

LB&I Process Unit

Unit Name	How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020	
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Process Overview

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

NOTE: Treas. Reg. 1.861-17 regarding the allocation and apportionment of R&E expenditures was significantly revised by TD 9922 in November 2020. The regulations under TD 9922 are for tax years beginning after December 31, 2019. However, taxpayers may choose to apply the new regulations to taxable years beginning on or after January 1, 2018, and before January 1, 2020.

This Practice Unit replaces the September 5, 2014, Practice Unit titled “How to Allocate and Apportion Research and Experimental (R&E) Expenses.” The title was modified to clarify that it is applicable to tax years that began before January 1, 2020. No other substantive changes were made to this Practice Unit.

The calculation of the limitation on the use of Foreign Tax Credits (FTCs) under Internal Revenue Code (IRC) 904 requires the calculation of Foreign Source Taxable Income (FSTI) for U.S. tax purposes. The calculation of FSTI requires that certain expenses of the U.S. taxpayer be allocated or apportioned against the taxpayer’s gross foreign source income. The deduction of these allocated and apportioned domestic expenses from foreign source gross income is essential to the proper calculation of the FTC limitation.

Treas. Reg. 1.861-17 requires that a portion of a domestic corporation’s research and experimental (R&E) expenses be allocated or apportioned to foreign source income whenever sales are made or gross income is obtained in foreign countries, even if all of these costs are incurred in the United States. Therefore, when research activities are located in the United States, the regulation often reduces foreign source taxable income for costs that do not reduce the amounts taxed by foreign countries. This may cause the foreign tax credit limitation to be less than the actual taxes imposed by foreign countries, even if U.S. and foreign tax rates are similar.

An affiliated group of corporations must generally apply these regulations, like the other rules on allocating and apportioning deductions, as though all members of the group were one corporation.

The allocation and apportionment of R&E is a multi-step process. Unlike other expenditures, the R&E deduction relates to all classes of income within a broad product category. Thus, the allocation is based on a product category and not on an income type. Also, each step in the apportionment process for R&E under Treas. Reg. 1.861-17 is made up of two or more sub steps, one of which is an exclusive apportionment not based on a mathematical ratio.

Process Overview (cont'd)

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

The regulations describe R&E as an inherently speculative activity that may contribute to unexpected benefits. Therefore, the approach on successful R&E follows the dual premise that gross income from successful R&E must bear the cost of unsuccessful R&E and that the income from current sales of products based on prior R&E pays for current R&E expenses.

This process unit will provide an overview of how to allocate and apportion R&E expenses against foreign source income in the determination of the FTC limitation.



CONSULTATION: Consult the Foreign Tax Credit Business Practice Network (PN) for assistance on Treas. Reg. 1.861-17 issues.

Process Applicability

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

R&E Expenses must be allocated and apportioned.

Criteria	Resources
<ul style="list-style-type: none">▪ The taxpayer claimed foreign tax credits, or a IRC 199 deduction, and also deducted R&E expenses.▪ Domestic production activities deduction – R&E is allocated in computing the allowable deduction.▪ Apportionment of deductions not definitely allocated – this is where R&E is apportioned.▪ The R&E deduction is normally contained in other deductions on the tax return.	<ul style="list-style-type: none">▪ IRC 199▪ Form 1118▪ Form 1120▪ Form 8903▪ Form 1118, Schedule H▪ Form 1120, Line 26

Summary of Process Steps

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

Process Steps

Step 1	Determine allowable R&E expense.
Step 2	Allocate to gross income from broad product categories to which income is definitely related.
Step 3	Reduce by any legally mandated R&E, which is allocated to a specific geographic source, if applicable.
Step 4	Reduce by any exclusive apportionment of R&E expense apportioned to a specific geographic source – (based on fixed percentages).
Step 5	Apportion the balance using either the sales method or one of the gross income methods, based on the election made by the taxpayer.

Step 1

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

Step 1

Determine the R&E expenses to allocate. R&E deductible under IRC 174 is subject to allocation, not IRC 41. R&E allocation applies to expenses in a much broader category than the R&E credit. R&E deductible under IRC 174 includes current R&E and old R&E.

