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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE TECHNICAL ASSISTANCE

MEMORANDUM FOR: Michael R. Picariello, IFASP Specialist
Office of the Assistant Commissioner, International

FROM: Anne P. Shelburne, Assistant to the Branch Chief
Office of Associate Chief Counsel (International),
Branch 6

SUBJECT: Revocation of Section 936(a) Election

This memorandum responds to your request for Technical Assistance dated January 6, 2000, requesting guidance District Directors may consider in determining whether to consent to requests to revoke possessions corporations' elections under Internal Revenue Code ("Code") section 936(a). Taxpayers seeking to revoke a section 936(a) election that has been in effect for less than ten years must request permission under Treasury Regulation section 1.936-7(c). Such requests must be addressed to the District Director having jurisdiction over the taxpayer's return.

Technical Assistance does not relate to a specific case and is not binding on Examination or Appeals. This document is not to be used or cited as precedent.

DISCUSSION:

A. Section 936(a) Election Generally

Sections 936(a) and (e) provide for an election for a corporation meeting certain criteria to be treated as a possessions corporation under section 936. Section 936(a) provides a credit against U.S. income tax in an amount equal to tax attributed to non-U.S. source taxable income from the active conduct of a trade or business within a U.S. possession, provided the domestic corporation derives at least 80% of its gross income for a preceding three-year period from sources within

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a U.S. possession, and at least 75% of such gross income is derived from the active conduct of a trade or business in a U.S. possession. I.R.C. § 936(a)(2). In 1996, Congress enacted The Small Business and Job Protection Act of 1996, which phases out the section 936 credit over a ten-year period, eliminating it entirely for some taxpayers for taxable years beginning after December 31, 1995 and others for tax years beginning before January 1, 2006. I.R.C. § 936(j)(8). Section 936(j)(1) states that, except as otherwise provided in section 936(j), the section 936 possession tax credit does not apply to any tax year beginning after December 31, 1995. Section 936(j)(2), however, provides that “existing credit claimants” may continue to elect the credit under sections 936(a)(1)(A) or 30A(a)(1)(A), under limited conditions.

Section 936(e) provides that an election for possession tax credit shall be made in accordance with regulations prescribed by the Secretary. I.R.C. § 936(e)(1). Such an election shall apply to the first taxable year for which the domestic corporation meets the requirements of Code section 936(a)(2) and for each taxable year thereafter until the election is revoked by the domestic corporation. I.R.C. § 936(e)(1). A section 936(a) election may be revoked only with the consent of the Secretary for any taxable year beginning before the expiration of the ninth taxable year following the taxable year for which the election first applies. I.R.C. § 936(e)(2)(A). A section 936(a) election may be revoked without the consent of the Secretary for any taxable year beginning after the expiration of the ninth taxable year for which the election first applies. I.R.C. § 936(e)(2)(B).

Treasury Regulation section 1.936-7(c) governs requests for revocation of section 936 elections and delegates authority to the District Director having jurisdiction over the taxpayer’s tax return to consent to requests for revocation. Treasury Regulation section 1.936-7(c) provides the following,

An election under [Internal Revenue Code] section 936(a) may be revoked during the first ten years of section 936 status only with the consent of the Commissioner, and without the Commissioner’s consent after that time. The Commissioner hereby consents to all requests for revocation that are made with respect to the taxpayer’s first taxable year beginning after December 31, 1982 provided that the section 936(a) election was in effect for the corporation’s last taxable year beginning before January 1, 1983, if the taxpayer agrees not to re-elect section 936(a) prior to its first taxable year beginning after December 31, 1988. A taxpayer that wishes to revoke a section 936(a) election under the terms of the blanket revocation must attach a “Statement of Revocation - Section 936” to the taxpayer’s timely filed return (including extensions) and must state that in revoking the election the taxpayer agrees not to re-elect section 936(a) prior to its first taxable year beginning after December 31, 1983. Other requests

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to revoke not covered by the Commissioner's blanket consent should be addressed to the District Director having jurisdiction over the taxpayer's tax return.

Treas. Reg. § 1.936-7(c) (emphasis added).

Whereas the Code and corresponding Treasury Regulations provide guidance on revoking a section 936(a) election that has been in effect for at least ten years, neither the Code nor regulations set forth criteria to consider when the District Director's consent is required to revoke a section 936(a) possessions corporation election that has been in effect for less than ten years. Therefore, in providing guidance to District Directors who may consider whether to consent to a taxpayer's request to revoke a section 936(a) election, we rely on legislative history of the section 936 possession tax credit for clarification of congressional intent, and judicial precedent as well.

