.

On its 2000 federal income tax return, P&G FSC reported sales income in the amount of \$374,790,000 attributable to the APT. On its 2000 federal income tax return, P&G reported sales income in the amount of \$288,588,300.

P&G incurred costs of \$359,344,974 to manufacture the products that were the subject of the APT. P&G reported the cost of goods sold as a deduction on its tax return for the 2001 Tax Period. P&G reported a net loss in the amount of \$70,756,674 on its 2000 and 2001 tax returns in connection with the APT.

During the 1999/2000 audit cycle, the IRS determined the \$288,588,300 transfer price between P&G and P&G FSC did not comply with the FSC Administrative Pricing Rules inasmuch as it understated P&G's income by \$86,201,700. The IRS assessed P&G accordingly. P&G now seeks a refund.

II. Summary Judgment

The standard governing summary judgment is set forth in Fed. R. Civ. P. 56(c), which provides:

The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law.

Summary judgment will not lie if there is a dispute as to a genuine issue of material fact. *Audi AG v. D'Amato*, 469 F.3d 534, 542 (6th Cir. 2006) (citing *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 247–8 (1986)). A factual dispute is genuine if the evidence on which the non-moving party relies could convince a reasonable juror to return a verdict in favor of the non-moving party. *Henderson v. Walled Lake Consol. Schs.*, 469 F.3d 479, 487 (6th Cir. 2006). A factual issue is material if its resolution could affect the

disposition of the case under the governing substantive law. *Id.*

When reviewing a summary judgment motion, the Court must draw all reasonable inferences in favor of the nonmoving party, and must refrain from making credibility determinations or weighing the evidence. *White v. Burlington Northern & Santa Fe R. Co.*, 364 F.3d 789, 794 (6th Cir. 2004). However, “[t]he mere existence of a scintilla of evidence in support of the plaintiff’s position will be insufficient; there must be evidence on which the jury could reasonably find for the plaintiff.” *Gues v. Leis*, 255 F.3d 325, 335 (6th Cir. 2001) (*quoting Anderson*, 477 U.S. at 252). Summary judgment is appropriate if the opposing party fails to make a showing sufficient to establish the existence of an element essential to that party’s case and on which that party will bear the burden of proof at trial. *In re Morris*, 260 F.3d 654, 665 (6th Cir. 2001) (*citing Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986)).

III. Discussion

The government argues it is entitled to summary judgment in its favor because the \$288,588,300 transfer price was based upon a CTI calculation that did not comply with the FSC Administrative Pricing Rules. Specifically, the government asserts the CTI was improperly calculated because it did not include the “total costs” of P&G and P&G FSC.

Plaintiffs contend they are entitled to summary judgment in their favor on the APT issue. Plaintiffs maintain the government’s interpretation of the FSC Administrative Pricing Rules improperly attempts to introduce the concept of “matching” of income and costs. Plaintiffs argue such matching runs counter to the fundamental principle of annual accounting embodied in the Internal Revenue Code, as well as the

text of the FSC Administrative Accounting Rules.

In 1971, Congress enacted the domestic international sales corporation (“DISC”) program to provide tax preferences to encourage international sales by United States businesses. Europeans complained the DISC program was an illegal subsidy in violation of the General Agreement on Tariffs and Trade (“GATT”). In response, Congress replaced the DISC program with the FSC program. The FSC program operated from 1984 until 2000, when Congress replaced it after the appellate body of the World Trade Organization concluded the FSC program was a prohibited export subsidy. See FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. 106-519.

Under the FSC program, a FSC was permitted to permanently exempt a portion of its income from taxation. 26 U.S.C. §§ 921, 923. If, as here, the FSC relied on the FSC Administrative Pricing Rules, 16/23 of its income was exempted. 26 U.S.C. § 923(a). Hence, the FSC program provided taxpayers a strong incentive to maximize the amount of income reported by a FSC by structuring a low transfer price between the FSC and its related United States supplier.

The FSC scheme gave taxpayers the choice of three methods to calculate the transfer price: (1) 1.8% of the gross receipts; (2) 23% of the CTI; and (3) the arm’s-length price. See 26 U.S.C. 925(a), *repealed by* FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. 106-519. The FSC Administrative Pricing Rules define CTI as “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 . . . which relate to the

foreign trading gross receipts.” 26 C.F.R. § 1.925(a)-IT(c)(6)(emphasis added).