Considerations	Resources
<ul style="list-style-type: none">▪ The R&D allocation includes the following qualifying R&E expenses –<ul style="list-style-type: none">– In the experimental or laboratory sense aimed at discovery of new knowledge.– Cost to develop or improvement of a product.– Cost of making or perfecting a patent application.– Discovery of information that would eliminate uncertainty relating to the development of or improvement of a product.– Expenses paid by the taxpayer or incurred by another on behalf of the taxpayer.– Testing in search for, or evaluation of product or process alternatives.– Design, construction, and testing of pre-product prototypes and models.– Design of tools, jigs, molds, and dies involved in new technology.– Design, construction, and operation of a pilot plant not useful for commercial production.– Engineering activity required to advance the design of a product to the manufacturing stage.	<ul style="list-style-type: none">▪ Treas. Reg. 1.174-2 (defines R&E expenses)▪ IRC 174 expenses are deducted on Form 1120, normally in the “other deductions” on line 26.▪ Review R&E study done to support the R&D credit as this is done to maximize the R&E credit. If no R&E credit is claimed, taxpayer still must apportion against to determine the IRC 904 limitation.

Step 1 (cont'd)

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

[Step 1](#)

Considerations	Resources
<ul style="list-style-type: none">▪ The following activities are not considered R&E:<ul style="list-style-type: none">– Engineering follow-through in an early phase of commercial production.– Quality control during commercial production including routine testing.– Trouble-shooting breakdowns during production.– Routine, on-going efforts to refine, enrich, or improve the qualities of an existing product.– Adaptation of an existing capability to a particular requirement or customer's need.– Periodic design changes to existing products.– Routine design of tools, jigs, molds, and dies.– Activity, including design and construction engineering related to the construction, relocation, rearrangement, or start-up of facilities or equipment.– Legal work on patent applications, sale, licensing, or litigation.	<ul style="list-style-type: none">▪ Treas. Reg. 1.174-2

Step 1 (cont'd)

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

[Step 1](#)

Considerations	Resources
<ul style="list-style-type: none">▪ Treatment of foreign patent maintenance expenses:<ul style="list-style-type: none">– The regulation expressly includes patent perfection within the category of "research or experimental" expenditures. However, costs incurred after the patent has been perfected are costs in the nature of ineligible administrative or other indirect research costs for purposes of the R&E credit. Therefore, foreign patent maintenance expenses should not be included in the R&E allocation and apportionment under Treas. Reg. 1.861-17. The source of these deductions would be dependent upon the factual relationship of the cost to the class of gross income.	<ul style="list-style-type: none">▪ Treas. Reg. 1.174-2(a)(1)

Step 2

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

Step 2

Allocate to gross income from broad product categories to which income is definitely related.

Considerations	Resources
<ul style="list-style-type: none">▪ The general approach used by the regulation provides that R&E expenses:<ul style="list-style-type: none">– Should be allocated by dividing the expense between or among specified product categories.– The R&E expense should be considered definitely related and allocable to all items of gross income as a class, including income from sales, royalties, and dividends related to the product category.▪ R&E not clearly identified to any product category is considered to have been conducted for all product categories. The affiliated group rules apply.	<ul style="list-style-type: none">▪ Treas. Reg. 1.861-17(a)

Step 2 (cont'd)

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

[Step 2](#)

Considerations	Resources
<ul style="list-style-type: none">▪ R&E allocated by dividing them between specific product categories using three digit SIC categories.<ul style="list-style-type: none">– Manufactured products.– Non-manufactured products & services:<ul style="list-style-type: none">– Cannot subdivide Standardized Industrial Classification (SIC) categories.– https://www.osha.gov/pls/imis/sicsearch.html– Income from successful R&E must bear the cost of unsuccessful R&E.– Wholesale/retail trade rule. Products that the wholesale/ retail product categories do not apply if a taxpayer both manufactures and wholesale/ retail products within the same product category.	<ul style="list-style-type: none">▪ Treas. Reg. 1.861-17(a)(2)(ii)▪ Treas. Reg. 1.861-17(a)(2)(iv) and (v)

Step 2 (cont'd)

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

[Step 2](#)

Considerations	Resources
<ul style="list-style-type: none">▪ If subpart F income is in the relevant product category, the subpart F income should not be excluded from the class of gross income related to the product category to which R&E expenses are allocated.▪ Where R&E is conducted with respect to more than one product category, the taxpayer may aggregate the categories for purposes of allocation and apportionment; however, the taxpayer may not subdivide the categories below the three digit category.▪ Where R&E is not clearly identified with any product category (or categories), it will be considered conducted with respect to all the taxpayer's product categories.	<ul style="list-style-type: none">▪ Treas. Reg. 1.861-17(a)(1)▪ Treas. Reg. 1.861-17(a)(2)(i)

Step 3

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

Step 3

The amount to be apportioned must be reduced by any legally mandated R&E, if applicable. Legally mandated R&E is allocated to the specific geographic source (i.e., country) which imposed the applicable legal requirements.