B. Legislative History

In 1976, Congress adopted section 936 as a substitute for trade and investment tax benefits that were permitted previously pursuant to section 931. Tax Reform Act of 1976 § 1051, I.R.C. § 936. Section 931 benefits, which Congress intended as "inducement[s] to U.S. corporate investment in active trades and businesses in Puerto Rico and the possessions . . ." placed limits on the operations of possessions companies while at the same time providing significant benefits. Specifically, corporations operating a trade or business in a U.S. possession were entitled to exclude from gross income all income from sources without the United States (including foreign source income earned outside the possession), provided the domestic corporation derived at least 80% of its gross income for a preceding three-year period from sources within a U.S. possession, and at least 50% of such gross income was derived from the active conduct of a trade or business in a U.S. possession. S. Rep. No. 94-938, 94th Cong., 2d Sess. 281 (1975), 1976-3 C.B. (Vol. 3) 319. In effect, under section 931, no U.S. tax was paid on foreign source income earned by the possessions corporation unless it paid dividends to its U.S. parent corporation. Because no current U.S. tax was imposed unless a section 931 possessions corporation's earnings were repatriated, section 931 corporations invested income in foreign countries, thus avoiding U.S. tax on the earnings from business conducted in a possession and on income obtained from reinvesting business earnings in foreign countries. S. Rep. No. 94-938, 94th Cong., 2d Sess. 277-278 (1976), 1976-3 C.B. (Vol. 3) 315-316. In enacting section 936 in 1976, Congress addressed the concern over non-repatriation of dividends by permitting a dividends-received deduction for dividends from a section 936 possessions corporation to its U.S. parent corporation. S. Rep. No. 94-938, 94th Cong., 2d Sess. 277-278 (1976), 1976-3 C.B. (Vol. 3) 315-316.

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In enacting section 936, Congress also expressed concern over the relationship of possessions corporation provisions to other Code provisions regarding consolidated tax returns, noting that an affiliated group with a possessions corporation could gain a double benefit where the losses of a possessions corporation were claimed on a consolidated return. Congress focused on the use of losses in response to the United States Tax Court's 1971 decision in Burke Concrete Accessories, Inc., and discussed the problem of possessions corporations offsetting possession-based losses against income of affiliated domestic corporations by filing consolidated tax returns. See S. Rep. No. 94-938, 94th Cong., 2d Sess. 279 (1976), 1976-3 C.B. (Vol. 3) 317 citing Burke Concrete Accessories, Inc., 56 T.C. 588 (1971).

In Burke Concrete, the Tax Court held that a corporation with a net operating loss, which qualified as both a section 931 possessions corporation and a section 921 Western Hemisphere Trade Corporation, properly joined in a consolidated return filed by its affiliated group. 56 T.C. 588 (1971). The Tax Court focused on whether the possessions corporation was an "includible corporation," defined in Code section 1504(b) as any corporation except "[c]orporations entitled to the benefits of section 931, by reason of receiving a large percentage of their income from sources within possessions of the United States."¹ In applying a literal definition of "benefit," the Tax Court determined that since the possessions corporation incurred operating losses, it could not benefit from the credit provisions of section 931 as it had no income to which the credit applied, regardless of the fact the corporation met the requirements of section 931 and was excluded from the definition of "includible corporation" under section 1504(b)(4). 56 T.C. at 591.

In response to the Tax Court's ruling in Burke Concrete, Congress expressed its concern that possessions corporations entitled to tax-free income should not derive an additional tax benefit by being permitted to offset their losses against taxable earnings of affiliated corporations.

A corporation which is entitled to the benefits of the special possessions corporation exclusion may not participate in the filing of a consolidated return. However, the courts have determined that possessions corporations may join in filing consolidated returns in years in which they incur losses [footnote omitted]. As a result, these corporations can in effect gain a double benefit. Not only is the

¹ The language of Code section 1504(b)(4) cited by the Tax Court in Burke Concrete was amended in 1976 by P.L. 94-455 to read the following, "[I]ncludible corporation means any corporation except - . . . (4) Corporations with respect to which an election under section 936 (relating to possession tax credit) is in effect for the taxable year." Tax Reform Act of 1976, Pub. L. No. 94-455, § 803(b)(3), 90 STAT. 1520, 1584.

