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# Opportunities in Puerto Rico: Tax Planning Under New Section 936

By STEVEN J. COHEN

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- I. Through the use of a U.S. subsidiary qualified under Internal Revenue Code (I.R.C.) § 936, it may be possible to permanently avoid all U.S. tax and be subject to Puerto Rican tax at low rates.
  - A. Section 936 allows a credit against U.S. tax to the extent such income is "possessions source income" earned by a section 936 corporation.
  - B. A planned assembly or manufacturing operation in Puerto Rico may allow the section 936 company to be entitled to special Puerto Rican tax holidays which, in general, provide for very low Puerto Rican taxes on income generated from Puerto Rican operations.
  - C. A major obstacle to maximizing the U.S. tax benefit of doing business in Puerto Rico is in pricing between the section 936 corporation and its related U.S. parent or affiliate.
- II. Section 936 has been amended by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324, to provide new important pricing and qualifications rules. Because of perceived abuses, section 936 was amended to possibly reduce tax benefits attributable to both marketing and manufacturing intangibles.
- III. TEFRA changes to section 936 rules.
  - A. Section 936(a)(2)(B): 50% active conduct test. Phase-in up to 65% (55% for 1983 and 60% for 1984).
  - B. Section 936(h): Tax treatment of intangible property income.
    1. General rule: Intangible property income (IPI) of the

section 936 corporation—passed through pro rata to shareholders (SH) as U.S. source income and excluded from the section 936 corporation's gross income.

2. IPI definition.

a. Gross income attributable to *any* intangible property.

b. Intangible property:

[A]ny (i) patent, invention, formula, process, design, pattern, or know-how; (ii) copyright, literary, musical, or artistic composition; (iii) trademark, trade name, or brand name; (iv) franchise, license, or contract; (v) method, program, system, procedure, campaign, survey, study, forecast, estimate customer list, or technical data; or (vi) any similar item, which has substantial value independent of the services of any individual.

I.R.C. § 936(h)(3)(B).

c. Exclusion of reasonable profit: determination by Secretary on direct and indirect costs of the section 936 corporation (read cost plus method). Note: Secretary's determination does not have to be by regulations.

C. Distribution to meet requirements.

1. General: if *Secretary determines* that either 65% or 80% tests of section 936 not met because IPI allocated from section 936 corporation to SH, then section 936 corporation can be deemed to meet the requirements if it distributes to SH pro rata with respect to stock an amount of *property* equal to the sum of shortfall of each test as a designated qualifying distribution.

Language of this subsection, section 936(h)(4), and section 316 seem to make it clear that distribution is dividend if there are earnings and profits. Corresponding amendment to section 246(e) provides no dividend received deduction for domestic U.S. corporations.

2. Nonresident alien and any foreign corporate SH treat distribution as effectively connected-permanent establishment income, *i.e.*, taxable at ordinary corporate rates.

3. Section 936 corporation not eligible to make qualifying distributions if test flunking was due to fraud or willful neglect.
- D. Election out.
1. General: above rules, paragraphs one-four do not apply to any taxable year that the section 936 corporation has in effect an election to use either cost-sharing or 50/50 profit-split method to compute "taxable income."
  2. Eligibility: Significant Business Presence.
    - a. To be able to elect one of these methods and maintain the election in effect for any year, a section 936 corporation has to have a Significant Business Presence in Puerto Rico (SBPPR) for the year. Test for *each product* for *each year*. Purpose is to insure real and substantial operations in Puerto Rico.
    - b. Definition of Significant Business Presence (SBP). The section 936 corporation manufacturing in Puerto Rico has SBP for year for product if it meets either of two tests:
      - 1) 25% Value Added Test: Total production costs (not including direct material cost and interest excluded by Treasury Regulations) of the section 936 corporation in producing units of products sold or disposed of in year by affiliated group equal to at least 25% of difference between;
        - i) annual affiliated group gross receipts from such units, and
        - ii) annual affiliated group direct material costs of purchase of materials for such units; or the
      - 2) 65% Labor Performed Test: At least 65% of affiliated group's direct labor costs for product units produced during year in whole or in part by the section 936 corporation "incurred" by section 936 corporation and is compensation for services performed in Puerto Rico; and

Additional test for profit split election: if the section 936 corporation wants to elect 50/50 profit split method, then product must also meet tests for being considered to have manufactured or pro-

duced the product in Puerto Rico under section 954(d)(1)(A).

Conference committee reports tell us: "In general, the figures to be used for these calculations will be those used by [the affiliated group] in then required inventory calculations." Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324, I.R.C. § 936 (Committee Report).

