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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Jacob Feldman
Field Service Special Counsel

SUBJECT:

This Field Service Advice responds to your memorandum dated May 31, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

A =
B =
Products =

ISSUES

Whether royalty income from a non-affiliated person with respect to manufacturing intangibles reduces product area research for purposes of computing the cost sharing floor under the profit split method.

CONCLUSIONS

The amount of royalty income received from a non-affiliated person allocable to manufacturing intangibles for products within the same 3-digit SIC Code as the possession product reduces the product area research for purposes of computing the cost sharing floor under the profit split method.

FACTS

A, a domestic section 936 corporation, is a wholly owned subsidiary of B. A elected to use the profit split method of computing its combined taxable income ("CTI") pursuant to section 936(h)(5)(C)(ii).

B's Products are made and distributed by related and unrelated parties. A makes Products on behalf of B in Puerto Rico. B receives royalties from unrelated Original Equipment Manufacturers ("OEMs"), for the right to make and distribute Products, which includes, among others, a license to use B's copyrights in those activities.

For purposes of computing combined taxable income under the profit split method under section 936(h)(5)(C)(ii), A determined its cost sharing floor by reducing its product area research by the amount of the royalty income it received from the OEMs.

LAW AND ANALYSIS

I.R.C. § 936 of the Internal Revenue Code of 1986, as amended, provides a credit against the amount of U.S. income tax that would otherwise be due for certain domestic corporations in Puerto Rico (and other possessions) that elect such treatment.[1] Section 936(h) limits the availability of the credit with respect to intangible property income derived in whole or in part by possession based sales. The general rule, set out in section 936(h)(1)-(4), provides that intangible property income is included in the gross income of the possession corporation's U.S. shareholders unless the possession corporation elects out of the general treatment pursuant to section 936(h)(5).

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[1] The Small Business Job Protection Act of 1996 (P.L. 104-188) terminated the Puerto Rico and possession tax credit for tax years beginning after December 31, 1995. I.R.C. § 936(j). Special phaseout rules apply to existing credit claimants.

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 possessions 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, 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.

The House-Senate Conference amended section 936(h) to provide alternative elections from the general rule if certain requirements were made in an effort to promote economic development in Puerto Rico. Section 936(h)(5) was added providing an "election out" from the general exclusion and permitted specified benefits for intangible property income under either the cost sharing or the profit split method.

The section 936(h)(5) election out is available on the condition that the electing corporation has a significant business presence in a possession with respect to the product for which section 936 benefits are 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.

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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 section 936 corporation and thereby avoided substantial federal income taxes).

Where the significant business presence threshold is satisfied, section 936 benefits are afforded for intangible property income with respect to the possession product under an election out of either the cost sharing or profit split methods.

Under the cost sharing method, the section 936 corporation is treated as the owner for purposes of obtaining a return on manufacturing intangibles if it pays a cost sharing payment under section 936(h)(5)(C)(i)(I). The cost sharing payment required is determined by a formula, but the payment cannot be less than would be required under section 367(d)(2)(A)(ii) or section 482 if the section 936 corporation were a foreign corporation. The formulary cost sharing payment is determined by multiplying the amount of product area research with respect to the 3-digit SIC Code which includes the possessions product by a fraction, the numerator of which is possession sales and the denominator of which is worldwide sales in the same 3-digit SIC Code.

The second method for affording section 936 benefits for intangible property income 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 (CTI) 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.

Section 936(h)(5)(C)(ii)(II) states that CTI is computed separately for each possession product produced by the possessions corporation. CTI is computed by deducting from the gross income of the U.S. members of the affiliated group from covered sales all expenses, losses, and other deductions properly apportioned or allocated thereto, plus a ratable part of all expenses, losses, or other deductions of the affiliated group that cannot definitely be allocated to some item or class of gross income. However, in computing CTI for each possession product, the R&D expenses and related deductions for the taxable year cannot be less than 120% of the cost sharing payment the possession corporation would make for its share of product area research had the cost sharing method been elected (“cost sharing floor”) as provided in section 936(h)(5)(C)(ii)(II) and in the regulations thereunder.

The regulations further provide:

(b) Profit split option -- (1) Computation of combined taxable income.

QUESTION 1: In determining combined taxable income from sales of a possession product, how are the allocations and apportionments of expenses, losses, and other deductions to be determined?

> ANSWER 1: (i) Expenses, losses, and other deductions are to be allocated and apportioned on a "fully-loaded" basis under § 1.861-8 to the combined gross income of the possessions corporation and other members of the affiliated group (other than foreign affiliates). . . . *The amount of research, development and experimental expenses and related deductions* (such as royalties paid or accrued with respect to manufacturing intangibles by the possessions corporation or other domestic members of the affiliated group to unrelated persons or to foreign affiliates) allocated and apportioned to combined gross income *shall in no event be less than the amount of the cost sharing payment that would have been required under the rules set forth in section 936(h)(5)(C)(i)(II) and paragraph (a) of this section if the cost sharing option had been elected*.

