

Instructions for Form 5735



Department of the Treasury
Internal Revenue Service

(Rev. April 2003)

Possessions Corporation Tax Credit (Under Sections 936 and 30A)

Section references are to the Internal Revenue Code, unless otherwise noted.

A Change To Note

The "Caution" on line 11 has been updated to reflect the transition rules of sections 936(j)(2) and (3).

General Instructions

Purpose of Form

Form 5735 is used to figure the possessions corporation tax credit under section 936 (or section 30A, if applicable). The credit is generally allowed against income tax imposed by Chapter 1 (see page 2 for exceptions) and is figured separately for each possession. For purposes of the credit, U.S. possessions include Puerto Rico, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands. Special rules apply to existing credit claimants (defined below) from Puerto Rico, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (see below).

Who Must File

A domestic corporation (other than an S corporation) that is an existing credit claimant (defined below) must complete Form 5735 for each year the possessions credit election is in effect.

Where To File

Attach Form 5735 to the corporation's income tax return and file the return with the Internal Revenue Service Center, Philadelphia, PA 19255.

Existing Credit Claimant

A corporation is an existing credit claimant with respect to a possession if the corporation:

1. Was engaged in the active conduct of a trade or business within the possession on October 13, 1995 **and**
2. Elected the benefits of the possessions credit, effective for its taxable year that includes October 13, 1995.

The determination of whether a taxpayer is an existing credit claimant is made separately for each possession. A corporation that acquires all of the assets of a trade or business of an existing credit claimant will qualify as an existing credit claimant.

Binding contract exception. For purposes of these rules, a corporation is treated as engaged in the active conduct of a trade or business within a possession on October 13, 1995, if the corporation had in effect on that date, and at all times thereafter, a binding contract for the acquisition of assets to be used in, or the sale of property to be produced from, that trade or business.

Substantial new line of business. A corporation that adds a substantial new line of business or that has a new

line of business that becomes substantial, ceases to be an existing credit claimant at the beginning of the tax year in which (a) it added the new line of business or (b) the new line of business becomes substantial. For details, see Regulations section 1.936-11.

Special Rules for Certain Possessions

Puerto Rico

An existing credit claimant with respect to Puerto Rico that is using the economic activity limitation figures its credit for income from Puerto Rico separately under section 30A. Generally, the provisions of section 936 apply for purposes of figuring the credit under section 30A. See section 30A(e) for more information.

Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands

For tax years beginning before January 1, 2006, the amendments made by the Small Business Job Protection Act of 1996 do not apply to existing credit claimants with respect to Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. Existing credit claimants may figure the credit with respect to those possessions (including the credit for qualified possession source investment income (QPSII)), using section 936 (as in effect before the 1996 Act). See section 936(j)(8).

Qualifying for the Credit

To qualify for the possessions corporation tax credit, a corporation must meet **all three** of the following requirements:

1. The corporation must have filed a valid **Form 5712**, Election to Be Treated as a Possessions Corporation Under Section 936, by the due date (including extensions) of the first return to which the election applies. In addition, the corporation must qualify as an existing credit claimant (see definition above).
2. The corporation must have derived 80% or more of its gross income from sources in a U.S. possession during the applicable period (defined in the instructions for Part I) immediately before the tax year ended.
3. The corporation must have derived 75% or more of its gross income from the active conduct of a trade or business in a U.S. possession during the applicable period immediately before the tax year ended.

Restrictions

The credit is not allowed against the following taxes:

1. Tax on accumulated earnings (section 531).
2. Personal holding company tax (section 541).

3. Additional tax for recovery of foreign expropriation losses (section 1351).

4. Recapture of investment credit (section 50).

5. Recapture of low-income housing credit (section 42(j)(4)(D)).

6. Recapture of Indian employment credit (section 45A).

IC-DISC or FSC

A corporation cannot take the possessions corporation tax credit for any tax year it is an IC-DISC or former IC-DISC, or for any tax year in which it owns stock in an IC-DISC or FSC, or former IC-DISC or former FSC (section 936(f)).

Alternative Minimum Tax

Income eligible for the possessions corporation tax credit is not taxed under the alternative minimum tax rules. See **Form 4626**, Alternative Minimum Tax—Corporations.

Foreign Tax Credit/Deduction

Generally, the corporation cannot take a deduction (however, see the instructions for Part V) or foreign tax credit for taxes it paid or accrued to a foreign country or U.S. possession if any of the income on which those taxes were paid or accrued is used in computing the possessions corporation tax credit.

Other Forms and Schedules That May Be Required

Form 5712-A. Use **Form 5712-A**, Election and Verification of the Cost Sharing or Profit Split Method Under Section 936(h)(5), to show that the corporation has a significant business presence in the U.S. possession for the tax year, and to elect either the cost sharing or profit split method of computing taxable income from certain possession products. Attach Form 5712-A to Form 5735.

