

Election and Verification of the Cost Sharing or Profit Split Method Under Section 936(h)(5)

Department of the Treasury
Internal Revenue Service

▶ **Attach to Schedule P (Form 5735)**

The corporation named below elects under section 936(h)(5) to use the cost sharing or profit split method for income tax purposes.

| | |
|---------------------|--------------------------------|
| Name of corporation | Employer identification number |
|---------------------|--------------------------------|

| | |
|--|------------|
| Enter the possession product to which this form relates: | SIC code ▶ |
|--|------------|

Significant Business Presence Tests

Note: A corporation engaged in start-up operations in a possession may be able to use transitional rules (see instructions) to determine whether it meets the direct labor test or the value added test in Part I below. If the transitional rules apply, you must complete Part III.

Part I Tests Used To Qualify for Cost Sharing or Profit Split Method

Complete the column and lines that apply for the method you elected and the test you meet.

| | Cost Sharing | Profit Split |
|---|--------------|--------------|
| Direct Labor Test | | |
| 1 Possessions corporation's direct labor costs | | |
| 2 Total direct labor costs of affiliated group | | |
| 3 Divide line 1 by line 2 | | |
| If line 3 is at least 65% (see Transitional Rules in the instructions for exceptions), you have met the direct labor test. You qualify to use the cost sharing method. To see if you qualify for the profit split method, answer question 18. If line 3 is less than 65%, you have not met the direct labor test. Complete the value added test to determine if you qualify under that test. | | |
| | | |
| Value Added Test | | |
| 4 Production costs of possessions corporation | | |
| 5 Gross receipts on sales or dispositions of possession product by the affiliated group to unrelated parties | | |
| 6 Cost of direct material purchased from unrelated suppliers used in the production of the possession product | | |
| 7 Subtract line 6 from line 5 | | |
| 8 Divide line 4 by line 7 | | |
| If line 8 is at least 25% (see Transitional Rules in the instructions for exceptions), you have met the value added test. You qualify to use the cost sharing method. To see if you qualify for the profit split method, answer question 18. If line 8 is less than 25%, you have not met the value added test. See Part II for an alternative test. | | |
| | | |

Part II Alternative Test Used To Qualify for Cost Sharing or Profit Split Method

| | | |
|---|--|--|
| 9 Direct labor costs of possessions corporation | | |
| 10 Direct labor costs of affiliated group | | |
| 11 Divide line 9 by line 10 | | |
| If line 11 is at least 50%, go to line 12. If line 11 is less than 50%, you do not meet the alternative test. | | |
| 12 Base period construction costs | | |
| 13 Add lines 9 and 12 | | |
| 14 Add lines 10 and 12 | | |
| 15 Divide line 13 by line 14 | | |
| If line 15 is at least 70%, you have met the alternative test. You qualify to use the cost sharing method. To see if you qualify for the profit split method, answer question 18. If line 15 is less than 70%, you have not met the alternative test. | | |
| | | |

Part III Transitional Rules (see instructions)

- 16 If the transitional rules apply, check this box
- 17 Enter the beginning date of the tax year the possessions corporation began producing the product in the possession ▶

Part IV Other Information

- 18 If you are claiming the profit split method: Is the possession product manufactured (as defined in Regulations section 1.954-3(a)(4)) in the possession? Yes No
- If "No," you do not qualify to use the profit split method of computing taxable income.

Note: Affiliated group members must attach a list showing name, address, and employer identification number of all members of the group.

Under penalties of perjury, I declare that I have been duly authorized by the above-named corporation to make this election, and that to the best of my knowledge and belief, the statements made are true, correct, and complete; and that I have received signed statements in which an authorized officer of each corporation in the attached list of affiliated group members for Part IV consents to the above election.

| | |
|--|------|
| Signature and title of officer of electing corporation | Date |
|--|------|

Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping 5 hr., 30 min.
Learning about the law or the form 42 min.
Preparing and sending the form to the IRS 49 min.

If you have any comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the instructions for the tax return with which this form is filed.

Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form

Use Form 5712-A to elect either the cost sharing or profit split method of computing taxable income for certain possession products, and to show that the corporation has a significant business presence in the possession by meeting either a direct labor test or a value added test. Complete Form 5712-A for each possession product for which the corporation has elected either the cost sharing or profit split method of computing taxable income. Complete the form each year to determine if the corporation has a significant business presence in the possession. Attach Form 5712-A to Schedule P (Form 5735), Allocation of Income and Expenses Under Section 936(h)(5).