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possessions and other foreign source income of these corporations excluded from U.S. taxable income, but losses of possessions corporations can, by filing a consolidated return, reduce U.S. tax on the U.S. income of related corporations in the consolidated group.

S. Rep. No. 94-938 at 279, 1976-3 C.B. at 317 (citing Burke Concrete Accessories, Inc., 56 T.C. 588 (T.C. 1971)), acq., 1973-2 C.B. 1.²

In response to the Tax Court's ruling in Burke Concrete, Congress curtailed the ability of a possessions corporation to join in a consolidated return once it had elected the U.S. tax credit under section 936(a).

The [Senate Finance] [C]ommittee believes that it is appropriate to allow the losses of a possessions corporation to reduce U.S. tax on other income by filing a consolidated return only in the case of initial or start-up losses of [sic] possessions corporation just beginning its possession operations. Moreover, even in the case of start-up losses the committee believes that these losses should be recaptured if in a later year foreign source income is derived Accordingly, the committee's amendment provides that a possessions corporation must make an election to obtain the benefits of possessions corporation status and that after this election the corporation is ineligible to join in filing a consolidated return for a period of ten years [footnote omitted].

S. Rep. No. 94-938 at 279 (emphasis added), 1976-3 C.B. at 317.

To further restrict the potential for double benefits, Congress explicitly limited a section 936 possessions corporation's ability to revoke its election within the first ten years, except in cases of substantial hardship where no tax avoidance could result.

In order to receive the benefits of the section 936 tax credit, a corporation must make an election at the time and in the manner as the Secretary prescribes by regulations. Once the election is made, the domestic corporation cannot join in a consolidated return with other related taxpayers. The election is to remain in effect for nine taxable years after the first year for which the election was effective

² Although the Service ultimately acquiesced in the Burke Concrete holding and reversed its position through Rev. Rul. 73-498, 1973-2 C.B. 316, both the Burke Concrete holding and the subsequent revenue ruling have been superseded by the enactment of section 936 by the Tax Reform Act of 1976, which deleted reference to Western Hemisphere Trade Corporations under Code section 921 for taxable years beginning after 1979.

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and for which the domestic corporation satisfied the 80 percent possession source income and 50 percent active trade or business income requirements. However, the election may be revoked before the expiration of the 10-year period with the consent of the Secretary. It is contemplated that consent will be given only in cases of substantial hardship where no tax avoidance can result from the revocation of the election. In determining whether there would be substantial hardship, the Secretary is to take into account changes in business conditions. The election shall remain in effect after the 10-year period unless such domestic corporation revokes such election

S. Rep. No. 94-938 at 281 (emphasis added), 1976-3 C.B. at 319.

Additionally, we note that the United States Claims Court has recognized Congress' legislative response to the Burke Concrete decision, in limiting the ability of affiliated companies on a consolidated return to benefit from losses incurred by a section 931 possessions corporation. See General Elec. Co. v. United States, 3 Cl. Ct. 289 (1983) (stating, "The firm legislative response to Burke [Concrete] suggests that Congress intended 931 corporations to offset losses only against their own income and not to use those losses to reduce the tax burden of related entities").

CONCLUSION:

The legislative history discussed above expresses Congress' concerns regarding abuses when taxpayers accumulate tax attributes within the first ten years of a section 936(a) election, and, by revoking the section 936(a) election, then seek to apply such tax attributes to produce a double benefit on a U.S. tax return. Taxpayers could, even under current law, then reelect section 936(a) possessions treatment in a subsequent year. In situations where Congress' concerns are evident, the District Director generally should refuse to consent to a revocation request. Such situations may include, for example, instances where a section 936 possessions corporation has accrued tax attributes or expenses including, but not limited to, accumulated losses, current operating losses, built-in losses or deductions during the period for which its section 936(a) election was in effect. However, in certain cases, it is within the District Director's discretion to consider whether revocation may be otherwise appropriate. In such cases where tax attributes or expenses are present and the District Director determines that consent to revoke may be appropriate, the District Director may consider entering into an agreement with the taxpayer whereby, for example, tax attributes or expenses accrued during the period for which its 936 election was in effect are eliminated and are ineligible for use on any tax return.

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

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