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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Barbara A. Felker
Chief, Branch 3
CC:INTL:BR3

SUBJECT:

This Field Service Advice responds to your memorandum dated September 15, 1998. 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.

<u>LEGEND:</u>

Corporation M =

Corporation N =

Corporation O =

Corporation P =

Corporation Q =

Possession A =

Year 1 =

Year 2 =

Year 3 =

ISSUE:

In determining the “combined taxable income” of the affiliated group of a corporation that has elected the application of the possession tax credit and the profit split method of accounting for intangible property income under I.R.C. § 936(h)(5)(C)(ii), how are interest expenses incurred by affiliated corporations apportioned?

CONCLUSION:

Because I.R.C. § 936(h)(7) provides that, for profit split purposes, combined taxable income shall be determined without regard to I.R.C. § 864(e)(1), only the interest expense of the possession corporation and those U.S. affiliates with income derived from covered sales of the possession product will be apportioned to combined taxable income using the asset method. Interest expense of other affiliates will be disregarded. Because we have concluded in this field service advice memorandum that the interest expense of Corporation M is not includible in combined taxable income, we do not address the second issue that you raised regarding the proper method of apportioning that interest under the asset method.

FACTS:

Corporation M is a domestic corporation. One of Corporation M’s principal operating subsidiaries is Corporation N, a pharmaceutical company, which in turn wholly owns Corporation O, a drug manufacturing company located in Possession A. Corporation N also owns 100 percent of the stock of Corporation P, a distributor located in Possession A that joined Corporation M’s consolidated group in both Years 2 and 3. Corporation N also owned 100 percent of Corporation Q, a manufacturing company also located in Possession A, which merged into Corporation O in Year 3.

When Corporation M acquired Corporation N and its subsidiaries in Year 1, Corporation M apparently assumed Corporation N’s long-term debt as part of the acquisition. In Years 2 and 3, Corporation M apparently paid undetermined amounts representing interest with regard to such debt to unrelated parties. It is unclear whether Corporations N and/or O reimbursed Corporation M for such payments.

Corporation O has elected the application of the possession tax credit under I.R.C. § 936 since at least Year 1, and the election continued in effect through Year 3. Corporation O has elected to use the profit split method of accounting for intangible property income under I.R.C. § 936(h)(5)(C)(ii) for all of the years at issue.

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] The statute effectively limits the availability of the credit, however, with respect to intangible property income derived by possession corporations: such income is included in the gross income of the possession corporation's U.S. shareholders unless the possession corporation elects one of two methods (the cost sharing method or the profit split method) of allocating intangible property income between the possession corporation and its U.S. affiliate or affiliates. I.R.C. § 936(h)(5).

The cost sharing and profit split methods operate by allocating to a possession corporation's U.S. shareholders a portion of the possession corporation's share of the costs incurred in developing the intangible property (in the case of the cost-sharing method) or a share of the profits generated by the intangible property (in the case of the profit-split method). I.R.C. § 936(h)(5)(C)(i) and (ii). By electing either of these two methods, a possession corporation is able to report, and thereby obtain a tax credit for, a portion of the income derived from the intangible property that would otherwise be reported by its U.S. shareholders. Once made, the election to use one of the two methods of accounting for intangible property income may not be revoked without the consent of the Commissioner.

If a possession corporation elects the profit split method of calculating its intangible property income, then it calculates the combined taxable income (CTI) of its affiliated group that is derived from covered sales of the product produced by the possession corporation. The total amount of CTI is then essentially divided in half, with 50 percent of CTI attributed to the possession corporation and 50 percent attributed to its affiliates. I.R.C. § 936(h)(5)(C)(ii)(I).

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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.

CTI is computed separately for each product that the possession corporation produces in the possession. I.R.C. § 936(h)(5)(C)(ii)(II). CTI is equal to:

> (1) the gross income of the possession corporation and its U.S. affiliates derived from covered sales (sales by U.S. affiliates to nonaffiliates and to foreign affiliates; I.R.C. § 936(h)(5)(C)(ii)(IV)) of the product, <u>less</u>
>
> (2) expenses, losses, or other deductions properly allocated and apportioned to the combined gross income of the possession corporation and its U.S. affiliates, plus a <u>ratable portion of all other deductions that are not definitely allocable to an item or class of gross income.</u>

I.R.C. § 936(h)(5)(C)(ii)(II) (emphasis added).

