Section 936.—Puerto Rico and Possession Tax Credit

26 CFR 1.936–6: Intangible property income when an election out is made; cost sharing and profit split options; covered intangibles.

T.D. 8669

DEPARTMENT OF THE TREASURY

Computation of Combined Taxable Income Under the Profit Split Method When the Possession Product Is a Component Product or an End-Product Form for Purposes of the Possessions Credit Under Section 936

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the computation of combined taxable income under the profit split method. These regulations amend the current regulations and provide revised rules for taxpayers to compute combined taxable income under the profit split method when the possession product chosen for purposes of section 936(h)(5) of the Internal Revenue Code is a component product or an end-product form. These regulations are necessary to provide guidance to taxpayers electing the profit split method of computing taxable income under section 936(h)(5).

DATES: These regulations are effective May 10, 1996.

See SUPPLEMENTARY INFORMATION for applicability dates.

FOR FURTHER INFORMATION CONTACT: Jacob Feldman, 202-622-3870 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On January 12, 1994, the IRS published a notice of proposed rulemaking in the **Federal Register** (INTL–0068–92, 59 FR 1690, [1994–1 C.B. 820]) relating to the computation of combined taxable income under the profit split method under section 936(h)(5) (relating to the possessions credit for U.S. companies doing qualified business in Puerto Rico and certain U.S. possessions). A number of written public comments were received concerning the proposed regulations and a public hearing was held on July 11, 1994. After consideration of all the comments, the proposed regulations are adopted as revised by this Treasury decision. The revisions are discussed below.

Discussion

The proposed regulations would amend §1.936–6(b)(1), Q&A 12. Under the proposed regulations, combined taxable income for a taxpayer that elects the profit split method for a possession product that is either a component product or an end-product form would be determined by multiplying the combined taxable income of the integrated product that includes the possession product by a production cost ratio. In the case of a component product, the combined taxable income of the integrated product would be multiplied by a ratio the numerator of which is the production costs of the component product and the denominator of which is the production costs of the integrated product. The combined taxable income of an end-product form would be determined in a similar manner using the production costs of the end-product form. The regulations were proposed to be effective for taxable years beginning after 1993.

Taxpayers have argued that the regulations should not be adopted as proposed because they would violate the arm's length standard under section 482 and that a necessary consequence of the abandonment of the arm's length standard would be distortions in taxpayers' income. That is, income would be computed inconsistently for related versus unrelated party sales of the same product, under the same terms and in the same market.

The proposed regulations did not apply the arm's length standard to component products and end-product forms under the profit-split method because application of section 482 in this context is inconsistent with the statutory framework. The effect of the profit split method when applied to possession products is to minimize disputes between taxpayers and the IRS because, unlike section 482 methods, there is no need to perform functional analyses to allocate income among the parties. Because Congress eliminated the section 482 analysis from the profit split method, the proposed regulations did not reinject this analysis into the area of intermediate products.

In response to taxpayer comments, however, the IRS and Treasury are providing an election to taxpayers that sell the same possession product in both component form and integrated form if the transactions meet certain section 482 standards. This method is both simple to apply and produces consistent results with respect to related and unrelated party transactions. Under this method, the combined taxable income from covered sales of the component product shall be determined by using the same per unit combined taxable income as is derived from uncontrolled sales of the product as an integrated product. Taxpayers may elect to compute the combined taxable income for an end-product form in a similar manner if all excluded components are manufactured by a member of the affiliated group that includes the possession corporation and also sold by the group separately in uncontrolled transactions. In that case, the combined taxable income of the end-product form will be computed by reducing the combined taxable income of the integrated product that includes the end-product form by the combined taxable income of the excluded components determined under the rules of section 936 as if the excluded components were possession products. In order to make the election, the uncontrolled sales must meet the comparability standards of the fourth sentence of §1.482–3(b)(2)(ii)(A), which requires that the uncontrolled and controlled transactions have no differences or minor differences for which adjustment can be made. However, under a no loss limitation, in no case can the taxpayer use as its per unit combined taxable income for a component product or an end-product form an amount that exceeds the per unit combined taxable income of the integrated product that includes the component product or end-product form.

