

Section 861.—Income From Sources Within the United States

26 CFR 1.861–8: Computation of taxable income from sources within the United States and from other sources and activities.

T.D. 8646

**DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1**

Allocation and Apportionment of Research and Experimental Expenditures

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document provides guidance concerning the allocation and apportionment of research and experimental expenditures for purposes of determining taxable income from sources within and without the United States. This document affects taxpayers that have income from United States and foreign sources and that have made expenditures for research and experimentation that the taxpayer deducts under section 174 of the Internal Revenue Code of 1986.

EFFECTIVE DATE: January 1, 1996.

FOR FURTHER INFORMATION CONTACT: Carl Cooper at (202) 622-3840 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

On May 24, 1995, the IRS published a notice of proposed rulemaking and notice of public hearing in the Federal Register (60 FR 27453 [INTL-23-95, 1995-1 C.B. 987]) proposing amendments to the Income Tax Regulations (26 CFR part 1) under section 861 of the Internal Revenue Code of 1986. Section 1.861-8(e)(3) of the Income Tax Regulations provides rules regarding the allocation and apportionment of research and experimental expenditures for purposes of determining taxable income from sources inside and outside the United States.

The notice of proposed rulemaking proposed three principal changes to the existing regulations. First, allocation of research and experimental expenditures to three digit SIC code product categories of gross income would be permitted. Second, the percentage of research and experimental expenditures that may be exclusively apportioned to United States source income under the sales method of apportionment under §1.861-8(e)(3)(ii) would be increased from 30 percent to 50 percent. Third, use of the optional gross income methods of apportionment would constitute a binding election to use such methods in subsequent years. The election would not be revocable without the prior consent of the Commissioner. The three changes were proposed in part on the basis of an economic study performed by the Treasury Department pursuant to Rev. Proc. 92-56 (1992-2 C.B. 409), "The Relationship between U.S. Research and Development and Foreign Income," which was published by the Treasury Department simultaneously with the proposed regulations.

Written comments responding to the notice were received, and a public hearing was held on September 8, 1995.

Regarding the determination of product categories under §1.861-8(e)(3)(i)(B) of the proposed regulations, commenters suggested that the rule requiring a taxpayer to determine relevant product categories by reference to the three digit classification of the Standard Industrial Classification Manual should be modified to allow determinations by reference to the five digit

classifications of the Manual. This suggestion was not adopted, because such a rule would too narrowly restrict the necessarily broad scope of the deduction. The IRS continues to believe that research and experimentation is an inherently speculative activity, that findings may contribute unexpected benefits, and that gross income derived from successful research and experimentation must bear the cost of unsuccessful research and experimentation.

Commenters suggested that the regulations permit taxpayers to determine product categories by reference to two or three digit categories at the annual election of the taxpayer. This suggestion was not adopted. The regulations provide that a taxpayer may determine product categories by reference to two or three digit categories. A taxpayer may aggregate, disaggregate or change a previously selected SIC code category if the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change in product category is appropriate. This rule provides a simple and workable format for balancing the need for consistency with the desire for flexibility.

Referring to current §1.861-8(g) *Example 6* (which has been redesignated §1.861-17(h) *Example 4*), commenters suggested that the regulations allow the use of the Wholesale Trade SIC code category with respect to sales from any other category. The current §1.861-8(g) *Example 6* was not correct on this point and does not override the rule stated parenthetically in the list of two digit SIC code categories in present §1.861-8(e)(3)(i)(A) that wholesale trade may not be combined with other product categories. The final regulations include this rule along with *Example 6* corrected to conform to the rule.

Regarding the exclusive place of performance apportionment rule under §1.861-8(e)(3)(ii)(A) of the proposed regulations, commenters suggested adding a rule providing that if the ratio of foreign research and experimental expenditures in a three digit SIC code category of all foreign affiliates of a United States consolidated group over foreign affiliate sales in that SIC code category exceed fifty percent of the ratio of United States consolidated group research and experimental expenditures in that SIC code category over United States consolidated group sales in that SIC code category, then the

United States consolidated group research and experimental expenditures should be exclusively apportioned to United States source gross income. This suggestion has not been adopted. Although a foreign affiliate may incur substantial research and experimental expenditures in a given product category, the foreign affiliate may still benefit from the research and experimental expenditures of the United States consolidated group. See *Perkin-Elmer Corporation v. Commissioner*, 103 T.C. 464 (1994).

