DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

CC:INTL:Br6

November 4, 1998

UILC: 936.03-05

Number: **199905014**
Release Date: 2/5/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: STEVEN A. MUSHER
CHIEF, CC:INTL:Br6

SUBJECT:

This Field Service Advice responds to your memorandum dated October 1, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Corporation A	=
Corporation B	=
Producers	=
Independent Producers	=
Corporate-Owned Producers	=
Product E	=
Product F	=
Product G	=
Date R	=
Date S	=
Date T	=
TY 1-7	=

ISSUE:

Whether Treas. Reg. § 1.936-6(b)(1) Q&A-12, governs the computation of combined taxable income under the section 936(h)(5)(C)(ii) profit split method in the case of the sale of Product E to Joint Venture Producers who are not part of the affiliated group.

CONCLUSION:

Treas. Reg. § 1.936-6(b)(1) Q&A-12, is inapplicable since sales of the possession product beyond the affiliated group to Joint Venture Producers are themselves "covered sales" within the meaning of section 936(h)(5)(C)(ii)(IV), not sales of a component product subject to further processing before covered sales outside the affiliated group. Accordingly, the general rules of Treas. Reg. § 1.936-6(b)(1) Q&A-1 et seq. apply for purposes of computing combined taxable income in this case.

FACTS:

Corporation A is a worldwide producer of Product E, Product F and Product G. Corporation B is Corporation A's Puerto Rican Product E manufacturing subsidiary. Corporation B claims section 936 benefits as a possessions corporation pursuant to an election under section 936(e) made in Date R. Corporation B has further made an election under section 936(h)(5)(C)(ii) to determine its section 936 benefits under the profit split method and has identified Product E as the possession product for this purpose. Corporation B sells the Product E to Corporation A who then on sells it at the same price to affiliate and non-affiliate Producers. Some of the Product E is sold as a "component product" to Corporate-Owned Producers where is it is further processed into its final form as Product F and Product G. Treas. Reg. § 1.936-5(a) Q&A-1. Corporation A also sells Product E as an "integrated product" to Independent Producers. Treas. Reg. § 1.936-5(a) Q&A-1.

Corporation B timely filed its federal income tax returns for each of TY 1-7. On Date S, Corporation A and Corporation B both filed amended federal income tax returns for the years TY 1-7. In the amended returns Corporation A claimed to have overstated the amount of expenses allocable and apportionable to its gross income from selling Product E for purposes of computing combined taxable income under the profit split method.

Corporation A, in its Date T revised expense allocation, identified a third category of Product E sales to non-affiliate Joint Ventures ("JV's") in which Corporation A owns a minority stock interest. Corporation A concedes that the JV's are not "affiliates" within the meaning of section 482. Accordingly, the JV's are not part of the affiliated group that includes Corporation B within the meaning of section 936(h)(5)(C)(i)(I)(b).

LAW AND ANALYSIS:

Taxpayer's Position

Corporation A seeks to allocate and apportion JV-related expenses pursuant to Treas. Reg. § 1.936-6(b)(1), Q&A-12, as interpreted in Coca-Cola Co, v. Commissioner, 106 T.C. 1 (1996).[1] Treas. Reg. § 1.936-6(b)(1) Q&A-12 applies by its terms to the computation of combined taxable income where the possession product is, inter alia, a "component product." Treas. Reg. § 1.936-5(a) Q&A-1 defines a "component product" to be a product which is subject to further processing before sale to an unrelated party. A component product is distinguished from an "integrated product," which the same regulation defines to be a product which is not subject to any further processing before sale to an unrelated party and which includes all component products from which it is produced. Corporation A argues the Product E sales to the JV's are sales of a "component product" as opposed to an "integrated product" within the meaning of the foregoing Treas. Reg. § 1.936-5(a) Q&A-1. Corporation A reasons that the Product E is subject to further processing by the JV's before sale to an "unrelated party," since none of the JV's themselves is an "unrelated party." In the latter regard, Corporation A refers to section 936(h)(5)(D), which defines "unrelated person" in terms of someone other than a "related person" as defined in section 936(h)(3)(D), which carries a ten percent relatedness test. Corporation A's conclusion is that since Corporation B is more than ten percent related to the JV's, sales of Product E cannot be of an "integrated product," and thus must be of a "component product." Corporation A supports its position with section 936(h)(5)(B)(iv)(IV), which allows the Secretary to prescribe regulations "for treating components produced in whole or in part by a related person as materials . . . ." Corporation A draws a parallel between the term "unrelated party," as found in the Treasury Regulations, and "unrelated person," as found in the Code.

