Internal Revenue Service

Department of the Treasury

Index Number: 936.00-00, 936.01-00, 338.00-00

Washington, DC 20224

Number: **200002012**
Release Date: 1/14/2000

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:CORP:5- PLR-110722-99
Date:
October 6, 1999

Taxpayer =

Seller =

P1 =

P2 =

P3 =

Purchaser =

Common Parent =

Parent =

Business A =

Date a =

Date b =

Date c =

Date d =

Date e =

This responds to your letter dated June 2, 1999, in which you requested a ruling concerning the applicability of § 936 of the Internal Revenue Code to Taxpayer after Taxpayer's revocation of its § 936 election and a deemed sale of its assets pursuant to elections under §§ 338(g) and 338(h)(10). The rulings contained in this letter are predicated upon facts and representations submitted by the taxpayer and accompanied by penalty of perjury statements executed by an appropriate party. This office has not verified any of the material submitted in support of the request for ruling. Verification of the factual information, representations, and other data may be required as part of the audit process.

Taxpayer is a domestic corporation that files its federal income tax return on a calendar year basis. Taxpayer operates solely in a possession of the United States as provided in § 936(d)(1), where it engages in Business A. Taxpayer elected the application of § 936(a) for 1981 and all subsequent taxable years. Taxpayer represents that it determined its taxable income under the cost sharing method of § 936(h)(5)(c)(i). Before Date a, Taxpayer was a wholly owned subsidiary of Seller.
Seller is a wholly owned subsidiary of Parent which is a wholly owned subsidiary of Common Parent. Common Parent, Parent, and Seller form part of a consolidated group of corporations, within the meaning of § 1.1502-1(h) of the Income Tax Regulations, with Common Parent as the common parent.

Purchaser is a domestic corporation. Purchaser is wholly owned by P3, a domestic corporation, which is wholly owned by P2, a domestic corporation. P2 is wholly owned by P1, which is a domestic corporation.

On Date b, Parent and Seller signed an agreement to sell 100 percent of the outstanding stock of Taxpayer and other business assets of Seller and Parent to Purchaser. Pursuant to that agreement, Purchaser acquired all the stock of Taxpayer on Date a.

The following steps are intended to be taken:

(i) Pursuant to § 936(e)(2), Taxpayer will revoke its election under §§ 936 and 30A.

(ii) Pursuant to § 936(j)(9)(A)(ii), Taxpayer will re-elect the application of §§ 936 and 30A to its taxable year beginning on Date c, which is the day after Date a.

(iii) Purchaser and Seller will make a joint election under § 338 (h)(10) to treat the sale of the stock of Taxpayer as a sale of Taxpayer's assets.

Section 338(h)(10)(A) provides that, generally, the parent of a selling consolidated group may make a joint § 338(h)(10) election with the purchaser if the target corporation was a member of the selling consolidated group for the period that includes the date of the transaction.

As defined in § 1.338-1(c)(12), a selling group is the affiliated group that is eligible to file a consolidated return with the target corporation for the target corporation's taxable period that includes the acquisition date. Section 1.338-1(c)(2) provides that corporations are affiliated on any day they are members of the same affiliated group. As provided in §§ 1.338-1(c)(5) and 1.338(h)(10)-1, a § 338(h)(10) target must be a domestic corporation as defined in § 7701(a)(4), except that a corporation to which an election under § 936 applies is not treated as a domestic corporation for purposes of § 338. Accordingly, § 338(h)(10) will not apply to the sale of stock of a § 936 corporation.

For § 338(h)(10) to apply to the sale of Taxpayer's stock, Taxpayer has to revoke its § 936 election pursuant to § 936(e)(2) for its taxable year that began January 1, and which includes Date a, the acquisition date.

The mechanics of § 338 and the regulations under that section only require the target corporation to qualify for a § 338(h)(10) election on the acquisition date. Because Taxpayer revoked its § 936 election for its taxable year beginning January 1, 1999, Taxpayer will be treated as a domestic corporation includible in Seller's consolidated group for that year that includes Date a, the acquisition date. Provided the requirements for making a § 338(h)(10) election are satisfied, Taxpayer, referred to as Old Taxpayer for the period ending on Date a, will be treated as having made an election under § 338(h)(10) and therefore as having sold all its assets on Date a. A new corporation, New Taxpayer, will be treated as having purchased all of Old Taxpayer's assets at the beginning of Date c. Old Taxpayer recognizes gain or loss on the deemed sale of its assets to New Taxpayer. Seller will not have to recognize gain or loss on the sale of Old Taxpayer's stock.

Section 936(a)(1)(A) provides that a qualified possessions corporation electing the application of § 936 is allowed a credit against its federal income tax. A qualified possessions corporation is a domestic corporation that satisfies the conditions of § 936(a)(2), which requires the corporation to derive (1) at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year from sources within a possession, and (2) at least 75 percent of its gross income for that same period from the active conduct of a possession business. Taxpayer represents that it has satisfied the conditions of § 936(a)(2) for all taxable years since it made the § 936 election.

The § 936 credit for a taxable year is based on the portion of the tax of the qualified possessions corporation that is attributable to its taxable income from the active conduct of a trade or business within a U.S. possession or the sale or exchange of substantially all of the assets used by the taxpayer in the active conduct of such trade or business. The § 936 credit is subject to the economic activity limitation of § 936(a)(4)(A) with respect to § 936(a)(1)(A) active business income, unless the taxpayer elects the percentage limitation of § 936(a)(4)(B). Under § 936(b)(4)(A), the amount of the credit is limited to the sum of (1) 60 percent of the taxpayer's qualifying wage and fringe benefit expenses, within the meaning of § 936(i)(1) and (2); (2) the percentages of the taxpayer's depreciation allowances with respect to qualifying tangible property, specified in § 936(i)(4); and (3) in certain cases, the taxpayer's qualifying possession income taxes, within the meaning of § 936(i)(3). Before the revocation of its § 936 election, Old Taxpayer was subject to the economic activity limitation of § 936(a)(4)(A).