Schedule P (Form 5735). If the corporation elects to use either the cost sharing or profit split method, it must complete and attach **Schedule P (Form 5735)**, Allocation of Income and Expenses Under Section 936(h)(5), to Form 5735. Attach a separate Schedule P for each product to which the cost sharing or profit split method applies.

Source of Gross Income, etc.

See sections 638, 861-864, and 936 to determine if the source of gross income, deductions, and taxable income is in or outside the United States or in a U.S. possession. Amounts received in the United States may be considered sourced outside the United States if they are from sources outside the United States and received from an unrelated person in the active conduct of a trade or business (section 936(b)).

Specific Instructions

Part I—Gross Income in Applicable Period

Applicable period. The “applicable period” is generally the shorter of 36 months or the period when the

corporation actively conducted a trade or business in a U.S. possession.

Column (f). Include amount(s) reported on line 6, Part II, Schedule(s) P.

Column (i). Gross qualified possession source investment income (QPSII) is gross income that is:

- From sources within a possession of the United States in which a trade or business is actively conducted and
- Attributable to the investment in that possession (for use therein) of funds derived from the active conduct of a trade or business in that possession or from that investment.



Do not enter an amount in column (i) unless the corporation is an existing credit claimant with respect to Guam, American Samoa, or the Commonwealth of the Northern Mariana Islands.

Part II—Taxable Income From Possession Sources



In column B, Part II, enter only QPSII received or accrued by a corporation that is an existing credit claimant with respect to Guam, American Samoa, or the Commonwealth of the Northern Mariana Islands.

Line 6a. Include amount(s) reported on line 6, Part II, Schedule(s) P.

Line 7a. With respect to amounts received in the United States:

- Enter U.S. source income from the active conduct of a trade or business within a U.S. possession that is received from a person who is not a related person.
- Do **not** include foreign source income from the active conduct of a trade or business within a U.S. possession that is received from a person who is **not** a related person. Instead, include these amounts on line 6a, 6b, or 6d, whichever applies.

Line 7c. Enter the amount of marketing intangible property income which is associated with any product(s) subject to the cost sharing method and which is not included in the gross income of a shareholder because such a shareholder is a foreign person or a tax-exempt U.S. person. See Regulations section 1.936-6(a)(5).

Line 8a. If the cost sharing method applies, enter the sum of all cost sharing amounts entered on line 7, Part I, Schedule(s) P.

Line 8b. Include all amounts entered on line 7, Part II, Schedule(s) P. Also include the corporation's other definitely allocable deductions.

Line 8c. Enter the ratable part of deductions that cannot be definitely allocated to qualified income. To obtain this amount, reduce the deductions by the amount entered on line 8b. Multiply this result by the amount obtained when you divide the amount entered on line 7e by the gross income on the corporation's income tax return.

Line 10a. If the corporation sustained a loss for the current year on any category of income for which a separate foreign tax credit limit applies, allocate the loss to the possessions income that qualifies for the credit in proportion to the ratio of that income to total taxable income, excluding the loss.

Line 10b. If the corporation sustained an overall foreign loss in any year, the loss is recaptured in later tax years by treating part of the corporation's taxable income from

sources outside the U.S. as income from sources in the U.S. (section 904(f)).

Line 11. Do not enter more than the corporation's adjusted base period income in column A.

Adjusted base period income is the average of the inflation-adjusted possession incomes of the corporation for each base period year.

Inflation-adjusted possession income is the possession income (as defined in section 936(j)(6)) of the corporation for the base period year, increased by the inflation adjustment percentage (defined in section 936(j)(4)(C)) for the base period year multiplied by the possession income.

Base period year generally means each of three of the corporation's five most recent tax years ending before October 14, 1995, without regard to the tax years with the highest and lowest inflation-adjusted possession incomes. Generally, for purposes of this computation, only years in which the corporation had significant possession income (as defined in section 936(j)(5)(B)(iii)) are taken into account.

Line 12. Corporations that are taking a deduction for possession income taxes (i.e., corporations that have elected the percentage limitation or that use the economic activity limitation **and** the profit split method), enter taxable income without regard to any deduction for possession income taxes.

Part III—Possessions Credit Using the Percentage Limitation Method

Note: *If a corporation is claiming the reduced credit (percentage limitation), the economic-activity limitation (figured in Part IV) does not apply.*

If the corporation made the election to use the percentage limitation in an earlier tax year, it remains in effect for all tax years unless it was revoked before the first tax year beginning in 1997. If the election was revoked, the revocation applies to all subsequent tax years.

The percentage limitation applies only if all possession corporations that are members of an affiliated group make the election. If an election is not in effect for a possession corporation that is a member of an affiliated group, the election for any other group member is revoked for the tax year and subsequent tax years.

For more information, see sections 936(a)(4)(B) and 936(j).

Part IV—Possessions Credit Using the Economic-Activity Limitation Method

Note: *Any wages or other expenses taken into account in determining the possessions credit using the economic-activity limitation of section 30A may not be taken into account in determining the research credit under section 41.*

Line 18. Enter 60% of the sum of:

- The aggregate amount of the possession corporation's qualified possession wages for the tax year and
- The allocable employee fringe benefit expenses of the possession corporation for the tax year.

