



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

November 13, 2001

Number: **200207012**
Release Date: 2/15/2002
CC:INTL:Br3/TL-N-7301-99
UILC: 861.08-05, 861.08-06, 861.08-07, 861.15-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL
(HEAVY MANUFACTURING, CONSTRUCTION AND
TRANSPORTATION: DETROIT)
CC:LM:MCT:DET

FROM: Chief, CC:INTL:Br3

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated April 25, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Parent =
product A =
product B =
CFC1 =
CFC2 =
CFC3 =
CFC4 =
FSCsub =

ISSUES

1. Whether Parent must allocate and apportion its research and development (R&D) expenditures for 1992, 1993, and 1994 to sales on which it pays to FSCsub a commission determined under the administrative pricing rules of section 925(a)(1) or (2) of the Internal Revenue Code, or whether the bonafide cost sharing arrangement that Parent had with CFC1 eliminates the requirement to allocate and apportion Parent's remaining R&D expenditures. Whether this determination must be made before Parent determines its foreign source taxable income under sections 861(b), 862(b), and 863(b) for purposes of section 904(a).

TL-N-7301-99

2. Whether during a taxable year Parent must use the same method of allocating and apportioning its R&D expenditures for all applicable operative Code sections, including both section 925(a)(1) or (2) of the Code for purposes of determining the FSC commission due FSCsub and sections 861(b), 862(b), and 863(b) for purposes of section 904(a).

CONCLUSIONS

1. Under Treas. Reg. §1.861-8(e)(3), Parent's R&D expenditures, after reduction for R&D expenditures covered by the bonafide cost sharing arrangement between Parent and CFC1, must be allocated and apportioned for purposes of determining the combined taxable income of Parent and FSCsub under section 925(a)(1) or (2) of the Code. This determination is made before Parent determines its foreign source taxable income under sections 861(b), 862(b), and 863(b) for purposes of section 904(a). Elimination of R&D expenditures that are reimbursed under the bonafide cost sharing arrangement between Parent and CFC1 does not eliminate the need to allocate and apportion Parent's remaining R&D expenditures under section 864(f) and Treas. Reg. §1.861-8.

2. Treas. Reg. §1.861-8(f)(2)(i) requires that during a taxable year Parent must use the same method of allocating and apportioning its R&D expenditures for all applicable operative Code sections. Accordingly, Parent must use the same method of R&D apportionment, either the gross income or sales method, in determining its foreign source taxable income under sections 861(b), 862(b), and 863(b) of the Code for purposes of section 904(a) and in determining the FSC commission due FSCsub under section 925(a)(1) or (2).

FACTS

Parent, a domestic corporation, manufactures and sells products A and B worldwide either directly or through subsidiaries. During its calendar year taxable years 1992, 1993, and 1994, Parent was engaged in extensive R&D in the U.S. associated with the manufacture and sale of product A. Parent had during those years a cost sharing arrangement with a foreign subsidiary, CFC1, under which Parent and CFC1 shared ratably based upon the number of product A produced by each corporation R&D expenses incurred in the development of intellectual property related to that product. Some of Parent's other foreign subsidiaries, CFC2, CFC3, and CFC4, had during those years a cost sharing arrangement amongst themselves to which Parent was not a party. Parent agrees that none of its R&D expenditures were "undertaken solely to meet legal requirements" as defined in Treas. Reg. §1.861-8(e)(3)(i)(B). Parent allocated all of its R&D expenses against domestic source income, asserting that all of the R&D expenses that related to foreign source income were eliminated under the cost sharing arrangement that it had with CFC1. Also, Parent did not take any of the R&D expenses into account in determining the FSC commission that it paid to FSCsub with regard to sales of product A.

TL-N-7301-99

LAW AND ANALYSIS

1. Requirement to allocate and apportion R&D expenditures in determining both FSC commission and foreign source income.

A. R&D allocation and apportionment rules.

Treas. Reg. §1.861-8 requires taxpayers, to the extent necessary to make the determination of taxable income from a specific source or activity required by an operative Code section, to allocate deductions to a class of gross income and to apportion deductions within the class between statutory and residual groupings of gross income. Treas. Reg. §1.861-8(a)(2). Operative Code sections include the geographic sourcing rules of sections 861(b), 862(b), and 863(b) of the Code, as applicable for purposes of section 904(a), and the foreign sales corporation (FSC) transfer pricing rules of section 925(a)(1) and (2) under which combined taxable income of the FSC and its related supplier is determined. A class of gross income may consist of one or more items (or subdivisions thereof) of gross income enumerated in section 61. Treas. Reg. §1.861-8(a)(3). Classes of gross income are not predetermined, but must be determined on the basis of the deduction to be allocated. Treas. Reg. §1.861-8(b)(1).

