TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 06-01

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

Tennessee excise tax treatment of income recognized under the Profit Split Method of IRC § 936(h)(5)(C)(ii).

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the Taxpayer. The rulings herein are binding on the Department and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time.

Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

(A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
(B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
(C) The applicable law must not have been changed or amended;
(D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
(E) The taxpayer directly involved must have acted in good faith in relying upon the ruling and a retroactive revocation of the ruling must inure to his detriment.

FACTS

The Taxpayer is a [INDUSTRY] company authorized to do business in Tennessee. The Taxpayer is the sole shareholder of a subsidiary company which has made a valid election under Internal Revenue Code ("I.R.C.") § 936. For federal tax purposes, the Taxpayer recognizes income pursuant to the Profit Split Method ("P.S.M.") outlined in I.R.C. § 936(h)(5)(C)(ii).

Pursuant to I.R.C. § 936, the subsidiary is not included in the Taxpayer's consolidated federal income tax return.

Under I.R.C. § 936, a U.S. corporation earning the majority of its income in U.S. possessions (including Puerto Rico and the Virgin Islands) can take a possession tax credit to offset federal income tax liability, regardless of whether a possession tax was ever paid. In 1982, Congress enacted I.R.C. § 936(h) to require U.S. shareholders of a § 936 corporation to recognize income generated from intangible property. The Joint Committee on Taxation ("J.C.T.") outlined the reasons for adding this provision noting that "under prior law, some taxpayers had taken the position that they could make tax-free transfers of intangible assets created or acquired in the United States (such as patents, secret processes, and trademarks) to an electing § 936 corporation, and that no allocation of income generated by those intangibles to the U.S. parent was required." To illustrate the need for this provision, the J.C.T. used the example of a pharmaceutical company:

> "For instance, a U.S. pharmaceutical company could spend (and deduct or amortize and take a research and development tax credit for) large sums for research and development of new drugs. When it developed an effective drug, it could transfer the patent on the drug and the know-how to manufacture the drug to a § 936 subsidiary in a purportedly tax-free exchange. Thereafter, the 936 company could manufacture the drug and claim for itself the extremely high profits which typically result for the sale of pharmaceutical products. It was Congress' understanding that high profits on certain pharmaceutical products must be realized because, according to the industry, the profits from the relatively few successful drugs must, in effect, amortize the development costs of all the unsuccessful products and finance the necessary research and development for future products. This results in the creation of extremely valuable intangibles (e.g. patents and trademarks) in the drug industry. If there is no allocation of income from the intangibles to the developer (the U.S. parent) a distortion of income results, with the parent obtaining deductions for its efforts while the 936 company realizes tax-free income."[1]

Thus, I.R.C. § 936(h) was enacted "to subject to U.S. tax income attributable to intangibles that add value to the products produced by a § 936 corporation."[2] I.R.C. § 936(h)(5) allows a shareholder of an I.R.C. § 936 company to compute its income pursuant to either the Cost Sharing Method or P.S.M. As noted above, [THE TAXPAYER] has elected to recognize income under this section using the P.S.M.

The P.S.M. essentially views the affiliated group's combined income from the subsidiary's product or service as a single effort. Sales from the group to third parties represent the group's revenue. Revenue less the costs incurred by the affiliated group in the development, production, and sale of the product equals the group's net income. Fifty percent (50%) of the income related

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[1] Staff of Joint Comm. On Taxation, 97th Cong., 2d Sess. General Explanation of the revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 at 83 (Comm. Print 1982).
[2] Ibid.

to these products is included in the parent's federal consolidated group's income. The remaining fifty percent (50%) is assigned to the subsidiary.

In addition, pursuant to the P.S.M., the parent is required to charge the subsidiary a minimum amount related to the Taxpayer's research and development expenses. This is calculated based on a formula provided in § 936. The parent recognizes this charge as income.

For federal income tax purposes, the Internal Revenue Service requires that the net income recognized under the P.S.M. be reported on Line 10, Form 1120, as "Other Income." Receipts and expenses associated with the goods manufactured by the subsidiary should not be reflected elsewhere on Form 1120.

QUESTION

How should the receipts associated with the I.R.C. § 936 company impact the calculation of the receipts factor of the Taxpayer's apportionment formula for excise tax purposes?