The regulations provide that, in determining CTI from sales of a possession product, expenses, losses, and other deductions are to be allocated and apportioned under Treas. Reg. § 1.861-8 to the combined gross income of the possession corporation and other members of the affiliated group. Treas. Reg. 1.936-6(b)(1), Q&A 1(i). Generally, expenses are allocated to the classes of gross income to which they are definitely related, then apportioned among statutory and residual groupings of gross income under operative sections of the Code. One such operative section is I.R.C. § 936. Treas. Reg. § 1.861-8(f)(1)(vi)(E). Accordingly, gross income taken into account in determining CTI under I.R.C. § 936 constitutes a statutory grouping to which expenses may be apportionable.

The regulations under I.R.C. § 936 provide that interest expense is to be allocated and apportioned under Treas. Reg. § 1.861-8(e)(2). Treas. Reg. 1.936-6(b)(1), Q&A 1(i). As a general rule, interest expense falls within the category of deductions that are not definitely allocable to any specific item or class of gross income, and therefore is apportioned ratably between income groupings. Treas. Reg. § 1.861-8(e)(9)(i). Special interest apportionment rules control, however, in determining the CTI of a possession corporation's affiliated group: I.R.C. § 936(h)(7) provides that I.R.C. § 936(h) shall apply as if I.R.C. § 864(e)(1) had not been enacted. I.R.C. § 864(e)(1) was enacted in 1986, and replaced the prior "separate company" rule of allocating and apportioning expenses not definitely allocable to an item or class of income with a new, "single taxpayer" rule for members of an affiliated group. Sec. 1215(a) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085. The single taxpayer rule was intended to limit the use of planning opportunities that one affiliated corporation with U.S. source income could borrow on behalf of another affiliate with foreign source income and allocate the interest expenses solely to reduce U.S. source income. In the context of I.R.C. § 936, the single taxpayer rule would, if applicable, allocate interest expenses of the U.S. parent to an I.R.C. § 936 subsidiary, thereby increasing the U.S.

parent's taxable income while decreasing the possession corporation's effectively tax-exempt I.R.C. § 936 income.

Accordingly, because I.R.C. § 864(e)(1) does not apply for purposes of I.R.C. § 936(h), each member of Corporation O's affiliated group is considered separately in allocating and apportioning interest expense to CTI. Since Corporation M derived no income from covered sales of the possession product, none of Corporation M's interest expense is allocated or apportioned to the CTI statutory grouping. Only interest expense of those corporations that derived income from covered sales (apparently only Corporations N and O) is taken into account in computing CTI. See Treas. Reg. § 1.861-8(f)(1)(vi)(E).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We understand that Corporation Q effectively filed duplicate tax returns for Year 2 by joining in Corporation M's consolidated tax return and at the same time electing and filing as a separate possession corporation under I.R.C. § 936. In Year 3, Corporation Q apparently merged into Corporation O. We note that an election under I.R.C. § 936 carries with it certain conditions, chief among which are the requirements that (i) the election apply to the tax year for which made and to all subsequent years unless revoked, and (ii) the Commissioner's consent be obtained before a corporation may revoke the election for any tax year beginning before the expiration of the ninth tax year following the election. I.R.C. § 936(e)(1) and (2). Furthermore, corporations that elect the possession tax credit under I.R.C. § 936 are ineligible to join in their affiliated group's consolidated tax return. I.R.C. § 1504(b)(4). These rules combine to effectively preclude possession corporations that elect the benefits of I.R.C. § 936 from joining in a consolidated return for at least ten years without the consent of the Commissioner. This rule arises from Congressional concern over the double tax benefit available under prior (pre-1976) law. See Staff of the Joint Comm. On Taxation, 94th Cong., 2d Sess., Joint Committee Explanation of Tax Reform Act of 1976, 1976-3 (Vol. 2) C.B. 1, pp. 274-5. [redacted]

Finally, the taxpayer has raised the argument that certain "advances" from Corporation M to Corporations N and/or O should be recharacterized as equity contributions by M to N and/or O, despite Corporation M's apparent original characterization of such advances as debt. Although the taxpayer has not provided the field with any facts with respect to any intercompany or third-party payments that would permit an analysis of the merits of this argument, we note that once a taxpayer chooses to structure a transaction, that taxpayer must generally "accept the consequences of his choice, whether contemplated or not . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not." See Commissioner v. National Alfalfa

Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) (citations omitted). [redacted]

If you have any further questions, please call (202) 622-3850.

BARBARA A. FELKER
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