

# Election and Verification of the Cost Sharing or Profit Split Method Under Section 936(h)(5)

Department of the Treasury  
Internal Revenue Service

▶ **Attach to Schedule P (Form 5735)**

The corporation named below elects under section 936(h)(5) to use the cost sharing or profit split method for income tax purposes.

Name of corporation	Employer identification number
Enter the possession product to which this form relates ▶	SIC code ▶

### Significant Business Presence Tests

**Note:** Corporations engaged in start-up operations in a possession may be able to reduce the percentages computed on lines 3 and 8 below. See the instructions for start-up operations.

#### **Part I** Tests Used To Qualify for Cost Sharing or Profit Split Method

Complete the column and lines that apply for the method you elected and the test you meet.

	Cost Sharing	Profit Split
<b>Direct Labor Test</b>		
1 Possessions corporation's direct labor costs. . . . .		
2 Total direct labor costs of affiliated group. . . . .		
3 Divide line 1 by line 2 . . . . .		
If line 3 is at least 65% (see the instructions for start-up operations for exceptions), you meet the <b>direct labor test</b> and you qualify to use the <b>cost sharing method</b> . To see if you qualify for the <b>profit split method</b> , answer the question on line 18. If line 3 is less than 65%, you do not meet the direct labor test. Complete lines 4 through 8 to see if you qualify under the value added test.		
<b>Value Added Test</b>		
4 Production costs of possessions corporation . . . . .		
5 Gross receipts on sales or dispositions of possession product by the affiliated group to unrelated parties . . . . .		
6 Cost of direct material purchased from unrelated suppliers used in the production of the possession product . . . . .		
7 Subtract line 6 from line 5 . . . . .		
8 Divide line 4 by line 7 . . . . .		
If line 8 is at least 25% (see the instructions for start-up operations for exceptions), you meet the <b>value added test</b> and you qualify to use the <b>cost sharing method</b> . To see if you qualify for the <b>profit split method</b> , answer the question on line 18. If line 8 is less than 25%, you do not meet the value added test. Complete lines 9 through 15 to see if you qualify under the alternative test.		

#### **Part II** Alternative Test Used To Qualify for Cost Sharing or Profit Split Method

9 Direct labor costs of possessions corporation . . . . .		
10 Direct labor costs of affiliated group . . . . .		
11 Divide line 9 by line 10 . . . . .		
If line 11 is at least 50%, go to line 12. If line 11 is less than 50%, you do not meet the alternative test.		
12 Base period construction costs . . . . .		
13 Add lines 9 and 12 . . . . .		
14 Add lines 10 and 12 . . . . .		
15 Divide line 13 by line 14 . . . . .		
If line 15 is at least 70%, you meet the alternative test and you qualify to use the <b>cost sharing method</b> . To see if you qualify for the <b>profit split method</b> , answer the question on line 18. If line 15 is less than 70%, you do not meet the alternative test.		

#### **Part III** Start-up Operations (see instructions)

16 If the corporation is engaged in start-up operations, check this box. . . . .

17 Enter the beginning date of the tax year the possessions corporation began producing the product in the possession . . . . . ▶

#### **Part IV** Other Information

18 If you are claiming the profit split method: Is the possession product manufactured (as defined in Regulations section 1.954-3(a)(4)) in the possession? . . . . .  Yes  No

If "No," you do not qualify to use the profit split method of computing taxable income.

**Note:** Affiliated group members must attach a list showing name, address, and employer identification number of all members of the group.

## Instructions

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

### Purpose of Form

Possession corporations complete Form 5712-A:

- To elect the cost sharing method or the profit split method of computing taxable income for all possession products in a product area (see **SIC Code**, below) and
- To show in subsequent tax years that the corporation continues to have a “significant business presence” (see below) in the possession with regard to the product or product area for that tax year.

Once an election is made, it generally applies for that year and all subsequent tax years, and may be revoked only with the consent of the Commissioner.

**Note:** All members of an affiliated group must consent to the election. See Regulations section 1.936-7(a) for details.

