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ALLOCATION OF CONTROLLED INTANGIBLE INCOME UNDER THE I.R.C. § 936 CREDIT: EFFECTS OF RECENT TRANSFER-PRICING REGULATIONS AND THE OMNIBUS BUDGET RECONCILIATION ACT OF 1993

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INTRODUCTION

U.S. multinational corporations face a serious challenge in determining the optimal situs for the sourcing and retention of profits earned from intangible property.¹ Ideally, such profits should be sourced in a low tax jurisdiction and then repatriated to the parent corporation as free of U.S.

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1. Intangible assets are defined in I.R.C. § 936(h)(3)(B) (1982) as any commercial transferrable interest in the following property: patent, invention, formula, process, design or knowhow; copyright, literary, musical or artistic composition; trademark, trade name or brand name; franchise, license or contract; method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, technical data, or: any similar item. This listing is crossreferenced in the other super-royalty sections. I.R.C. §§ 367(a)(3)(B)(iv) (1986) and the last sentence of 482 (1986). The 1993 transfer-pricing regulations contain a similar listing. Temp. Reg. § 1.482-4(T)(b) (1993). Rules governing the use of copyrights in manufacturing are further enumerated in Treas. Reg. § 1.936-6(a)(5), Question 4 (1986).

taxation as possible. Since the creation of the Puerto Rico and possession tax credit of § 936 of the Internal Revenue Code ("I.R.C.") under the Tax Reform Act of 1976,² Puerto Rico and the other U.S. possessions³ have proved to be the preferred locations.⁴ Shifting income to possession based operations can be a highly effective tax planning maneuver since the Puerto Rico and possession credit of I.R.C. § 936 effectively shelters possession sourced income from U.S. taxation entirely. The dividends received deduction of I.R.C. § 243 then provides for the tax free repatriation of intangible based income. Inherent difficulties in determining appropriate division of profits between the U.S. parent corporation and its subsidiary in the possessions amplifies the opportunities to shift income on these assets to operations in the possessions.

To prevent abusive tax-motivated shifting of income, Congress has placed restrictions on the ability of U.S. multinational to allocate income earned on controlled transfers and licensing agreements⁵ of intangible property to their subsidiaries in Puerto Rico and the other U.S. possessions. The greatest barrier is the "super royalty" provisions of I.R.C. § 482 and 936,⁶ which imposes an arm's-length standard on such asset transfers.

2. Pub. L. 94-455.

3. U.S. territorial possessions include the following: American Samoa, Guam, Johnston Island, Puerto Rico, the U.S. Virgin Islands and Midway Island. The independent states of the Commonwealth of the Northern Mariana Islands, the Federated States of Micronesia and the Marshall Islands are also considered U.S. possessions for federal income tax purposes. Rev. Rul. 80-167, 1980-1 C.B. 176 and the Compact of Free Association § 255, HJ Res 187, 99th Cong., 1st Sess. 278, Pub. L. No. 99-239, 99 Stat. 1770 (1986). The bulk of U.S. investment in the possessions is directed toward Puerto Rico. Accordingly, Congressional revision of the taxation of possession sourced income is often limited to its effect on U.S. investment there.

4. See generally Griggs, *Operating in Puerto Rico in the Section 936 Era*, 32 TAX L. REV. 239 (1977).

5. The super-royalty statutes are found in I.R.C. §§ 367(d)(2)(A) (1986), 936(h)(5)(C)(i)(I) (1982) and the last sentence of 482(1986). I.R.C. § 367(d)(2)(A) (1986) requires that foreign corporations make appropriate payments to their U.S. affiliates for use of property transferred in an exchange that would otherwise be tax free under I.R.C. §§ 351 and 361. I.R.C. § 936(h)(5)(C)(i)(I) (1982) requires that U.S. corporations electing the Puerto Rico and possession income credit of I.R.C. § 936 make similar payments to affiliated taxpayers on controlled transfer and licensing agreements of intangibles. I.R.C. § 482 (1986) requires that the appropriate transfer-price on any transaction between controlled taxpayers approximate an arm's-length price between independent parties. In each instance, income earned on the controlled transfer or licensing agreement of intangible property must be "commensurate with the income attributable to the intangible." These provisions were completed with the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986). See generally Marc M. Levey & Stanley C. Ruchelman, *Section 482—The Super Royalty Provisions Adopt the Commensurate Standard*, 41 TAX LAW. 611 (1988).

6. The super-royalty provisions crossreference the definition of control used in transfer-pricing regulations under I.R.C. § 482 (1986). I.R.C. § 936(h)(5)(C)(i)(I)(b) (1982). Controlled transactions are any transfers between controlled parties. Control is defined as any form of control, direct or indirect, whether legally enforceable and however exercised. No objective measure defining control in terms of percentages of common ownership has even been applied under I.R.C. § 482 (1986). A presumption of control exists whenever income or deductions have been arbitrarily shifted by two or more taxpayers acting together or towards a common end. Temp. Reg. § 1.482-1T(g)(4) (1993). Control is applied exclusively as to the exercise of practical or economic control over the entities. The legal right of control is

I.R.C. § 936 also imposes specific limits on how much U.S. multinational corporations may allocate intangible based income to their affiliates in the possessions. This section provides for only two methods of allocating income from controlled intangibles, the cost sharing⁷ and profit split methods.⁸ Prior to the Omnibus Budget Reconciliation Act of 1993, the profit split option was clearly the preferable method since it was (1) easier to utilize; (2) was not subject to the super-royalty provisions⁹ which rank among the most complex of all U.S. tax regulations; and (3) allowed for a higher allocation of interest income to the possession corporation.¹⁰

During 1992 and 1993, three separate developments have significantly limited the advantages of the profit split method. Two proposed amendments to the transfer-pricing regulations under I.R.C. § 482 have liberalized the taxpayer's ability to allocate controlled intangible income to possession based operations. Proposed regulations issued in 1992¹¹ clarified the operation of qualified cost sharing arrangements and provided detailed guidance in allocating research and development costs within a controlled group. In 1993, temporary regulations (1993 transfer-pricing regulations) were issued and provided greater flexibility in coordinating the transfer-pricing schema used to allocate income from the possessions.¹² The third development, the amendment to I.R.C. § 936 by the Omnibus Budget Reconciliation Act of

considered irrelevant. *Your Host, Inc. v. Comm'r*, 489 F.2d 957 (2d Cir. 1973).

7. I.R.C. § 936(h)(5)(C)(i) (1982).

8. I.R.C. § 936(h)(5)(C)(ii) (1982).

9. *Supra* note 1. The requirement that cost sharing payments satisfy the commensurate with income standard of I.R.C. §§ 482 (1986) and 367(d)(2)(A)(ii) (1986) is contained in I.R.C. § 936(h)(5)(C)(i)(I) (1982). No such requirement is stated in the rules governing the profit split method. I.R.C. § 936(h)(5)(C)(ii) (1982).

10. I.R.C. § 864(e)(1) (1988). In response to the preference toward the profit split method, the I.R.S. issued Notice 89-82, 1989-2 C.B. 402 allowing a possession corporation to switch from the cost sharing to the profit split method without the Commissioner's approval, which would otherwise have been mandatory under I.R.C. § 936(h)(5)(F)(iii)(I) (1982). This change could be made retroactive to the first year after 1986 in which the cost sharing method was used. Rev. Proc. 89-61, 1989-2 C.B. 782 (1989) extended this privilege to all amended returns pursuant to the possession corporation's last taxable year before January 1, 1990. Rev. Proc. 91-53, 1991-2 C.B. 782 extended this election for one more year. Rev. Proc. 92-68, 1992-2 C.B. 433 provides detailed guidance in making this election as well as extending the deadline to all amended returns pursuant to the possession corporation's last taxable year before January 1, 1992.

11. Prop. Treas. Reg. § 1.482-2(g) (1992) [hereinafter 1992 cost sharing regulations]. *Intercompany Transfer Pricing and Cost Sharing Regulations Under Section 482*, Prop. Treas. Reg. §§ 1.482-1, -2, 57 Fed. Reg. 3571 (1992). See generally Peter A. Glicklich, *IRS Guidelines For Cost Sharing Arrangements Provide Insufficient Certainty*, 77 J. TAX'N 42 (1992). Except for the 1992 cost sharing regulations, these proposed regulations were withdrawn with the publication of the 1993 transfer-pricing regulations mentioned in the following footnote. See generally Alan Winston Granwell & Kenneth Klein, *'Objective' Tests of Transfer Pricing Prop. Regs. Require Subjective Determinations*, 74 J. TAX'N 308 (1992).

12. Prop. Treas. Reg. § 1.482-1T1(f)(3) (1993). *Intercompany Transfer Pricing: Accuracy Related Penalty*, Temp. Treas. Regs. §§ 1.482-0T - 1.482-7T Relating to Intercompany Transfer Pricing Under Code Sec. 482, 58 Fed. Reg. 4047 (1993). See generally Peter A. Glicklich & Seth B. Goldstein, *New Transfer Pricing Regs. Adhere More Closely to an Arm's-Length Standard*, 78 J. TAX'N 306 (1993).

1993¹³ may have tipped the scale by providing a larger credit under the cost sharing method than under the profit split method.¹⁴

These new rules could significantly change the optimal method of allocation. Action is especially imminent as critical elections must be made by the end of 1994 tax year. This article discusses the effects of these new rules upon the allocation of controlled intangible income earned by a possession corporation. Planning perspectives will also be presented. The mechanics of I.R.C. § 936 will first be explained followed by a brief history of the valuation methods utilized under this section.

I. MECHANICS OF THE I.R.C. § 936 CREDIT

Since 1921, the U.S. has encouraged the economic development of its possessions by granting preferential treatment to U.S. taxpayers who do business in the possessions.¹⁵ Currently, the focal point of U.S. tax policy with respect to the possessions is the Puerto Rico and possession tax credit of I.R.C. § 936 which extends the foreign tax credit (FTC) mechanism to effectively exempt possession sourced income from U.S. taxation.¹⁶

13. Omnibus Budget Reconciliation Act of 1993, § 13227, Pub. L. No. 103-66, 107 Stat. 489 (1993) [hereinafter new I.R.C. § 936].

14. I.R.C. § 936(a)(4)(A)(iii) (1993).

15. U.S. tax law has permitted multiple concession schemes on investment in the possessions. The most common approach has been the exemption of income earned by residents of the possessions and sourced therein from U.S. taxation. The cornerstone of this policy was the often-amended I.R.C. § 931 which excluded all income earned outside the U.S. by qualified possession corporations. This provision was repealed in 1976 in response to widespread abuse that allowed U.S. multinational corporations to use possession corporations to exclude income sourced within tax havens rather than the possession. H.R. Rep. No. 658, 94th Cong., 1st Sess. 254 (1976). The I.R.C. § 931 exclusion was replaced by the I.R.C. § 936 Puerto Rico and possession tax credit under the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1643. (1976).

Current statutory provisions governing the U.S. possessions are classified under the following I.R.C. §§:

(1) I.R.C. § 931 allows the exclusion of income from U.S. taxation for all individuals residing in American Samoa, Guam and the Northern Mariana Islands provided that such income is sourced within these possessions and certain percentage standards are satisfied;

(2) I.R.C. § 932 provides coordination rules for individual citizens or residents of the U.S. having income sourced within the U.S. Virgin Islands.

