OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE: May 15, 2000

MEMORANDUM FOR DISTRICT COUNSEL
CONNECTICUT – RHODE ISLAND CC:NER:CTR:HAR

FROM: Steven A. Musher
Chief CC:INTL:BR6

SUBJECT:

This Field Service Advice responds to your memorandum dated March 15, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND

Amount A =

Date 1 =

Product A =

Sub =

Taxable Year 1 =
Taxable Year 2 =

USCo =

Year X =

ISSUE:

Whether Sub, a taxpayer that has made a cost sharing election under I.R.C. § 936(h)(5)(C)(i), is entitled to location savings under Rev. Proc. 63-10, 1963-1 C.B. 490. If so, whether this answer would be affected by a consideration of comparable uncontrolled manufacturers operating at arm's length and the competitive positions of buyers and sellers in the relevant market. See Treas. Reg. § 1.482-1(d)(4)(ii)(C) (1994).

CONCLUSION:

As long as Rev. Proc. 63-10 is in effect, the benefit of location savings pursuant to section 3.02(3) of Rev. Proc. 63-10 is available to a taxpayer that has made a cost sharing election under section 936(h)(5)(C)(i). This answer would not be affected by a consideration of comparable uncontrolled manufacturers operating at arm's length and the competitive positions of buyers and sellers in the relevant market.

FACTS:

USCo, a leading manufacturer of Product A, filed consolidated Federal income tax returns for Taxable Year 1 and Taxable Year 2. USCo manufactures the majority of its Product A itself.

Sub is a United States corporation owned by USCo. Sub began operations in Year X and remains actively engaged in manufacturing Product A. For taxable years beginning on Date 1, Sub elected the section 936(a) Puerto Rico and possession tax credit.

For the purposes of this advice, we assume Sub is treated as having timely filed a valid cost sharing election under section 936(h)(5)(C)(i).

Citing Rev. Proc. 63-10, USCo has claimed for Taxable Years 1 and 2 that Sub is entitled to approximately $ Amount A in location cost savings attributable to the fact that Sub operates in Puerto Rico, in addition to whatever profit Sub would otherwise be entitled to based on beneficial ownership of manufacturing intangibles. The majority (85% to 90%) of the location savings relate to "burden" (general overhead such as utilities), with the remainder attributable to labor savings.

LAW AND ANALYSIS:

Section 482 provides that the Secretary may allocate income, deductions, credits and allowances between two or more commonly controlled organizations, trades, or businesses in order to prevent evasion of taxes or to clearly reflect the income of any of such organizations, trades, or businesses. The temporary 1993 section 482 regulations are applicable to the taxable years at issue here,[1] unless USCo has made an election to apply the 1994 section 482 regulations retroactively.[2] See Treas. Reg. § 1.482-1(j)(2) (1994).

Where applicable,[3] Temp. Treas. Reg. § 1.482-1T(b)(2)(iii) (1993) provides:

> The arm's length result of a controlled transaction must be determined under the method that provides the most accurate measure of an arm's length result under the facts and circumstances of the transaction under review. The factors to be considered in selecting a method include the completeness and accuracy of the data used to apply each method, the degree of comparability between controlled and uncontrolled transactions, and the number, magnitude, and accuracy of the adjustments required to apply each method. An arm’s length result may be determined under any of the available methods without first establishing the inapplicability of any other method. If additional evidence becomes available permitting the application of another method that is more accurate, the district director will apply such method to determine an arm’s length result.[4]

Furthermore, Temp. Treas. Reg. § 1.482-1T(c)(4)(ii)(C) (1993) provides:

> *Location savings.* If an uncontrolled taxpayer operates in a different geographic market than the controlled taxpayer, adjustments may be necessary to account for significant differences in costs attributable to the geographic locations. These adjustments must be based on the effect such differences may have on the consideration charged or paid in the controlled transfer given the relative competitive positions of buyers and sellers in each location. Thus, the fact that production is

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[1] The temporary 1993 section 482 regulations are generally effective for taxable years beginning after April 21, 1993. Temp. Treas. Reg. § 1.482-1T(h) (1993). The 1994 section 482 regulations are generally applicable for taxable years beginning after October 6, 1994.