### How To File

Attach Form 5712-A to **Schedule P (Form 5735)**, Allocation of Income and Expenses Under Section 936(h)(5), and file with **Form 5735**, Possessions Corporation Tax Credit (Under Sections 936 and 30A).

### SIC Code

An election to use the cost sharing or profit split method applies to all products in a product area. In the space at the top of the form for “SIC code,” enter the three-digit code for the product or product area for which this Form 5712-A is being filed. See the Standard Industrial Classification Manual for the proper code for the product or product area.

### Significant Business Presence Tests

The possessions corporation must show that it had a significant business presence in the possession for the tax year by meeting one of the tests in Parts I and II. Corporations that use the profit split method must also certify that the possession product was manufactured in the possession.

If the corporation is using the **cost sharing method**, it must meet **one** of the following tests:

- Direct labor test (Part I)
- Value added test (Part II)
- Alternative test (Part II)

If the corporation is using the **profit split method**, it must:

- Meet one of the tests specified above **and**:
- Answer “Yes” to the question on line 18 in Part IV.

### Start-up Operations

Products that were not previously produced (or services that were not previously rendered) in the possession are eligible for a 3-year phase-in of the 65% direct labor test (line 3) and the 25% value added test (line 8), beginning with the year the corporation first starts to sell the product (or provide the service). For more information, see Regulations section 1.936-5(b)(7). The percentages that apply during the phase-in are:

	Year		
	1	2	3
<b>65% Direct labor test</b>	35%	45%	55%
<b>25% Value added test</b>	10%	15%	20%

**Line 3.** Use the applicable percentage from the chart above (instead of 65%).

**Line 8.** Use the applicable percentage from the chart above (instead of 25%).

### Signature

By filing Form 5712-A, the taxpayer declares it has met all requirements for a valid election under section 936(h)(5). All signed consents of its affiliated members will be made available upon request. See Regulations section 1.936-7(a) for more details.



## Definitions

### Possession Product

“Possession product” means an item of property which is the result of a manufacturing process. The term “product” includes component products, integrated products, and end-product forms. An affiliated group may establish reasonable groupings of possession products as a single product. New groupings may be established each year. The Commissioner may disallow any grouping that materially distorts income or the significant business presence test. See Regulations section 1.936-5(a) for more details.

### Direct labor

This is labor associated with units of production. Basic compensation, overtime, holiday and vacation pay, shift differential, payroll taxes, contributions to unemployment benefit plans, and certain types of payments for sick leave are all part of direct labor if they can be associated with production. Direct labor costs are only those costs that are inventoriable under section 471.

### Production costs

These include direct labor costs and fixed and variable indirect production costs. Only those costs that are inventoriable under section 471 are qualified production costs.

### Base period construction costs

These costs are the average construction costs incurred by or on behalf of the possessions corporation for services in the possession during the current and preceding 4 tax years for section 1250 property. This property must be used to manufacture the product or to render the services in the possession, and must represent the original use of the section 1250 property. If the possessions corporation did not exist during any year or years in the base period, the total amount of base period construction costs for such year or years is zero.

### Manufacturing in a Possession

The rules under Regulations section 1.954-3(a)(4) apply in determining if the possession product has been manufactured in a possession. Manufacturing has taken place if:

1. The product has been substantially transformed by the possessions corporation in the possession;
2. Operations performed by the possessions corporation in the possession for the property are substantial and are generally considered to constitute the manufacture or production of property; or
3. Conversion costs incurred by the possessions corporation in the possession, including direct labor, factory burden, testing of components before incorporation into an end product, and testing of the manufactured product before sales, are at least 20% of the total cost of goods sold of the possessions corporation. Packaging, repackaging, labeling, or minor assembly operations do not qualify as manufacturing.

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

- Recordkeeping** . . . . . 5 hr., 15 min.
- Learning about the law or the form** . . . . . 53 min.
- Preparing and sending the form to the IRS** . . . . . 1 hr., 1 min.

If you have any 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.