Electronic Arts, Inc. & Subs. v. Comm'r, 118 T. C. 226 (2002), United States Tax Court, 2002.

The U. S. Tax Court ruled that Electronic Arts Puerto Rico, Inc. (EAPR) actively conducted a trade or business in Puerto Rico, qualifying for possessions tax credits under section 936. However, the court denied EAPR's use of the profit split method due to insufficient proof of manufacturing the video games in Puerto Rico, impacting the eligibility for tax benefits related to intangible property income.

Parties

Plaintiff: Electronic Arts, Inc. and Subsidiaries (EA), Electronic Arts Puerto Rico, Inc. (EAPR), both Delaware corporations, initially at trial and on appeal.

Defendant: Commissioner of Internal Revenue, respondent at trial and on appeal.

Facts

EA developed and marketed interactive entertainment software. Before the years in issue, EA relied on unrelated manufacturers in Taiwan and Japan. In 1992, EA established EAPR to move manufacturing operations to Puerto Rico. EAPR entered into agreements with Power Parts, Inc. (PPI), leasing space, employees, and purchasing equipment, raw materials, and components from unrelated suppliers. EAPR sold the manufactured video games to EA. EAPR employed a manager who supervised PPI's employees and managed materials and inventory control in Puerto Rico.

Procedural History

EA and EAPR moved for partial summary judgment in the U. S. Tax Court, asserting entitlement to possessions tax credits under section 936. They contended that EAPR actively conducted a trade or business in Puerto Rico and maintained a significant business presence, allowing them to use the profit split method. The Tax Court granted partial summary judgment on the active conduct issue but denied it on the profit split method issue, finding genuine material factual disputes regarding EAPR's role as the manufacturer of the video games.

Issue(s)

Whether EAPR was engaged in the active conduct of a trade or business in Puerto Rico under section 936(a)(2)(B), and whether EAPR had a significant business presence in Puerto Rico to use the profit split method under section 936(h)(5)(B)?

Rule(s) of Law

Section 936(a)(2)(B) requires that at least 75% of the corporation's gross income be derived from the active conduct of a trade or business within a U. S. possession.

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Section 936(h)(5)(B) allows an election out of certain intangible property income rules if the corporation has a significant business presence in the possession, defined by specific tests including manufacturing within the meaning of section 954(d)(1)(A).

Holding

The Tax Court held that EAPR was engaged in the active conduct of a trade or business in Puerto Rico, thus qualifying for possessions tax credits under section 936(a)(2)(B). However, the court denied EAPR's motion for partial summary judgment on the issue of significant business presence under section 936(h)(5)(B), finding that EAPR failed to show it manufactured the video games in Puerto Rico within the meaning of section 954(d)(1)(A).

Reasoning

The court's reasoning on the active conduct issue relied on precedents such as *MedChem (P. R.), Inc. v. Commissioner* and Western Hemisphere Trading Corporation cases, concluding that EAPR's activities in Puerto Rico, including ownership of equipment and materials, leasing of space, and supervision by its manager, satisfied the active conduct test. The court rejected the Commissioner's argument against attribution of activities to EAPR, emphasizing that the facts were sufficient to establish active conduct.

On the significant business presence issue, the court analyzed the legislative history of section 936(h) and section 954(d)(1)(A), concluding that EAPR met the first prong of the test by satisfying the direct labor test. However, the court found genuine disputes over whether EAPR was the manufacturer of the video games under the second prong, requiring further factual development before determining eligibility for the profit split method.

Disposition

The Tax Court granted EA and EAPR's motion for partial summary judgment on the active conduct issue but denied it on the significant business presence issue related to the profit split method.

Significance/Impact

The decision clarifies the criteria for qualifying for possessions tax credits under section 936, particularly emphasizing the requirement for active conduct of a trade or business in a U. S. possession. It also highlights the complexities of proving manufacturing within the meaning of section 954(d)(1)(A) for tax purposes, impacting how corporations structure operations in U. S. possessions to maximize tax benefits. The ruling has implications for other corporations seeking similar tax credits, underscoring the need for a substantial business presence and active involvement in the manufacturing process.

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