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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR:

FROM: Elizabeth G. Beck
Senior Technical Reviewer CC:INTL:BR.6

SUBJECT:

This Field Service Advice responds to your memorandum dated August 20, 1999. 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

a =
b =
c =
d =

Company A =
Country A =
Country B =
Country C =
Country D =
Country E =

FBranch =
FSub =
Function A =

Function B =
Function C =
Function D =
Function E =
Function F =
Function G =

PSub =
Product A =
Product B =

Taxable Year 1 =
Taxable Year 2 =

USParent =

ISSUE

Whether a domestic corporation located in Puerto Rico that elects to be taxed as a possessions corporation under section 936(e) of the Internal Revenue Code and computes its income using the cost sharing method of section 936(h)(5) may, in determining the prices at which it sells the products it produces to its U.S. parent corporation, retain the benefits of location savings it achieves by having some of its production activities performed outside of Puerto Rico under a contract manufacturing arrangement with a foreign affiliate.

CONCLUSION

Without appropriate supporting facts and economic analysis, a Puerto Rican manufacturing affiliate cannot retain the benefits of location savings it achieves by having certain production activities performed outside of Puerto Rico under a contract manufacturing arrangement with a foreign affiliate. We have considered Rev. Proc. 63-10, 1963-1 C.B. 490, which as long as it remains in effect allows location savings to be retained by Puerto Rican manufacturing affiliates in certain circumstances. However, the location savings which Rev. Proc 63-10 allows to be retained are only those derived from “activities carried on in Puerto Rico.” The general rule on location savings, found in Temp. Treas. Reg. § 1.482-1T(c)(4(ii)(C) and Treas. Reg. § 1.482-1(d)(4)(ii)(C), applies with respect to activities carried on outside of Puerto Rico. These location savings regulations require an economic analysis of facts concerning the competitive positions of uncontrolled buyers and sellers regarding the geographical market in which the controlled taxpayer's location savings are obtained.

FACTS

USParent is a U.S. corporation that wholly owns PSub and FSub. PSub is a U.S. corporation located in Puerto Rico that qualifies as a "possessions corporation" under section 936. FSub is a Country A corporation that has a branch, FBranch, located in Country B.

PSub manufactures Product A for sale to USParent. Functions A through G are performed in manufacturing Product A. Functions E and F are the most labor-intensive operations in the manufacturing process. FSub performs some of Functions E and F under a contract manufacturing arrangement with PSub. FSub performs these operations in Country B, through its FBranch.

For the taxable years being examined, Taxable Years 1 and 2, PSub elected, under section 936(h)(5)(F), to compute its income under the cost sharing method provided by section 936(h)(5)(C)(i). A possessions corporation that elects this method is required by section 936(h)(5)(C)(i)(IV)(*b*) to determine its intercompany pricing under "the appropriate section 482 method." USParent has submitted a transfer pricing study to the Service in support of the prices used in transfers of Product A from PSub to USParent. The primary method used in this transfer pricing study was a Comparable Uncontrolled Price ("CUP") analysis.[1] In support of its CUP analysis, USParent submitted a Cost Plus method analysis, which included a location savings analysis.

USParent calculated the location savings attributable to PSub as follows:

Location savings from operations in Puerto Rico:	$ a
Location savings from operations in Country B:	$ b
Location dissavings for freight:	$ (c)
Net Total Location Savings	$ d

The location savings derived from operations in Country B consisted mainly of labor cost savings and related fringe benefits savings. In support of the

[1] We have not been asked for advice concerning this CUP analysis, which Examination has not accepted.

allocation of the entire location savings to PSub, USParent's transfer pricing study cited Rev. Proc. 63-10, 1963-1 C.B. 490, as authority for allowing the full amount of the location savings to be allocated to PSub. USParent also stated that

> [t]he [Functions E and F] operations of [FSub] are reflected via a "twin-plant" arrangement with [PSub]. All [Country B] production is shipped to [PSub] in Puerto Rico for [performance of Function G], before being shipped to [USParent] in the U[nited] S[tates]. The [Country B] operations are considered a portion of Puerto Rican production and therefore all the location savings is attributable to the manufacturing location-Puerto Rico. All [Country B] costs are reflected in [PSub's] significant business presence test - 65% direct labor test. The [Country B] location savings is consequently incorporated into the Puerto Rican manufacturing production.