In 1993, Congress adopted limitations on the amount of the section 936 credit; the taxpayer may be subject to an activity based limitation or may elect a percentage limitation. The election for the percentage limitation had to be made for the first taxable year beginning after December 31, 1993. Taxpayers commented that the proposed regulations created uncertainty with respect to the consequences of making the percentage limitation election and, therefore, the period for making the election should be extended until after the regulations are finalized. This comment is adopted. Taxpayers that have not elected the percentage limitation under section 936(a)(1) for the first taxable year beginning after December 31, 1993, may so elect if the taxpayer has elected the profit split method and the computation of combined taxable income is affected by §1.936–6(b)(1) Q&A 12.

With respect to the proposed effective date, taxpayers commented that the regulations should not be applied retroactively. One of the justifications for the proposed rule was that it would simplify the computation of combined taxable income and applying the regulation retroactively would not simplify the computation because it would require filing amended returns. This comment is adopted in part. The regulation is effective for taxable years ending 30 days after May 10, 1996. If however, the election under paragraph (v) of A. 12 of §1.936–6(b)(1) is made, this election must be made for the taxpayer's first taxable year beginning after December 31, 1993, and if not made effective for that year, the election cannot be made for any later taxable year.

The last sentence of paragraph (vi) of A. 13 of §1.936–6(b)(1) in the proposed regulations provided that, for purposes of determining the estimated tax liability of an affiliate of the possessions corporation with respect to income allocated to it from the possessions corporation, the income would be deemed received on the last day of the taxable year of each such affiliate in which or with which the taxable year of the possessions corporation ended. This rule is limited to taxable years beginning prior to January 1, 1995. For taxable years beginning after December 31, 1994, quarterly estimated tax payments will be required as provided under section 711 of the Uruguay Round Agreements, Public Law 103–465 (1994), page 230, and any administrative guidance issued by the IRS thereunder. See Rev. Proc. 95–23 (1995–1 C.B. 693).

Accordingly, the proposed regulations are finalized as proposed except with respect to the changes discussed above and the necessary conforming changes.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that this regulation does not have a significant impact on a substantial number of small entities. Thus, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply to these regulations, and therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Jacob Feldman and Mary Gillmarten of the Office of Associate Chief Counsel (International), IRS. Other personnel from the IRS and Treasury Department participated in their development.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805

Par. 2. In §1.936–6, paragraph (b)(1) is amended by:

1. Revising *Q. 10*.

2. Amending *A. 10* by:

a. Redesignating the text of *A. 10* as paragraph *A. 10*(i).

b. Removing the last two sentences of newly designated *A. 10*(i).

c. Adding paragraphs *A. 10*(ii) through (v).

3. Revising the first sentence of *A. 11*.

4. Revising *Q&A. 12*.

5. Revising *A. 13*.

The revisions and addition read as follows:

§1.936–6 Intangible property income when an election out is made; cost sharing and profit split options; covered intangibles.

(b)

(1)

Q. 10: If the possessions corporation is entitled to use the profit split method in the situation described in *Q. 9* (leasing units of the possession product or use of such units in the taxpayer's own trade or business), how should it compute combined taxable income with respect to such units?

A. 10: (i)

(ii) If the possession product is a component product or an end-product form, the combined taxable income with respect to the possession product shall be determined under *Q&A. 12* of this paragraph (b)(1).

(iii) For purposes of determining the basis of a component product or an end-product form, the deemed sales price of such product must be determined. The deemed sales price of the component product shall be determined by multiplying the deemed sales price of the integrated product that includes the component product by a ratio, the numerator of which is the production costs of the component product and the denominator of which is the production costs of the integrated product that includes the component product. The deemed sales price of an end-product form shall be determined by multiplying the deemed sales price of the integrated product that includes the end-product form by a ratio, the numerator of which is the production costs of the end-product form and the denominator of which is the production costs of the integrated product that includes the end-product form. For the definition of production costs, see *Q&A. 12* of this paragraph (b)(1).

(iv)(A) If combined taxable income is determined under paragraph (v) of *A. 12* of this paragraph (b)(1), in the case of a component product, the deemed sales price shall be determined by using the actual sales price of that product when sold as an integrated product (as adjusted under the rules of the fourth sentence of §1.482–3(b)(2)(ii)(A)).