Section 936(e)(2) provides that a possessions corporation that has elected the application of § 936 may revoke its election without the consent of the Commissioner for any taxable year beginning after the ninth taxable year following the taxable year for which the election first applied.

The Small Business and Job Protection Act of 1996 (the Small Business Act) enacted certain provisions that phase out § 936 over 10 years, eliminating it for taxable years beginning after December 31, 2005. Except as otherwise provided, the § 936 credit does not apply to taxable years beginning after December 31, 1995. Sections 936 and 30A however, provide that a domestic corporation that operates in Puerto Rico and elects the provisions of § 936(a) is eligible for the § 936 credit for taxable years beginning after December 31, 1995, only if the corporation qualifies as an existing credit claimant within the meaning of § 936(j)(9)(A). As provided in § 30A(g), an existing credit claimant may make the § 936 election and claim the credit, subject to the restrictions provided in § 936(j), in its taxable years beginning after December 31, 1995, and before January 1, 2006.

A corporation is an existing credit claimant within the meaning of § 936(j)(9)(A)(i) if it was actively conducting a trade or business in a possession on October 13, 1995, and had a § 936 election in effect for its taxable year that included October 13, 1995. Alternatively, a corporation may qualify as an existing credit claimant if it acquired all of the assets of a trade or business of a corporation that actively conducted a trade or business in a possession on October 13, 1995, and had a § 936 election in effect for its taxable year that included that date. However, § 936(j)(9)(ii) provides that a corporation will not qualify as an existing credit claimant after it adds a substantial new line of business.

The following representations have been made in connection with the transaction:

(a) Taxpayer, Common Parent, and P1 represent that Taxpayer properly elected to be treated as a §936 corporation effective Date d.

(b) Taxpayer, Common Parent and P1 represent that Taxpayer, for each taxable year since its inception on Date d, has earned 80 percent or more of its gross income from sources within Puerto Rico, a possession of the United States, as provided under §§936(a)(2)(A) and 30A(b)(1).

(c) Taxpayer, Common Parent and P1 represent that Taxpayer, for each taxable year since its inception on Date d, has satisfied the §§936(a)(2)(B) and 30A(b)(2) requirements for earning gross income from the active conduct of a trade or business within Puerto Rico, a possession of the United States.

(d) Based on representation (a) through (c), Taxpayer, Common Parent and P1 represent that Taxpayer has had a valid §936 election in effect since its inception on Date d.

(e) Taxpayer, Common Parent and P1 represent that Taxpayer was actively conducting a trade or business in Puerto Rico, a U.S. possession, from its inception through Date e, and on into the present.

(f) Taxpayer, Common Parent and P1, represent that a §936 election was in effect for Taxpayer’s taxable year which includes Date e.

(g) Based on representations (e) and (f), Taxpayer, Common Parent and P1, represent that Taxpayer considered an “existing credit claimant” as defined in §936 (j)(9)(A)(i) for purposes of applying §§30A and 936.

(h) Taxpayer, Common Parent and P1, represent that Taxpayer qualifies for the Puerto Rico economic activity credit under §§936(a)(4)(A) and 30A.

(i) Taxpayer, Common Parent and P1, represent that Taxpayer satisfies the requirements under §936(h)(5) and Treas. Reg. §§1.936-5, -6 and -7 with respect to its election to utilize the cost sharing method of computing its federal taxable income.

(j) Taxpayer, Common Parent and P1, represent that Taxpayer has not added a "substantial new line of business" on or after Date e, as provided in §936(j)(9)(B) and defined in Temp. Treas. Reg. §1.936-11T.

Based solely on the information and representations submitted, it is held as follows:

(1) Pursuant to §936(e)(2) and Treas. Reg. §1.936-7(c), Taxpayer may revoke its §30A/936 election, effective as of January 1, Thus, for its short taxable year beginning January 1, and ending Taxpayer will not be a §936 corporation.

(2) Upon revocation of Taxpayer's election under §§ 936 and 30A, Taxpayer is considered to be a § 338(h)(1) target within the meaning of § 1.338(h)(10)-1(c)(1), and Seller and Purchaser may make a joint election under § 338 (h)(10) effective Date a, to treat the sale of Taxpayer as an asset sale.

(3) It is held that Beginning on pursuant to §§936(j)(9)(A)(ii) and 30A(e)(1) and Temp. Treas. Reg. §1.936-11(b)(3)(ii)(B), New Taxpayer may prospectively elect to apply §30A, subject to the transition rules under §§936(j) and 30A.

No opinion is expressed, and none was requested, whether the purchase of Taxpayer qualifies as a qualified stock purchase under § 338, or whether the other requirements for making a § 338(h)(10) election are satisfied, other than the requirement that Taxpayer is a domestic corporation on the acquisition date. No opinion is requested, and none is expressed, about any other federal income tax consequence of the purchase and sale of Old Taxpayer's stock and revocation of the § 936 election and its reelection, or about whether Seller and Taxpayer satisfy all the requirements for filing a consolidated federal income tax return.

This ruling letter is directed only to Taxpayer on whose behalf the letter was requested. Section 6110(k)(3) provides that this ruling letter may not be used or cited as precedent.

A copy of this ruling letter should be attached to the federal income tax return of the taxpayers involved for the taxable year in which the transaction covered by this letter is consummated.

In accordance with the power of attorney on file in this office, copies of this letter are being sent to your authorized representatives.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By: Debra Carlisle
Debra Carlisle
Chief, Branch 5