P&G and P&G FSC, applying the annual accounting method, calculated CTI for 2000 by adding the gross receipts of P&G FSC for the APT. They did not subtract the “total costs” of the APT because, under the annual accounting principle, the costs of the APT were not incurred until the following year. The following illustrates plaintiffs’ calculation of CTI for tax year 2000:

Gross Receipts	\$374,790,000
Costs of goods	- \$0
Other costs	- \$0
	<hr/>
Combined Taxable Income	\$374,790,000

Thus, plaintiffs did not account for any costs related to the APT in the 2000 tax year. Under § 925(a) and applicable regulations, plaintiffs shifted 23% of the CTI to P&G FSC. Plaintiffs’ calculation allowed P&G FSC to earn a profit of \$86,201,700, which was then afforded the FSC exemption. The resulting transfer price was therefore \$288,588,300.

The government maintains the calculation should have included the “total costs” attributable to the APT, regardless of whether they had been incurred that year, as follows:

Gross Receipts	\$374,790,000
Cost of goods	- \$359,344,974
Other costs	- \$2,721,689

Combined Taxable Income	\$12,723,337
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According to the government, the FSC exemption should have applied to only \$12,723,337 rather than \$86,201,700.

Plaintiffs argue their accounting method was proper under the “annual accounting concept” relating to the calculation of taxable income. The annual accounting concept is embodied in 26 U.S.C. §§ 451 and 461. These statutes essentially require taxpayers to report income in the year it is received, and costs in the year they are incurred. Plaintiffs contend these statutory provisions are controlling, and trump the government’s interpretation of “total costs” in 26 C.F.R. § 1.925(a)-1T(c)(6). Plaintiffs maintain the annual accounting concept is so fundamental that, if there had been an intent to override it, the Code and regulations would have been explicit.

Plaintiffs assert their application of the annual accounting concept to the APT is permissible under the FSC Administrative Pricing Rules. Specifically, they refer to 26 C.F.R. 1.925(a)-1T(c)(6), which provides as follows:

Subject to the provisions of subdivision (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 determining the amounts of income and expense (including depreciation) and the taxable year for which those items are taken into account. (added)

Id. This provision, plaintiffs argue, sets forth two principles which support its calculation of CTI. First, it requires the Service to accept the taxpayers’ methods of accounting. Here, P&G and P&G FSC both used the annual accounting method. Second, the provision requires the Service to accept the year for which income and expense are taken into account. In this case, P&G and P&G FSC accounted for income in the year

it was received, and expenses in the year they were incurred.

The government acknowledges §§ 451 and 461 apply to the calculation of taxable income. The government, however, asserts that despite the similarity of the terms, “taxable income” as used in the tax code is distinct from the more specific “combined taxable income” as set forth in the FSC Administrative Pricing Rules. Taxable income, the government maintains, represents the bottom line dollar amount to which tax rates of the Internal Revenue Code apply. CTI, in contrast, is an intermediary calculation used to determine the transfer price between a domestic business and its FSC.

The government cites a tax court decision in support of its argument: *General Dynamics v. Commissioner*, 108 T.C. 107 (1997). In *General Dynamics*, the petitioners used the completed contract method of accounting. Typically, when the completed contract method is used, the income and expenses connected with long-term contracts are not reported or claimed until the contract is completed. The petitioners, however, elected to expense rather than capitalize certain period costs¹ as was permitted under 26 C.F.R. 1.451-3(d)(5)(iii).

In calculating CTI, the petitioners in *General Dynamics* did not make a reduction for period costs incurred before the year of completion. They calculated CTI as follows:

(a) Add: Gross receipts from the contract as determined under the completed contract method of accounting;

¹ “Period costs include marketing and selling expenses, distribution expenses, general and administrative expenses attributable to the performance of services that benefit the taxpayer’s activities as a whole, casualty losses, certain pension and profit-sharing contributions, and costs attributable to strikes, rework labor, scrap, and spoilage.” *General Dynamics*, 108 T.C. at 126 (citing 26 C.F.R. 1.451-3(d)(5)(iii)).

(b) Less: direct costs allocated to the contract under section 1.451-3(d)(5)(i), Income Tax Regs.;

(c) Less: indirect costs allocated to the contract under section 1.451-3(d)(5)(ii), Income Tax Regs.;

(d) Less: period costs incurred only in the year of completion allocated to the contract under section 1.451-3(d)(5)(iii), Income Tax Regs.