[2] It is our understanding that USCo has not made such an election.

[3] See supra notes 1 and 2 and accompanying text.

[4] Treas. Reg. § 1.482-1(c) (1994) contains substantially the same provision.

> less costly in the taxpayer’s geographic market ordinarily justifies additional profits only where the location savings would increase the profits of uncontrolled taxpayers operating at arm’s length, given the competitive positions of buyers and sellers in that market.[5]

Temp. Treas. Reg. § 1.482-1T(c)(4)(ii)(D) (1993) contains an example illustrating these principles. According to this example,

> the fact that production is less costly in Country Y will not, in and of itself, justify additional profits derived from lower costs of manufacturing in Country Y inuring to [a wholly-owned Country Y manufacturer], because of the competitive effects attributable to the other producers in similar geographic markets capable of performing the same functions at the same low costs.[6]

While it remains in effect, Rev. Proc. 63-10, 1963-1 C.B. 490, sets forth guidelines to be followed for the application of section 482 in cases involving the allocation of income and expenses between U.S. companies and their Puerto Rican manufacturing affiliates. The revenue procedure antedated the 1968 section 482 regulations and is generally consistent with these regulations, except to the extent that it allocated location savings to Puerto Rican affiliates regardless of whether such an allocation would have occurred in the market. Section 3.02(3) of Rev. Proc. 63-10 provides that in situations where there are no independent prices, and the product involved "represents a type which is manufactured in the United States or for which it is reasonable to assume that the mainland affiliate could, without incurring a loss, have contracted for United States manufacture," the best approximation of the arm's length price is the price necessary to induce a U.S. manufacturer to produce in the United States the product in question for the mainland affiliate, adjusted for any differences in costs incident to transportation. In effect, the methodology takes the expenditures of the Puerto Rican entity and adjusts them by any increases or decreases that would have resulted from conducting the activity in the United States and then allows the Puerto Rican entity a profit margin equivalent to that realized by similar U.S. manufacturers. This provision allocates all income or loss resulting from the choice of Puerto Rico as the manufacturing venue (i.e., location savings) to the Puerto Rican affiliate.

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[5] Treas. Reg. § 1.482-1(d)(4)(ii)(C) (1994) contains substantially the same provision.

[6] Treas. Reg. § 1.482-1(d)(4)(ii)(D) (1994) contains a similar example.

We note that Rev. Proc. 68-22, 1968-1 C.B. 819, which concerned the application of the 1968 section 482 regulations, provided that the Service would continue to use the guidelines contained in Rev. Proc. 63-10 in cases involving the allocation of income and deductions between U.S. companies and their Puerto Rican affiliates where the result was more taxpayer-favorable than that reached under the section 482 regulations. 1968-1 C.B. at 821.

Pursuant to the cost sharing election under section 936(h)(5)(C)(i), Sub must bear its portion of the related group's product area research expenses and is treated as owning the nonmarketing intangibles associated with the products it manufactures for purposes of earning a return on such intangibles. As a consequence of the election, USCo and Sub are required to determine the intercompany pricing of the products manufactured by Sub under the appropriate section 482 pricing method (see I.R.C. § 936(h)(5)(C)(i)(IV)(b)). Use of the resale price method may not be denied merely because the reseller adds more than an insubstantial amount to the value of the products by the use of intangible property. Id.; Treas. Reg. § 1.936-6(a)(5) Q&A 13.

In 1982, Congress made its own determination as to how it wanted income/profits to be split between U.S. entities and their Puerto Rican manufacturing affiliates. In essence, section 936(h) offers Puerto Rican manufacturers and their U.S. affiliates the choice of splitting their total combined income 50-50 or paying an appropriate share of product area research expenses and receiving a return on the manufacturing intangibles portion of the arm's length price of the products. Section 936(h)(5)(C)(i)(IV)(b) specifically provides that a company electing cost sharing shall determine its intercompany pricing under the appropriate section 482 method. Because the cost plus location savings method of Rev. Proc. 63-10 is not a method provided in the section 482 regulations, the automatic allocation of location savings to a Puerto Rican affiliate is arguably contrary to section 936(h)(5)(C)(i)(IV)(b).