(3) I.R.C. § 933 exempts from U.S. taxation Puerto Rican sourced income of an individual taxpayer who resided in Puerto Rico for the entire taxable year.

(4) I.R.C. § 934 provides special rules governing the limitation on the reduction in U.S. tax liability by corporations and individuals resident in the U.S. Virgin Islands.

For a history of U.S. tax policy regarding the possessions, *see generally* Hoff, *U.S. Federal Tax Policy Towards the Territories: Past, Present and Future*, 37 TAX L. REV. 51 (1981).

16. FTC rules are provided in I.R.C. §§ 901-908. The FTC is intended to ameliorate the harsh effects of double international taxation. The U.S. taxes both its citizens and residents on their aggregate income regardless of where the income is sourced. I.R.C. § 61(a) (1984). Foreign sourced income would normally be taxed by the nation of source as well. Foreign corporations and nonresident aliens are taxed only on income sourced within the U.S. I.R.C. §§ 871 and 881. The principle of worldwide tax jurisdiction is based on the theory of capital export neutrality. This approach was upheld in *Cook v. Tait*, 265 U.S. 47 (1924). *See also* *Bowring v. Bowers*, 24 F.2d 918 (2d Cir. 1928), *cert. denied*, 277 U.S. 608 (1928); and *Burnet*

A. I.R.C. § 936 Credit and Concept of Tax-Sparing

Under the general operation of the FTC mechanism, the FTC cannot exceed the lesser of foreign taxes paid or accrued or U.S. tax liability on foreign sourced income determined as if such income had been earned in the U.S. The equivalent U.S. tax liability is determined using the following formula:¹⁷

$$\frac{\text{Foreign sourced taxable income}}{\text{Worldwide taxable}} \times \text{U.S. tax liability on worldwide taxable income before the FTC.}$$

The calculations are as follows:

Foreign sourced income	\$90.00	
Worldwide sourced income	\$100.00	(sum of U.S. and foreign income)
U.S. tax liability worldwide	35	(\$100 x 35%)

As shown in example 1, U.S. corporations normally derive no benefit from foreign tax holidays and only a limited benefit from significantly lower foreign tax rates.

Example 1:

USCorp, a domestic corporation, owns all outstanding shares of USSub, which is also a domestic corporation. USSub carries on manufacturing operations in both the U.S. and foreign country *P*.

Pertinent data relating to USSub is as follows (stated in \$ millions):

Income sourced in <i>P</i>	\$90
Income sourced in U.S.	10
Applicable tax rate charged by <i>P</i>	4.5% (flat rate)
Applicable tax rate charged by U.S.	35% (flat rate)

USSub's U.S. tax liability without regard to the FTC is \$35. Its FTC as determined under the above formula is \$31.50. However, since USSub paid *P* income taxes of only \$4.05, its FTC is limited to that amount, as shown above. U.S. tax liability would be \$30.95.

v. Brooks, 288 U.S. 378 (1933).

The tax free status of possession sourced income is a rare exception to the principle of worldwide tax jurisdiction. Other examples whereby income earned by U.S. taxpayers are subject solely to a foreign tax regime include the foreign earned income exclusion of I.R.C. § 911, the deferral of recognition of income earned by U.S. taxpayers of foreign corporations prior to the actual distribution of income and tax treaty-based exclusions of specific income and business profits in the absence of a permanent establishment.

17. I.R.C. § 904(a) (1986).

The Puerto Rico and possession tax credit of I.R.C. § 936 is a tax sparing¹⁸ provision that determines the possession credit without regard to the amount of possession taxes actually paid or accrued to Puerto Rico or the other possessions.¹⁹ As a result, the I.R.C. § 936 credit preserves all tax incentives provided by the possessions.

Example 2:

Assume the same facts as in example 1 except that *P* is Puerto Rico and USSub qualifies for and elects the I.R.C. § 936 credit. The I.R.C. § 936 credit would be \$31.50 regardless of any Puerto Rican tax liability. The U.S. tax liability would be only \$3.50 or 35% of USSub's U.S. sourced income of \$10.

Dividends received by a domestic corporation from a possession corporation also qualify for the dividend received deduction of I.R.C. § 243.²⁰ If the corporate shareholder and distributing possession corporation are members of the same affiliated group, the dividend received deduction is 100%.²¹ Therefore, both the parent and subsidiary corporations can avoid U.S. taxation on repatriated possession sourced profits.²² In fact, the tax advantages of operating in a possession are generally superior to those in

18. Tax sparing is a mechanism commonly found in tax treaties between developed and less developed nations. In its various forms, it provides that the tax system of the industrialized nation grants tax credits approximately equal to foreign taxes that would have been paid in the absence of tax concessions provided by less developed nations.

Due to its strict reliance upon the principle of capital export neutrality, U.S. treaty policy is adamantly opposed to tax sparing. No U.S. treaty allows any form of tax sparing. Ironically, the U.S. was a pioneer of the tax sparing system. Treaties negotiated with Israel, India, Pakistan and the United Arab Republic in the 1950s contained tax sparing language. The U.S. Senate agreed to ratification of these treaties with the reservation that tax sparing be omitted, an amendment only Pakistan was willing to accept. S. Rep. No. 536, 85th Cong., 1st Sess. (1959).

19. Any income, war profits and excess profits taxes paid or accrued to any U.S. possession can be credited under I.R.C. § 936. I.R.C. § 901(b) (1986). I.R.C. § 936 prohibits the use of the possession credit against the environmental tax of I.R.C. § 59A, the accumulated earnings tax of I.R.C. § 531, the personal holding tax of I.R.C. § 541 and the tax on recoveries of foreign expropriation losses of I.R.C. § 1351. An I.R.C. § 936 corporation may not take the FTC for taxes imposed by a possession or foreign country on any income that is effectively exempted from U.S. taxation by the operation of I.R.C. § 936. I.R.C. § 936(d) (1990). Nor can those taxes be deducted or used in determining the ordinary FTC. I.R.C. § 936(c) (1986). In addition, there is no FTC available on any withholding taxes imposed on distributions to the parent corporation that qualify for the dividend received deduction. I.R.C. § 936(g) (1976).

20. I.R.C. § 243 (b)(1)(ii) (1990).

21. I.R.C. § 243(a)(3) (1964).

22. Under normal circumstances, possession sourced income is exempt from the U.S. alternative minimum tax scheme as well. A possession corporation's net income after subtracting the I.R.C. § 936 credit is not included in the alternative minimum taxable income of the possession corporation. I.R.C. § 59(b) (1986). Since dividends received by the parent corporation may be offset by the dividend received deduction, they are not included in the parent's alternative minimum taxable income either. For a detailed analysis of the effects of the alternative minimum tax system on possession corporations and their corporate shareholders, see generally 1 RUFUS VON THULEN RHOADES & MARSHALL J. LANGER, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS ¶ 4.12[1].

tax havens.²³

The vast majority of U.S. investment in the possessions is directed toward Puerto Rico which extends the incentives of I.R.C. § 936 with its own liberal tax regime, leaving U.S. investment there almost free of Puerto Rican taxes as well. The maximum Puerto Rican corporate tax rate on U.S. corporations utilizing the I.R.C. § 936 credit is only 4.5%.²⁴ As a result, Puerto Rico has prospered.²⁵

B. Eligibility

The I.R.C. § 936 credit is available only to domestic corporations that make a proper election.²⁶ Two gross income tests must be met:

Possession source test. At least 80% of the corporation's gross income for the three year period preceding the current taxable year must be sourced²⁷ within a U.S. possession,²⁸ and;

Trade or business test. At least 75% of the corporation's gross income must be derived from the active conduct of a trade or business within a U.S. possession.²⁹

23. There are several distinct advantages of operating a subsidiary in a U.S. possession vis-a-vis in a tax haven. Most noted is the inapplicability of the draconian rules subject to controlled foreign corporations. I.R.C. §§ 951-964. Avoidance of controlled foreign corporation status may be especially beneficial after the Omnibus Budget Reconciliation Act of 1993 imposed the excess passive assets test of I.R.C. § 956A. Transfers of certain intangible assets to the subsidiary located in a tax haven country may be assessed a toll charge under I.R.C. § 367. Operations in tax havens also cannot avoid the super-royalty provisions regardless of its method for dividing controlled income. In addition, the differences between U.S. tax law and that of the foreign country may result in the double taxation of certain intercompany royalty payments. In contrast, there is considerable coordination and cooperation between Puerto Rico and the U.S.

24. Puerto Rico's corporate tax regime imposes a combination of a normal tax of 22% and a graduated surtax. The combined tax is \$105,500 on the first \$300,000 and 42% on any excess. If taxable income exceeds \$500,000, the lower tax brackets are recaptured through a 5% surcharge until a flat 42% rate is reached. Internal Revenue Code of Puerto Rico § 1(c) (1990).

U.S. corporations electing the possession tax credit of I.R.C. § 936 qualify for an exemption of 90% of taxable income; the remaining 10% is taxed at a flat rate of 45% resulting in an effective tax rate of 4.5%. Internal Revenue Code of Puerto Rico § 1(d) (1990). In addition, a 10% withholding tax applies on profit remittances. Internal Revenue Code of Puerto Rico § 1(c) (1990). Puerto Rican tax exemptions, however, vary according to the industry and time horizon. Most time periods, however, range from 10 to 25 years. Intangible-sensitive manufacturing industries frequently qualify for maximum exemptions.

25. Numerous studies have concluded that the economic development of Puerto Rico is directly due to tax incentives provided U.S. corporations. Staff of Joint Comm. on Tax'n, 97th Cong., 2d Sess., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, at 80-81 (Comm. Print 1982). S. Rep. No. 1134, 103rd Cong., 1st Sess. 299 (1993).

26. I.R.C. § 936(a)(1) (1976). The election procedures are enumerated in Treas. Reg. § 1.936-1(a) (1986).

27. Applicable sourcing rules are contained in I.R.C. § 904(f) (1988).

28. I.R.C. § 936(a)(2)(A) (1976).

29. I.R.C. § 936(a)(2)(B) (1986).

Since independent domestic corporations will rarely meet both gross income tests, domestic subsidiaries whose operations are restricted to those qualifying for the credit are normally utilized.

C. Classification of Possession Sourced Income

Income meeting the two gross income tests falls into two broad categories, active business income and qualified possession source investment income (QPSIIa). Active business income is derived from the active conduct of a trade or business within a U.S. possession or the sale of substantially all of its assets.³⁰ QPSII is investment income resulting from retained possession sourced active business income which has been reinvested within the possession.³¹

II. PROBLEM OF ALLOCATING INCOME FROM INTANGIBLE ASSETS UNDER I.R.C. § 936

The most troublesome issue under I.R.C. § 936 has been the proper rates of return on transfers or licensing agreements of intangible assets to controlled possession subsidiaries. The proper treatment of intangible based income is an especially critical issue due to the inherent difficulty in determining the appropriate arm's-length division of profits on controlled transfers. The nature of intangible assets also provides ample opportunities to shift income on these assets to operations in the possessions.