Considerations	Resources
<ul style="list-style-type: none">▪ Legally mandated R&E is only found in very limited circumstances such as for certain U.S. FDA required testing.▪ If the taxpayer claims that R&E expenses were legally mandated, verify that taxpayer has met the very high qualification requirements.	<ul style="list-style-type: none">▪ Treas. Reg. 1.861-17(a)(4)

Step 4

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

Step 4

Reduce by any exclusive apportionment of R&E expense apportioned to a specific geographic source – (based on fixed percentages). If the taxpayer performed more than 50% of its R&E activities in a particular geographic location, the taxpayer may apportion R&E (after being reduced by the amount of legally mandated R&E) to that geographic source.

Considerations	Resources
<ul style="list-style-type: none">▪ If the taxpayer uses the sales method, 50% of such R&E is apportioned to the geographic source; 25% if the taxpayer uses one of the gross income methods.▪ The taxpayer may apportion more than 50% or 25% if the taxpayer demonstrates to the satisfaction of the Commissioner that the research has a very limited or long-delayed application outside that geographic location.	<ul style="list-style-type: none">▪ Treas. Reg. 1.861-17(b)

Step 5

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

Step 5

Apportion the balance under the sales method or one of the gross income methods based on the election made by taxpayer.

Considerations	Resources
<p><u>Sales Method</u></p> <ul style="list-style-type: none">▪ Under the sales method, for each product category, the ratio is: $\frac{\text{Foreign/domestic sales of product category}}{\text{Total sales of product category}}$▪ Foreign sales are determined as follows:<ul style="list-style-type: none">– CFC sales per consolidated schedules.– Foreign disregarded entity sales.– Sales by uncontrolled parties. In example 6 of the regulations which may not apply in all circumstances, sales by uncontrolled foreign licensees were determined at 10X the royalty rate where the actual amounts of sales were not known.– IRC 863(b) foreign source sales.▪ Controlled and uncontrolled party sales are included if those parties can reasonably be expected to benefit from the R&E.	<ul style="list-style-type: none">▪ Treas. Reg. 1.861-17(c)

Step 5 (cont'd)

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

[Step 5](#)

Considerations	Resources
<p><u>Sales Method (Cont'd)</u></p> <ul style="list-style-type: none">▪ Controlled party sales are included if there is an expected benefit:<ul style="list-style-type: none">– Controlled party sales included if they expect to benefit from taxpayer's research connected with the product category.– Benefit can be direct or indirect, through another member of the controlled group.– Controlled corporation reasonably benefits in the following ways:<ul style="list-style-type: none">– Sale, license, or transfer by taxpayer of intangible to that controlled corporation.– Transfer of a secret process to that controlled corporation directly or indirectly through a member of the controlled group.– Sales are counted only once, when products are sold outside of the controlled group to a third party.	<ul style="list-style-type: none">▪ Treas. Reg. 1.861-17(c)(3) ▪ Treas. Reg. 1.861-17(c)(3)(iii)

Step 5 (cont'd)

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

[Step 5](#)

Considerations	Resources
<p><u>Sales Method (Cont'd)</u></p> <ul style="list-style-type: none">▪ Uncontrolled party (U/C) sales are included if there is an expected benefit:<ul style="list-style-type: none">– U/C party sales are included if taxpayer (or a member of taxpayer's controlled group) licensed or sold an intangible to that party and the U/C party can reasonably be expected to benefit directly or indirectly from the taxpayer's R&E if taxpayer or a member of taxpayer's controlled group expects to sell, license or transfer intangible property to that party.– Past experience with R&E is considered in determining reasonable expectations.▪ If the sales method is selected verify that the taxpayer considered sales of the relevant product category of controlled and uncontrolled entities. Sales must be considered even if one of the gross income methods is selected because of the floor on the optional methods on the gross income methods.	<ul style="list-style-type: none">▪ Treas. Reg. 1.861-17(c)(2) ▪ Taxpayer's R&E Expense allocation work-papers▪ Treas. Reg. 1.861-17(d)(2)(i)and(ii)