The allocation rules of the regulations emphasize the factual relationship between a deduction and a class of gross income. As a result, a deduction must be definitely related to a class of income in order to be allocated to that class. A deduction is considered definitely related to a class of gross income if the deduction is incurred as a result of, or incident to, an activity or in connection with the property from which such class of gross income is derived. Once a deduction has been allocated to a class of gross income, Treas. Reg. §1.861-8 next requires that it be apportioned if a deduction has been allocated to a class of gross income that includes both statutory and residual groupings of gross income. A statutory grouping is the gross income from a specific source or activity that must first be determined in order to arrive at taxable income from that specific source or activity for purposes of an operative Code section. Treas. Reg. §1.861-8(a)(4).

For 1992-94, the regulations at Treas. Reg. §1.861-8(e)(3) and (g), section 864(f) of the Code, and Rev. Proc. 92-56, 1992-2 C.B. 409, set forth special rules for the allocation and apportionment of R&D expenditures deductible under section 174. Treas. Reg. §1.861-8(e)(3)(i)(A), promulgated in 1977, provides that R&D expenditures are ordinarily considered deductions that are definitely related to all gross income reasonably connected with the relevant two-digit Standard Industrial Classification (SIC) product category of the taxpayer and therefore allocable to all items of gross income (including income from sales, royalties, and dividends) related to such product category. Treas. Reg. §1.861-8(e)(3)(i)(B) provides a limited exception permitting a direct allocation of R&D that is undertaken solely to meet legal requirements imposed by a political entity and that cannot reasonably be expected to generate gross income (beyond de minimis amounts) outside a single

TL-N-7301-99

geographic source to gross income within that geographic source as a class. Since Parent agrees it did not have legally mandated R&D expenditures in 1992, 1993, or 1994, the general rule of Treas. Reg. §1.861-8(e)(3)(i)(A) requiring allocation of R&D expenditures to Parent's gross income reasonably connected with the broad SIC code product category applies.

After the R&D expenditures are allocated to the class of gross income in the two-digit SIC code product category, they must be further apportioned between the relevant statutory and residual groupings of gross income in that class for purposes of determining taxable income under a particular operative section of the Code. In this case, the relevant operative sections of the Code are section 925(a)(1) or (2) for purposes of determining the FSC benefit, for which the statutory grouping is the gross income from which combined taxable income is derived, and section 904 for purposes of determining the amount of Parent's allowable foreign tax credit, for which the statutory grouping is the amount of Parent's foreign source taxable income determined under sections 861(b), 862(b), and 863(b). See Treas. Reg. §1.861-8(g), Example (23). Taxpayers may choose to apportion R&D expenditures between the statutory and residual groupings of gross income in the SIC code product category on the basis of either sales or gross income, under methods set forth in Treas. Reg. §1.861-8(e)(3)(ii) and (iii), respectively, as modified by applicable provisions of section 864(f) and Rev. Proc. 92-56.

Under the sales method, Treas. Reg. §1.861-8(e)(3)(ii)(A) initially provides for exclusive apportionment of 30 percent of R&D expenditures to gross income from the geographic source where more than 50 percent of the R&D activities are performed, in cases where an apportionment based on geographic sources is required (e.g., for purposes of section 904 of the Code, but not for purposes of section 925). Treas. Reg. §1.861-8(e)(3)(ii)(B) provides that amounts not apportioned under subdivision (ii)(A) are apportioned between the statutory and residual groupings in the same proportions that the amount of sales from the product category which resulted in gross income in the statutory and residual groupings bear to the total amount of sales in the product category. For purposes of determining this apportionment ratio, sales by uncontrolled parties of products involving intangibles licensed or purchased from the taxpayer are included if the uncontrolled party can reasonably be expected to benefit directly or indirectly from the research expense connected with the product category. Treas. Reg. §1.861-8(e)(3)(ii)(C). Such sales by controlled parties are also included; except that to avoid duplication the amount sold by the selling corporation to the buying corporation is subtracted from the sales of the buying corporation. Treas. Reg. §1.861-8(e)(3)(ii)(D). A controlled corporation is expected to benefit from the taxpayer's research expense if the taxpayer can be expected to license, sell, or transfer intangible property or secret processes to that corporation, unless the corporation has entered into a bona fide cost sharing arrangement with the taxpayer for developing the intangible property. *Id.*