General Dynamics, 108 T.C. at 110. The government determined the petitioners' failure to include prior year period costs resulted in an understatement of the costs. Thus, the issue in *General Dynamics* was whether in computing CTI under §§ 924 and 925, the petitioners were required to deduct prior year period costs in addition to current year period costs in calculating CTI.

The court in *General Dynamics* found the term "total costs" to be ambiguous because the regulations did not indicate whether "total" was for the taxable year or all costs including those incurred in prior years. 108 T.C. at 120. The court concluded legislative history indicated Congress intended taxpayers to account for all costs relating to export sales, including period costs deducted in prior years. 108 T.C. at 119, 122-25. Moreover, the *General Dynamics* court concluded 26 C.F.R. § 1.861-8 requires taxpayers to prove the prior year period costs definitely relate to gross income other than export sales to avoid having to account for those costs in determining CTI. 108 TC at 122-25. The petitioners had failed to do so. *Id.* at 124. In addition, the court found no support for the petitioners' argument that "total costs" are only those costs claimed in the year of completion. *Id.* The court in *General Dynamics* held the petitioners must account for both current and prior year period costs in calculating CTI. 108 T.C. at 125.

The petitioners in *General Dynamics* maintained the government must defer to the taxpayer's method of accounting for purposes of determining costs for calculating CTI, citing the above-quoted 26 C.F.R. 1.925(a)-1T(c)(6)(iii)(A). The *General Dynamics* court rejected the petitioners' argument, observing the taxpayer's method of accounting was expressly subject to section 1.925(a)-1T(c)(6)(iii)(D), which sets forth the definition of costs related and allocable to the petitioners' export sales. 108 T.C. at 125.

The petitioners in *General Dynamics* also argued § 1.861-8 required the application of the annual accounting method to income and cost allocations. They maintained requiring them to account for prior year period costs was inconsistent with annual accounting principles. The court rejected this argument as well, explaining as follows:

Accepting petitioners' argument would mean that taxpayers using the completed contract method of accounting would calculate their CTI in accordance with section 1.451-3, Income Tax Regs., as opposed to the regulations under sections 994 and 925. Under section 1.861-8, Income Tax Regs., the costs to be allocated are defined by the operative section which references that regulation. Thus, we look to sections 994 and 925 and the related regulations to determine which costs are allocable to export sales for purposes of determining CTI, not the regulations under section 451 as petitioners contend. Although period costs are not required to be allocated to long-term contracts for cost-deferral purposes under section 1.451-3(d)(5)(iii), Income Tax Regs., sections 994(a) and 925(a) and the related regulations require that all costs, including prior year period costs, be accounted for in determining CTI.

Requiring petitioners to account for all period costs in determining CTI is consistent with the completed contract method of accounting. Allowing taxpayers to use their normal method of accounting to compute CTI does not necessarily cede to the accounting methodology the computation of the limitation of the benefit to be generated by foreign exports. Petitioners must account for all related costs, including period costs, of both current and prior years in determining their CTI from export sales.

108 T.C. at 128.

Plaintiffs argue *General Dynamics* is distinguishable because the petitioners in that case used the completed contract method of accounting, whereas plaintiffs in the instant case used the annual accounting method. The Court disagrees. First, the petitioners in *General Dynamics* had maintained the *annual accounting method* controlled their treatment of period costs pursuant to section 1.451-3(d)(5)(iii). 108 T.C. at 126. Moreover, nothing in the reasoning of *General Dynamics* suggests the court's holding is limited to cases in which the taxpayer used the completed contract method of accounting.² That is, *General Dynamics* did not hinge on the petitioners' method of accounting. Rather, it turned upon the court's interpretation of the requirements of § 925 and related regulations in light of legislative history. Nor is *General Dynamics* limited to period costs, as the court referred to "*all related costs, including period costs.*" 108 T.C. at 128 (emphasis added).

