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

November 24,1999

Number: **200009012**
Release Date: 3/3/2000
CC:INTL:Br6
WTA-N-112983-99
UILC: 936.03-04

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

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

SUBJECT:

This Field Service Advice responds to your memorandum dated March 7, 1997. 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

Corporation X =

Corporation Y =

Product Group A =

Division 1 =

Years 1 - 3 =

ISSUE

Whether Corporation Y, having elected cost sharing under I.R.C. section 936(h), is entitled to the benefits of location savings as provided in Rev. Proc. 63-10. If so, whether this answer is affected by the fact that Corporation X's major competitors also have manufacturing subsidiaries in Puerto Rico.

CONCLUSION

As long as Rev. Proc. 63-10 is in effect, the benefit of location savings as provided in Rev. Proc. 63-10 applies when the cost plus method of pricing is used in conjunction with a cost sharing election under section 936(h). Since the Rev. Proc. allocates location savings to the Puerto Rican affiliate regardless of whether location savings would have been so allocated by the market, the presence of Corporation X's major competitors in Puerto Rico does not affect this answer.

FACTS

Corporation X, a U.S. corporation, has a wholly owned subsidiary, Corporation Y, which manufactures Product Group A in Puerto Rico. Product Group A represents a type of product that is manufactured in the United States. Division 1 of Corporation X purchases over 80% of Corporation Y's output. The remainder is purchased by other divisions of Corporation X. The transfer prices between Division 1 and Corporation Y are being examined.

When Division 1 bought products from Corporation Y, it resold 50% of them to unrelated parties, and retained 50% of them for either retail sale or integration into other products.

Corporation X characterizes the method used to set prices between Corporation Y and Division 1 as a variant of the resale price method. Corporation X's method involves starting with the resale prices charged by Division 1 to unrelated parties (which vary according to whether those parties are manufacturers or distributors, and according to the volume of products sold), subtracting expenses (estimated at 15% of the net average sales price), and subtracting the net profit of comparable Product Group A distributors (estimated at 5% of the net average sales price). This results in a price to Corporation Y equal to 80% of the average resale price.

The Service proposes to make a section 482 allocation of income to Corporation X based on a cost plus methodology. The 1968 regulations apply to the years in issue, Years 1-3, and Corporation X has not yet elected to apply the 1994 section 482 regulations.

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.

For taxable years beginning on or before April 21, 1993, Treas. Reg. 1.482-2A(e)(1)(ii) establishes the following mandatory order of priority for methods of

determining the arm’s length price of tangible property: (1) comparable uncontrolled price method, (2) resale price method, (3) cost plus method and (4) any other appropriate method.

For taxable years beginning after October 6, 1994, and for cases where the taxpayer has elected pursuant to Treas. Reg. 1.482-1(j)(2) to apply the 1994 final section 482 regulations retroactively, Treas. Reg. 1.482-1(c) provides as follows:

> The arm’s length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm’s length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm’s length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm’s length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm’s length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm’s length result.

Corporation Y has made a cost sharing election pursuant to I.R.C. 936(h)(5)(C)(i). That is, it has agreed to bear its portion of the related group’s product area research expenses and to be 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 such election, Corporation Y and Corporation X are required to determine the intercompany pricing of products under the appropriate section 482 pricing method. Section 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.

However, Rev. Proc. 63-10, 1963-1 C.B. 490, sets forth guidelines to be followed for the proper application of section 482 in cases involving the allocation of income and expenses between U.S. companies and their Puerto Rican manufacturing affiliates. Section 3.02(3) of Rev. Proc. 63-10 provides that in situations where there are no independent prices for the products involved in related party sales, and when the product in question “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. This effectively allocates all income or loss resulting from the choice of Puerto Rico as the manufacturing venue to the Puerto Rican affiliate.

