



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

OFFICE OF  
CHIEF COUNSEL

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MEMORANDUM FOR

FROM: Barbara B. Franklin  
Special Counsel CC:INTL:FO

SUBJECT:

This Field Service Advice responds to your request for advice. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

A	=
B	=
C	=
Y Product	=
X Components	=

You raised the question of how to determine the Treas. Reg. § 1.861-8 expenses associated with the excluded component. The combined taxable income (CTI) computation for section 936 corporations which elect profit split is determined by reducing the possession sales by the costs of goods sold pursuant to Treas. Reg. § 1.471-11 and then a further reduction by the below line expenses under § 1.861-8. The below line expenses are treated by either requiring the § 1.861-8 expenses to be determined on a factual basis for the excluded component or determined based on a production cost ratio (PRC). The CTI of the end-product form is the CTI of the integrated product reduced by the CTI of the excluded component.

Treas. Reg. § 1.936-6(b)(1) Q&A12(ii) is the operative provision for determining the combined taxable income for an end-product form, in this case the value minus the U.S. made components. This regulatory provision provides that the sales price of the end-product form is the difference between the third party sales price of the integrated product (product) and the sales price of the excluded components

(components) using the independent sales price of the excluded components from comparable uncontrolled transactions (CUP). If a CUP cannot be determined, then the sales price of the excluded component is determined using the production cost ratio (i.e. multiplying the sales price of the integrated product (Y Product) by a fraction, the numerator of which is the production costs (not including interest and direct material costs) of the excluded component and the denominator is the production costs (determined in the same manner) of the integrated product. Whether there is a CUP for the excluded component is the issue in the case.

A subsidiary issue is whether in determining the CTI of the excluded component, the Treas. Reg. § 1.861-8 expenses for the excluded component must be the actual § 1.861-8 expenses related to that excluded component or whether these expenses can be determined using the PRC. (Note that the regulation requires that the actual costs of goods sold be used.) The issue would arise when the purchase price of the X Components from C is treated as a CUP or a modified CUP. Although it is probably impossible for A to determine C's § 1.861-8 expenses if the purchase price of the excluded component from C is treated as a CUP, the "sales" price from A to B of its own manufactured X Components would also be treated as a CUP and A could easily determine its actual § 1.861-8 expenses on a factual basis. Therefore, the issue is whether A must use its own § 1.861-8 expenses or can it determine these expenses using the PCR.

This issue was raised in a partial summary judgment motion in Coca Cola v. Commissioner, 106 T.C. 1 (1996). In that case the taxpayer manufactured concentrate in Puerto Rico, a component product, and also manufactured syrup in Puerto Rico, an integrated product. The taxpayer used the PCR to determine the Treas. Reg. § 1.861-8 expenses of the concentrate and treated the sales price to third parties of the concentrate as a CUP (although the CUP issue was never litigated and eventually settled). In our view, the taxpayer had to use its actual Treas. Reg. § 1.861-8 expenses. Taxpayer prevailed; we did not appeal.

Therefore, in determining CTI for modified CUP for the excluded components, the calculation must take into account that A can and will use the PCR in determining the Treas. Reg. § 1.861-8 expenses to calculate the CTI of the excluded carbon component.

In conclusion, if we permit A to use C's price as a CUP price or use a modified CUP price, A could still use the PCR method to determine its Treas. Reg. § 1.861-8 expenses in determining the CTI of the excluded component. We cannot require A to use the §1.861-8 expenses actually allocated and apportioned to the carbon components it manufactures.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