Examination does not agree that the benefit of location savings resulting from operations in Country B can be retained by PSub. Examination has determined that the labor provided by FSub through its FBranch in Country B was not unique or of limited source. Examination has found that there is a ready market of such laborers, willing to work at similar compensation rates. Examination states that countries with low labor rates specialize in this same type of labor-intensive production and that Asian and Central American countries have available labor to perform Functions E and F. For example, Examination states that Company A, used by USParent in its CUP analysis as a comparable, had some of its Functions E and F performed in Country C and Country D. Also, USParent has had Functions E and F performed for the manufacture of Product B in Country E and Country A, as well as in Country B.

LAW AND ANALYSIS

A. Law

Section 936(a)(1)(A)(i) allows an electing domestic corporation that satisfies certain conditions (a "possessions corporation") to claim, subject to certain limitations, an income tax credit equal to the tax attributable to, among other items, its foreign source taxable income from the active conduct of a trade or business within certain possessions of the United States, including Puerto Rico.

A possessions corporation may elect, under section 936(h)(5)(F), to use a method under section 936(h)(5)(C) to compute its taxable income. Cost sharing is one such method, as provided for by section 936(h)(5)(C)(i). A possessions corporation electing the cost sharing method is required by section 936(h)(5)(C)(i)(IV)(*b*) to "determine its intercompany pricing under the appropriate section 482 method."

For possessions corporations located in Puerto Rico, guidance on intercompany pricing, including the issue of location savings, is provided by Rev. Proc. 63-10, *supra,* as long as it remains in effect. This revenue procedure was issued "to set forth guidelines to be followed for the proper application of section 482 . . . in cases involving the allocation of income and expenses between United States companies and their manufacturing affiliates in Puerto Rico." *Id.,* 1963-1 C.B. at 490. The guidelines were "based on a recognition that Puerto Rican allocation problems arise in a unique factual context in that the economic relationship between Puerto Rico and the United States has special characteristics." *Id.*

The guidelines are "for use in cases in which there may have been improper shifting of income between a mainland United States company and an affiliate company manufacturing in Puerto Rico." *Id.* They provide that the "arm's length" standard is to be applied in determining whether section 482 of the Code should be applied to correct an improper shifting of income. *Id.*, 1963-1 C.B. at 492. The revenue procedure explains the application of the arm's length standard as follows:

> Thus, the price which an island affiliate charges a mainland affiliate for its product is required to be that price which the island company would receive from the mainland company if each were independent and unaffiliated, but otherwise unchanged. In this connection, wherever reference is made . . . to transactions between independent parties in order to establish usable independent prices, it is necessary to determine the material circumstances of the sales between the independent parties as well as the material circumstances of the sales between the mainland and island affiliates, including the nature and extent of the operations in each case, so that the comparison made is between sales which are comparable in all particulars.

Id.

The revenue procedure outlines three pricing methods, the third of which is intended for use when no independent prices for similar products are available. Under this third method,

> so long as 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 price which would have been necessary to induce an independent United States firm to produce in the United States the product in question for the mainland affiliate in the quantities involved constitutes the best approximation of the applicable arm's length price, subject to appropriate adjustment for differences, if any, in costs incident to transportation. That price normally would be those costs which would be incurred in the United States if the activities performed by the island affiliate were performed in the United States rather than in Puerto Rico plus a rate of profit which is representative for that type of United States manufacturing activities. The procedure here will involve determining what activities are carried on in Puerto Rico and what an independent United States firm would charge to perform the same activities in the United States. This procedure properly allocates to the island affiliate all income or loss resulting from the choice of Puerto Rico rather than the United States as a location for manufacturing activity.

Id., 1963-1 C.B. at 494. In effect, this methodology takes the costs of the Puerto Rican entity for activities performed in Puerto Rico 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. We assume that the last sentence of this quoted portion of the revenue procedure is the basis for USParent's claim that Rev. Proc. 63-10 authorizes PSub to retain the benefits of the location savings achieved by having a portion of its production performed in Country B under a contract manufacturing arrangement with FSub.

The revenue procedure goes on to provide an alternative version of its third method, in the following paragraph, which states:

> It may be, in some instances, that the island affiliate manufactures a product for sale in the United States which product is not manufactured in the United States and for which type of product it is not reasonable to assume that the mainland affiliate could have contracted for United States manufacture. For example, there may be situations in which competition among foreign manufacturers holds the United States price of the product in question at a level insufficient to permit profitable United States production. In this regard, Puerto Rico may be the foreign country whose production holds the United States

> price of the product in question at a level insufficient to permit United States production. . . . In this case [where profitable manufacture in the United States is not possible], the arm's length price should be based on the costs, including United States import duties, and profit which is representative for the type of manufacturing activities involved in the country which dominates the United States market for the product. Except for basing the costs and profit on an assumed foreign producer rather than . . . on an assumed United States producer, the procedure here is the same as in the preceding paragraph. The procedure here is based on foreign costs and profit because competition among foreign producers has held the price for the product at a level that makes United States manufacture of the product unprofitable.