If the corporation elects the profit split method, it must certify in Part IV that the possession product was manufactured in the possession as defined in Regulations section 1.954-3(a)(4).

Intangible Property Income

Generally, intangible property income of a possessions corporation will be included in the income of its shareholders unless: (1) The shareholders are foreign persons or tax-exempt U.S. shareholders, or (2) Any class of stock of the possessions corporation is traded on a securities market. See Regulations section 1.936-4 for more information.

Possession Product

"Possession product" means an item of property which is the result of a manufacturing process. The term "product" includes component products, integrated products, and end-product forms. An affiliated group may establish reasonable groupings of possession products as a single product. New groupings may be established each year. The Commissioner may disallow any grouping that materially distorts income or the significant business presence test. See Regulations section 1.936-5(a) for more details.

Significant Business Presence in a Possession

The possessions corporation must establish that it had a "significant business presence" in the possession to elect the cost sharing or the profit split method. To qualify to use the cost sharing method, a direct labor test or a value added test must be met. To qualify to use the profit split method, one of the tests must be met and the possession product must be manufactured in the possession as defined in Regulations section 1.954-3(a)(4).

Extent of Election

Possessions corporations may elect to change from one method to the other only with the consent of the Commissioner. However, certain exceptions apply. See Regulations section 1.936-7, and Rev. Proc. 94-70, 1994-44 I.R.B. 20.

Manufacturing in a Possession

The rules under Regulations section 1.954-3(a)(4) apply in determining if the possession product has been manufactured in a possession. Manufacturing has taken place if:

1. The product has been substantially transformed by the possessions corporation in the possession;

2. Operations performed by the possessions corporation in the possession for the property are substantial and are generally considered to constitute the manufacture or production of property; or

3. Conversion costs incurred by the possessions corporation in the possession, including direct labor, factory burden, testing of components before incorporation into an end product, and testing of the manufactured product before sales, are at least 20% of the total cost of goods sold of the possessions corporation. Packaging, repackaging, labeling, or minor assembly operations do not qualify as manufacturing.

Alternative Test

An alternative significant business presence test is available to possessions corporations that do not qualify under the direct labor or value added test. The alternative rule applies for any tax year. To qualify, the possessions corporation must meet a direct labor test and a combined direct labor and construction costs test. Complete Part II to see if the corporation meets these tests.

Transitional Rules

Transitional rules apply to a possession product or service that was not produced or rendered in a possession on or before September 3, 1982. Under these rules, the full requirement of the direct labor test and the value added test are phased in over a period of 3 tax years, beginning with the year the corporation first starts to sell the product or render the service. The 65% labor test is reduced to 35% in the first year, 45% in the second year, and 55% in the third year. The 25% value added test is reduced to 10% for the first year, 15% for the second year, and 20% for the third year.

In determining whether the corporation meets the direct labor test (line 3), use the percentage above that applies for the tax year instead of 65%.

In determining whether the corporation meets the value added test (line 8), use the percentage above that applies for the tax year instead of 25%.

If the corporation does not meet the direct labor test or the value added test in Part I, complete Part II to see if it meets the alternative test.

For more information, see Regulations sections 1.936-5(b)(7) and 1.936-5(b)(8).

Definitions

Direct labor

This is labor associated with units of production. Basic compensation, overtime, holiday and vacation pay, shift differential, payroll taxes, contributions to unemployment benefit plans, and certain types of payments for sick leave are all part of direct labor if they can be associated with production. Direct labor costs are only those costs that are inventoriable under section 471.

Production costs

These include direct labor costs and fixed and variable indirect production costs. Only those costs that are inventoriable under section 471 are qualified production costs.

Base period construction costs

These costs are the average construction costs incurred by or on behalf of the possessions corporation for services in the possession during the current and preceding 4 tax years for section 1250 property. This property must be used to manufacture the product or to render the services in the possession, and must represent the original use of the section 1250 property. If the possessions corporation did not exist during any year or years in the base period, the total amount of base period construction costs for such year or years is zero.

SIC Code

Enter the three-digit code for the product or product group for which this Form 5712-A is being filed. See the Standard Industrial Classification Manual for the proper code for the product or product group.

Signature

Form 5712-A must be signed by the president, vice president, treasurer, assistant treasurer, chief accounting officer, or other corporate officer (such as tax officer) authorized to sign.