TL-N-7301-99

Accordingly, if Parent uses the optional sales method to apportion its R&D expenses, sales of product A by Parent and its CFCs, including FSCsub, other than the sales of CFC1 with which Parent had a bonafide cost sharing arrangement,¹ must be included in the apportionment formula. The sales of each CFC must be reduced, however, by the amount of Parent's sales to the CFC.

Under the gross income method, Treas. Reg. §1.861-8(e)(3)(iii) provides two options. Treas. Reg. §1.861-8(e)(3)(iii)(A) (Option One) provides that the taxpayer may apportion R&D expenses (after reduction for legally mandated expenses, if any) on the basis of gross income in the statutory and residual groupings, provided that the amounts so apportioned to each of the statutory and residual groupings are at least 50 percent of the amounts that would be apportioned to those groupings under the sales method. If this condition is not met, under Treas. Reg. §1.861-8(e)(3)(iii)(B) (Option Two) the taxpayer must make additional apportionments to the statutory or residual groupings so that the 50 percent tests are met.

Accordingly, if Parent uses the optional gross income method under the regulations to apportion its R&D expense, the amounts apportioned to each of the statutory and residual groupings must be at least 50 percent of the amounts that would be apportioned to such groupings under the sales method.

The regulatory rules governing the allocation and apportionment of R&D expenditures for purposes of the geographic sourcing rules during the years in issue were modified several times by legislative enactments. Section 864(f) of the Code, enacted in 1989 and amended in 1990, 1991, and 1993, suspended the application of Treas. Reg. §1.861-8(e)(3) and provided statutory rules to govern the allocation and apportionment of deductions for qualified R&D expenditures to domestic and foreign source gross income under sections 861(b), 862(b), and 863(b). Varying sets of special statutory rules applied to R&D expenditures incurred during a taxpayer's first two taxable years beginning after August 1, 1989, during the first six months of a taxpayer's first taxable year beginning after August 1, 1991, and for "the taxpayer's first taxable year (beginning on or before August 1, 1994) following the taxpayer's last taxable year to which Revenue Procedure 92-56[, 1992-2 C.B. 409,] applies or would apply if the taxpayer elected the benefits of such Revenue Procedure." Section 864(f)(6). Rev. Proc. 92-56 permitted a taxpayer to apply R&D allocation and apportionment rules based on the expired statutory rules in lieu of the rules of Treas. Reg. §1.861-8(e)(3) during the last six months of a taxpayer's first taxable year beginning after August 1, 1991, and during the immediately succeeding taxable year. Rev. Proc. 92-56, sec. 3.01.

¹ For purposes of this advice we are assuming that the cost sharing agreement between Parent and CFC1 is a bonafide arrangement under Treas. Reg. §§1.861-8(e)(3)(ii)(D), 1.482-2(d)(4) for 1992 and 1993, and 1.482-2A(d)(4) for 1994.

TL-N-7301-99

With respect to Parent, the statutory changes provided for exclusive geographic apportionment of a portion (64 percent in the first six months of 1992 and 50 percent in 1994) of R&D expenditures conducted within and without the U.S. prior to apportionment of the remaining R&D expenditures in determining domestic and foreign source taxable income. Under the statute, exclusive geographic apportionment applies regardless of whether the taxpayer used the sales method or the gross income method to apportion R&D expenditures. (Treas. Reg. §1.861-8(e)(3)(ii)(A) provides for apportionment of 30 percent of total expenses to the jurisdiction where more than 50 percent of expenditures are made only if the taxpayer uses the sales method). Section 864(f)(1)(B) of the Code. For the same periods, section 864(f)(1)(C) reduced the amounts required to be apportioned to the statutory grouping of foreign source income under the optional gross income method of Treas. Reg. §1.861-8(e)(3)(iii) from 50 to 30 percent of amounts that would be apportioned under the sales method. As noted, Rev. Proc. 92-56 permitted taxpayers to apply modified rules based on the 1992 statutory percentages in lieu of the provisions of Treas. Reg. §1.861-8(e)(3) for the last six months of 1992 and for 1993.