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[1] In Coca-Cola, the petitioners successfully argued that they could properly allocate the expenses associated with concentrate sales separately and differently depending upon whether the sale was to an independent franchised bottler, or to an affiliated company owned bottler. This result enabled a greater section 936 benefit for concentrate sales to affiliates as compared with independent franchised bottlers. The issue of joint ventures was not in the present case.

This case raises issues of interpretation of various terms appearing in the statute and regulations, namely “unrelated person,” “related person,” “unrelated party,” and “related party.” To provide a context, it is useful to consider the framework for taxing intangible property income under section 936.

Framework and History of Section 936 Benefits for Intangible property income

Section 936(h), enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”), is intended to benefit business operations that contribute to the economy of the possessions. Pub. L. 97-248, sec. 213, H. Conf. Rept. 97-760 at 505 (1982). The mechanics of providing the benefits are a credit for the tax on qualified income of an electing corporation coupled with a dividend received deduction for dividends made from the possession corporation. I.R.C. §§ 243(b)(1)(B)(ii), 936(a).

Section 936(h) was added in response to the perceived abuse under prior law by U.S. businesses in developing intangibles and deducting the development costs in the U.S., followed by a transfer of the intangibles for exploitation on a tax-favored basis in the possessions:

> The provision as modified is intended to lessen the abuse caused by taxpayers claiming tax-free income generated by intangibles developed outside of Puerto Rico. . . .

H. Conf. Rept. 97-760 at 505 (1982).[2]

Accordingly, under section 936(h)(1) of the bill as originally passed by the Senate and as ultimately enacted by TEFRA, the general rule excludes income attributable to intangibles from the benefits of section 936, by treating such income as included by the shareholders rather than by the electing corporation as follows:

> (h) Tax treatment of intangible property income.
> (1) In general.
> (A) Income attributable to shareholders. The intangible property income of a corporation electing the application of this section for any taxable year shall be included on a pro rata basis in the gross income of all shareholders of such electing corporation at the close of the taxable year of such electing corporation as income from sources within the

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[2] Section 936(h) was, in part, a response to issues raised in Eli Lilly & Co. v. Commissioner, 84 T.C. 996 (1985), aff’d. in part, rev’d. in part and remanded 856 F.2d 855 (7th Cir. 1988) (taxpayer transferred valuable patents and other intangibles to its Puerto Rican subsidiary and thereby avoided substantial federal income taxes).

> United States for the taxable year of such shareholder in which or with which the taxable year of such electing corporation ends.

S. Rep. No. 97-494 at 259 (1982).

The Senate bill did contain circumscribed exclusions permitting section 936 benefits for certain intangibles (to be referred to as “covered intangibles”). Under the Senate bill, covered intangibles included intangibles developed solely by the electing corporation and manufacturing intangibles acquired by such corporation from a person who was not “related” to such corporation (or to any person related to such corporation). The Senate amendment, in section 936(h)(3)(A), provided for the exclusion from section 936 benefits of:

> the gross income of a corporation attributable to any intangible property other than intangible property which —
> (i) was developed solely by such corporation in a possession, or
> (ii) acquired by such corporation from a *person* who was *not related* to such corporation (or to any other *person related* to such corporation) at the time of, or in connection with, such acquisition.