Id.

In 1968, section 482 transfer pricing regulations were issued. These regulations included a cost plus method for determining an arm's length price of a controlled sale of property. Treas. Reg. § 1.482–2(e)(4), 1968-1 C.B. 218, 241. Under this method, the arm's length price was computed by adding to the actual cost of producing the property an amount based on the gross profit percentage earned in uncontrolled sales similar to the controlled sale, plus or minus adjustments in cases where the most similar uncontrolled sales differed in any material respect from the controlled sale. *Id.* These regulations did not include specific guidance on adjustments for savings attributable to operation in different geographical markets. However, they provided that adjustments were necessary where "the most similar sale or sales from which the appropriate gross profit percentage is derived differ in any material respect from the controlled sale" and identified "[t]he geographic market in which the functions are performed by the seller" as one of the "most important characteristics to be considered in determining the similarity of the uncontrolled sale or sales." Treas. Reg. §§ 1.482–2(e)(4)(iii) & (v), 1968-1 C.B. 218, 241-42.

Thus, the cost plus method of the 1968 regulations did not provide for an automatic allocation of location savings to a controlled taxpayer that operated in a geographical market in which costs were less than the costs related to uncontrolled sales. However, when the 1968 section 482 transfer pricing regulations were issued, Rev. Proc. 68-22, 1968-1 C.B. 819, was also issued. This revenue procedure provided that Rev. Proc. 63-10 could still be applied in certain circumstances, stating that:

> [t]he Service will continue to close cases on the basis of the guidelines published in Revenue Procedure 68[sic]-10 in cases involving the allocation of income and deductions between U.S. companies and their manufacturing affiliates in Puerto Rico if the result is more favorable to the taxpayer than the result under the regulations prescribed by Treasury Decision 6952 [the 1968 section 482 regulations].

Id., 1968-1 C.B. at 821.

In 1988, the Service and the Treasury Department completed a study and issued a report on the theory and administration of section 482. They noted then that "'location savings' were specifically authorized for certain Puerto Rican affiliates by Rev. Proc. 63-10," and that such savings "do not otherwise automatically accrue to an affiliate, but under the arm's length standard of section 482 are distributed as the marketplace would divide them." Notice 88-123, 1988-2 C.B. 458, 471 n. 99.

The 1993 temporary section 482 regulations made this arm's length standard for allocating the benefit of location savings an explicit part of the regulations, by adding a provision to address the situation in which adjustments may be necessary to account for significant differences in costs attributable to the controlled and uncontrolled taxpayers operating in different geographic markets. In such cases,

> [t]hese 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 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.

Temp. Treas. Reg. § 1.482-1T(c)(4)(ii)(C), 1993-1 CB. 90,105. Application of this regulation was illustrated by an example. Temp. Treas. Reg. § 1.482-1T(c)(4)(ii)(D).

This arm's length principle for allocating the benefit of location savings was carried forward into the 1994 final section 482 regulations, which became generally effective for taxable years beginning after October 6, 1994, and which now appears at Treas. Reg. § 1.482-1(d)(4)(ii)(C), as follows:

> (C) *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 markets. These adjustments must be based on the effect such differences would have on the consideration charged or paid in the controlled transaction given the relative competitive positions of buyers and sellers in each market. Thus, for example, the fact that the total costs of operating in a controlled manufacturer's geographic market are less than the total costs of operation in other markets ordinarily justifies higher profits to the manufacturer only if the cost difference would increase the profits of comparable uncontrolled manufacturers operating at arm's length, given the competitive positions of buyers and sellers in that market.

Again, an example is provided in the regulations. Treas. Reg. § 1.482-1(d)(4)(ii)(D).

B. Analysis

1. Rev. Proc. 63-10

We have considered USParent's claim that Rev. Proc. 63-10 can be applied to allow PSub to retain the benefit of location savings it obtained by having a portion of its production performed outside of Puerto Rico under a contract manufacturing arrangement with FSub. We have concluded that, by its terms and consistent with its purpose, Rev. Proc. 63-10 does not afford a basis on which location savings resulting from operations in Country B may be attributed to PSub.

