

Audit Techniques

- Audit Guidelines Related to Section 936 Conversion Issues

<http://www.irs.gov/businesses/corporations/article/0,,id=167559,00.html>

- Information Document Request

<http://www.irs.gov/businesses/article/0,,id=169957,00.html>

Current Status of Issue

- Supplemental guidance/IDD's may be developed
- IMT technical members continue to provide direction and support to teams through conference calls, various field visits and plant tours
- Work with Appeals on appropriate coordination

Executing IMT Strategy for Tier I Issues

Audit Teams Should:

- Establish the Tier I Issue on IMS using the UIL code per the ID Directive.
- Research the issue on the Tier I website.
- Communicate with the IMT early to determine the strategy and any special requirements for the issue.
- Consider the issue in the audit planning and risk assessment in accordance with the IMT strategy.
- Utilize the audit tools and techniques provided by the IMT to develop the issue.
- Resolve the issue using all resolution tools in alignment with the IMT strategy.

Issue Management Team (IMT)

- **Issue Executive Owner** - Sergio Arellano
- **Area Counsel** - Jim Lanning
- **IMT Lead** - Tony Russo
- **Program Analyst** - Khin Chow
- **Economist Program Liaison** - TBD
- **Technical Advisor**—James Guidone, Matthew Hartman, Lou Milano
- **International Appeals Officer** - Tony Swindle
- **Counsel Support**— Michael Calabrese, Naseem Khan, Thomas Vidano, Tom Beem, Joe Dewald, John Hinding

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Tier I



Section 936 Exit Strategies (Transfer Pricing)

Quick Reference Guide

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Issue Owner Executive (IOE)

Sergio Arellano, Director

Retailers, Food,

Pharmaceuticals & Healthcare



Tier 1

Tier I: Section 936 Exit Strategies

Issue Description

In general, Section 936 Exit Strategies address the off-shore migration of intangibles under Section 367 and the transfer pricing of U.S.-owned intangibles under section 482 that result from the restructuring of section 936 corporations. The issue is relevant to cases with former and/or currently operating Section 936 corporations.

Section 936 terminated for tax years beginning in 2006, as the result of a 10-year phase-out that first began in 1996. As part of this phase-out, the tax benefit taxpayers received from the credit in the last few years had been gradually diminishing, so most taxpayers began restructuring their operations for post-1996 tax years which are currently in the audit stream.

In order to receive the benefits of Section 936, a domestic corporation (i.e. the "936 corporation") had to conduct most of its operations in Puerto Rico. This 936 corporation was typically a wholly-owned subsidiary of a U.S. parent corporation. As a result of this corporate structure, all intangible assets (patents, trademarks, know-how, etc.) were owned by a U.S. corporation (either the US parent corporation or the 936 corporation). Under the new corporate structures, the Puerto Rican operations are generally set up as branches of a foreign affiliate (usually a tax haven entity). Income relating to intangible assets that was previously taxed to a U.S. corporation, subject to the Section 936 credit, is now attributed to the foreign affiliate and is subject to deferral as part of the taxpayer's new structure.

Issues which are likely to prove worthy of consideration by examiners include the appropriate transfer pricing of transactions between domestic and off-shore related corporations, the appropriate royalty structure between domestic and off-shore related entities, and the transfer of property from the former 936 corporation (or its domestic parent) and off-shore related entities under section 367(d). Each of these issues must be considered and evaluated for materiality and examination risk.

Proforma IDRs

There is a recommended proforma IDR:
<http://www.irs.gov/businesses/article/0,,id=169957,00.html>

Appeals Settlement Guidelines (ASGs)

Currently there are no ASGs for this issue.

Administrative Codes

Potential issues resulting from the termination of Section 936 can cut across multiple code sections. The type and number of issues may vary depending on the particular situation of the taxpayer under examination. As a result, a specific Uniform Issue Listing (UIL) code has not been assigned. Rather the UIL code that reflects the specific issue(s) resulting from the restructuring of Section 936 operations should be used. In order to track the issue, all examiners must also use the Secondary Standard Audit Index Number (SAIN), **240**, in conjunction with the issue-specific UIL code.

Example: If an issue and/or issues under examination involve Section 482 and/or Section 367, potential issue tracking codes may include, but are not limited to:

Section 482	UIL Code	Secondary SAIN
Transfer and Use of Intangibles	482.11-00	240
Cost Sharing Arrangements	482.11-08	240
Intercompany Pricing	482.12-00	240
Services	482.09-00	240
Section 367		
Transfers of Intangibles to CFCs under section 367(d)	367.30-00	240
Property Subject to section 367(a)	367.05-00	240

Other issues may arise that are beyond the scope of this directive, such as subpart F and foreign tax credit issues as well as issues under Section 367(a). Under those circumstances, the same principle of using the issue-specific UIL code and the Secondary SAIN code of 240 designated for Section 936 Exit Strategies should apply.

Teams with cost sharing issues under Treas. Reg. § 1.482-7 should also refer to guidance provided by the Cost Sharing Issue Management Team (IMT), including an examination checklist for cost sharing arrangements released in 2005.

Tracking/Project: Code: 0571

ITA Code: R240—936 Strategy licenses, incorporations, reorganizations, and service transactions with imbedded intangibles

Administrative & Technical Guidance

Industry Issue Directives

- [Industry Issue Directive #1 issued 2/2/07:](http://www.irs.gov/businesses/corporations/article/0,,id=167555,00.html)
- ◆ [Industry Director Directive Attachment to Industry Directive - Audit Guidelines Related to Section 936 Conversion Issues:](http://www.irs.gov/businesses/corporations/article/0,,id=167559,00.html)
- ◆ [Industry Director Directive #2 issued 2/22/08:](http://www.irs.gov/businesses/article/0,,id=179270,00.html)
- Emerging Issue Alert on Puerto Rico withholding tax issues related to royalties on the use of US manufacturing intangibles (6/28/2007)

Issue Guidance

- [Notice 2005-21 - Guidance Related to Section 936 Termination:](http://www.irs.gov/irb/2005-11_IRB/ar12.html)

Strategic Importance

Globalization is a key strategic initiative of the LMSB division, with a significant focus on the migration of intangibles and transfer pricing. Economic activities have become increasingly integrated throughout the multinational enterprise. Globalization has increased the complexity and sophistication of international business planning. The phase out of the section 936 credit for certain operations in Puerto Rico occurred concurrently with these international business trends.

Thus, many of the companies that had historically operated in Puerto Rico, and enjoyed the tax benefits of section 936, undertook to realign their international structures as these tax benefits phased out. This planning can be entirely proper. However, some of these plans can have a substantial impact on income subject to US taxation, and therefore this is an area of potential risk that should be considered during the audit planning process.