S. Rep. No. 97-494 at 261 (1982). (Emphasis added). The Senate bill, in section 936(h)(3)(D) defined “related person” for this purpose as a person having a greater than ten percent relationship with the electing corporation:

> (D) Related person.
> (i) In general. A person (hereinafter referred to as the "related person") is related to any person if —
> (I) the related person bears a relationship to such person specified in section 267(b) or section 707(b)(1), or
> (II) the related person and such person are members of the same controlled group of corporations.
> (ii) Special rule. For purposes of clause (i) —
> (I) section 267(b) and section 707(b)(1) shall be applied by substituting "*10 percent*" for "50 percent,” and
> (II) section 267(b)(3) shall be applied without regard to whether a person was a personal holding company or a foreign personal holding company.”

S. Rep. No. 97-494 at 263 (1982).[3] (Emphasis added). This provided a clear rule to ensure that intangibles developed by persons related to the electing corporation (rather

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[3] Note that (h)(3)(D) was adopted in TEFRA as is, with the exception of (h)(3)(D)(ii)(II), which was deleted in conference.

than solely by the electing corporation itself) could not become the subject of section 936 benefits.

The House-Senate Conference decided to amend the categories of intangible property income for which section 936 benefits would be afforded. To effectuate this revision, the exception for covered intangibles was eliminated from the general exclusion of intangible property income from under section 936(h)(3)(A) of the Senate bill, although the definition of related person remained in section 936(h)(3)(D). Section 936(h)(5) was added providing an "election out" from the general exclusion and permitting specified benefits for intangible property income under either the cost sharing or the profit split method. Benefits for covered intangibles were incorporated within the "cost sharing" election in section 936(h)(5)(C)(i)(II):

> Such electing corporation shall not be treated as the owner (for purposes of obtaining a return thereon) of any intangible property described in subsection (h)(3)(B)(ii) through (v) (to the extent not described in subsection (h)(3)(B)(i)) or of any other nonmanufacturing intangible. Notwithstanding the preceding sentence, an electing corporation shall be treated *as the owner* (for purposes of obtaining a return thereon) of (a) *intangible property which was developed solely by such corporation in a possession and is owned by such corporation, (b) intangible property described in subsection (h)(3)(B)(i) acquired by such corporation from a person who was not related to such corporation (or to any person related to such corporation)* at the time of, or in connection with, such acquisition, and (c) any intangible property described in subsection (h)(3)(B)(ii) through (v) (to the extent not described in subsection (h)(3)(B)(i)) and other nonmanufacturing intangibles which relate to sales of units of products, or services rendered, to *unrelated persons* for ultimate consumption or use in the possession in which the electing corporation conducts its trade or business.

I.R.C. § 936(h)(5)(C)(i)(II). (Emphasis added). Note, as redrafted by the Conference Committee, a third category of covered intangibles are added, namely possession product marketing intangibles involved in the sale of the possession product to unrelated persons for ultimate consumption or use in the possession. Section 936(h)(5)(D) defines an "unrelated person" as a person other than a related person within the meaning of section 936(h)(3)(D).

The section 936(h)(5) election out is available on the condition that the electing corporation have a significant business presence in a possession with respect to the product for which section 936 benefits is claimed. Significant business presence is measured under three alternative tests geared to a minimum level of specified costs of the product being incurred in the possession.

Where the significant business threshold is satisfied, section 936 benefits are afforded for intangible property income from the possession product under an election of either the cost sharing or profit split method. Under cost sharing, an electing corporation is treated as the owner for purposes of obtaining a section 936 benefitted return on manufacturing intangibles for which it makes a specified cost sharing payment with regard to product area research costs incurred by the affiliated group. Section 936(h)(5)(C)(i)(I)(b) defines "affiliated group" by reference to common control in a section 482 sense. In addition to cost shared intangibles, as noted above, section 936 benefits are also made available under cost sharing for the covered intangibles — which had been the only types of intangibles for which the Senate bill would have allowed section 936 benefits.