This issue is most acute when high-profit potential intangibles are involved. Parent corporations have historically been able to transfer patents to their foreign subsidiaries at an early stage of development to justify low royalty rates due to the inability to accurately value the intangible or to take advantage of unrealistically low industry norms relative to the intangible asset.³²

Legal precedent has also established the ability of a parent corporation to transfer intangible assets to an I.R.C. § 936 corporation in a tax free

30. I.R.C. § 936(a)(1)(A) (1976).

31. I.R.C. § 936(d)(2) (1976). Three requirements define QPSII. The income must be sourced within a possession. I.R.C. § 936(d)(2)(A) (1976). The property producing the income must be located within the possession. This category includes the income generated from funds invested in financial institutions such as the Government Development Bank to the extent that those deposits are then reinvested in qualified Caribbean Basin Initiative countries. I.R.C. § 936(d)(4) (1976). Finally, the funds so invested must be derived from an active trade or business within the possession, a reinvestment of QPSII funds or the proceeds from a sale of property that produced such income. I.R.C. § 936(d)(4)(B) (1976).

32. G.D. Searle and Co. v. Comm'r, 88 T.C. 252 (1987); Bausch & Lomb, Inc. v. Comm'r, 933 F.2d 1084, 1089 (2d Cir. 1991); United States Steel Corp. v. Comm'r, 617 F.2d 942 (2d Cir. 1980). The ramifications of these cases are discussed in H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-637-638 (1986), and H.R. Rep. No. 426, 99th Cong., 1st Sess. 420-427 (1985).

exchange. In the landmark case of *Eli Lilly & Co. & Subs. v. Comm'r*,³³ Lilly, a U.S. parent corporation, transferred patents and related manufacturing intangibles to its Puerto Rican subsidiary in a nonrecognition transaction under I.R.C. § 351. The I.R.S. argued that no part of intercompany product sales should be sourced in Puerto Rico. They also argued that the subsidiary must reimburse the U.S. parent for a portion of research and development costs. The Court disagreed, although it did apply the profit split method to increase the parent's share of income on the controlled intangibles.

In reaction, Congress enacted the super-royalty provisions,³⁴ which require that income earned from controlled transfers or licensing of intangibles to be "commensurate with" the income attributable to the intangibles. The clear intent of the super-royalty provisions is to enable the I.R.S. to periodically reallocate royalty income to the developer of the intangible often relegating only minimal income levels to the transferee despite any contractual terms to the contrary.³⁵

III. METHODS OF ALLOCATING INTANGIBLE ASSET INCOME UNDER I.R.C. § 936

Under the general rule of I.R.C. § 936(h), a possession corporation using intangibles developed by another member of its affiliated group is only entitled to a limited mark-up on its direct and indirect costs.³⁶ Excluded from eligible costs are inventory costs relating to raw materials, work-in-process and finished goods, costs relating to the intangibles and any interest expenses.³⁷

Since the cost mark-up method generally results in limited allocation of income to the possession corporation, the possession corporation can elect out of the general rule under I.R.C. § 936(h)(5).³⁸ This election allows the possession corporation to allocate intangible asset income under one of two

33. 856 F.2d 855 (7th Cir. 1988). See also *Ciba-Geigy Corp. v. Comm'r*, 85 T.C. 172 (1985) (*acq.*) in which the Service was precluded from disallowing deductions related to fixed long term licensing agreements with stated royalty rates.

34. *Supra* note 1.

35. *Supra* note 23. The super-royalty language would also allow the I.R.S. to adjust long-term royalty contracts so that each year can be treated independently. This is a clear attempt to overrule the results in *R.T. French Co. v. Comm'r*, 60 T.C. 836 (1973). In *French*, the I.R.S. was unable to adjust a fixed long term controlled royalty agreement which met arm's-length standards at the time of inception but not during the year under audit.

36. I.R.C. § 936(h)(1)(A) (1982).

37. Treas. Reg. § 1.936-4, Question 3 (1986).

38. The election to apply either the cost sharing or profit split methods is made during the possession corporation's first taxable year. I.R.C. § 936(h)(5)(F)(i) (1982). Treas. Reg. § 1.936-7(a), Question 1 (1986) extends the election period to the final due date with extensions. Therefore, the election cannot be made on any amended or delinquent returns. The election cannot be revoked without I.R.S. consent. I.R.C. § 936(h)(5)(F)(iii) (1982). Once revoked, the election cannot be rendered again without similar consent. I.R.C. § 936(h)(5)(F)(i) (1982). Affiliated groups with more than one possession corporate member operating within the same product area must all elect the same method. I.R.C. § 936(h)(5)(F)(iv)(I) (1982).

alternative methods, the cost sharing³⁹ and the profit split method.⁴⁰

To utilize either method, the possession corporation must have a significant business presence in the possession with respect to the product type⁴¹ or service at issue.⁴² A significant business presence is established if the possession corporation meets the following three independent tests:

Value added test. Total production costs incurred by an electing corporation in its operations within the possession must be at least 25% of the excess of the gross receipts on sales of the product over the direct material costs for the product;⁴³

Direct labor test. At least 65% of the direct labor costs incurred in producing any product or service must be incurred within the possession, and;⁴⁴

Possession services test. At least 65% of a possession corporation's direct labor costs must be paid for services performed within the possession.⁴⁵

The election is automatically revoked if the possession corporation fails to meet any of these tests for any year.⁴⁶

A. Cost Sharing Method Under I.R.C. § 936(h)(5)(C)(i)

The cost sharing method reduces the amount of the tax deduction allowed to the possession corporation's U.S. affiliates for research and development.⁴⁷ Under the cost sharing method, the possession corporation computes and renders a cost sharing payment to all domestic members of its affiliated group⁴⁸ that incurred research and development costs related to the

39. *Supra* note 5.

40. *Supra* note 6.

41. The term product type is defined as any output of a production process. Products consist of components or products subject to further manufacturing before sale to unrelated parties, integrated products, or products in the final stage of development and sold to unrelated parties, and end products, or products in the final stage of development and sold to unrelated parties but contains certain components that did not utilize intangibles developed by affiliated parties. Treas. Reg. § 1.936-5(a), Question 1 (1986).

42. I.R.C. § 936(h)(5)(B)(i) (1982).

43. I.R.C. § 936(h)(5)(B)(ii)(I) (1982).

44. I.R.C. § 936(h)(5)(B)(ii)(II) (1982).

45. I.R.C. § 936(h)(5)(B)(ii)(III) (1982).

46. I.R.C. § 936(h)(5)(B)(i) (1982).

47. Treas. Reg. § 1.936-6(a)(5), Question 4 (1986).

48. Treas. Reg. § 1.936-6(a)(5), Question 2 (1986). The term affiliated group has the same meaning as controlled group under I.R.C. § 482 regulations. *Supra* note 2.

intangibles used by the possession corporation.⁴⁹

The possession corporation's proportionate share of the research and development costs must be paid to the domestic affiliate that actually incurred these costs. Any research and development costs incurred directly by the possession corporation may be deducted from the required payment unless they are paid to or for the benefit of a related party.⁵⁰ Since the required payment will affect only the research and development deduction of corporations doing business in the U.S., payments to foreign corporations need be made only if no domestic affiliates exist.⁵¹

The recipient corporation recognizes cost sharing payments as reductions in research and development deductions rather than as gross income.⁵² The possession corporation may deduct the payment as well, although the effect of doing so reduces its taxable income qualifying for the I.R.C. § 936 credit.

The cost sharing payment is the greater of the amounts determined under the following:⁵³ (1) statutory cost sharing formula of I.R.C. § 936(h)(5)-(C)(i)(I); or (2) an arm's-length royalty payment mandated under the super-royalty provisions of I.R.C. §§ 482 or 367(d)(2)(A)(ii). Both methods are explained in the sections that follow.

1. Cost Sharing Formula

The cost sharing payment equals 110% of the cost of the product area research.⁵⁴ The cost of the product area research is determined under the

49. Actual payment to all domestic affiliates must be made by the due date (as extended) of the possession corporation's tax return. I.R.C. § 936(h)(5)(C)(i)(III)(a) (1982). In the case of delinquent payments whether or not caused by fraud or willful negligence, a nondeductible interest charge must also be paid. If the lateness was caused by fraud or willful negligence, the cost sharing election is automatically terminated. Interest is also charged on any underpayment determined on subsequent I.R.S. audits.

50. I.R.C. § 936(h)(5)(C)(i)(I) (1982). Related party is defined in I.R.C. § 936(h)(3)(D) (1982) by crossreferencing the definition of related parties in I.R.C. §§ 267(b) and 707(b)(1) and of controlled groups of corporations in I.R.C. § 1563(a) (1984) except that common ownership is defined as only 10% rather than 50 and 80% respectively. I.R.C. § 936(h)(3)(D) (1986).

51. I.R.C. § 936(h)(5)(C)(i)(IV)(a) (1982). Foreign shareholders can also be excluded under I.R.C. § 936(h)(2)(A) (1982).

52. I.R.C. § 936(h)(5)(C)(i)(IV)(c) (1982). Any foreign taxes paid on cost sharing payments can be neither credited nor deducted. I.R.C. § 936(h)(5)(C)(i)(III)(b) (1982).

53. I.R.C. § 936(h)(5)(C)(i)(I) (1982).

54. The term product area research encompasses all research and experimentation expenses allocated to the same product area in which the possession corporation conducts its operations. I.R.C. § 936(h)(5)(C)(i)(I)(a) (1982). Product area is normally determined by the three digit Standard Industrial Classification (SIC) codes although other SIC codes may be used when the facts and circumstances, normally related to data restrictions, so dictate. I.R.C. § 936(h)(5)(C)(i)(I)(d) (1982) and Treas. Reg. § 1.936-6(a)(1), Question 1 (1986).

Applicable costs include the following: research contracted by the possession corporation or any of its affiliates to unrelated parties; royalties or similar payments for the use of a patent, invention, formula, process, design, pattern, or know-how; depreciation on a manufacturing intangible acquired by purchase, and; costs qualifying the research and experimentation credit under I.R.C. § 41. I.R.C. § 936(h)(5)(C)(i)(I)(a) (1982) limits the costs of a research area to costs directly allocable to research in a particular research area and a ratable portion of research

following formula:⁵⁵

$$\frac{\text{Sales of possession products to unrelated persons}^{56}}{\text{Total sales of products}^{57}} \times \text{Worldwide product area research}$$

Example 3:

Assume the same facts in example 2. Also assume that USSub sells goods it manufactured in Puerto Rico to USCorp for \$200. USCorp resells these goods to unrelated buyers for \$300. USSub's worldwide sales total \$600. The affiliates' worldwide product area research is \$50.

The actual cost sharing payment is calculated as

$$110\% \frac{\text{Sales of possession products to unrelated persons}(\$300)}{\text{Total sales of products} (\$600)} \times \text{Worldwide} (\$50) \text{ product area research}$$

$$110\% (.5 \times \$50) = \$27.50$$

USSub must pay \$27.50 to the affiliated developer of intangibles used by USSub.

2. Super-Royalty Formula

The cost sharing payment under the super-royalty formula is calculated under the super-royalty provisions governing deemed royalties in I.R.C. § 367(d)(2)(A)(ii) and the transfer-pricing regulations of I.R.C. § 482.⁵⁸ The required royalty payment cannot be less than a similar payment between uncontrolled corporations operating at arm's length.

costs that cannot be allocated to any specific product area.