Qualified possession wages. Qualified possession wages are wages paid or incurred by the possession corporation during the tax year in connection with the active conduct of a trade or business in a U.S. possession to an employee for services performed in that possession, but only if the services are performed while the employee's principal place of employment is in that possession.

The term "wages" generally means wages as defined in section 3306(b), but without regard to any dollar limitation contained in that section. For this purpose, section 3306(b) is applied as if the term "United States" includes all possessions of the United States. See section 936(i)(1)(D)(ii) for a special rule for agricultural labor and railway labor.

The wages that are taken into account for the tax year for any employee are limited to 85% of the old-age, survivors, and disability insurance (OASDI) contribution and benefit base for the calendar year in which that tax year begins. The OASDI contribution and benefit base for 2003 is \$87,000. The amount for future tax years may be found at www.ssa.gov.

Special rules apply to part-time employees and employees whose principal place of employment with the possession corporation is not within the possession at all times during the tax year.

For more information, see section 936(i)(1).

Allocable employee fringe benefit expenses. The total amount of employee fringe benefit expenses taken into account in figuring the economic-activity limitation is the amount deductible by the possession corporation in the tax year for:

- Employer contributions to stock bonus, pensions, profit-sharing, or annuity plans,
- Employer-provided health or accident plan coverage for the employees, and
- The cost of life or disability insurance provided to employees.

Note: *Any amount treated as wages (above) may not be treated as an employee fringe benefit expense.*

The amount of allocable employee fringe benefit expenses for a tax year is equal to the total amount of employee fringe benefit expenses (defined above) multiplied by a fraction. The fraction consists of the possession corporation's qualified possession wages (defined above) for the tax year, divided by the aggregate amount of wages paid or incurred by the possession corporation during the tax year.

The allocable employee fringe benefit expenses cannot exceed 15% of the possession corporation's qualified possession wages for the tax year.

For more information, see section 936(i)(2).

Line 19. Enter the total of the following amounts:

- 15% of the depreciation deduction for short-life qualified tangible property (defined below),
- 40% of the depreciation deduction for medium-life qualified tangible property, and
- 65% of the depreciation deduction for long-life qualified tangible property.

Qualified tangible property means any tangible property used by the possession corporation in a possession of the United States in the active conduct of a trade or business within such possession.

Short-life qualified tangible property is qualified tangible property that is 3-year or 5-year property under section 168.

Medium-life qualified tangible property is qualified tangible property that is 7-year or 10-year property under section 168.

Long-life qualified tangible property is qualified tangible property that is not short-life or medium-life qualified tangible property.

For more information, see section 936(i)(4).

Note: *In the case of any qualified tangible property to which section 168 (as in effect before the date of enactment of the Tax Reform Act of 1986) applies, any references above to section 168 are to that Code section as then in effect.*

For more information on classifying property and figuring the depreciation deduction, see section 168 and the Instructions for **Form 4562**, Depreciation and Amortization.

Line 23. Enter possession income taxes on line 23 only to the extent that they do not exceed 9% of taxable income for the tax year.

For this purpose, possession income taxes are any income, war profits, or excess profits taxes of a possession of the United States that are not taken into account in computing the foreign tax credit. See section 936(i)(3)(C).

Line 24. For more information on figuring possession income taxes allocable to nonsheltered income, see section 936(i)(3).

Part V—Deduction For Possession Income Taxes

Complete Part V to figure the corporation’s deduction for possession income taxes. A corporation may take a deduction for a portion of its possession income taxes if it is **either**:

- A corporation that uses the economic-activity limitation and the profit split method to allocate income from intangible property **or**
- A corporation that claims the percentage limitation (reduced credit).

Note: *In determining the credit or the deduction, taxable income is determined without regard to any deduction for possession income taxes. See section 936(i)(3)(B).*

For this purpose, possession income taxes are any income, war profits, or excess profits taxes of a possession of the United States that are not taken into account in computing the foreign tax credit. See section 936(i)(3)(C).

Part VI—Summary From Schedule P (Form 5735)

The corporation is not required to complete Part VI if it has attached less than 10 Schedules P. Although Part VI information will not affect the corporation’s tax liability, failure to complete this part, if required, will delay the processing of Form 5735.

Line 34. Enter on line 34a the sum of sales of possession products (as reported on line 2, Part I, Schedule(s) P) subject to the cost sharing method. Enter on line 34b the sum of sales of possession products (as reported on line 2, Part I, Schedule(s) P) subject to the profit split method.

Line 35. Enter on lines 35a through 35e the sum of sales of possession products (as reported on line 2, Part I, Schedule(s) P) which have met the listed business presence test. Total sales included on lines 35a through 35e should equal the total of lines 34a and 34b.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	20 hr., 5 min.
Learning about the law or the form	4 hr., 48 min.
Preparing the form	7 hr., 12 min.
Copying, assembling, and sending the form to the IRS	32 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the instructions for the tax return with which this form is filed.