Treas. Reg. § 1.936-6(b)(1) Q&A 1 (emphasis added).

A possessions corporation that has elected the profit split method must therefore make alternate calculations for purposes of computing combined taxable income, i.e., the corporation must allocate and apportion expenses consistent with Treas. Reg. § 1.861-8 and calculate the formulary cost sharing payment. Therefore, the amount of R&D expenses deducted in computing combined taxable income is the greater of the cost sharing floor which is 120% of the cost sharing formula or the amount determined under Treas. Reg. § 1.861-8 (e)(3) (or § 1.861-17).

However, in determining the cost sharing payment, the regulations under § 1.936-6 (a)(1) Q&A 4 provide that royalty income from a person from outside the affiliated group with respect to the manufacturing intangibles within a product area reduces the product area research pool within the same product area. In other words, the royalty income reduces the cost sharing payment. Unanswered directly in the regulations is whether the royalty income also reduces the cost sharing floor.

Based on an analysis of the statutory and regulatory provisions under section 936(h)(5), we conclude that the royalty income described above does reduce the cost sharing floor used in computing CTI under the profit split method. Although Treas. Reg. § 1.936-6(b), which deals with the computation of CTI under the profit split method, is silent about whether this reduction occurs, we believe that this position is supported by the language of the statute. Section 936(h)(5)(C)(ii)(II) modifies the computation of the cost sharing payment under section 936(h)(5)(C)(i)(I) by increasing the formula's multiplier from 110% to 120% and removing the requirement that the cost sharing formula not be less than the amounts determined under sections 482 and 367(d). Otherwise, section 936(h)(5)(C)(ii)(II) and Treas. Reg. § 1.936-6(b)(1) Q&A1 direct the cost sharing floor to be determined as the cost sharing payment would have been determined had the cost sharing method been elected. Thus, Treas. Reg. § 1.936-6(a)(1)

Q&A 4 is applicable for purposes of determining the cost sharing floor under the profit split method.

Note, however, that in applying our conclusion to the facts in this case, it is necessary to determine whether the royalty income B receives derives from a manufacturing or non-manufacturing intangible, as only royalty income paid with respect to manufacturing intangibles reduces product area research and, thereby, the cost sharing floor under profit split.

Intangibles are defined under section 936(h)(3)(B) and manufacturing intangibles are defined under section 936(h)(3)(B)(i). See §1.936-6(c)Q&A1. The determination as to whether the intangible is a manufacturing or a non-manufacturing intangible is a factual one that should be made with reference to section 936(h)(3)(B). However, the facts presented indicate that the royalty income B receives is at least partially for the use of copyrights. Copyrights are generally considered to be nonmanufacturing or marketing intangibles. Section 936(h)(5)(C)(i)(II). However, under certain circumstances a copyright may be a manufacturing intangible based upon the function it serves:

> Question 10: Can a copyright be, in whole or in part, a manufacturing intangible for purposes of the allocation of income under the cost sharing method?
>
> Answer 10: In general, a copyright is a marketing intangible. See section 936(h)(3)(B)(ii). However, copyrights may be treated either as manufacturing intangibles or nonmanufacturing intangibles (or as partly each) depending upon the function or the use of the copyright. If the copyright is used in manufacturing, it will be treated as a manufacturing intangible; but if it is used in marketing, even if it is also classified as knowhow, it will be treated as a marketing intangible.

Treas. Reg. § 1.936-6(a)(1) Q&A 10.

To the extent the copyright licensed to the OEMs is used in manufacturing, the royalties received therefrom would reduce product area research, but to the extent the copyright is used for nonmanufacturing purposes the royalties received therefrom should be disregarded when calculating the cost sharing floor.

Factual determinations should be made with regard to what part of the royalty income received by B relates to the licensing of copyrights and whether any portion of the royalty income received that is specific to the copyrights is attributable to a manufacturing function. The portion of the royalty income received by B that is allocable to copyrights that are, in fact, used in manufacturing reduce the cost sharing floor.

We recommend that you develop the facts regarding whether and to what extent the royalties B receives are for use of a copyright as opposed to other intangible property, and whether the copyright is used in a manufacturing function. We also recommend that you seek field service advice, as appropriate, in conjunction with the above determinations.

Please call (202) 874-1490 if you have any further questions.

Jacob Feldman
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Office of Associate Chief
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