(B) If combined taxable income is determined under paragraph (v) of *A. 12* of this paragraph (b)(1), in the case of an end-product form, the deemed sales price shall be determined by subtracting from the deemed sales price of the integrated product that includes the end-product form (*e.g.*, the leased property) the actual sales price of the excluded component when sold as an integrated product to an unrelated person (as adjusted under the rules of the fourth sentence of §1.482–3(b)(2)-(ii)(A)).

(v) The full amount of income received under the lease shall be treated as income of (and be taxed to) the U.S. affiliate and not the possessions corporation.

A. 11: The U.S. affiliate shall be treated, for purposes of computing its basis in such units, as if it had repurchased such units immediately following the deemed sale and at the deemed sales price as provided in *Q&A. 10* of this paragraph (b)(1). * * *

Q. 12: If the possession product is a component product or an end-product form, how is the combined taxable income for such product to be determined?

A. 12: (i) Except as provided in paragraph (v) of this *A. 12*, combined taxable income for a component product or an end-product form is computed under the production cost ratio (PCR) method.

(ii) Under the PCR method, the combined taxable income for a component product will be the same proportion of the combined taxable income for the integrated product that includes the component product that the production costs attributable to the component product bear to the total production costs (including costs incurred by the U.S. affiliates) for the integrated product that includes the component product. Production costs will be the sum of the direct and indirect production costs as defined under §1.936–5(b)(4) except that the costs will not include any costs of materials. If the possession product is a component product that is transformed into an integrated product in whole or in part by a contract manufacturer outside of the possession, within the meaning of §1.936–5(c), the denominator of the PCR shall be computed by including the same amount paid to the contract manufacturer, less the costs of materials of the contract manufacturer, as is taken into account for purposes of the significant business presence test under §1.936–5(c) *Q&A. 5*.

(iii) Under the PCR method the combined taxable income for an end-product form will be the same proportion of the combined taxable income for the integrated product that includes the end-product form that the production costs attributable to the end-product form bear to the total production costs (including costs incurred by the U.S. affiliates) for the integrated product that includes the end-product form. Production costs will be the sum of the direct and indirect production costs as defined under §1.936–5(b)(4) except that the costs will not include any costs of materials. If the possession product is an end- product form and an excluded component is contract manufactured outside of the possession, within the meaning of §1.936–5(c), the denominator shall be computed by including the same amount paid to the contract manufacturer, less cost of materials of the contract manufacturer, as is also taken into account for purposes of the significant business presence test under §1.936–5(c) *Q&A. 5*.

(iv) This paragraph (iv) of *A. 12* illustrates the computation of combined taxable income for a component product or end-product form under the PCR method. S, a possessions corporation, is engaged in the manufacture of microprocessors. S obtains a component from a U.S. affiliate, O. S sells its production to another U.S. affiliate, P, which incorporates the microprocessors into central processing units (CPUs). P transfers the CPUs to a U.S. affiliate, Q, which incorporates the CPUs into computers for sale to unrelated persons. S chooses to define the possession product as the CPUs. The combined taxable income for the sale of the possession product on the basis of the given production, sales, and cost data is computed as follows:

Production costs (excluding costs of materials):	
1. O’s costs for the component	100
2. S’s costs for the microprocessors	500
3. P’s costs for the CPU’s (the possession product)	200
4. Q’s costs for the computers	400
5. Total production costs for the computer (Add lines 1 through 4)	1,200
6. Combined production costs for the CPU (the possession product) (Add lines 1 through 3)	800
7. Ratio of production costs for the CPUs (the possession product) to the production costs for the computer	0.667
Determination of combined taxable income for computers:	
Sales:	
8. Total possession sales of computers to unrelated customers and foreign affiliates	7,500
Total costs of O, S, P, and Q incurred in production of a computer:	
9. Production costs (enter from line 5)	1,200
10. Material costs	100
11. Total costs (line 9 plus line 10)	1,300
12. Combined gross income from sale of computers (line 8 minus line 11)	6,200
Expenses of the affiliated group (other than foreign affiliates) allocable and apportionable to the computers or any component thereof under the rules of §§1.861–8 through 1.861–14T and 1.936–6 (b)(1), Q&A. 1:	
13. Expenses (other than research expenses)	980
Research expenses of the affiliated group allocable and apportionable to the computers:	
14. Total sales in the 3-digit SIC Code	12,500
15. Possession sales of the computers (enter from line 8)	7,500
16. Cost sharing fraction (divide line 15 by line 14)	0.6
17. Research expenses incurred by the affiliated group in 3-digit SIC Code multiplied by 120 percent	700
18. Cost sharing amount (multiply line 16 by line 17)	420
19. Research of the affiliated group (other than foreign affiliates) allocable and apportionable under §§1.861–17 and 1.861–14T(e)(2) to the computers	300
20. Enter the greater of line 18 or line 19	420
Computation of combined taxable income of the computer and the CPU:	
21. Combined taxable income attributable to the computer (line 12 minus line 13 and line 20)	4,800
22. Combined taxable income attributable to CPUs (multiply line 21 by line 7) (production cost ratio)	3,200
23. Share of combined taxable income apportioned to S (50 percent of line 22)	1,600
Share of combined taxable income apportioned to U.S. affiliate(s) of S:	
24. Adjustments for research expenses (line 18 minus line 19 multiplied by line 7)	80
25. Adjusted combined taxable income (line 22 plus line 24)	3,280
26. Share of combined taxable income apportioned to affiliates of S (line 25 minus line 23)	1,680

(v) (A) If a possession product is sold by a taxpayer or its affiliate to unrelated persons in covered sales both as an integrated product and as a component product and the conditions of paragraph (v)(C) of this *A. 12* are satisfied, the taxpayer may elect to determine the combined taxable income derived from covered sales of the component product under this paragraph (v). In that case, the combined taxable income derived from covered sales of the component product shall be determined by using the same per unit combined taxable income as is derived from covered sales of the product as an integrated product, but subject to the limitation of paragraph (v)(D) of this *A. 12*.

(B) In the case of a possession product that is an end-product form, if all of the excluded components are also separately sold by the taxpayer or its affiliate to unrelated persons in uncontrolled transactions and the conditions of paragraph (v)(C) of this *A. 12* are satisfied, the taxpayer may elect to determine the combined taxable income of such end-product form under this paragraph (v). In that case, the combined taxable income derived from covered sales of the end-product form shall be determined by reducing the per unit combined taxable income from the integrated product that includes the end-product form by the per unit combined taxable income for excluded components determined under the rules of this paragraph (v), but subject to the limitation of paragraph (v)(D) of this *A. 12*. For this purpose, combined taxable income of the excluded components must be determined under section 936 as if the excluded components were possession products.

(C) In the case of component products, this paragraph (v) applies only if the sales price of the possession product sold in covered sales as an integrated product (*i.e.*, in uncontrolled transactions) would be the most direct and reliable measure of an arm's length price within the meaning of the fourth sentence of §1.482–3(b)(2)(ii)(A) for the component product. For purposes of applying the fourth sentence of §1.482–3(b)(2)(ii)(A), the sale of the integrated product that includes the component product is treated as being immediately preceded by a sale of the component (*i.e.* without further processing) in a controlled transaction. In the case of end-product forms, this paragraph (v) applies only if the sales price of excluded components separately sold in uncontrolled transactions would be the most direct and reliable measure of an arm's length price within the meaning of the fourth sentence of §1.482–3(b)(2)(ii)(A) for all excluded components of an integrated product that includes an end-product form. For purposes of applying the fourth sentence of §1.482–3(b)(2)(ii)(A), the sale of the integrated product that includes excluded components is treated as being immediately preceded by a sale of the excluded components (*i.e.*, without further processing) in a controlled transaction. Under the fourth sentence of §1.482–3(b)(2)(ii)(A), the uncontrolled transactions referred to in this paragraph (v)(C) must have no differences with the controlled transactions that would affect price, or have only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made (resulting in appropriate adjustments to the computation of combined taxable income). If such adjustments cannot be made, or if there are more than minor differences between the controlled and uncontrolled transactions, the method provided by this paragraph (v)(C) cannot be used. Thus, for example, these uncontrolled transactions must involve substantially identical property in the same or a substantially identical geographic market, and must be substantially identical to the controlled transaction in terms of their volumes, contractual terms, and market level. See §1.482–3(b)(2)(ii)(B).