55. I.R.C. § 936(h)(5)(C)(i)(I) (1982). The computation of the cost sharing formula is covered under Treas. Reg. § 1.936-6(a)(4) (1986) except that the actual amount must equal at least 110% of the amount specified in this regulation.

56. Possession sales includes the selling price of all goods produced within the possession and subsequently sold by any member of the affiliated group to an unrelated party. I.R.C. § 936(h)(5)(C)(i)(I)(c) (1982). *Supra* note 48.

57. The term total sales includes the selling price of all goods and services within the product area sold by all members of the affiliated group to unrelated parties. I.R.C. § 936(h)(5)(C)(i)(I)(c) (1982). *See also* Treas. Reg. § 1.936-6(a)(2) (1986).

58. I.R.C. § 936(h)(5)(C)(i)(I) (1982). The net effect of applying the commensurate with income standard to possession corporations is to treat the possession corporation as the owner of any possession product related intangibles used by such corporation. Treas. Reg. § 1.936-6(a)(5), Question 4 (1986). Thus, reasonable rates of return must be allocated under I.R.C. § 482(1986) to the possession corporation on any controlled transactions. Profits on sales of goods or services by the possession corporation to unrelated parties can also be allocated to the possession corporation's affiliates as well.

Applicable payments are then determined under the terms of I.R.C. §§ 367(d)(2)(A)(ii) and 482. The former section governs intangibles transferred to a possession corporation in a tax-free transaction under I.R.C. §§ 351 or 361. In such a case, the transferor is treated as having sold the property for a series of payments contingent upon the actual rates of return earned on the property.⁵⁹ The deemed royalty payments must be made annually over the useful life of the property⁶⁰ or when the property is subsequently disposed of, directly or indirectly, by the possession corporation.⁶¹ The actual amount of the deemed royalty is determined under the transfer-pricing rules of I.R.C. § 482.

Other controlled uses of intangibles must conform to I.R.C. § 482. This section authorizes the I.R.S. to allocate gross income, deductions, credits and other allowances among two or more organizations, trades or businesses⁶² under common ownership or control whenever the allocation is needed "in order to prevent the evasion of taxes⁶³ or clearly to reflect the income." The I.R.S. is thus empowered to restate tax liabilities arising from controlled cross-border transactions to approximate the results achieved on similar transactions between independent parties operating at arm's-length. I.R.C. § 482 would thus impose tax parity between controlled and uncontrolled taxpayers.⁶⁴

B. Profit Split Method Under I.R.C. § 936(h)(5)(C)(ii)

Before the 1993 amendments to I.R.C. § 936, the profit split method possessed clear advantages over the cost sharing method.⁶⁵ It was simpler to apply, not subject to the super-royalty provisions of I.R.C. §§ 367, 482 and 936⁶⁶ and allowed for a broader allocation of interest income amongst

59. I.R.C. § 367(d)(2)(A) (1986). The possession corporation then must be treated as a foreign corporation. I.R.C. § 367(a)(1) (1986).

60. I.R.C. § 367(d)(2)(A)(ii)(I) (1986).

61. I.R.C. § 367(d)(2)(A)(ii)(II) (1986).

62. I.R.C. § 482(1986) applies to any form or combination of entities regardless of the site of operation provided that the required element of control is present. Temp. Reg. § 1.482-1T(g)(2) (1993).

63. For purposes of I.R.C. § 482(1986), the term "tax evasion" would include any transfer-pricing scheme which effectively minimizes U.S. tax liability. The term is synonymous with "tax avoidance." *Asiatic Petroleum Co. v. Comm'r*, 79 F.2d 236, 236 (2d Cir. 1935), *cert. denied*, 296 U.S. 645 (1935).

64. Indicative of its broad authority under I.R.C. § 482(1986), the I.R.S. need inquire into only the economic reality of controlled transactions and it can compel allocations based on the arm's-length standard even if its actions negate arrangements which are legally enforceable and were established for sound business reasons in the absence of any tax avoidance motives. A controlled taxpayer challenging an I.R.C. § 482(1986) reallocation has the burden of overcoming the presumption of correctness and to establish that the Service acted arbitrarily, capriciously or unreasonably. Criteria applicable to the Service's utilization of I.R.C. § 482(1986) are defined by regulation and numerous judicial precedents.

65. *Supra* note 9.

66. *Supra* note 6.

affiliated corporations, which could have led to more profit being allocated to the possession corporation.⁶⁷

Under the profit split method, fifty percent of combined taxable income from sales of products manufactured in the possession are allocated to the possession corporation.⁶⁸ The combined taxable income from covered sales, or deemed sales, of units produced by the possession corporation is computed on an affiliate wide basis.⁶⁹ The allocation among the affiliates is based on the individual affiliate's proportionate share of gross income from the product, gross income from the product area, or gross income, whichever is appropriate.⁷⁰

Combined taxable income is calculated separately for each type of product produced or service performed by the possession corporation within the possession.⁷¹ It is based on the total selling price charged by domestic affiliates to uncontrolled parties or to foreign members of the group. The receipts are reduced only by costs incurred by domestic affiliates that can be allocated to the sales and a ratable portion of the group's costs that cannot be allocated. However, profits are considered on a consolidated basis.⁷²

67. I.R.C. § 864(e)(1) (1988). A major disadvantage of the profit split method lies in its requirement that research and development costs deducted in determining the combined taxable income of the affiliated group must equal or exceed a prescribed amount. I.R.C. § 936(h)(5)(C)(ii)(II) (1982). This amount is determined by using the statutory cost sharing formula of I.R.C. § 936(h)(5)(C)(i)(I) (1982) but substituting 120% for 110%.

68. I.R.C. § 936(h)(5)(C)(ii)(I) (1982). The remaining fifty percent of the combined taxable income is allocated in the following manner:

- (1) To U.S. taxable affiliates within the group, as defined in § 482(1986), which derive income from the product produced in whole or in part in the possession, or if there are no such affiliates;
- (2) To U.S. taxable affiliates that derive income from the active conduct of a trade or business in the same product area as the possession product, or if there are no such affiliates;
- (3) To U.S. taxable affiliates, or if no such affiliates;
- (4) To foreign affiliates that derive gross income from the same product area, unless those affiliates are resident in country which has a tax treaty with the U.S., then to those foreign affiliates that derive income in the same product area as the possession product in a permanent establishment in the U.S., or if no such affiliates, and;
- (5) To all foreign affiliates. Treas. Reg. § 1.936-6(b)(1), Question 13 (1986).

69. I.R.C. § 936(h)(5)(C)(ii)(II) (1982). Covered sales include sales to unrelated domestic parties or to foreign members of the group. I.R.C. § 936(h)(5)(C)(i)(IV) (1982). Only products manufactured or performed partially or completely by the possession corporation are included.

70. *Id.* The determination of combined taxable income is complicated by the allocation and apportionment rules of Treas. Reg. § 1.861-8. Treas. Reg. § 1.936-6(b)(1), Question 1 (1986).

71. I.R.C. § 936(h)(5)(C)(ii)(II) (1982).

72. *Id.* Thus, intercompany profits and payments are ignored. Costs incurred by affiliates would also reduce combined taxable income. When a substantial amount of the income generated by a possession product is attributable to marketing intangibles, the profit split method will usually provide the lowest U.S. tax burden. The combined taxable income that is split between the possession corporation and its affiliates includes income attributable to both marketing and manufacturing intangibles. Treas. Reg. § 1.936-6(b)(1), Question 6 (1986).

Example 4:

Assume the same facts present in example 3. Further assume that the goods cost USSub \$120 to manufacture. USCorp incurred \$50 in additional costs relative to the goods.

In order to avoid the double counting of intercompany profits, only the final sale to unrelated buyers is considered in the determination of gross income and costs. Intercompany sales are ignored in the computation as either gross income of the subsidiary or as a cost of the parent. Combined income is \$130 (\$300 less the sum of USSub's cost of \$120 and USCorp's additional costs of \$50). Half of the combined income, or \$65, must be allocated to USSub as the possession corporation.

IV. EFFECTS OF NEW I.R.C. § 482 REGULATIONS

The 1992 cost sharing regulations and the 1993 transfer-pricing regulations provide different tax ramifications for controlled groups with possession operations. Possession corporations electing the cost sharing method must defend their cost sharing payments under one of two sets of regulations. The operation of each set of regulations is explained below.

A. 1992 Cost Sharing Regulations

Possession corporations may also base their cost sharing payments mandated by I.R.C. § 936(h)(5)(C)(i) under the 1992 cost sharing regulations.⁷³ These regulations provide wider latitude and guidance in forming cost sharing arrangements,⁷⁴ as well as more objective measures of calculating actual arm's-length cost sharing payments. Since controlled groups electing the 1992 cost sharing regulations are not subject to other transfer-pricing regulations, possession corporations electing I.R.C. § 936(h)(5)(C)(i) can avoid the 1993 transfer-pricing regulations.⁷⁵

73. *Supra* note 11. The 1992 cost sharing rules can be applied to any controlled development or transfer of intangibles by an affiliated group. Its application is not limited to cost sharing payments under I.R.C. § 936. Readers are cautioned not to be confused by the similarity of terminology.

74. The new rules replaced the more rigid regulations governing bona fide cost sharing arrangements. Treas. Reg. § 1.482-2(d) (1968). The old rules were not only unduly concise but still reflect the stranglehold of the comparable transaction approach.

75. Despite improvements, problems still remain with the 1993 transfer-pricing regulations. These rules provide the I.R.S. several opportunities to arbitrarily reallocate income to the developer of an intangible asset. Temp. Reg. § 1.482-1T(d)(3) (1993) allows the Service to ignore the actual contractual terms of any controlled transaction. Royalty payments may be recomputed to the intangible's developer under Temp. Reg. § 1.482-1T(d)(3)(iii) (1993).

1. Applicability and Mechanics

Under the 1992 cost sharing regulations, all eligible members⁷⁶ of any controlled group may elect to form a qualified cost sharing arrangement (QCSA).⁷⁷ Members of a QCSA divide the costs and risks of developing intangibles in proportion to anticipated benefits.⁷⁸ The allocation plan need only reflect a reasonable method of sharing costs in proportion to anticipated sales, gross or net profit or any other reasonable criteria.⁷⁹ It must, however, be periodically examined and adjusted if prior projections prove inaccurate.⁸⁰

A separate QCSA must be calculated for each intangible development area (IDA).⁸¹ An IDA is a classification of products and services with respect to which intangible development is conducted under a QCSA.⁸² The term is virtually synonymous with product research area of I.R.C. § 936.⁸³ In fact, the 1992 cost sharing regulations recommend the use of the three digit SIC classification codes normally mandated under the cost sharing method of I.R.C. § 936(h)(5)(C)(i).⁸⁴ For planning considerations, relevant data may be used interchangeably.⁸⁵

2. Cost to Income Ratios

In determining the applicability of QCSA estimates, the 1992 cost sharing regulations rely upon the ratio of cost to income (C/I), or the proportionality to profit rule, of all eligible QCSA members.⁸⁶ The C/I ratio analysis is used both to validate a particular QCSA and to determine the reasonableness of cost sharing payments on the part of each U.S. participant. If the C/I ratio of all U.S. participants, including all possession

76. Eligible participants of a qualified cost sharing arrangement are defined in Prop. Treas. Reg. § 1.482-2(g)(3)(i) (1992).