Step 5 (cont'd)

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

[Step 5](#)

Considerations	Resources
<p><u>Sales Method (Cont'd)</u></p> <ul style="list-style-type: none">▪ Cost Sharing Arrangements<ul style="list-style-type: none">– If the corporation controlled by the taxpayer has entered into a bona fide cost sharing arrangement (CSA), in accordance with the provisions of Treas. Reg. 1.482-7, with the taxpayer for the purpose of developing intangible property, then that corporation shall not reasonably be expected to benefit from the taxpayer's share of the research expense.– When a related foreign entity has a CSA with the parent company, the taxpayer must exclude the sales included in the cost sharing allocation or the sales covered by the CSA of the controlled entity because the foreign entity does not benefit from that share of the research expense.	<ul style="list-style-type: none">▪ FSA 200207012▪ Treas. Reg. 1.482-7▪ Treas. Reg. 1.861-17(c)(3)(iv)

Step 5 (cont'd)

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

[Step 5](#)

Considerations	Resources
<p><u>Sales Method (Cont'd)</u></p> <ul style="list-style-type: none">▪ Cost Sharing Arrangements (cont'd)<ul style="list-style-type: none">– FSA 200207012 states that sales not connected with the taxpayer's CSA should be included in the apportionment calculation.– Review the CSA to determine which projects are covered by the CSAs and determine if the right amount of sales were properly excluded from the R&E apportionment calculation.	<ul style="list-style-type: none">▪ FSA 200207012▪ Treas. Reg. 1.482-7▪ Treas. Reg. 1.861-17(c)(3)(iv)

Step 5 (cont'd)

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

[Step 5](#)

Considerations	Resources
<p><u>Sales Method (Cont'd)</u></p> <ul style="list-style-type: none">▪ Royalties from Uncontrolled Foreign Licensees<ul style="list-style-type: none">– When there are sales by uncontrolled foreign licensees, the sales associated with the royalty payment are included in the numerator/denominator when using the sales method to apportion R&E expenses.– Review the foreign royalties reported to determine if there are royalties from uncontrolled foreign licensees. If there are royalties from uncontrolled licensees, then the taxpayer's sales computation methodology must contain the amount of foreign sales related to the uncontrolled foreign licensees. If the amount of sales are not known, then if the facts support the 10x royalty (10 times the amount of the royalty) maybe used.	<ul style="list-style-type: none">▪ Treas. Reg. 1.861-17(h), Example 6 (iii)

Step 5 (cont'd)

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

Step 5

Considerations	Resources
<p><u>Sales Method (Cont'd)</u></p> <ul style="list-style-type: none">▪ CFC Distributor Sales<ul style="list-style-type: none">– Taxpayer may argue that only foreign affiliates who manufacturer would have benefited from the taxpayer's R&E, and therefore only sales from manufacturing CFCs, not distributors CFCs, should be included in the R&E apportionment calculation. The taxpayer's position is that distributors did not benefit from the R&E. Review of the sales by CFC included in the taxpayer's R&E allocation and apportionment work-papers will show which CFC's were included in the apportionment calculation and which CFC's were not.– FSA 199918027 determined that nonmanufacturing CFCs should be considered in Taxpayer's gross sales method computation. The FSA further states that the fact that Taxpayer did not formally transfer any intangible property to the CFCs does not affect these conclusions and the regulation applies to stated as well as unstated transfers of intangibles to controlled corporations.– Review Forms 5471 to determine if the CFC distributors were included as foreign sales in the taxpayer's R&E allocation work-papers. Worldwide sales can also be reconciled by regions in the financial statements and annual reports.	<ul style="list-style-type: none">▪ FSA 199918027▪ Treas. Reg. 1.861-17(a)(1) ▪ Treas. Reg. 1.861-17(c)(3)▪ Form 5471, Schedule M▪ Form 926 (Return by a US Transferor of Property to a Foreign Corporation), Part III

Step 5 (cont'd)

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

[Step 5](#)