(D) In no case can the per unit combined taxable inc ome as determined under paragraph (v)(A) or (B) of this *A. 12* be greater than the per unit combined taxable income of the integrated product that includes the component product or end-product form.

(E) The provisions of this paragraph (v) are illustrated by the following example.

Taxpayer manufactures product A in a U.S. possession. Some portion of product A is sold to unrelated persons as an integrated product and the remainder is sold to related persons for transformation into product AB. The combined taxable income of integrated product A is $400 per unit and the combined taxable income of product AB is $300 per unit. The production cost ratio with respect to product A when sold as a component of product AB, is 2/3. Unless the taxpayer elects and satisfies the conditions of this paragraph (v), the combined taxable income with respect to A will be $200 per unit (combined taxable income for AB of $300 × the production cost ratio of 2/3). If, however, the comparability standards of paragraph (v)(C) of this *A. 12* are met, the taxpayer may elect to determine combined taxable income of product A when sold as a component of product AB using the same per unit combined taxable income as product A when sold as an integrated product. However, the per unit combined taxable income from sales of product A as a component product may not exceed the per unit combined taxable income on the sale of product AB. Therefore, the combined taxable income of component product A may not exceed $300 per unit.

(vi) Taxpayers that have not elected the percentage limitation under section 936(a)(1) for the first taxable year beginning after December 31, 1993, may do so if the taxpayer has elected the profit split method and computation of combined taxable income is affected by *Q&A.12* of this paragraph (b)(1).

(vii) The rules of *Q&A. 12* of this paragraph (b)(1) apply for taxable years ending 30 days after May 10, 1996. If, however, the election under paragraph (v) of *A. 12* of §1.936–6(b)(1) is made, this election must be made for the taxpayer's first taxable year beginning after December 31, 1993, and if not made effective for that year, the election cannot be made for any later taxable year. A successor corporation that makes the same or substantially similar products as its predecessor corporation cannot make an election under paragraph (v) of A.12 of §1.936–6(b)(1) unless the election was made by its predecessor corporation for its first taxable year beginning after December 31, 1993.

A. 13: (i) The income shall be allocated to affiliates in the following order, but no allocations will be made to affiliates described in a later category if there are any affiliates in a prior category—

(A) First, to U.S. affiliates (other than tax exempt affiliates) within the group (as determined under section 482) that derive income with respect to the product produced in whole or in part in the possession;

(B) Second, to U.S. affiliates (other than tax exempt affiliates) that derive income from the active conduct of a trade or business in the same product area as the possession product;

(C) Third, to other U.S. affiliates (other than tax-exempt affiliates);

(D) Fourth, to foreign affiliates that derive income from the active conduct of a U.S. trade or business in the same product area as the possession product (or, if the foreign members are resident in a country with which the U.S. has an income tax convention, then to those foreign members that have a permanent establishment in the United States that derives income in the same product area as the possession product); and

(E) Fifth, to all other affiliates.

(ii) The allocations made under paragraph (i)(A) of this *A. 13* shall be made on the basis of the relative gross income derived by each such affiliate with respect to the product produced in whole or in part in the possession. For this purpose, gross income must be determined consistently for each affiliate and consistently from year to year.

(iii) The allocations made under paragraphs (i)(B) and (i)(D) of this *A. 13* shall be made on the basis of the relative gross income derived by each such affiliate from the active conduct of the trade or business in the same product area.

(iv) The allocations made under paragraphs (i)(C) and (i)(E) of this *A. 13* shall be made on the basis of the relative total gross income of each such affiliate before allocating income under this section.

(v) Income allocated to affiliates shall be treated as U.S. source and section 863(b) does not apply for this purpose.

(vi) For purposes of determining an affiliate's estimated tax liability for income thus allocated for taxable years beginning prior to January 1, 1995, the income shall be deemed to be received on the last day of the taxable year of each such affiliate in which or with which the taxable year of the possessions corporation ends. For taxable years beginning after December 31, 1994, quarterly estimated tax payments will be required as provided under section 711 of the Uruguay Round Agreements, Public Law 103–465 (1994), page 230, and any administrative guidance issued by the Internal Revenue Service thereunder.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved April 4, 1996.

Leslie Samuels,
Assistant Secretary of the Treasury.

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