

FIRST CIRCUIT HOLDS CORPORATION'S POSSESSIONS TAX CREDIT WAS NOT REDUCED

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Tags
Foreign tax credit
Corporate tax

Recently, the First Circuit held that Code §936 does not require a credit cap decrease for the U.S. seller of business lines in Puerto Rico if the buyer is a foreign entity that does not pay U.S. corporate income tax. In *OMJ Pharmaceuticals, Inc. v. U.S.*,¹⁵ a U.S. corporation based in Puerto Rico transferred a significant portion of its assets to an Irish subsidiary; the corporation was not required to decrease its base period income for the purposes of computing the cap on its Section 936 possessions tax credit. As a result, the corporation's credit was not capped at the lower amount that was asserted by the I.R.S., thus allowing the corporate taxpayer a refund of close to \$53 million.

From 1976 to 1996, Code §936 provided to U.S. corporations a credit that fully offset the federal tax owed on income earned in the operation of any trade or business in Puerto Rico. Under the Small Business Job Protection Act of 1996 (P.L. 104-188), the credit was repealed and phased out over a ten-year period. During this transition period, the credit remained available only to those taxpayers who had claimed it in previous years. Furthermore, during the last eight years of the transition period the taxable income that an eligible taxpayer could take into account in computing its credit was capped at an amount roughly equal to the average of the amounts it had claimed in previous years. Although the cap was generally fixed, it could be adjusted up and down to account for the taxpayer's purchases and sales of lines of business that had generated credit-eligible income.

Code §936 provides that rules for computing research credits when there are acquisitions or dispositions similar to those in subparagraphs (A) and (B) of Code §41(f)(3) apply here. More specifically, Code §41(f)(3)(A) requires an increase in the amount of qualified research expenses and gross receipts (*i.e.*, a cap increase) when a taxpayer acquires a major portion of a trade or business, and Code §41(f)(3)(B) requires a cap decrease when assets are disposed of in a transaction to which subparagraph (A) applies. Therefore, if, for example, one U.S. corporation sold to a second U.S. corporation assets that accounted for an average of \$1 million in prior year credit claims, then the credit cap for the purchasing corporation would increase by \$1 million and the credit cap for the selling corporation would decrease by the same amount (*i.e.*, \$1 million).

¹⁵

(CA 1 2014) 113 AFTR 2d ¶ 2014-892.

OMJ Pharmaceuticals, Inc. (“OMJ”) was a subsidiary of Johnson & Johnson with its principal place of business in Puerto Rico. From 1993 to 2000, OMJ elected to be treated as a possessions corporation under Code §936, and from 1993 until 1998, it reported and claimed Section 936 credits for its manufacturing operations in Puerto Rico.

In 1998, OMJ transferred some of its assets in certain entities to a wholly-owned subsidiary, OMJ Ireland. The transaction consisted of two steps: first, OMJ transferred some of its assets in each entity to a newly formed L.L.C. (collectively, “the L.L.C.’s”) in exchange for a membership interest; second, it transferred its interests in the L.L.C.’s to OMJ Ireland in exchange for common stock. After the transfers, OMJ still retained a small portion of its assets and continued to manufacture products in Puerto Rico and claim Section 936 credits. Each L.L.C. acquired a plant in Puerto Rico, and OMJ charged the L.L.C.’s for the wages it paid at the plants and for the federal employment taxes it paid.

OMJ argued that when a buyer is not subject to U.S. corporate income tax and therefore has no credit cap to increase or even establish, the Code §41(f)(3)(A) rule is inapplicable. OMJ emphasized the inclusion of the phrase, “in a transaction to which subparagraph (A) applies,” in the text of subparagraph (B). The company reasoned that the seller cap decrease under §41(f)(3)(B) is triggered only if there is a buyer increase under §41(f)(3)(A). Thus, a cap reduction was dependent on the acquiring corporation’s ability to claim an increase in its own cap.

The I.R.S. argued that regardless of whether the purchase of a line of business could increase or establish a credit cap, a seller was required to reduce its own cap by the amount associated with the line of business.

The district court, granting summary judgment for the I.R.S., concluded that OMJ had to decrease its base period income for purposes of computing the cap on its Section 936 possessions tax credit. However, the First Circuit reversed the ruling and adopted a “straightforward” reading of Code §41(f)(3). The opinion noted that if the government’s interpretation of the statute was accepted, a seller-side adjustment would be required any time there was a sale of a trade or business, which would render subparagraph (B)’s cross-reference to subparagraph (A) mere surplusage. Furthermore, the Court determined that its reading of Code §41(f)(3)(A) was supported by unambiguous textual indications elsewhere in Code §41(f)(3).

Looking at the purpose of the statute, it was clear to the Court that Congress’s focus in implementing Code §936(j)(5)(D) was the Puerto Rican economy. In terminating the possessions tax regime, Congress intended to provide a transition period during which pre-existing credits for existing lines of business would generally remain viable, neither increasing nor decreasing. Code §936 furthered this goal by ensuring that any increases in caps on the buyer’s side would be offset by decreases on the seller’s side, leaving the balance of caps in Puerto Rico as mostly unaffected as a whole. To have required a decrease in the caps with no corresponding increase would thwart Congress’s objective and marginally decrease the size of the transitional cushion.

Therefore, upon analyzing the Code section, the Court rationalized that the language, structure, purpose, and history of the rules point to the conclusion that a reduction in a seller’s cap as a result of the sale of a business line is appropriate only in the event of a corresponding increase in the buyer’s cap. As there was no claim here that the transaction increased or could have increased any credit cap

attributed to OMJ Ireland or its subsidiaries, since it was not a U.S. taxpayer, the transfers did not reduce OMJ's credit cap.