Considerations	Resources
<p><u>Sales Method (Cont'd)</u></p> <ul style="list-style-type: none">▪ CFC Distributor Sales (cont'd)<ul style="list-style-type: none">– Applications of the R&E allocation and apportionment rules are highly fact specific. The rules recognize that R&E is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful R&E must bear the cost of unsuccessful R&E. The CFC sales should be included in the apportionment calculation if a corporation can reasonably be expected to benefit directly or indirectly (through another member of the controlled group of corporations to which taxpayer belongs) from the taxpayer's research expense connected with the product category or categories.– Sales of controlled corporations that receives technology as a contribution to capital are included because the technology was transferred to the controlled corporation. Review Forms 926 for transfers of technology.	<ul style="list-style-type: none">▪ FSA 199918027▪ Treas. Reg. 1.861-17(a)(1)▪ Treas. Reg. 1.861-17(c)(3)▪ Form 5471, Schedule M▪ Form 926 (Return by a US Transferor of Property to a Foreign Corporation), Part III

Step 5 (cont'd)

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

Step 5

Considerations	Resources
<p><u>Gross Income Methods</u></p> <p>There are two options within the gross income method.</p> <ul style="list-style-type: none">▪ Optional method one<ul style="list-style-type: none">– R&E may be apportioned ratably between the statutory (foreign) grouping and the residual (domestic) grouping of gross income on the basis of gross income. The gross income must relate to the product category.– “Not less than 50% test” must be met:<ul style="list-style-type: none">▪ R&E apportioned under this method must not be less than 50% of what the sales method would be for each of the following:<ol style="list-style-type: none">1. Statutory grouping – foreign source income.2. Residual grouping – domestic source income.▪ Optional method two:<ul style="list-style-type: none">– Optional method two is used when the 50% test in optional method one is not met.– Floor adjustment is made – 50% of the amount that would have been apportioned using the sales method (for either statutory or residual grouping, depending on which one failed the test). The remainder is then apportioned to the other grouping.	<ul style="list-style-type: none">▪ Treas. Reg. 1.861-17(d)(1)(i)▪ Treas. Reg. 1.861-17(d)(2) ▪ Treas. Reg. 1.861-17(d)(3)

Step 5 (cont'd)

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

[Step 5](#)

Considerations	Resources
<p><u>Gross Income Methods (cont'd)</u></p> <ul style="list-style-type: none">▪ Gross income includes sales, services, royalties, dividends, subpart F inclusions, and any other income relating to the product category. Interest income is not included in gross income unless it is interest from financed sales and services relating to the product category. Foreign income includes foreign dividends, royalties, interest, 863(b) income, other sources of foreign income and gross profit from foreign disregarded entities and foreign branches relating to the product category.▪ Separate computations are not made for different product categories▪ Gross income from controlled or uncontrolled parties are not considered.▪ Subpart F Income: Review the deemed dividends reported on Form 1118, Schedule A, lines 2(b) and 3(b) to determine if these dividends are reported as gross income when using the gross income method. Subpart F dividends are included in the gross income computation if this income is reasonably connected to the relevant broad product category or categories.	<ul style="list-style-type: none">▪ Treas. Reg. 1.861-17(a)(2) ▪ R&E expense A&A workpapers▪ Form 1118, Schedule A▪ Treas. Reg. 1.861-17(a)(1)

Other Considerations / Impact to Audit

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

Considerations	Resources
<p><u>Partnerships</u></p> <ul style="list-style-type: none"> ▪ R&E expense should include the distributive share of any R&E performed by the partnership. ▪ If less than 10% interest, use the equity interest in the partnership. ▪ The distributive share of partnership sales or gross income from the product category should be included in the R&E allocation and apportionment relating to the method chosen. ▪ Foreign partners ECI from the partnership is reduced by the same-SIC-code R&E, regardless of where incurred. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.199-4(d)(3) ▪ There are special rules for partnerships. Treas. Reg. 1.861-17(f)
<p><u>IRC 199 and FTC Apportionment</u></p> <ul style="list-style-type: none"> ▪ There is no exclusive apportionment for IRC 199 calculations and no geographic apportionment (i.e., the 25% reduction for gross income methods or 50% reduction for gross income method) for IRC 199 calculations. ▪ Taxpayer must use the same apportionment method, either the sales method or one of the gross income methods, for all purposes of the Code including IRC 199 and the foreign tax credit limitation of IRC 904. Accordingly, if the taxpayer used the sales method for FTC purposes, the taxpayer must use the sales method for IRC purposes. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.199-4(d)(3) ▪ Treas. Reg. 1.199-4(d)(1)
<ul style="list-style-type: none"> ▪ There is a five year binding election of the apportionment method chosen. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.861-17(e)