For purposes of allocating and apportioning its R&D expenditures to domestic and foreign source gross income under sections 861(b), 862(b), and 863(b) of the Code, Parent must use the rules set forth in the applicable version of section 864(f) for the first six months of 1992, as well as all of 1994. With respect to the last six months of 1992 (its first taxable year beginning after August 1, 1991) and 1993, Parent may apply either the provisions of Rev. Proc. 92-56 or the provisions of Treas. Reg. §1.861-8(e)(3) to apportion its R&D expenditures incurred during those periods to domestic and foreign source gross income in determining taxable income under sections 861(b), 862(b), and 863(b). The statutory amendments and Rev. Proc. 92-56, like the exclusive geographic apportionment rule of Treas. Reg. §1.861-8(e)(3)(ii)(A), apply only for purposes of determining U.S. and foreign source taxable income under sections 861(b), 862(b), and 863(b). Accordingly, these rules apply in apportioning expenses only for purposes of the operative sections requiring a determination of foreign source taxable income, which include the foreign tax credit limitation under section 904 but not the determination of combined taxable income in computing FSC benefits under section 925. See St. Jude Medical, Inc. v. Commissioner, 34 F.3d 1394 (8th Cir. 1994) (rules providing for exclusive geographic apportionment of R&D expense do not apply for purposes of the DISC provisions).

B. Amount of R&D expense to be allocated and apportioned; priority of determining FSC commission and section 904(d) limitation.

Parent's deductible R&D expenditures will not include the amount covered by Parent's cost sharing arrangement with CFC1, since under such agreement CFC1 shared in the cost of developing the intangible property. See Treas. Reg. §§1.482-2(d)(4) and 1.861-8(g), *Example* (5). However, elimination of R&D expenditures that are reimbursed under the bonafide cost sharing arrangement between Parent

TL-N-7301-99

and CFC1 does not eliminate the need to allocate and apportion Parent's remaining R&D expenditures. Under the regulations, the deductible portion of Parent's R&D expenditures are considered definitely related and allocable to all of Parent's gross income in the applicable two-digit SIC code product category, and are subject to allocation and apportionment under the rules discussed above.

In a commission FSC arrangement, a related supplier, such as Parent, uses a FSC, such as FSCsub, as a commission agent in the disposition of export property or services producing foreign trading gross receipts. Temp. Treas. Reg. §1.927(d)-2T(a). Section 925 of the Code provides that in order to determine the amount of commission income that it will pay the FSC on a qualified export transaction, or group of transactions, the related supplier of the FSC may use one of three pricing methods: gross receipts; combined taxable income; or sales price determined under section 482. Section 925(a); Temp. Treas. Reg. §1.925(a)-1T(a)(1). If the combined taxable income method is used, the FSC's commission income with regard to the export transaction, or group of export transactions, will equal 23% of combined taxable income plus any expenses the FSC incurred with regard to that transaction, or group of transactions. Combined taxable income is also relevant for purposes of the gross receipts method since the amount determined under that method is limited to 46% of combined taxable income. The FSC's commission income is its gross income on the transaction, or group of transactions. Temp. Treas. Reg. §1.927(b)-1T(e)(1)(i).

Temp. Treas. Reg. §1.925(a)-1T(c)(6)(i) provides that the combined taxable income of the FSC and its related supplier from a sale of export property is the excess of the foreign trading gross receipts of the FSC from the sale (in the case of a commission FSC, the gross receipts derived by the related supplier from the sale with respect to which the commission arose) over the total costs that relate to the foreign trading gross receipts (*i.e.*, cost of goods sold and its and the FSC's non-inventoriable costs which relate to the foreign trading gross receipts) of the FSC and related supplier. Temp. Treas. Reg. §1.925(a)-1T(c)(6)(iii)(D) provides, in part, that costs which are "treated as relating to gross receipts from sales of export property" and that are therefore taken into account for purposes of computing combined taxable income "are the expenses, losses, or deductions definitely related, and therefore allocated and apportioned thereto, and a ratable part of any other expenses, losses, or deductions which are not definitely related to any class of gross income, determined in a manner consistent with the rules set forth in §1.861-8."