Regarding the optional gross income methods of apportionment under §1.861-8(e)(3)(iii) of the proposed regulations, commenters suggested that the final regulations include a fifty percent exclusive place of performance apportionment under the optional gross income methods to be parallel with §1.861-8(e)(3)(ii)(A). This suggestion has been adopted in part. Section (b)(1)(ii) of the final regulations includes a twenty-five percent exclusive place of performance apportionment under the optional gross income methods. This twenty-five percent exclusive apportionment ensures that taxpayers electing to use one of the optional gross income methods also obtain results comparable to those obtained by taxpayers electing to use the sales method, *i.e.*, an overall allocation that is twenty-five percent lower on average than the allocation to foreign source income resulting from the current regulations. The Treasury Department study does not support a greater exclusive apportionment.

Commenters suggested that the proposed regulations should be modified to reduce the floor on the amount of research and experimental expenditures that must be apportioned to foreign source income under the optional gross income methods from fifty percent to thirty percent of the amount that would have been apportioned under the sales method. This suggestion has not been adopted. The adoption of this suggested rule in addition to the twenty-five percent exclusive apportionment rule is not supported by the Treasury Department study.

Commenters suggested the elimination of the binding election to use the optional gross income methods under §1.861-8(e)(3)(iii)(C) of the proposed regulations. Commenters also suggested that the binding election rule should be modified to provide for a change of method without the prior consent of the

Commissioner after five years' use of one method. This suggestion, which recognizes the need for consistency while reducing the administrative burden on taxpayers, has been adopted.

Commenters suggested that the effective date election under §1.861-8(e)-(3)(vi) of the proposed regulations permit election by fiscal year taxpayers whose taxable years begin after August 1, 1994, but before January 1, 1995. This suggestion has been adopted.

Finally, these provisions, which were previously published as §1.861-8(e)(3), have been renumbered and will now be published as §1.861-17. This change has been made solely for the purpose of achieving greater clarity in formatting and is not intended to result in any additional substantive changes.

Special Analyses

It has been determined that these final regulations are not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and therefore a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these final regulations has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Carl Cooper, Office of the Associate Chief Counsel (International). However, other personnel from IRS and Treasury participated in their development.

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Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation continues to read as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.861-8 is amended by:

1. Revising paragraph (e)(3) to read as set forth below.

2. Removing and reserving paragraph (g), *Examples 3 through 16 and 23.*

§1.861-8 Computation of taxable income from sources within the United States and from other sources and activities.

* * * * *

(e) * * *

(3) *Research and experimental expenditures.* For rules regarding the allocation and apportionment of research and experimental expenditures, see §1.861-17.

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Par. 3. Section 1.861-17 is added to read as follows:

§1.861-17 Allocation and apportionment of research and experimental expenditures.

(a) *Allocation*—(1) *In general.* The methods of allocation and apportionment of research and experimental expenditures set forth in this section recognize that research and experimentation is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and experimentation must bear the cost of unsuccessful research and experimentation. Expenditures for research and experimentation that a taxpayer deducts under section 174 ordinarily shall be considered deductions that are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories). For purposes of this allocation, the product category (or categories) that a taxpayer may be considered to have shall be determined in accordance with the provisions of paragraph (a)(2) of this section.

(2) *Product categories*—(i) *Allocation based on product categories.* Ordinarily, a taxpayer's research and experimental expenditures may be divided between the relevant product categories. Where research and experi-

mentation 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. Where research and experimentation is not clearly identified with any product category (or categories), it will be considered conducted with respect to all the taxpayer's product categories.

(ii) *Use of three digit standard industrial classification codes.* A taxpayer shall determine the relevant product categories by reference to the three digit classification of the Standard Industrial Classification Manual (SIC code). A copy may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. The individual products included within each category are enumerated in Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual, 1987 (or later edition, as available).