In providing guidelines for application of the arm's length standard to transactions between a mainland United States company and an affiliate company manufacturing in Puerto Rico, Rev. Proc. 63-10, by its terms, applies only to manufacturing activities that take place in Puerto Rico. Thus, the location savings that are allocated to a Puerto Rican manufacturing affiliate under the revenue procedure are ascertained by

> determining what activities *are carried on in Puerto Rico* and what an independent United States firm would charge to perform the same activities in the United States. This procedure properly allocates to the island affiliate all income or loss resulting from the *choice of Puerto Rico* rather than the United States *as a location for manufacturing activity*.

Rev. Proc. 63-10, 1963-1 C.B. at 494 (emphasis added). There is nothing in this revenue procedure that would allow location savings resulting from the choice of a location outside of Puerto Rico for manufacturing activity to be automatically allocated to a Puerto Rican affiliate.[2]

The fact that Rev. Proc. 63-10 does not, by its terms, allocate location savings from operations outside of Puerto Rico to a Puerto Rican manufacturing affiliate is consistent with the overall objectives of the tax laws enacted to promote investment and to create jobs in Puerto Rico, beginning with the Revenue Act of 1921, which provided an exemption from taxes for certain possessions source income, and continuing with the Tax Reform Act of 1976, which replaced the exemption with a tax credit. *See, e.g.*, S. Rep. No. 94-938, 94th Cong., 2d Sess. 277, 1976-3 (Vol. 3) C.B. 315. Rev. Proc. 63-10 recognized these objectives and sought to assure that undue advantage not be taken of the tax benefits then afforded by an exemption under section 931 of the Internal Revenue Code of 1954 through the artificial shifting of income to Puerto Rican affiliates that were eligible for the exemption. Rev. Proc. 63-10, 1963-1 C.B. at 491.

It would be plainly inconsistent with the legislative goals set out above to extend the exceptional automatic treatment of location savings allowed for Puerto Rican manufacturing affiliates by Rev. Proc. 63-10 as long as it remains in effect beyond the revenue procedure's express limitation to savings that result from activities carried on in Puerto Rico. Such an extension would allow Puerto Rican affiliates to receive benefits of location savings that would be unwarranted. The additional profits and tax credits that would be gained by allocating to a Puerto Rican affiliate location savings resulting from manufacturing operations performed outside of Puerto Rico would neither reflect competitive factors nor encourage the creation of jobs in Puerto Rico. In fact, such an unwarranted extension of Rev. Proc. 63-10 would have the opposite effect of encouraging Puerto Rican

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[2] We note that even with respect to manufacturing activities that are carried on in Puerto Rico, Rev. Proc. 63-10 may limit the amount of location savings that can be allocated to a Puerto Rican corporation if market conditions are such that the manufacturing activities in question cannot be profitably conducted in the United States. In such a case, the costs and profits that are to be used under the revenue procedure to determine an arm's length transfer price are those that are "representative for the type of manufacturing activities involved in the country which dominates the United States market for the product," *i.e.*, those of an "assumed foreign producer." Rev. Proc. 63-10, 1963-1 C.B. at 495. We need not consider this issue here, however, since the manufacturing activities in question were not carried on in Puerto Rico.

manufacturing affiliates to export jobs in order to conduct manufacturing activities in locations outside of Puerto Rico that have lower labor costs.

2. Section 482 Regulations

We have determined that Rev. Proc. 63-10 does not apply with respect to the costs of operations performed in Country B. Therefore, the provisions regarding location savings under Treas. Reg. § 1.482-1(d)(4)(ii)(C) must be applied.[3] The regulations include an example of an application of the location savings regulation as follows:

> *Example.* Couture, a U.S. apparel designing corporation, contracts with Sewco, its wholly owned Country Y subsidiary, to manufacture its clothes. Costs of operation in Country Y are significantly lower than the operating costs in the United States. Although clothes with the Couture label sell for a premium price, the actual production of the clothes does not require significant specialized knowledge that could not be acquired by actual or potential competitors to Sewco at reasonable cost. Thus, Sewco's functions could be performed by several actual or potential competitors to Sewco in geographic markets that are similar to Country Y. Thus, the fact that production is less costly in Country Y will not, in and of itself, justify additional profits derived from lower operation costs in Country Y inuring to Sewco because the competitive positions of the other actual or potential producers in similar geographic markets capable of performing the same functions at the same low costs indicate that at arm's length such profits would not be retained by Sewco.

