MedChem (P. R.), Inc. v. Commissioner, 116 T. C. 308 (2001)

In MedChem (P. R.), Inc. v. Commissioner, the U. S. Tax Court ruled that MedChem (P. R.), Inc. did not qualify for a tax credit under IRC Section 936 because it failed to actively conduct a trade or business in Puerto Rico. The court found that MedChem (P. R.) did not participate regularly, continually, extensively, and actively in the management and operation of the Avitene manufacturing business, despite outsourcing production to Alcon P. R. This decision clarifies the requirements for the active conduct of a trade or business in U. S. possessions for tax credit eligibility.

Parties

MedChem (P. R.), Inc. and MedChem Products, Inc. were the petitioners, with MedChem (P. R.), Inc. initially filing as a wholly owned subsidiary of MedChem Products, Inc. The Commissioner of Internal Revenue was the respondent. The case was heard in the U. S. Tax Court.

Facts

MedChem Products, Inc. (MedChem U. S. A.) is a Massachusetts corporation that acquired the Avitene business from Alcon Puerto Rico Inc. (Alcon P. R.) and related entities on December 18, 1987. MedChem (P. R.), Inc. , a wholly owned subsidiary of MedChem U. S. A. , was established to facilitate the transaction. Under the agreements, Alcon P. R. continued to manufacture Avitene, a blood clotting drug, using MedChem (P. R.)'s raw materials and equipment in its Puerto Rico facility. MedChem (P. R.) had no employees after June 30, 1990, and all its officers and directors were also officers and/or directors of MedChem U. S. A. , based in Woburn, Massachusetts. MedChem (P. R.) attempted to build its own manufacturing facility in Puerto Rico but abandoned the project following financial difficulties related to another product, Amvisc, and moved the Avitene manufacturing process to MedChem U. S. A. 's facility in Woburn.

Procedural History

The Commissioner determined deficiencies in MedChem (P. R.), Inc. 's and MedChem Products, Inc. 's federal income taxes for the fiscal year ending August 31, 1992, asserting that MedChem (P. R.), Inc. did not meet the requirements for the Puerto Rico and possession tax credit under IRC Section 936. The cases were submitted to the U. S. Tax Court without trial and were consolidated. The standard of review applied was de novo, with the burden of proof on the petitioners.

Issue(s)

Whether MedChem (P. R.), Inc. met the "active conduct of a trade or business within a possession" requirement of IRC Section 936(a)(2)(B) by virtue of the activities of Alcon P. R. in Puerto Rico, the use of MedChem (P. R.)'s raw materials and equipment, the continuous ownership of raw materials by MedChem (P. R.),

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and the payment of labor costs to MedChem U. S. A. and Alcon P. R. ?

Rule(s) of Law

IRC Section 936(a) allows a domestic corporation to claim a tax credit for its income derived from sources within a U. S. possession, provided it meets certain conditions. Specifically, Section 936(a)(2)(B) requires that 75 percent or more of the corporation's gross income for the 3-year period immediately preceding the close of the taxable year be derived from the active conduct of a trade or business within a U. S. possession.

Holding

The U. S. Tax Court held that MedChem (P. R.), Inc. did not meet the "active conduct of a trade or business within a possession" requirement of IRC Section 936(a)(2)(B). The court found that MedChem (P. R.), Inc. did not participate regularly, continually, extensively, and actively in the management and operation of a profit-motivated activity in Puerto Rico.

Reasoning

The court analyzed the phrase "active conduct of a trade or business" by reference to the Secretary's definitions of similar phrases for other purposes of the Internal Revenue Code and the legislative history of Section 936. The court determined that to qualify for the tax credit, a taxpayer must participate meaningfully in the management and operation of a profit-motivated activity in the possession, and that the services underlying a manufacturing contract may be imputed to a taxpayer only to the extent that they are adequately supervised by the taxpayer's own employees. The court found that MedChem (P. R.), Inc. 's involvement in Puerto Rico was minimal, with no operational or directional control over the Avitene business, which was directed by Alcon P. R. and MedChem U. S. A. The court rejected MedChem (P. R.), Inc. 's argument that it actively conducted a trade or business in Puerto Rico based on its ownership of raw materials and equipment and the use of a contract manufacturer.

Disposition

The court decided that decisions would be entered under Rule 155, indicating that the case would proceed to a computation of the tax deficiencies owed by MedChem (P. R.), Inc. and MedChem Products, Inc.

Significance/Impact

The MedChem (P. R.), Inc. case is significant for clarifying the requirements for the active conduct of a trade or business in a U. S. possession under IRC Section 936. The decision underscores that mere ownership of assets used in a business or the use of a contract manufacturer is insufficient to meet the active conduct

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requirement. This ruling impacts how corporations structure their operations in U. S. possessions to qualify for tax incentives and has implications for tax planning and compliance in such jurisdictions. The case also highlights the importance of substantial involvement in the management and operation of the business within the possession to claim the tax credit.

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