General Dynamics is instructive. It teaches "total costs" means *all costs* regardless of the year they were incurred. In the instant case, plaintiffs' calculation of CTI did not account for *any* costs, let alone all costs. Furthermore, *General Dynamics* stands specifically for the proposition that the taxpayer's accounting method does not override the limiting principle of the § 925 regulations which require all costs to be included in the CTI calculation. Moreover, the court in *General Dynamics* observed the petitioners were attempting "to avoid the *matching of costs with income* for purposes of computing CTI *as required by the regulations under sections 994 and 925.*" 108 T.C. at

² One district court recognized the limitation urged by plaintiffs. See *Boeing Co. v. United States*, No. C96-1990C, 1998 WL 767305, at * 5 (W.D. Wash. Sept. 10, 1998), *rev'd*, 258 F.3d 958 (9th Cir. 2001), *aff'd*, 537 U.S. 437 (2003). Although the scope of *General Dynamics* was not an issue in the subsequent appeals, the district court's decision was reversed. This Court respectfully disagrees with the district court in *Boeing*, and declines to follow its decision.

127 (emphasis added).

As the petitioners in *General Dynamics* argued, plaintiffs in the instant case contend principles of annual accounting dictate what costs must be included in the CTI calculation, and matching of income and expenses is not required. Under *General Dynamics*, plaintiffs' arguments must be rejected.

The government's position finds further support in legislative history of the FSC provisions, as discussed in *Boeing Co. v. United States*, 537 U.S. 437 (2003). At issue in *Boeing* was 26 C.F.R. 1.861-8(e)(3), which governed the allocation of research and development ("R&D") expenditures in the calculation of CTI. The regulation required taxpayers to use specific product categories in allocating R&D expenditures. Boeing had expended monies for R&D in connection with certain aircraft years before it actually sold the aircraft. The regulation, however, directed taxpayers to allocate such expenses to the sales of other aircraft because the other aircraft fell within the same product category. Boeing argued the regulation was invalid because it conflicted with congressional intent that there be a "direct" relationship between items of gross income and expenses "related thereto." In advancing this argument, Boeing relied heavily on legislative history.

The Court in *Boeing* upheld the regulation. 537 U.S. at 457. As to legislative history, the Court observed:

If anything, what little relevant legislative history there is in this suit weighs in favor of the Government's position in two important respects. First, whereas the DISC transfer price could be set at a level that attributed over half of the CTI to the DISC, when Congress enacted the FSC provisions in 1984, it lowered the maximum allowable share of CTI attributable to an FSC to 23 percent. Compare 26 U.S.C. § 994(a)(2) with 26 U.S.C. § 925(a)(2) (1988 ed.). This dramatizes the point that even though the

purpose of the DISC and FSC statutes was to provide American firms with a tax incentive to increase their exports, Congress did not intend to grant "undue tax advantages" to firms. S. Rep., at 13. Rather, the statutory formulas were designed to place ceilings on the amount of those special tax benefits. See Committee Print 636 ("[T]he income of the foreign sales corporation must be determined according to transfer prices specified in the bill: either actual prices for sales between unrelated, independent parties or, if the sales are between related parties, formula prices which are intended to comply with GATT's requirement of arm's-length prices").

Boeing, 537 U.S. at 456. Hence, Congress intended the transfer price resulting from the calculation of CTI to approximate an arm's-length price.

In the instant case, plaintiffs arrived at a transfer price of \$288,588,300. It is undisputed the cost to produce the goods was \$359,344,974. The arms-length price of the products was \$374,790,000. Without question, the \$288,588.300 transfer price is so much drastically lower than the arm's-length price, it cannot, as a matter of law, be viewed as an approximation of the same. As a result, the \$288,588,300 price runs counter to congressional intent to limit the FSC exemption to an approximation of an arms-length price to comply with GATT.

For the above reasons, the Court holds the \$288,588.300 transfer price violates the FSC Administrative Pricing Rules. Accordingly, the government is entitled to summary judgment in its favor on the APT issue.

IV. Disposition

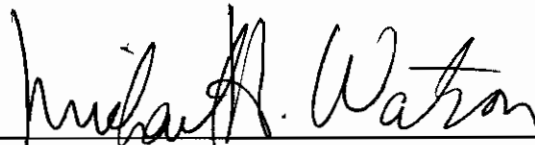
Based on the above, the Court **DENIES** plaintiffs' summary judgment motion (Doc. 63) and **GRANTS** the government's summary judgment motion (Doc. 76).

This decision renders the remaining motions in limine moot (Docs. 89, 90 and 95).

The government shall submit a proposed final judgment entry consistent with the

parties' settlement agreement by **October 6, 2007**.

IT IS SO ORDERED.

A handwritten signature in black ink, appearing to read "Michael H. Watson", written over a horizontal line.

**MICHAEL H. WATSON, JUDGE
UNITED STATES DISTRICT COURT**