77. See Prop. Treas. Reg. § 1.482-2(g)(2)(i) (1992) for rules governing the QCSA election. In reaction to Ciba-Geigy, all regulations under I.R.C. § 482(1986), the I.R.S., but not the taxpayer, can impose the new rules in the absence of the QCSA election. Prop. Treas. Reg. § 1.482-2(g)(2)(iii) (1992). *Supra* note 31.

78. Prop. Treas. Reg. § 1.482-2(g)(2)(i)(D) (1992).

79. Prop. Treas. Reg. § 1.482-2(g)(2)(ii)(A) (1992).

80. Prop. Treas. Reg. § 1.482-2(g)(2)(ii)(C) (1992).

81. Prop. Treas. Reg. § 1.482-2(g)(4)(i)(A) (1992).

82. *Id.*

83. Prop. Treas. Reg. § 1.482-2(g)(4)(i)(B) (1992).

84. *Id.*

85. Prop. Treas. Reg. § 1.482-2(g)(4)(ii)(A) (1992). The I.R.S. may also make adjustment's to the cost shares of the U.S. participant if the QCSA is defined in terms that are too broad or too narrow. The intangible development area is too broad if any participant will not be able to use developed intangibles in its trade or business and too narrow if it does not encompass all intangible development that may reasonably be regarded as leading to the development of any product or service in the stated intangible development area, whether successfully developed or not.

86. Prop. Treas. Reg. § 1.482-2(g)(2)(ii)(C)(2) (1992).

corporations,⁸⁷ is not substantially disproportionate, the QCSA is deemed accurate and the only possible adjustment is to the U.S. participant's cost shares.⁸⁸ To be considered substantially disproportionate, the C/I ratio of all U.S. participants must be less than twice the C/I ratio of the other eligible participants, over a three year time period ending with the current year.⁸⁹ If the C/I ratio is substantially disproportionate, any adjustments are made as if the intangible had been transferred outside of the QCSA. The QCSA election will be void and the I.R.S. may reallocate income to the U.S. participants to reflect arm's-length returns.⁹⁰

3. Cost Sharing Payments

Cost sharing payments by the U.S. participant will be considered reasonable if the C/I ratio of each U.S. participant is approximately equal to those of the foreign participants.⁹¹ Example 5 illustrates.

Example 5:

USSub and its foreign affiliate Fcorp enter into a long-standing agreement for the development of a patent to be used in the manufacturing operations of both corporations. Applicable data averaged over the past three years is given as:

	<u>USSub</u>	<u>Fcorp</u>
Cost sharing payment	\$50	\$90
Operating income	\$90	\$225
C/I Ratio	56	.40

Appropriate data for the current year is given as:

	<u>USSub</u>	<u>Fcorp</u>
Cost sharing payment	\$20	\$25
Operating income	\$35	\$60

87. A U.S. participant is defined in Prop. Treas. Reg. § 1.482-2(g)(7)(iii) (1992) as any corporation whose earnings can be taxed by the U.S. Therefore, possession corporations and controlled foreign corporations covered under I.R.C. § 957 would qualify as a U.S. participant.

88. Prop. Treas. Reg. § 1.482-2(g)(4)(ii)(B) (1992).

89. Prop. Treas. Reg. § 1.482-2(g)(2)(ii)(C)(2) (1992).

90. Prop. Treas. Reg. § 1.482-2(g)(4)(ii)(D) (1992).

91. There is no actual requirement in the 1992 cost sharing regulations that C/I ratios be approximately equal. However, the conclusion that possession corporations equalize those C/I ratios are not approximately equal is derived from the examples in Prop. Treas. Reg. § 1.482-2(g)(4)(ii)(E) (1992). In each case, unequal C/I ratios were adjusted by the I.R.S. unless they were determined to be substantially disproportionate in the first place.

Since USSub's C/I ratio is less than twice the C/I ratio of the foreign participant, USSub's C/I ratio is not considered substantially disproportionate. The only adjustment would be to the costs borne by USSub. In order that the cost shares be approximately equal, the appropriate C/I ratios of .56 and .4 must be adjusted. USSub's cost share payment is decreased by \$3 while Fcorp's payment is increased by \$3, which is treated as a reimbursement of the intangible development expenses to USSub. USSub's C/I ratio is then .49 (\$17/\$35) and Fcorp's C/I ratio is .47 (\$28/\$60).

4. Buy-In and Buy-Out Rules

The possession corporation can also use the liberal buy-in and buy-out payment rules.⁹² If an eligible participant of a QCSA transfers an intangible asset to another member, the appropriate transfer-price must be determined by reference to applicable transfer-pricing rules.⁹³ Qualifying transfers can occur under three separate scenarios: (1) an intangible developed outside of the cost sharing arrangement is transferred to any member of the QCSA; (2) an intangible developed within the cost sharing arrangement is transferred to a new member of the QCSA; and (3) an intangible covered by the cost sharing arrangement is transferred by any member departing the QCSA.⁹⁴ The actual payments may be in the form of installment payments⁹⁵ or royalties contingent upon the use of the intangibles.⁹⁶

B. 1993 Transfer-Pricing Regulations

The primary disadvantage of the cost sharing method of I.R.C. § 936(h)(5)(C)(i) is the requirement that cost sharing payments satisfy the transfer-pricing rules of I.R.C. § 482, which rank among the most chaotic in federal tax law. Prior regulations have been noted for undue rigidity, reliance upon the comparable transaction approach⁹⁷ and the determination of an appropriate transfer-price as a specific amount. Before the 1993 transfer-pricing regulations were issued, I.R.C. § 936 corporations often elected the profit split method of I.R.C. § 936(h)(5)(C)(ii) to avoid the

92. Prop. Treas. Reg. § 1.482-2(g)(4)(iv)(A) (1992).

93. *Id.*

94. *Id.* An eligible participant may also be deemed to have acquired rights in an intangible if another member of the QCSA relinquishes its rights. Prop. Treas. Reg. § 1.482-2(g)(4)(iv)(C) (1992).

95. Prop. Treas. Reg. § 1.482-2(g)(4)(iv)(B)(2) (1992).

96. Prop. Treas. Reg. § 1.482-2(g)(4)(iv)(B)(3) (1992). Consideration in the form of lump sum payments is reserved under Prop. Treas. Reg. § 1.482-2(g)(4)(iv)(B)(1) (1992).

97. The comparable transaction approach calculates the international transfer-price by reference to comparable transactions between independent parties. The Service, however, often came to regard comparable as identical. Difficulties arose when no comparable sales could be found, as often occurred in the case of unique products, such as intangibles, that are usually transferred only in controlled transactions. H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess II-637-638 (1986).

antiquated transfer-pricing regulations and their severe penalties for noncompliance,⁹⁸ even though the cost sharing method may have resulted in a smaller overall tax liabilities.

The 1993 transfer-pricing regulations,⁹⁹ however, provide a possession corporation flexibility absent in prior transfer-pricing rules. The hierarchical approach that has dominated transfer-pricing regulations¹⁰⁰ has been replaced with a series of transfer-pricing schema from which the taxpayer must choose the best method given the facts and circumstances of its controlled transactions.¹⁰¹ Instead of proving the inapplicability of competing transfer-pricing schema, the possession corporation need only justify its transfer-pricing method as that which provides the most accurate measure of the arm's-length result given the factual situation of the transactions under review.¹⁰² The criteria used to define the best method include the adequacy

98. The penalties for noncompliance with transfer-pricing regulations can be severe. In addition to interest and penalties on underpayment of tax prescribed elsewhere, documentation and reporting penalties of I.R.C. §§ 6001, 6038, 6038A, 6038C and 6662(e) (1993) apply. I.R.C. § 6662(a) (1986) imposes an accuracy-related penalty of 20% if the taxpayer cannot demonstrate reasonable cause to support its transfer-pricing schema. Exceptions relating to good faith and reasonable cause appear in I.R.C. § 6664(c)(1) (1989). In the case of "gross valuation misstatements," the penalty can be assessed at 40%. I.R.C. § 6662(h)(1)(1986).

Affected taxpayers must pay close attention to the transfer-pricing rules since this penalty is applied at relatively low thresholds. The penalty can apply in any instance where the taxpayer is determined to be negligent or to have disregarded I.R.C. § 482 Regulations. I.R.C. § 6662(c) (1986). In cases of substantial understatement of income tax, the penalty can be assessed whenever the reported understatement of tax exceeds the greater of 10% of the correct tax liability or \$5,000. I.R.C. § 6662(d) (1986). I.R.C. § 6662(d)(1)(B) (1986) restates the \$5,000 threshold as \$10,000 in the case of Subchapter S corporations or personal holding companies as defined in I.R.C. § 542. Presumably, foreign personal holding companies as defined in I.R.C. § 552 follow the \$5,000 threshold.

To further complicate taxpayer compliance, existing I.R.C. § 6662 regulations seem ill-suited to deal with the complexities of I.R.C. § 936. Further issues regarding these penalties are likely to be addressed in regulations covering these sections rather than under I.R.C. § 482. IRS Deputy Associate Counsel (International) Charles Triplett has announced that the Service will not issue any I.R.C. § 6662 regulations prior to the publication of the final I.R.C. § 482 regulations. See 4 TAX NOTES INT'L 577 (1992).

99. *Supra* note 12.

100. Transfer-pricing regulations have long since mandated a hierarchical approach. Controlled corporations were required to select among transfer-pricing methodologies by applying a rigid hierarchy of rules. Treasury's 1988 White Paper on the application of the commensurate with income standard advocated its own hierarchy. A Study of Intercompany Pricing Under Section 482 of the Code, Notice 88-123, 1988-2 C.B. 458 [hereinafter White Paper]. See generally Carlson et al., *The Section 482 White Paper: Highlights and Implications*, 41 TAX NOTES 547 (1988); and Fuller, *The IRS Section 482 White Paper*, 41 TAX NOTES 655 (1988). The withdrawn 1992 proposed regulations modified this hierarchy. Prop. Treas. Reg. § 1.482-2(d)(2)(iii) (1992) establishes the three following methods of pricing intangibles in their respective hierarchical ranking: (1) the matching transaction method (Prop. Treas. Reg. § 1.482-2(d)(3) (1992) based with minor amendment on the White Paper's exact comparable method (White Paper, at 485-487)); (2) the comparable transaction method (Prop. Treas. Reg. § 1.482-2(d)(4) (1992) and similar to the White Paper's inexact comparable method (White Paper, at 487-488)); and (3) the new comparable profit method (Prop. Treas. Reg. § 1.482-2(d)(5) (1992)).

101. Temp. Reg. § 1.482-1T(b)(2)(iii)(A) (1993).

102. *Id.* If the possession corporation can justify its transfer-pricing scheme, the Service would be in the position of proving the preference for another method or that two competing methods would produce inconsistent results. Temp. Reg. § 1.482-1T(b)(2)(iii)(B) (1993).

and accuracy of data, the degree of comparability between the controlled and uncontrolled transactions and the minimization of adjustments required to apply each method.¹⁰³

1. Choice of Transfer-Pricing Method

To determine its cost sharing payment, a possession corporation must select from the following three methods: the comparable uncontrolled transaction method, the comparable profit method and other unspecified methods.