Treas. Reg. §1.861-8(g), *Example* (23), illustrates that the related supplier's and FSC's expenses, including R&D expenses, are allocated and apportioned in two stages. In the first stage, the expenses of the related supplier, such as Parent, and FSC, such as FSCsub, including R&D expenses, are allocated and apportioned in order to calculate combined taxable income of the FSC and related supplier. Treas. Reg. §1.861-8(f)(1)(iii) and (g), *Example* (23). Treas. Reg. §1.861-8(e)(3) applies to the allocation and apportionment of R&D expenses in this first stage.

TL-N-7301-99

This determination requires only apportionment of R&D expenses between the statutory grouping of gross income of the related supplier from sales of export property on which the FSC is to receive a commission and the residual grouping of other gross income of the related supplier. A related supplier may derive gross receipts qualifying for FSC treatment because of the sale of export property and pay a commission to its FSC based on the combined taxable income on that sale irrespective of whether the sale generates foreign source or domestic source income. Therefore, the geographic sourcing of income is not relevant for purposes of calculating combined taxable income. Accordingly, Treas. Reg. §1.861-8(e)(3)(ii)(A), providing for exclusive apportionment of R&D to the location where the R&D was performed, is irrelevant for purposes of determining combined taxable income of the related supplier and FSC. See Rev. Rul. 86-144, 1986-2 C.B. 101. Likewise, the rules of section 864(f)(1)(B) of the Code and Rev. Proc. 92-56 that provide for exclusive geographic apportionment do not apply to the determination of combined taxable income since that determination is not an allocation and apportionment to geographic sources.

In the second stage, Parent's and FSCsub's expenses, including R&D expenditures, are allocated and apportioned for purposes of calculating Parent's foreign source income under sections 861(b), 862(b) and 863(b) of the Code for purposes of the foreign tax credit limitation under section 904. Treas. Reg. §1.861-8(f)(1)(i) and (g), *Example* (23). For this stage, the full set of rules under the applicable provisions of Treas. Reg. §1.861-8(e)(3), Rev. Proc. 92-56 or section 864(f) apply, as discussed herein, for purposes of allocating and apportioning Parent's R&D expenditures. This two-stage process is required since the FSC commission determined in the first stage is an expense of Parent, the related supplier, that must be allocated and apportioned for purposes of the second stage, determination of foreign source taxable income.

2. Consistency of R&D allocation and apportionment methods.

If a taxpayer is required to allocate and apportion expenses under more than one operative Code section, Treas. Reg. §1.861-8(f)(2)(i) provides that

it may be necessary to apply [the regulations] separately for each applicable operative section. In such a case, the taxpayer is required to use the same method of allocation and the same principles of apportionment for all operative sections.

Accordingly, Parent must allocate its R&D expenditures to its gross income in the relevant two-digit SIC code product category and consistently use either the sales method or the gross income method to apportion these expenses for purposes of all operative Code sections. Because the rules of section 864(f) of the Code and Rev. Proc. 92-56 and (if Parent uses the sales method) Treas. Reg. §1.861-8(e)(3)(ii)(A) apply by their terms only for purposes of determining foreign source taxable income under sections 861(b), 862(b), and 863(b), the exclusive geographic

TL-N-7301-99

apportionment rules of those sections do not apply in computing Parent's and FSCsub's combined taxable income for purposes of section 925. However, Temp. Treas. Reg. §1.925(a)-1T(c)(6)(iii)(D) and the consistency rule of Treas. Reg. §1.861-8(f)(2)(i) require Parent to use either the sales method described in Treas. Reg. §1.861-8(e)(3)(ii)(B), (C), and (D) or the gross income method described in Treas. Reg. §1.861-8(e)(3)(iii) to apportion its total deductible R&D expenditures for purposes of determining its and FSCsub's combined taxable income, consistent with its choice to apply either the sales method or the gross income method under the applicable provisions of section 864(f), Rev. Proc. 92-56, and Treas. Reg. §1.861-8(e)(3) to apportion its residual R&D expenditures in determining its domestic and foreign source taxable income under sections 861(b), 862(b), and 863(b) in each of its 1992-94 taxable years.

Please call (202) 622-3850 if you have any further questions.

BARBARA A. FELKER
Chief, CC:INTL:Br3