- 3) Trading Company Test: For a section 936 corporation selling to third parties goods produced by third parties, at least 65% of affiliated group's total direct labor costs connected with purchase and sale of goods sold during year by the section 936 corporation must be incurred by the section 936 corporation and constitute compensation for services performed in Puerto Rico.
- c. Special Rules.
- 1) If the section 936 corporation produced the product in Puerto Rico on September 3, 1982, it is given until 1986 to meet SBPPR test and then is free to elect either of alternative methods until then.
  - 2) Costs incurred by the section 936 corporation or other affiliated group member for contract manufacturing by a third party are treated as direct labor costs and not as section 936 production costs in Puerto Rico, or as direct material costs or as compensation for services performed in Puerto Rico, *except* as provided in Treasury Regulations.
- d. Treasury Regulations may provide:
- 1) transitional test for up to three years for operations started after September 3, 1982;
  - 2) business presence test for other appropriate cases consistent with regular 25% and 65% tests;
  - 3) definition of product (conference report directs Treasury to define "product" narrowly so that SBPPR test met more easily on product by product basis);
  - 4) rules for treating components produced in whole or in part by related person as materials and treat-

ing related costs (including direct labor costs) as cost of materials if component has independent resale price, or if consistent with "intent of substantial business tests," *i.e.*, that Puerto Rico operations are substantial.

3. The two elective methods of computing taxable income from a product:

a. Cost-Sharing Method

1) Cost-Sharing Payment: The section 936 corporation must pay not less than its share of affiliated group's annual worldwide product area research expenses (PARE). This is equal to:  $\text{Worldwide PARE} \times \text{Sales of section 936 corporation product area products to third parties, divided by total affiliated group's sales of all product area products to third parties, less section 936 corporation's own annual PARE.}$

i) PARE: R&D costs, losses, expenses, and other related deductions allocated to some product area in which the section 936 corporation conducts activities and ratable part of such expenses not definitely allocable to any product area.

ii) Affiliated Group: the section 936 corporation and all other taxable entities covered or controlled by some interests under section 482. Thus, much broader group than under consolidated return and related provisions.

iii) Product Area: three-digit Standard Industrial Classification Code. Secretary may aggregate two or more three-digit classifications or use another classification system if appropriate.

2) Effect of Election

In general: the section 936 corporation treated as owner of those "manufacturing intangibles" related to the product it produced in year. Manufacturing intangibles are *only* those set out in section 936(h)(3)(B)(i) and (vi), *i.e.*, any patent, invention, formula, process, design, pattern, know-how, or any similar item.

b. Profit-Split Method

- 1) General rule: The section 936 corporation's taxable income from products it produces in whole or part in Puerto Rico will be 50% of affiliated group's\* combined taxable income (CTI) from sales to third parties or to foreign affiliates ("covered sales").
- 2) CTI computation: Covered sales CTI to be computed separately for each product as per section 861(b) and section 862(b) methods for computing taxable income from sources within and without the United States: gross income less all deductions properly apportioned or allocated thereto and ratable part of all deductions not definitely allocable to some other item or class of income;\*\* provided, however, the amount of PARE, if any, properly allocated to covered sales of any product cannot be less than amount determined under the cost-sharing formula.
- 3) Effect of allocating CTI: the section 936 company gets 50% of CTI computed per *supra* section III.D.3.b.2) of this outline.

Appropriate other domestic member(s) of affiliated group get CTI computed without PARE—cost-sharing formula limitation less amount allocated to section 936 corporation (*i.e.*, 50% CTI with PARE — cost-sharing limitation). Could be more than is allocated to section 936 corporation.

4. Election and Revocation of Methods.

- a. Time: extended due date for filing section 936 corporation's return for first taxable year beginning after December 31, 1982.
- b. Binding each subsequent taxable year.
- c. Revocation: only with Secretary's consent or if deemed revoked for failure to meet SBPPR test or for failure to make timely cost-sharing payment.
- d. Re-election: only with Secretary's consent.
- e. Aggregation: all section 936 affiliates must elect same

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\* Taxable income of foreign affiliates excluded for purpose of this computation.

\*\* Excluding gross income and deductions of foreign affiliates.

method for products in same product area, but each may use a different method for *export sales*. Product exported must be manufactured in Puerto Rico under section 954(d)(1)(A) and income derived by foreign buyer on resale cannot be foreign base company income under section 954(a).

5. Transfer of intangibles: gain or loss by section 936 corporation on sale of intangibles to related persons is deemed U.S. source, and cost-sharing and profit-split methods do not apply; provided, however, that for determining 50% and 80% qualification tests the normal rules of determining source of income will apply.
6. Section 367 amendments.
  - a. Transfer of intangibles by section 936 corporation to any foreign corporation after August 14, 1982, deemed to be for tax avoidance purposes.
  - b. Same treatment for former section 936 corporation if transfer takes place within five years after section 936 election terminated and for transfers by U.S. affiliates of intangibles held for use by section 936 corporation.
7. Revoking section 936 election: conference report "anticipates" Secretary will adopt liberal consent policy for corporations requesting revocation by December 31, 1983.