The comparable uncontrolled transaction method¹⁰⁴ is based on the comparison of transfer-prices to an adequate number of uncontrolled transactions that are sufficiently similar to determine an arm's-length price.¹⁰⁵ This method is thus the remnant of the Service's reliance upon the use of a comparable transaction approach and would normally be inoperative in the case of the I.R.C. § 936 credit due to the unique nature of intangibles transferred to possession corporations.¹⁰⁶

The comparable profit method¹⁰⁷ determines a range of arm's-length rates of return rather than a single point. The possession corporation need only demonstrate that its operating profit is within the permitted range.¹⁰⁸ The range can be determined with reference to one financial ratio applied to the data of several similarly situated uncontrolled corporations,¹⁰⁹ or by reference to several financial ratios applied to a single similarly situated taxpayer.¹¹⁰

Other unspecified methods might be available.¹¹¹ If the taxpayer can demonstrate the inapplicability of either of the two specified methods, it can employ other methods, such as the profit split method.¹¹² The profit split method,¹¹³ offers extensive guidance to possession corporations employing

103. *Id.*

104. Temp. Reg. § 1.482-4T(c) (1993).

105. Temp. Reg. § 1.482-4T(c) (1993).

106. *Supra* note 99.

107. Temp. Reg. § 1.482-5T(1993).

108. *See generally* Wacker et al., *The Comparable Profits Method Under the Temporary Section 482 Regulations: A Radical Attempt To Introduce an Objective Standard For international Transfer-Pricing Activities*, 11 INT'L TAX & BUS. LAW. 26 (1993).

109. Temp. Reg. § 1.482-5T(d)(1) (1993).

110. Temp. Reg. § 1.482-5T(d)(2) (1993). The financial ratios are termed profit level indicators. Temp. Reg. § 1.482-5T(e)(1) and (2) (1993).

111. Temp. Reg. § 1.482-4T(d) (1993).

112. Temp. Reg. § 1.482-4T(d) (1993).

113. Prop. Treas. Reg. § 1.482-6T(1993). The profit split method permitted under the proposed regulation to the 1993 transfer-pricing regulations is not specific to I.R.C. § 936 corporations. The profit split method so delineated is not synonymous with the method defined in I.R.C. § 936(h)(5)(C)(ii) (1982) which has an identical name.

valuable nonroutine intangibles.¹¹⁴ The profit split is determined by periodically splitting combined income in direct relationship to each controlled corporation's relative economic contribution to the combined operations.¹¹⁵ The commensurate with income standard is broadened by linking income to each controlled party's share of the group's success.¹¹⁶ Another advantage of the profit split method is that internally generated data of the controlled group is used rather than relying on data of similarly situated taxpayers.¹¹⁷

The 1993 transfer-pricing regulations also offer safe harbor rates for small possession corporations. U.S. corporations with annual sales of less than \$10 million¹¹⁸ or which engage in aggregate cross-border transactions with foreign controlled corporations of less than \$10 million annually are eligible.¹¹⁹ The financial ratios will be published in future revenue rulings.¹²⁰ Once an election to use the safe harbor ratios is made, it is irrevocable for all years during which the corporation is eligible to make the election, even if the results achieved under the safe harbor rates produce higher tax liabilities than would have been realized in the absence of these rates.¹²¹

V. 1993 STATUTORY AMENDMENTS TO I.R.C. § 936

Restrictions on the I.R.C. § 936 credit legislated under the Omnibus Budget Reconciliation Act of 1993 mark the most significant retrenchment of the I.R.C. § 936 credit. The amendment to I.R.C. § 936 is intended to realign the credit in manner that is more cost effective from a U.S. tax standpoint.¹²² Disproportionate tax benefits have long been realized by U.S. possession corporations in intangible intensive industries relative to the number of Puerto Rican jobs created.¹²³ This is especially true in the

114. Prop. Treas. Reg. § 1.482-6T(b) (1993). The use of the comparable profit method is precluded only if both controlled parties to a controlled transaction employ valuable nonroutine intangibles. Temp. Reg. § 1.482-5T(a) (1993).

115. *Id.*

116. The profit split may be constructed under any of the following methods: (1). residual allocation rule; (2). capital employed allocation rule; (3). comparable profit split rule, and (4). other unspecified methods. Prop. Treas. Reg. § 1.482-6T(c)(1) (1993).

117. Prop. Treas. Reg. § 1.482-6T(a) (1993).

118. Temp. Reg. § 1.482-1T(f)(2)(A) (1993).

119. *Id.*

120. Temp. Reg. § 1.482-1T(f)(1) (1993).

121. *Id.*

122. *Summary of the Administration's Revenue Proposals, Department of the Treasury, February 1993, reprinted in STANDARD FEDERAL TAX REPORTS (CCH) Vol. 80 No. 10 at 155.*

123. *Pharmaceutical Industry—Tax Benefits of Operating in Puerto Rico, United States General Accounting Office Briefing report, to the Chairman, Special Committee on Aging, U.S. Senate, GAO/GGD-92-72-BR.*

electronics and pharmaceutical industries.¹²⁴

Congress attempted to limit the amount of the I.R.C. § 936 credit without causing undue economic dislocation in Puerto Rico and the other possessions which depend upon tax concessions from the U.S.¹²⁵ The I.R.C. § 936 credit is now linked to actual job creation within the possessions and retards the exportation of investment capital from the possessions.¹²⁶ The requirement of job creation is addressed through an economic-activity method which limits the I.R.C. § 936 credit to applicable percentages of possession based employee compensation, depreciation and possession income taxes.¹²⁷ Investment retention is addressed through an alternative percentage limitation¹²⁸ and the exemption of income classified as QPSII from both new limitations altogether.¹²⁹ Neither limitation amends the qualificational and operational rules of the I.R.C. § 936 credit under prior law.

A. Economic-Activity Limitation

Under the economic-activity limitation, a possession corporation's I.R.C. § 936 credit is the sum of the applicable U.S. tax liability on QPSII as determined under prior law and on possession sourced active business income not exceeding the aggregate of the following percentages:

- (1) Sixty percent of qualified possession compensation, defined as the sum of the possession corporation's qualified possession wages¹³⁰ and employee fringe benefits expenses allocable to operations in the possession,¹³¹
- (2) The aggregate of 15% of the depreciation deduction on short-term qualified tangible property,¹³² 40% of the depreciation deduction on medium-term qualified tangible property¹³³ and 65% of the deprecia-

124. The more blatant abuses occurred prior to the amendments to I.R.C. § 936 under the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 420 (1982). Before these reforms, only 14 cents was earned by Puerto Rican employees in the pharmaceutical for every dollar saved in U.S. taxes. Letter from Senator Robert Dole to the Governor of Puerto Rico dated October 18, 1982, *reprinted in* Hellawell & Pugh, *THE STUDY OF FEDERAL TAX LAW—TRANSITIONAL TRANSACTIONS 1983-1984*, ¶ 4201 (2d ed. 1983). These reforms failed to end all abuses. The same industry was still able to save \$1.09 in U.S. taxes for every dollar it spent in wages to its Puerto Rican employees in 1991. *Supra* note 121.

125. Staff of Joint Comm. on Tax'n, 103rd Cong., 1st Sess., *GENERAL EXPLANATION OF THE REVENUE RECONCILIATION BILL OF 1993* at 155 (Comm. Print 1993).

126. *Id.*

127. I.R.C. § 936(a)(4)(A) (1993).

128. I.R.C. § 936(a)(4)(B) (1993).

129. *Id.*

130. I.R.C. § 936(a)(4)(A)(i)(I) (1993).

131. I.R.C. § 936(a)(4)(A)(i)(II) (1993).

132. I.R.C. § 936(a)(4)(A)(ii)(I) (1993).

133. I.R.C. § 936(a)(4)(A)(ii)(II) (1993).

tion deduction on long-term qualified tangible property, and;¹³⁴

(3) If the possession corporation does not elect the profit split method of allocating income on controlled intangibles,¹³⁵ the amount of qualified possession income taxes for the taxable year allocable to non-sheltered income.¹³⁶

1. Qualified Possession Compensation

Qualified possession compensation consists of wages and employee fringe benefits paid or incurred by the possession corporation that are directly related to the active conduct of a trade or business within the possession.¹³⁷ The maximum qualifying wage is 85% of earnings per individual employee subject to the old age survivors and disability income (OASDI) segment of the Social Security tax.¹³⁸

The employee's principal place of employment must be within the possession.¹³⁹ Treasury is to determine appropriate adjustments for part-time employees and employees whose principal place of employment is not within the possession for the entire taxable year.¹⁴⁰ Wages paid to employees assigned to perform services for another taxpayer are excluded, unless the possession corporation normally operates as a temporary employment agency.¹⁴¹ Affiliated groups treated as one corporation are also treated as one employer.¹⁴²

Allocable fringe benefits are deductible employee benefits multiplied by the ratio of the aggregate of the possession corporation's qualified possession

134. I.R.C. § 936(a)(4)(A)(ii)(III) (1993).

135. I.R.C. § 936(h)(5)(C)(ii) (1982). Possession corporations not electing the profit split method would include those which elect the cost sharing method of I.R.C. § 936(h)(5)(C)(i) (1982), do not elect out of the general rule of I.R.C. § 936(h)(5) (1982) disallowing the allocation of such income to the possession corporation or have no intangibles that were developed or used by other members of its affiliated group. In the interest of simplicity, the remainder of this analysis assumes that a possession corporation not electing the profit split method follows the cost sharing method since this represents the second best option.

136. I.R.C. § 936(a)(4)(A)(iii) (1993).

137. I.R.C. § 936(i)(1)(A) (1993). To define the term wage, I.R.C. § 936(i)(1)(D) (1993) borrows the definition of wages used for federal unemployment tax (FUTA) purposes found in I.R.C. § 3306 but without regard to the annual limitation imposed in I.R.C. § 3306(b)(1993). In the case of agricultural and railroad labor, the definition of wages found in I.R.C. § 51(h)(2) (1986) is imposed. I.R.C. § 936(i)(1)(D)(ii) (1993).

138. I.R.C. § 936(i)(1)(B)(i) (1993). Wages subject to OASDI are determined under § 230 of the Social Security Act. The 1993 base amount is \$57,600 and is adjusted annually for inflation. A compensation base of 85% of the OASDI allowance is a surprisingly liberal allowance for Puerto Rico and the other possessions where abundant cheap labor is still a primary stimulus to investment. Wages should be far less than the maximum except in the case of managers and other highly compensated employees.

139. I.R.C. § 936(1)(1)(A) (1993).

140. I.R.C. § 936(i)(1)(B)(ii) (1993).

141. I.R.C. § 936(i)(1)(C) (1993).

142. *Id.*

wages for the taxable year (85% of OASDI)¹⁴³ to the aggregate of total wages paid or incurred within the possession by the possession corporation during the taxable year.¹⁴⁴ Allocable fringe benefits may not exceed 15% of the possession corporation's aggregate amount of qualified possession wages for the year.¹⁴⁵

Fringe benefits taken into account in determining the limitation include the following:

(1) Employer contributions under a stock bonus, pension, profit-sharing or annuity plan;¹⁴⁶

(2) Employer-provided coverage under any accident or health plan for employees,¹⁴⁷ and;

(3) The cost of life or disability insurance provided to employees.¹⁴⁸

Wages included in the qualified possession wage base (85% of OASDI) cannot also be treated as allocable employee fringe benefits.¹⁴⁹ Example 6 below illustrates the computation of the compensation component of the economic-activity limitation base.