Treas. Reg. § 1.482-1(d)(4)(ii)(D).[4]

We assume the facts in this case support the conclusion that the benefits of the location savings resulting from PSub's use of low-cost labor in Country B are equally available to uncontrolled buyers located in the United States.

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[3] The analysis is the same under the provisions of the 1993 temporary regulations. *See* Temp. Treas. Reg. § 1.482-1T(c)(4)(ii)(C).

[4] This example is substantially similar to the example contained in the 1993 temporary regulations at Temp. Treas. Reg. § 1.482-1T(c)(4)(ii)(D).

On this assumption, in arm's length transactions between uncontrolled U.S. buyers and uncontrolled foreign manufacturers having access to low-cost labor in Country B, market forces would prevent the benefits of such Country B location savings from being retained by the uncontrolled foreign manufacturers. Accordingly, the benefits of Country B location savings would not be retained by PSub.

<u>3.</u> <u>Taxpayer's Other Arguments</u>

In support of the allocation to PSub of the benefits of the location savings resulting from operations in Country B, the taxpayer has stated that "All [Country B] costs are reflected in [PSub's] significant business presence test - 65% direct labor test." This is an apparent reference to section 936(h)(5)(B)(ii)(II), which provides that a possessions corporation may establish that it has a "significant business presence" in a possession for a taxable year with respect to a product if "no less than 65 percent of the direct labor costs [for a product] . . . is incurred by the [possessions] corporation and is compensation for services performed in the possession. . . ." This statutory language makes clear that labor costs for services performed outside of Puerto Rico cannot be counted toward the "65% direct labor test," as the taxpayer seems to suggest. We understand, however, that PSub meets this test without counting the cost of labor performed outside of Puerto Rico.

We note that Treas. Reg. § 1.936-5(c), which concerns certain contract manufacturing costs, is consistent with this statutory limit on the direct labor costs that a possessions corporation may count toward meeting the significant business presence test to only those labor costs that are incurred for services performed in the possession. Contract manufacturing is defined, for this purpose, to include "any arrangement between a possessions corporation (or another member of the affiliated group) and an unrelated person. . . ." Treas. Reg. § 1.936-5(c), Q&A 1. The regulations make clear that the cost of contract manufacturing that is performed outside of the possession under such an arrangement cannot be included by the possessions corporation as a direct labor cost. Treas. Reg. § 1.936-5(c), Q&A 5. Although PSub's costs for labor performed outside of Puerto Rico result from a contract manufacturing relationship with an affiliate, rather than with an unrelated person, such costs are equally prohibited from inclusion by PSub as a direct labor cost under the plain language of section 936(h)(5)(B)(ii)(II), which limits direct labor costs to the costs incurred for compensation for services performed in the possession.

Thus, the taxpayer's statement that Country B costs are reflected in PSub's significant business presence test appears to be inaccurate. Moreover, the extent to which costs may be taken into account for purposes of meeting the significant business presence test in order to qualify for tax benefits under section 936 does not appear to be directly relevant to the transfer pricing issue posed in this case.

The taxpayer has also stated that “[t]he . . . operations of [FSub] in [Country B] are reflected via a ‘twin-plant’ arrangement with [PSub].” This is an apparent reference to the provisions of section 936(d)(4), which pertain to investments in qualified Caribbean Basin countries. The section 936 tax credit under section 936(a)(1)(B) includes amounts equal to “qualified possession source investment income.” Such income has been defined by section 936(d)(4) to include income from investments in certain Puerto Rican financial institutions that invest in certain projects in qualified Caribbean Basin countries. The effect of this provision was that, prior to the repeal of section 936(d)(4), investment income from investments in qualified Caribbean Basin countries would qualify for the section 936 credit. Section 936(d)(4) neither permits the costs incurred for labor performed at the twin plant to qualify as direct labor costs performed within the possession for purposes of the significant business presence test nor does this section permit such costs to be considered Puerto Rican labor costs for purposes of determining location savings under Rev. Proc. 63-10.

We have considered whether the fact that Country B is a qualified Caribbean Basin country should affect the result in this case and have found nothing to suggest that any legislation or regulations relating to Caribbean Basin countries pertains to the determination of transfer prices between a possessions corporation and its U.S. affiliate or to the allocation of the benefits of location savings from operations in a qualified Caribbean Basin country.

If you have any further questions, please call (202) 874-1490.

By: ____________________________

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