The legislative history of section 936(h) does not make clear whether Rev. Proc. 63-10 should continue to apply in setting prices after a cost sharing election has been made. The Conference Report on the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), H.R. Rep. 97-760, 97th Cong., 2d Sess. p. 510 (Aug. 17, 1982), contains a paragraph discussing pricing if a cost sharing payment is made, which concludes with the following sentence:

> The regulations under section 482 and Internal Revenue Service revenue procedures (Revenue Procedure 63-10, as amplified by Revenue Procedure 68-22) will continue to apply except to the extent modified by the election.

This statement may be interpreted in two different ways. One interpretation is that the application of Rev. Proc. 63-10 would have to be modified to reflect the fact that, after a cost sharing election, the island affiliate would be treated as the owner of the manufacturing intangibles. In all other respects, the revenue procedure would continue to apply. Because this sentence is included in a section specifically dealing with pricing after a cost sharing election has been made, it could be argued that Congress intended the special benefits of Rev. Proc. 63-10, as confirmed by Rev. Proc. 68-22, to continue to apply after TEFRA in connection with calculating transfer prices.

A second interpretation of the legislative history is that because the quoted sentence does not specifically mention location savings, the cost plus pricing method of Rev. Proc. 63-10 would be modified/eliminated by a section 936(h) election, specifically by the provision in section 936(h)(5)(c)(i)(IV)(b) stating that if an election of the cost sharing method is in effect, the electing corporation must determine its intercompany pricing under the appropriate section 482 method (subject to the expressly provided flexibility regarding the resale price method).

In light of the ambiguity of the legislative history, one could conclude that the language of the statute should stand on its own — i.e., "the electing corporation shall determine its intercompany pricing under the appropriate section 482 method." However, as long as Rev. Proc. 63-10 is in effect, the pricing method of section 3.02(3) should continue to be given effect when a section 936(h) cost sharing election has been made. It should be noted that, if location savings are taken into account, they should be taken into account both for purposes of calculating the income attributable to manufacturing intangibles and in setting intercompany prices, so as to avoid double counting.

Our conclusion is predicated on the taxpayer establishing an appropriate factual basis for the claimed location savings – i.e., the existence and amount of the location savings.

The existence of arm’s length transactions involving similar products between unrelated buyers and sellers in the relevant geographic markets will not affect this conclusion. As noted above, the cost plus method of Rev. Proc. 63-10 does not follow the arm’s length standard as currently embodied in the section 482 regulations.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

1. Examination indicates that there is a factual dispute regarding the existence and amount of the location savings in this case. The taxpayer’s burden in

establishing and quantifying any location savings is no different from that for any other factual issue in a transfer pricing case.

2. Because USCo has provided very little information on the calculation of its transfer prices, the above discussion is necessarily abstract. It is stated in the request for advice that the taxpayer has claimed location savings "in addition to whatever profit [Sub] would otherwise be entitled to based on beneficial ownership of [manufacturing] intangibles." [redacted] Naturally, it would not be correct to allocate to Sub a return to non-existent intangibles. Furthermore, since the cost plus/ location savings method allocates location savings to the Puerto Rican affiliate without regard to how the market would have allocated any location savings at arm's length, adding a manufacturing intangible profit (determined by reference to comparables) on top of the location savings could result in a double counting of profit. Accordingly, as we have stated, if location savings are taken into account, they should be taken into account both for purposes of calculating the income attributable to manufacturing intangibles and in setting intercompany prices, so as to avoid double counting.

3. Our analysis assumes that Sub is treated as having timely filed a valid cost sharing election. We understand that Sub did not make a formal section 936(h)(5)(C)(i) election but rather that Examination accepted a District Counsel recommendation (in a memorandum dated April 15, 1998) that Sub be deemed to have timely filed a valid cost sharing election.

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

By: STEVEN A. MUSHER
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(International)