Other Considerations / Impact to Audit (cont'd)

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

Considerations	Resources
<p><u>Subpart F Income</u></p> <ul style="list-style-type: none"> ▪ If the subpart F dividend income is in the relevant product category, the subpart F dividend income should not be excluded from the class of gross income to which R&E expenses are allocated. ▪ Review the deemed dividends reported on Form 1118, Schedule A, lines 2(b) and 3(b) to determine if these dividends are reported as gross income when using the gross income method. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.861-17(a)(1) includes dividend income ▪ Form 1118, Schedule A
<p><u>Cost Sharing</u></p> <ul style="list-style-type: none"> ▪ If there is a bona fide CSA per the provisions of Treas. Reg. 1.482-7 and Treas. Reg. 1.861-17(c)(3)(iv), then the controlled corporation shall not be expected to benefit from the taxpayer's share of R&E and its sales or gross income is not included in the R&E apportionment. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-7 ▪ Treas. Reg. 1.861-17(c)(3)(iv)
<p><u>Wholesale/Retail Trade Rule:</u></p> <ul style="list-style-type: none"> ▪ The Wholesale/Retail Trade Rules provisions of Treas. Reg. 1.861-17(a)(2)(iv) and (v), respectively, is illustrated in Example 4 of Treas. Reg. 1.861-17(h). That example shows that taxpayers that both manufacture and wholesale (or retail) products in the same product category may not separate their manufacturing gross income from their wholesale (or retail) gross income that they then must allocate and apportion their R&E solely to the combined gross income. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.861-17(a)(2)(iv) and (v) ▪ Treas. Reg. 1.861-17(h), Example 4

Other Considerations / Impact to Audit (cont'd)

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

Considerations	Resources
<p><u>Audit Tips</u></p> <ul style="list-style-type: none"> ▪ Determine if there are any foreign items in the denominator, but not in the numerator. ▪ Compare the numerator (foreign sales/gross income) with the denominator (total sales/gross income). ▪ Compare the R&E expense to audited financial statements (F/S) amounts. ▪ Request reconciliation of R&E expenses by subsidiary to the tax return. This may help in showing what is included and excluded. ▪ Request in an Information Document Request (IDR) the calculations of the following components: <ul style="list-style-type: none"> – Computation of the R&E expense within the product category (or categories). The R&E expense summary should show the total R&E expense and any amounts excluded as non- R&E expenses. – Legally mandated R&E. – Amount of R&E exclusively apportioned. – The numerator of the apportionment fraction (foreign sales or gross income). – The denominator of the apportionment fraction (total sales or gross income). ▪ Credit for Increasing Research Activities - The TP may seek to maximize the R&E for purposes of claiming an R&E credit. The R&E claimed of Form 6765 should be compared to the R&E expense used in the allocation and apportionment calculation. 	<ul style="list-style-type: none"> ▪ Form 6765 – Credit for Increased Research Activities

Training and Additional Resources

How to Allocate and Apportion Research and Experimental (R&E) Expenses for Tax Years Beginning Before 1/1/2020

Type of Resource	Description(s)
Other Training Materials	<ul style="list-style-type: none">▪ FY 11 CPE – International Foreign Tax Credit Management – Slides 97 to 104▪ International Phase II Training – Module D – 3135-407▪ International Phase II Training – Lesson D-3

Glossary of Terms and Acronyms

Term/Acronym	Definition
A&A	Accounting & Accrual
CFC	Controlled Foreign Corporation
CSA	Cost Sharing Agreement
ECI	Effectively Connected Income
FTC	Foreign Tax Credit
F/S	Financial Statements
FSA	Field Service Advice
FSTI	Foreign Source Taxable Income
IDR	Information Document Request
IRC	Internal Revenue Code
PN	Practice Network
R&E	Research & Experimental
R&D	Research & Development
SIC	Standardized Industrial Classification
Treas. Reg.	Treasury Regulation
U/C	Uncontrolled