The second method for affording section 936 benefits for intangible property income under the Conference Committee bill that was enacted by TEFRA is the profit split method. Unlike the cost sharing method, the profit split method does not attempt to distinguish among different types of intangible property income, with some types qualifying, and others not qualifying, for section 936 benefits. Rather, under the profit split method, the electing corporation receives section 936 benefits with regard to 50 percent of the combined taxable income of the affiliated group (other than foreign affiliates) from "covered sales" of the possession product. Section 936(h)(5)(C)(ii)(IV) defines covered sales to mean sales by the affiliated group (other than foreign affiliates) to persons who are not members of the affiliated group, or to foreign affiliates. The same definition of "affiliated group" applies for purposes of the profit split as for the cost sharing method, i.e., by reference to common control in a section 482 sense. I.R.C. § 936(h)(5)(C)(i)(I)(b) ("[f]or purposes of this subsection"). Thus, covered sales are transactions of the affiliated group (other than foreign affiliates) with non-affiliates (or with foreign affiliates) under a section 482 standard. There is <u>no</u> provision under the profit split method that incorporates any reference to the ten percent relatedness standard under section 936(h)(3)(D) or 936(h)(5)(D). As explained, those concepts are tied to the covered intangible provisions that were moved by the Conference Committee from the general provisions of section 936(h)(1)-(4) to the cost sharing provisions.

The level of significant business presence and section 936 benefits depends on the designation of the possession product. Congress intended that taxpayers should not be limited to designating the entire product ultimately sold to customers as the possession product. Congress contemplated that section 936 would apply, both for purposes of the significant business presence test and for the computation of combined taxable income, with regard to a partial product, whether transferred as a component to an affiliate for further transformation, or sold as an integrated product to non-affiliates. H. Conf. Rept. 97-760, at 508 (1982). Pursuant to that authority, the Service promulgated Treas. Reg. § 1.936-6(b)(1) Q&A-12, controlling the computation of combined taxable income from affiliated group sales to non-affiliates of component products incorporated into integrated products, and Treas. Reg. § 1.936-6(b)(1) Q&A-1

on the computation regarding possession sales of the integrated product to non-affiliates. Coca Cola, supra, 106 T.C. at 24.

Application of Law to this Case

Corporation A bases its argument on its construction of "component product" as defined in Treas. Reg. § 1.936-5(a) Q&A-1, since the existence of such a component product is the condition for availability of Treas. Reg. § 1.936-6(b)(1) Q&A-12 to compute the combined taxable income subject to the profit split method. Treas. Reg. § 1.936-5(a) Q&A-1 defines "component product" to be a product which is subject to further processing before sale to an "unrelated party." The regulation does not define "unrelated party" for this purpose. Corporation A's argument assumes that "unrelated party" means "unrelated person" within the meaning of section 936(h)(3)(D) and 936(h)(5)(D). In light of the statutory context, legislative history, and judicial authority, we believe that unrelated party in this provision means a person that is not a member of the affiliated group.

None of the terms "unrelated person," "related person," "unrelated party," or "related party" appear in the statutory profit split provisions. As explained above, the legislative history of the ten percent relatedness terms may be traced to the covered intangibles exception under the Senate bill. That exception and the associated terminology was moved in the Conference Committee into the cost sharing provisions. The ten percent relatedness standard, however, has no function under the profit split provisions.

Corporation A points to section 936(h)(5)(B)(iv)(IV) to support its position. This provision authorizes regulations for purposes of the significant business presence test that ignore the costs of producing components that are not included as part of the possession product. See Treas. Reg. § 1.936-5(b)(1) Q&A-5. The provision does not control the computation of combined taxable income under the profit split method.

The profit split method divides the combined taxable income of the affiliated group from covered sales of the possession product. Section 936(h)(5)(C)(ii)(IV) defines covered sales to mean sales by the affiliated group (other than foreign affiliates) to persons who are not members of the affiliated group, or to foreign affiliates. Section 936(h)(5)(C)(i)(I)(b) defines "affiliated group" by reference to common control in a section 482 sense. Thus, covered sales are transactions of the affiliated group (other than foreign affiliates) with non-affiliates (or with foreign affiliates) under a section 482 standard, not with reference to the ten percent relatedness standard.

