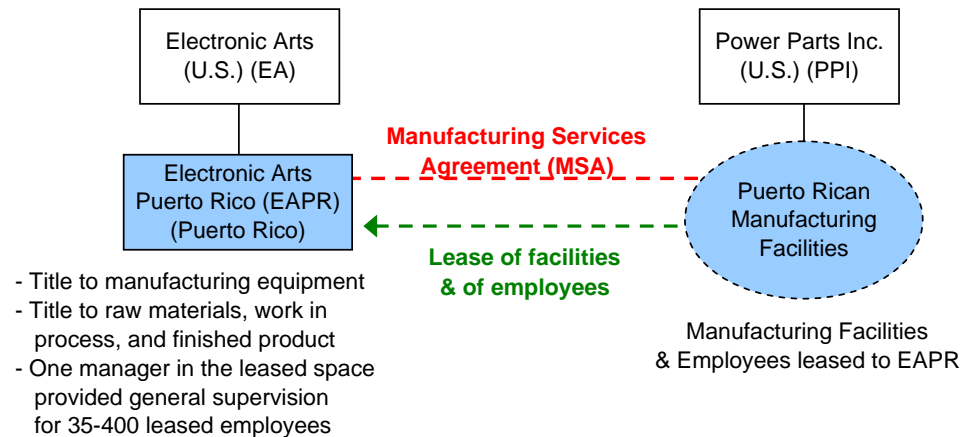


# Electronic Arts v. Commissioner 118 T.C. 226 (2002)

## Contract Manufacturing in Puerto Rico

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The case was before the Tax Court as a motion for partial summary judgment. The first issue was whether EAPR met the "active conduct of a trade or business" in Puerto Rico requirement under Code § 936(a)(2)(B). For this issue, the Tax Court held for the taxpayer. The second issue was whether EAPR had a significant business presence in Puerto Rico so as to entitle EAPR to elect to use the profit split method. The Tax Court provided the statutory setting as follows:

If a possessions corporation has "intangible property income", then that income is generally treated as income of the possessions corporation's shareholders, in accordance with rules set forth in section 936(h). However, a possessions corporation may "elect out" under section 936(h)(5) and choose to compute its relevant taxable income under one of the methods described in section 936(h)(5)(C) --the cost sharing method or the profit split method --but only if the possessions corporation "has a significant business presence" in a possession. Sec. 936(h)(5)(B)(i). Section 936(h)(5)(B)(ii) provides that a possessions corporation "has a 'significant business presence' in a possession if the corporation satisfies any one of three statutory tests. . . . However, the final flush language of section 936(h)(5)(B)(ii) provides that, if the possessions corporation claims the profit split method with respect to a product that the possessions corporation produces in whole or in part in the possession, then the possessions corporation does not have a significant business presence in that possession unless such product is manufactured or produced in the possession by the electing corporation within the meaning of subsection (d)(1)(A) of section 954.

The Tax Court stated that "the only bone of contention on this issue [is] whether EAPR satisfies the requirement that the video games were 'manufactured or produced' in Puerto Rico 'by' EAPR 'within the meaning of subsection (d)(1)(A) of section 954.'" A particularly complicating factor in the case was the overlap of Code § 936 and § 954. The Tax Court stated the IRS "urges us to rely on section 1.936-5(b)(6), Q&A-1, Income Tax Regs. Petitioners urge us to rely on section 1.954-3(a)(4), Income Tax Regs. . . . [W]e reject petitioners' thesis, that we follow regulations numbered 1.954 and ignore regulations numbered 1.936." In summarizing its conclusions, the Tax Court stated "we conclude that proper evaluation of the merits of the instant cases requires a fuller development of the facts and perhaps a fuller exposition of the law."

The Tax Court stated "petitioners' focus on certain language in section 1.954-3(a)(4), Income Tax Regs., overlooks the regulation's requirement that various actions have been done 'by' the corporation being evaluated" and "that petitioners failed to consider the 'by such corporation' language of section 1.954-3(a)(4)(i), Income Tax Regs." A review of Treas. Reg. § 1.954-3(a)(4)(i) could lead some to believe that "manufacturing" is the only thing that needs to be done "by" the corporation. Further, Treas. Reg. § 1.954-3(a)(4)(i) appears to "deem" certain transactions to be considered manufacturing. Treas. Reg. § 1.954-3(a)(4)(i) provides:

A foreign corporation will be considered . . . to have manufactured . . . property which it sells if the property sold is in effect not the property which it purchased. . . . [T]he property sold will be considered . . . as not being the property which is purchased [if . . . [the] property is substantially transformed prior to sale]."

This straightforward language makes one wonder whether the Tax Court would have felt the same if there were no Code § 936 overlay. It is difficult for some to understand how the regulation quoted above could be interpreted in any way other than treating a corporation as having manufactured product where "the property sold is in effect not the property which it purchased."

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