RULING

Under the P.S.M., the combined taxable income associated with the subsidiary's product is divided equally between the Taxpayer and the subsidiary. Thus, half the income (that amount attributed to the Taxpayer) will be included in the denominator of the Taxpayer's receipts factor. For purposes of the receipts numerator, these receipts will be sourced based on the destination state of the recipient of the product. Additionally, the Taxpayer is required to recognize income related to its research and development activities. The research and development income will be included in the denominator of the Taxpayer's receipts factor. For purposes of the receipts factor numerator, these receipts will be sourced to each state based on the location where the services are performed.

ANALYSIS

Tenn. Code Ann. § 67-4-2007 imposes an excise tax on certain persons doing business in Tennessee. Tenn. Code Ann. § 67-4-2012 provides that the apportionment formula for excise tax shall consist of three factors: property, payroll and receipts. The receipts factor is counted twice in the numerator of the formula. These factors are then divided by a denominator of four (4).

Regarding the receipts factor, Tenn. Code Ann. § 67-4-2012, provides the following:

> (h) Sales of tangible personal property are in this state if:
> (1) The property is delivered or shipped to a purchaser, other than the United States government, inside this state regardless of the F.O.B. point or other conditions of the sale; or
> (2) The property is shipped from an office, store, warehouse, factory or other place of storage in this state and the purchaser is the United States government.

(i) Sales, other than sales of tangible personal property, are in this state if the earnings-producing activity is performed:
(1) In this state; or
(2) Both in and outside this state and a greater portion of the earnings-producing activity is performed in this state than in any other state, based on the costs of performance.

The same provisions apply to franchise tax. See Tenn. Code Ann. § 67-4-2111(h).

Tenn. Comp. R. & Regs. 1320-6-1-.34 (Rule 34) provides further guidance by defining the terms "earning producing activity" and "cost of performance" as follows:

> (2) The term "earnings producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gain or profit.
> (3) The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer.

The Taxpayer's question concerns two sources of income. First, as noted in the facts, under the P.S.M., the income from the subsidiary's sales is split so that the fifty percent (50%) of the income related to their product sales is assigned to the subsidiary and the remaining fifty percent (50%) is assigned to the other members of the affiliated group, in this case, the Taxpayer. Second, under the P.S.M. the Taxpayer charges the subsidiary a fee related to the Taxpayer's research and development expenses. The Taxpayer recognizes this fee as income.

On first glance, it might appear the provisions of Tenn. Code Ann. § 67-4-2012(j) regarding royalties from licensing intangibles would apply. That section provides, in pertinent part, "…any person doing business in Tennessee, who licenses the use of patents, trademarks, tradenames, copyrights, or know-how, or other intellectual property to another person in Tennessee, and who is paid royalties or other income based on the sale of products or other activity in Tennessee by the licensee, shall source such income to Tennessee for purposes of its apportionment formula receipts factor." However, there is nothing in the facts indicating the Taxpayer has licensed these intangibles. Thus, Tenn. Code Ann. § 67-4-2012(h) and (i), as quoted above, are the applicable subsections.

Under IRC § 936(h)(5)(C)(ii)(III), half of the affiliated group's income derived from the sales of the subsidiary's products are assigned to the Taxpayer. The Taxpayer, therefore, recognizes income from the sale of tangible personal property that will be sourced pursuant to Tenn. Code Ann. § 67-4-2012(h). That income will be included in the Taxpayer's receipts factor, sourced to the appropriate state based on the destination of the sale.

Under the P.S.M., the Taxpayer is required to charge the subsidiary for a percentage of the research and development costs attributed to the development of the subsidiary's product. The income from this charge is considered income from the performance of services and should be included in the Taxpayer's receipts factor. Pursuant to Tenn. Code Ann. § 67-4-2012(i) and

Rule 34, the income would be included in the numerator for Tennessee if the activities that resulted in the income were performed solely in Tennessee or the earnings producing activities were performed inside and outside Tennessee with the greater proportion of the earnings producing activity having been performed in Tennessee. That determination is based on the "costs of performance" as defined in Rule 34. In this case, the cost of performance is the research and development expense the Taxpayer incurred developing the intangibles (manufacturing processes, patents, trademarks, etc.) that the Taxpayer transferred to the subsidiary.

The facts presented do not indicate in what state the earnings producing activities occurred. If the taxpayer performed the research and development in Tennessee and incurred the costs, or at least a majority of those costs in Tennessee, than in any other state, the income will be sourced to Tennessee and included in the numerator of the Taxpayer's receipts factor. If the taxpayer incurred a greater portion of those costs outside Tennessee, the income will not be included in the numerator of the Taxpayer's receipts factor.

Craig A. Jenkins
Tax Counsel

APPROVED: Loren L. Chumley
Commissioner of Revenue

DATE: 01/09/2006