Example 6:

Assume the same facts present in example 2. Also assume that USSub paid qualified possession wages and total wages of \$25 and \$28 respectively. USSub also paid fringe benefits of \$7.45. All of these expenses were paid to employees in Puerto Rico.

USSub's compensation component of the economic-activity limitation base is calculated as follows:

Qualifying possession wages	\$15.00 (60% X \$25)
Allocable fringe benefits	<u>3.75</u> (15% X \$25)

Compensation limitation base \$18.75

Allocable fringe benefits would normally be calculated as total fringe benefits multiplied by the appropriate fraction. The appropriate fraction is \$25 / \$28 or 89.3%. The base limitation would be \$4 [60% (89.3% X \$7.45)]. However, allocable fringe benefits cannot exceed 15% of qualified possession wages, which would equal \$3.75 (\$25 X 15%).

143. I.R.C. § 936(i)(2)(A)(i) (1993).

144. I.R.C. § 936(i)(2)(A)(ii) (1993).

145. I.R.C. § 936(i)(2)(A) (1993).

146. I.R.C. § 936(i)(2)(B)(i) (1993).

147. I.R.C. § 936(i)(2)(B)(ii) (1993).

148. I.R.C. § 936(i)(2)(B)(iii) (1993).

149. I.R.C. § 936(i)(2)(B) (1993).

2. Depreciation

To qualify for the depreciation portion of the economic-activity limitation base, the possession corporation must depreciate tangible property located within a possession and used in an active trade or business therein.¹⁵⁰ The applicable temporal limits on qualified tangible property are specified as short-term in the case of 3 and 5 year cost recovery property,¹⁵¹ medium-term in the case of 7 and 10 year cost recovery property¹⁵² and long-term in the case of any property whose cost recovery exceeds 10 years.¹⁵³ A transitional rule allows any pre-1987 property to be classified as if it were placed into service after 1986.¹⁵⁴

Example 7:

Assume the same facts present in example 6. Also assume that USSub has qualified tangible property as listed below. The depreciation component of the economic-activity limitation base is computed as follows:

<u>Property</u>	<u>Allowable Deduction Under I.R.C. § 168</u>	<u>Depreciation Component</u>
Short-term	\$ 2.00	\$.30 (\$2 X 15%)
Medium-term	\$ 5.00	\$ 2.00 (\$5 X 40%)
Long-term	\$ <u>6.00</u>	\$ <u>3.90</u> (\$6 X 65%)
Totals	\$ <u>13.00</u>	\$ <u>6.20</u>

3. Possession Income Taxes Allocable To Non-Sheltered Income

The final component of the economic-activity limitation applies to possession corporations that do not elect the profit split method of allocating controlled income from intangibles. This component of the limitation base consists of possession income taxes¹⁵⁵ paid or accrued on non-sheltered

150. I.R.C. § 936(i)(4)(B)(i) (1993).

151. I.R.C. § 936(i)(4)(B)(ii) (1993).

152. I.R.C. § 936(i)(4)(B)(iii) (1993).

153. I.R.C. § 936(i)(4)(B)(iv) (1993). In each instance, asset depreciation ranges are determined under I.R.C. § 168(e)(3)(1989).

154. I.R.C. § 936(i)(4)(B)(v) (1993). The Tax Reform Act of 1986 substantially changed the tax rules governing depreciation. Most notably, it lengthened various asset depreciation ranges. The transitional rule would not require a possession corporation still using former depreciation rules to recalculate its depreciation deduction under the new rules. *Id.*

155. Possession income taxes includes any tax imposed by a possession other than income, war profits and excess profits taxes treated as paid or accrued to a possession by reason of I.R.C. § 936(c) (1982). I.R.C. § 936(i)(3)(C) (1993).

income.¹⁵⁶ The aggregate of possession taxes paid or accrued is multiplied by the ratio of two hypothetical U.S. tax liabilities based on the assumption that possession taxes can be neither credited nor deducted.¹⁵⁷ The numerator is the U.S. tax liability of the possession corporation as determined under the economic-activity limitation in the absence of any tax credit or deduction applicable to possession taxes.¹⁵⁸ The denominator is the possession corporation's U.S. tax liability in the absence of any tax credit or deduction for possession income taxes.¹⁵⁹ In no event, however, may possession taxes exceeding an effective tax rate of nine percent be included in the limitation base. If the effective tax rate exceeds 9%, only that portion exceeding this threshold will be omitted from the increment in the limitation base.¹⁶⁰ Example 8 illustrates.

Example 8:

Assume the facts present in example 6. Also assume that USSub properly elects the cost sharing method and that USSub's Puerto Rican sourced income consists of \$82 in active business income and \$8 in QPSII. The possession taxes allocable to the non-sheltered income component of the economic-activity limitation base is computed in four sequential steps:

Step 1: Determine if the effective possession tax rate exceeds 9%. USSub pays effective possession income tax rate of 4.5%. Since this is less than the 9% threshold, all taxes paid to Puerto Rico are included in the calculation of non-sheltered income.

Step 2: Determine the increment in the possession corporation's U.S. tax liability due to the limitations on qualified possession compensation and depreciation.

In the absence of any limitation on its applicable I.R.C. § 936 credit, USSub's U.S. tax liability would be \$3.50 as computed in example 2. The increase in USSub's U.S. tax liability caused by the limitations on compensation and depreciation expenses would be calculated as the possession credit determined under prior law minus the aggregate of the credit allocable to qualifying compensation and depreciation and QPSII. The credit of \$31.50 allowable under prior law must be reduced by the active business I.R.C. § 936 credit given as the aggregate of the compensation and depreciation components of the credit limitation base or \$24.95 (\$18.75 + \$6.20) and the

156. I.R.C. § 936(i)(3)(A)(i) (1993).

157. *Id.*

158. I.R.C. § 936(i)(3)(A)(i)(I) (1993).

159. I.R.C. § 936(i)(3)(A)(i)(II) (1993).

160. I.R.C. § 936(i)(3)(A)(ii) (1993).

QPSII credit of \$2.80 (35% X \$8). The increase in USSub's U.S. tax liability is \$3.75 [\$31.50 - (\$24.95 + \$2.80)].

Step 3: Determine the possession's corporation's U.S. tax liability in the absence of I.R.C. § 936. USSub's U.S. tax liability in the absence of I.R.C. § 936 is \$35 as determined in example 1.

Step 4: Multiply the includable possession taxes by the appropriate ratio. The amount of possession income taxes on non-sheltered income that can be included in the credit limitation is calculated as \$.43 [(\$3.75 / \$35) X \$4.05].

The I.R.C. § 936 credit pursuant to active business income can now be calculated as the aggregate of the following components of the limitation base:

Compensation base	\$18.75
Depreciation base	6.20
Possession taxes base	<u>43</u>
Total	<u>\$25.38</u>

USSub's total I.R.C. § 936 credit is the aggregate of the following amounts:

Credit on active income	\$25.38
Credit on QPSII	<u>2.80</u>
Total I.R.C. § 936 credit	<u>\$28.18</u>

USSub's U.S. tax liability is \$6.82 (\$35 - \$28.18).

A possession corporation electing the profit split method is allowed to deduct the amount of possession taxes determined as creditable to possession corporations.¹⁶¹ Example 9 illustrates.

Example 9:

Assume that USSub in the preceding example chose the profit split method. It can then deduct possession taxes equal to the increment in the limitation base determined in the preceding example. USSub can then deduct \$.43. Its U.S. tax liability before the I.R.C. § 936 credit would be \$34.85 [35% or the applicable U.S. corporate tax rate (\$100 or USSub's total taxable income minus \$.43)].

The I.R.C. § 936 credit pursuant to active business income is limited to

161. I.R.C. § 936(i)(3)(B) (1993).

the compensation and depreciation components or \$24.95 (\$18.75 + \$6.20). USSub can also claim a full credit of \$2.80 against its U.S. tax on QPSII. USSub's total possession credit is \$27.75. Its U.S. tax liability is then \$7.10 (\$34.85 - \$27.75).

B. Percentage Limitation

The possession corporation can elect to determine its I.R.C. § 936 credit on active business income within the possession at a fixed percentage of the credit that would have been allowed under I.R.C. § 936 before the 1993 amendment.¹⁶² Under the transitional rule, the reduced credit is calculate as the following percentages of the credit allowable prior to 1994.¹⁶³

<u>Taxable Years</u> <u>Beginning In</u>	<u>Percentage of Credit Allowed</u> <u>Before 1993 Amendment</u>
1994	60%
1995	55%
1996	50%
1997	45%
1998 and thereafter	40%

A possession corporation electing the percentage limitation method can also deduct a portion of its possession income taxes. The deduction is calculated as the portion allocable on a pro-rata basis to the possession corporation's U.S. taxable income. Such income is calculated before taking into account any deduction for the possession tax and prior to offsetting the U.S. tax liability by the I.R.C. § 936 credit.¹⁶⁴

Example 10:

Assume the same facts present in example 8. If the taxable year begins in 1994, USSub's I.R.C. § 936 credit on active business income is determined as \$17.22 [60% (\$82 X 35%)]. The I.R.C. § 936 credit is the sum of this amount and the I.R.C. § 936 credit on QPSII of \$2.80 for a total credit of \$20.02 (\$17.22 + \$2.80).

In addition, \$.48 [\$4.05 (\$3.75 / \$31.50)] of Puerto Rican taxes can be deducted by USSub thereby reducing its U.S. taxable income to \$99.52. Its U.S. tax liability prior to I.R.C. § 936 is then \$34.83 which is reduced by the I.R.C. § 936 credit of \$20.02 resulting in a U.S. tax liability of \$14.81.

162. I.R.C. § 936(a)(4)(B)(i) (1993). There is no requirement that a possession corporation actually qualified for any I.R.C. § 936 credit under the prior statute.

163. I.R.C. § 936(a)(4)(B)(ii) (1993).

164. I.R.C. § 936(a)(4)(B)(i) (1993).

A qualifying possession corporation wishing to use the percentage limitation method must make a proper election for the corporation's first taxable year beginning after December 31, 1993 for which it is a possession corporation.¹⁶⁵ Therefore, this option must be given considerable attention prior to filing the corporation's 1994 tax return.