It is irrelevant for purposes of the profit split that a possession product that has already been sold in a covered sale to a non-affiliate may be subject to further processing before subsequent sale of the processed product by the non-affiliate. Such further processing does not thereby render the possession product a "component product" within the congressional contemplation. The Conference Report states in pertinent part:

> The Secretary will prescribe regulations providing for appropriate treatment in cases where the *island affiliate* . . . produces a *component* which it sells to an *affiliate* for incorporation into a product sold to third parties.

H. Conf. Rept. 97-760 at 508 (1982). (Emphasis added). The Tax Court in Coca Cola similarly notes:

> Congress recognized in enacting section 936(h) that some section 936 corporations produce products that are not sold to unrelated parties, but rather are transferred to *affiliates*, and used as *component parts* in the production of other products that are then sold by the *affiliates* to unrelated parties.

106 T.C. at 23-24. (Emphasis added). Note, from the context, the Tax Court in speaking of "unrelated parties" was referring to non-affiliates (rather than ten percent or less related parties).

Indeed, the possession product at issue in the Coca Cola case was subject to further processing following sales both to affiliated buyers and non-affiliated buyers. Yet the Tax Court concluded that only the sales to non-affiliated buyers qualified as sales of component products eligible for treatment under Treas. Reg. § 1.936-6(b)(1) Q&A-12.

Further statutory support for this conclusion may be drawn from section 936(h)(5)(F)(iv)(III), controlling making the election for either “cost sharing” or “profit split” treatment:

> All members of an affiliated group must consent to an election under this subsection at such time and in such manner as shall be prescribed by the Secretary by regulations.

§ 936(h)(5)(F)(iv)(III). The regulations supporting this section are contained in Treas. Reg. § 1.936-7, which provide that:

> [a] possessions corporation makes an election to use the cost sharing or profit split method by filing Form 5712-A and attaching it to its tax return . . . . All members of the affiliated group must consent to the election. An authorized officer of the electing corporation must sign the statement of election and must declare that he has received a signed statement of consent from an authorized officer, director, or other appropriate official of each member of the affiliated group. The election is not valid unless all members consent.

Treas. Reg. § 1.936-7(a) Q&A-1.

The process of making the election demonstrates that only members of the affiliated group may participate in the profit split method and in the allocation and apportionment of expenses which follow from such treatment. The regulations further demonstrate that only affiliate members are considered for purposes of profit split through the following requirement:

> By consenting to the election out, all affiliates agree to provide information necessary to compute the cost sharing payment under the cost sharing method or combined taxable income under the profit split method . . . .

Id.

Importantly, the remaining 50 percent of combined taxable income, after the allocation of the 50 percent portion benefitted under section 936 to the possessions corporation, is allocated to the domestic members of the affiliated group:

> 50 percent of the combined taxable income computed as provided in subparagraph (C)(ii)(II) shall be allocated to the electing corporation. Combined taxable income, computed without regard to the last sentence of subparagraph (C)(ii)(II), less the amount allocated to the electing corporation under the preceding sentence, shall be allocated to the appropriate domestic member or members (other than any electing corporation) of the affiliated group and shall be treated as income from sources within the United States . . . .

I.R.C. § 936(h)(5)(C)(ii)(III); see also Treas. Reg. § 1.936-6(b)(1) Q&A-13.

Consistent with the statutory framework, legislative history, and the Coca Cola case, we conclude that sales of Product E to the JV's who are not part of the affiliated group are themselves "covered sales," not sales of a "component product" subject to further processing before sold beyond the affiliated group. Accordingly, the general rules of Treas. Reg. § 1.936-6(b)(1) Q&A-1 et seq., apply for purposes of computing combined taxable income in this case.

If you have any further questions, please call (202) 874-1490.

By: ______________________________
STEVEN A. MUSHER

Chief, Branch 6
Office of Associate Chief Counsel
(International)