Having elected to share the related group's product area research expenses pursuant to I.R.C. 936(h)(5)(C)(i) for purposes of being treated as the owner of the nonmarketing intangibles associated with its products, Corporation Y is required to price its products to Division1 under an appropriate section 482 method (i.e., a method which includes a return on the nonmarketing intangibles). During the years in issue, Treas. Reg. 1.482-2A(e)(1)(ii) prioritized the methods of computing transfer prices for tangible property with a requirement that the higher ranked method be used if the conditions for using that method were met. The 1994 final section 482 regulations, which taxpayers may elect retroactively, require the use of the "best method", i.e. the one which provides the most reliable measure of an arm's length result.

When it is available, the most reliable method is generally the comparable uncontrolled price (CUP) method, which evaluates whether the amount charged in a controlled transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction. Corporation X and the Service agree that CUPs do not exist for the products manufactured by Corporation Y. Although Corporation X has characterized its methodology as a variant of the resale price method, it does not qualify as a resale price method because that method requires the utilization of an appropriate gross profit markup expressed as a percentage of sales. Treas. Reg. § 1.482-2A(e)(3)(vi). When net profits are used, they introduce many discretionary expenditures that may vary from company to company. Corporation X has expressed its markup percentage as a percentage of sales, but the markup being used is a "net profit" markup percentage. While Corporation X's method might be reasonable, under certain facts and circumstances, it is a fourth method rather than a resale price method. Neither Corporation X nor the Service has developed the information necessary to determine an appropriate gross profit markup percentage for Product Group A distributors, and consequently, the resale price method is unavailable.

The Service proposes to make section 482 allocations by adjusting the prices for products sold by Corporation Y to Division 1 using a cost plus method, which would allow Corporation Y a markup on its costs plus a return on the value of the nonmarketing intangibles, if any. This raises the question of whether Corporation X should also get the benefit of any location savings as provided in Rev. Proc. 63-10. This revenue procedure provided special rules for applying section 482 to situations involving U.S. companies with Puerto Rican manufacturing affiliates. Sec. 3.02(3) of the revenue procedure states that in instances where no independent prices exist, and the product in question "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 that would have been necessary to induce a U.S. manufacturer to produce the goods in question, adjusted for any differences in transportation costs. 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 U.S. and then allows the Puerto Rican entity a profit margin equivalent to that realized by similar U.S. manufacturers.

Although Rev. Proc. 63-10 ante-dated the 1968 section 482 regulations, it was generally consistent with those regulations, except to the extent that it allocated location savings to the Puerto Rican affiliate under a modified cost plus method regardless of whether location savings would have been allocated to the Puerto Rican affiliate by the market. In Rev. Proc. 68-22, 1968-1 C.B. 819, the Service stated that "[i]n recognition that Puerto Rican allocation problems arise in a unique factual context," the guidelines of Rev. Proc. 63-10 would continue to be used "if the result is more favorable to the taxpayer than the result under the [1968 section 482] regulations."

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) is not clear whether Rev. Proc. 63-10 should continue to apply in setting prices after a cost sharing election. The Conference Report on TEFRA, H.R. Rep. 97-760, 97th Cong., 2d Sess. p. 510, contains a paragraph discussing pricing after a cost sharing payment is made. The paragraph 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.

There are two ways to interpret this sentence. One interpretation is that the application of Rev. Proc. 63-10 would need to be modified to reflect the fact that, after a cost sharing election, the island affiliate would be the owner of the manufacturing intangibles. In all other respects, the Rev. Proc. would continue to apply. Because the sentence falls under 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 certain 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 cost-plus pricing method of section 3.02(3) should continue to be given effect when a section 936(h) cost sharing election has been made and a cost-plus method of pricing is used. 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.

The fact that Corporation X's competitors also have manufacturing subsidiaries in Puerto Rico will not change this result. In such a situation, it is likely that any location savings would not be allocated by the market to the Puerto Rican subsidiaries. However, as noted above, the cost-plus method of Rev. Proc. 63-10 does not necessarily follow the arm's length standard as currently embodied in the section 482 regulations.

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

STEVEN A. MUSHER
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