If a possession corporation fails to timely elect the percentage limitation method, the economic-activity limitation will automatically apply. The percentage limitation election will remain in force for all taxable years unless revoked.¹⁶⁶ In order to revoke the election, the general rules governing the revocation of the election to apply I.R.C. § 936 control.¹⁶⁷ The election cannot be revoked for nine years without the consent of the Secretary of the Treasury.¹⁶⁸ After this period, such consent is not required to revoke the election.¹⁶⁹

C. Affiliated Groups

Under the 1993 statutory restrictions, an affiliated group of corporations can elect to be treated as if the group were one corporation for purposes of computing the I.R.C. § 936 credit.¹⁷⁰ The applicable definition of affiliated group is identical to that used in I.R.C. § 1504 except that all possession and foreign corporations are included in the group.¹⁷¹ The available consolidated possession corporation credit limitation must then be allocated to each member of the group under regulations to be proscribed by the Treasury Secretary.¹⁷²

A special consistency rule also applies if any member of an affiliated group elects the percentage limitation method. If any member of an affiliated

165. I.R.C. § 936(a)(4)(B)(iii)(I) (1993).

166. I.R.C. § 936(a)(4)(B)(iii)(II) (1993).

167. This conclusion is drawn from the actual statutory language of I.R.C. § 936(e)(2)(1989) that any election contained within I.R.C. § 936(a) (1993) is covered under the general revocation rule. The percentage limitation election is actually provided in I.R.C. § 936(a)(4)(B) (1993). This limitation rule was, of course, not envisioned when the 10 year revocation rule was imposed.

The Congressional Conference Report expressly intends that the I.R.S. take into account the significant changes made in the I.R.C. § 936 credit in allowing possession corporations to easily revoke their I.R.C. § 936 elections. *Supra* note 124.

In the past, the IRS has been lenient in allowing for the revocation of I.R.C. § 936 elections when the statute was substantially modified. Upon the imposition of extensive rules for allocating income from intangible assets of I.R.C. § 936(h) in 1982, the IRS agreed to consent for all requests for revocation made in 1983 if the taxpayer did not reelect I.R.C. § 936 prior to 1988. Treas. Reg. § 1.936-7(c), Question 1 (1986).

168. I.R.C. § 936(e)(2)(A) (1993).

169. I.R.C. § 936(e)(2)(B) (1993).

170. I.R.C. § 936(i)(5)(A) (1993).

171. *Id.*

172. *Id.* An I.R.C. § 936 corporation is precluded from filing a consolidated return with affiliated corporations while the election under I.R.C. § 936 is in force regardless of whether it currently qualifies for any I.R.C. § 936 credit. I.R.C. § 1504(b)(4) (1988).

group described under I.R.C. § 1504(a)¹⁷³ is a possession corporation electing the percentage limitation method, all other possession corporations belonging to the group must elect the same method. If one member corporation fails to make this election, the elections rendered by all other possession corporations belonging to the group are considered revoked or otherwise invalid.¹⁷⁴ No such consistency rule applies to affiliated groups where individual members utilize the economic-activity limitation method.

VI. EFFECTIVE DATES

All provisions enumerated in this article will be in effect by the end of 1994. The statutory restrictions imposed by the Omnibus Budget Reconciliation Act of 1993 are effective for all tax years beginning after December 31, 1993, but may not be applied retroactively.¹⁷⁵ The 1992 cost sharing regulations are to be effective for all tax years beginning after December 31, 1992¹⁷⁶. These regulations, however, may be applied retroactively with regard to the commensurate-with-income standards of I.R.C. § 482 for all tax years beginning after December 31, 1986 on transfers and licenses of intangibles.¹⁷⁷ In cases of retroactive application, taxpayers are required to follow reasonable rules applicable to commensurate-with-income standards consistent with the statute, including those set out in the 1992 cost sharing regulations.¹⁷⁸ The 1993 transfer-pricing regulations go into effect for all taxable years after April 21, 1993.¹⁷⁹ Identical rules of retroactive application apply.¹⁸⁰

VII. PLANNING CONSIDERATIONS

The three new sets of rules pose serious tax planning problems for the possession corporations. Action is imminent as applicable I.R.C. § 482 regulations are already in force and the method for determining the I.R.C. § 936 credit must be made by the end of the forthcoming tax year.¹⁸¹

173. *Id.* For purposes of determining an affiliated group, the exceptions listed in I.R.C. § 1504(b) (1988) are ignored. Constructive ownership rules of I.R.C. § 1563(e) (1954) specifically apply. The statute specifically calls upon Treasury to promulgate regulations concerning deconsolidation of affiliated groups.

174. I.R.C. § 936(a)(4)(B)(iii)(III) (1993).

175. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13227(f), 107 Stat. 489 (1993).

176. 1992 cost sharing regulations at 3.

177. *Id.* The new rules do not apply to transfers of intangible property made or licenses granted to foreign persons before November 17, 1985, or to others before August 17, 1986, provided that the property was in existence or owned by the taxpayer on such date.

178. *Id.*

179. 1993 transfer-pricing regulations at 1.

180. Temp. Reg. § 1.482-1T(h) (1993).

181. *Supra* note 164.

Effective long-term planning is equally imperative due to the inherent difficulty in amending transfer-pricing schema and the possibility that the selection of the method of determining the I.R.C. § 936 credit may not be revocable for an entire decade.¹⁸² Possession corporations should also consider the current window of opportunity to easily alter their elections to use either method of allocating intangible income as the Conference Report expressly instructs the Service to allow affected corporations to change their method of allocation.¹⁸³ This privilege, however, may be short lived.

A. Effects of the 1993 Statutory Restrictions On the Determination of the Method of Allocating Intangible Income

Possession corporations must first consider the effects of the 1993 statutory restrictions since reduced credits may make the choice of the method of allocating intangible income irrelevant. It is equally clear that the use of the percentage limitation method would prove a neutral factor in making this decision as the amount of the I.R.C. § 936 credit would normally be equal regardless of the method of allocating intangible income. Possession corporations electing the economic-activity limitation method would, however, have a clear cut motive to elect the cost sharing method since the I.R.C. § 936 credit would be higher than under the profit split method.¹⁸⁴

The possession corporation's first consideration is the potential maximization of the credit under the economic-limitation method. Since the amount of the credit is tied to compensation and depreciation deductions, corporations with labor or capital-intensive operations, such as manufacturing, within a possession should normally elect this method.¹⁸⁵ Whether the additional possession credit will justify the use of the cost sharing method will depend upon a detailed analysis of the effects of both methods on

182. *Supra* note 166.

183. *Supra* note 124.

184. Since possession corporations electing the profit split method can deduct only an amount equal to the incremental credit allowed similar corporations using cost sharing method, the net savings in U.S. taxes would be equal to the possession taxes allocated to non-sheltered income multiplied by one minus the effective U.S. corporate tax rate paid by the possession corporation.

185. It is equally doubtful that the I.R.C. § 936 credit for a large scale manufacturing operation would even decline under the new law since the majority of all factor costs would be included in the credit's base. For example, assume that a possession corporation with no QPSII earns a net income before U.S. taxes of 20% of gross revenue. If applicable U.S. and possession corporate tax rates of 35 and 4.5% respectively are applied, its I.R.C. § 936 credit would be seven cents per dollar of revenue under the prior statute. If only half of its possession compensation and depreciation deductions qualify for the economic-activity credit base, the aggregate of possession compensation and depreciation costs need be only 17.5% of the corporation's total costs in order to qualify for a I.R.C. § 936 credit of seven cents per dollar of revenue under the new statute. If the possession corporation had retained its maximum QPSII allowance of 25% of total income, the required percentage of total costs would drop to 13.125 percent.

controlled group income.

A possession corporation with marginal compensation and depreciation deductions, such as a high tech manufacturer or a corporation whose total contribution to its affiliated group's manufactured processes is only marginal, can maximize its possession credit by increasing its wage base and long-term depreciation deductions. Strategies can include assuming a larger percentage of the manufacturing process, expansion of possession based operations, the direct employment of all personnel rather than contracting out any services and the substitution of wages and allocable fringe benefits to satisfy the dual requirements that qualifying wages not exceed 85% of the OASDI allowance and that allocable fringe benefits not exceed 15% of qualifying compensation.¹⁸⁶ All possession corporations should maximize their QPSII to the extent of 25% of possession sourced income¹⁸⁷ as the new statutory limitations do not apply to QPSII.

A possession corporation subject to decreased possession credits should also consider revoking its election under I.R.C. § 936 credit.¹⁸⁸ Possession income taxes would then qualify as foreign taxes creditable under the general FTC mechanism. This action would free it from the obligation of electing one of the two methods of allocating controlled intangible income under I.R.C. § 936(h)(5)(C). The corporation would then be able to divide intangible based profits in any reasonable transfer-pricing scheme permitted under I.R.C. § 482. This course of action would be attractive if the payments required either under the statutory cost sharing formula or the profit split method would be greater than under the transfer-pricing methodology selected. The possession income taxes could also avoid U.S. taxation depending upon the extent of other foreign taxes paid or incurred by the possession corporation. Possession taxes exceeding U.S. levels could be offset by taxes on operations in lower tax nations. The reverse would hold if possession taxes were lower than U.S. rates.

B. Effects of the New I.R.C. § 482 Transfer-Pricing Regulations On the Selection of the Method of Allocating Intangible Income

The effects of both the 1992 cost sharing regulations and the 1993 transfer-pricing regulations on the election of the optimal method of dividing

186. Possession corporations failing such strategies can still achieve tax savings under the percentage limitation method although the selection of the method of allocating intangible income would be irrelevant. If the possession corporation described in the preceding footnote had no QPSII, it would pay an effective U.S. tax rate of only 20.04% after 1997. Assuming it had QPSII of 25% of total income, its effective U.S. tax rate would have fallen to only 14.79%. In both cases, U.S. liabilities are well below applicable rates on domestic investment. Had the economic-limitation method applied, however, the possession corporation could have possibly escaped U.S. taxation altogether.

187. *Supra* note 27.

188. The Conference Report also expressly intends that the Service allow an affected corporation to easily revoke their elections to claim an I.R.C. § 936 credit. *Supra* note 124.

intangible income can be determined only through detailed financial analysis. Whether the benefits provided by either set of regulations will elevate the cost sharing method superior to the profit split method can be determined only through data analysis specific to each possession corporation.

While the new regulations cannot escape the underlying subjectivity of transfer-pricing schema, both sets of rules are sufficiently flexible to overcome the frequent presumption that the profit split method should be elected simply to avoid the chaotic requirements of the super-royalty provisions. Both sets of potential regulations can make it easier for possession corporations to determine if required payments that meet the commensurate-with-income standard exceed amounts determined under both the statutory cost sharing formula method and the profit split method.

The 1992 cost sharing regulations will be easier of the two to apply due to the comparative ease in equalizing the requisite cost to income ratios. Although these rules allow few safe harbors, problems related to the conceptual framework and application may well be less than the statutory requirements governing both the cost sharing formula and the profit split method.

The 1993 transfer-pricing regulations provide possession corporations certain latitude in constructing the appropriate transfer-price on intangible allocations. The determination of a transfer-price in terms of an acceptable range allowed in the comparable profit method and proposed amendments allowing a profit split on intangibles may prove to be critical tax planning tools. Hopefully, problems of application will be resolved in the final regulations.

CONCLUSION

Possession corporations utilizing controlled intangibles must contend with a series of new rules which may cause immediate and serious tax ramifications. At the heart of issue is the determination of the optimal method of dividing intangible based income with other members of an affiliated group. While the thrust of the new rules is to enhance the benefits of the cost sharing method of I.R.C. § 936(h)(5)(C)(i), there is the real threat that the added complexities may decrease the attractiveness of the possession corporation. Regardless of the probable effects of the new rules, affected corporations must begin to adjust their tax strategies in light of the changes. Effective long range planning is especially critical since it may be difficult if not impossible to amend or revoke the requisite elections in future years.