(iii) *Consistency.* Once a taxpayer selects a product category for the first taxable year for which this section is effective with respect to the taxpayer, it must continue to use that product category in following years, unless the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change in the product category is appropriate. For this purpose, a change in the taxpayer's selection of a product category shall include a change from a three digit SIC code category to a two digit SIC code category, a change from a two digit SIC code category to a three digit SIC code category, or any other aggregation, disaggregation or change of a previously selected SIC code category.

(iv) *Wholesale trade category.* The two digit SIC code category "Wholesale trade" is not applicable with respect to sales by the taxpayer of goods and services from any other of the taxpayer's product categories and is not applicable with respect to a domestic international sales corporation (DISC) or foreign sales corporation (FSC) for which the taxpayer is a related supplier of goods and services from any of the taxpayer's product categories.

(v) *Retail trade category.* The two digit SIC code category "Retail trade" is not applicable with respect to sales

by the taxpayer of goods and services from any other of the taxpayer's product categories, except wholesale trade, and is not applicable with respect to a DISC or FSC for which the taxpayer is a related supplier of goods and services from any other of the taxpayer's product categories, except wholesale trade.

(3) *Affiliated Groups*—(i) *In general*. Except as provided in paragraph (a)(3)(ii) of this section, the allocation and apportionment required by this section shall be determined as if all members of the affiliated group (as defined in §1.861-14T(d)) were a single corporation. See §1.861-14T.

(ii) *Possessions corporations*. (A) For purposes of the allocation and apportionment required by this section, sales and gross income from products produced in whole or in part in a possession by an electing corporation (within the meaning of section 936(h)(5)(E)), and dividends from an electing corporation, shall not be taken into account, except that this paragraph (a)(3)(ii) shall not apply to sales of (and gross income and dividends attributable to sales of) products with respect to which an election under section 936(h)(5)(F) is not in effect.

(B) The research and experimental expenditures taken into account for purposes of this section shall be reduced by the amount of such expenditures included in computing the cost-sharing amount (determined under section 936(h)(5)(C)(i)).

(4) *Legally mandated research and experimentation*. Where research and experimentation is undertaken solely to meet legal requirements imposed by a political entity with respect to improvement or marketing of specific products or processes, and the results cannot reasonably be expected to generate amounts of gross income (beyond *de minimis* amounts) outside a single geographic source, the deduction for such research and experimentation shall be considered definitely related and therefore allocable only to the grouping (or groupings) of gross income within that geographic source as a class (and apportioned, if necessary, between such groupings as set forth in paragraphs (c) and (d) of this section). For example, where a taxpayer performs tests on a product in response to a requirement imposed by the U.S. Food and Drug Administration, and the test results cannot reasonably be expected to gen-

erate amounts of gross income (beyond *de minimis* amounts) outside the United States, the costs of testing shall be allocated solely to gross income from sources within the United States.

(b) *Exclusive apportionment*—(1) *In general*. An exclusive apportionment shall be made under this paragraph (b), where an apportionment based upon geographic sources of income of a deduction for research and experimentation is necessary (after applying the exception in paragraph (a)(4) of this section).

(i) *Exclusive apportionment under the sales method*. If the taxpayer apportions on the sales method under paragraph (c) of this section, an amount equal to fifty percent of such deduction for research and experimentation shall be apportioned exclusively to the statutory grouping of gross income or the residual grouping of gross income, as the case may be, arising from the geographic source where the research and experimental activities which account for more than fifty percent of the amount of such deduction were performed.

(ii) *Exclusive apportionment under the optional gross income methods*. If the taxpayer apportions on the optional gross income methods under paragraph (d) of this section, an amount equal to twenty-five percent of such deduction for research and experimentation shall be apportioned exclusively to the statutory grouping or the residual grouping of gross income, as the case may be, arising from the geographic source where the research and experimental activities which account for more than fifty percent of the amount of such deduction were performed.

(iii) *Exception*. If the applicable fifty percent geographic source test of the preceding paragraph (b)(1)(i) or (ii) is not met, then no part of the deduction shall be apportioned under this paragraph (b)(1).

(2) *Facts and circumstances supporting an increased exclusive apportionment*—(i) *In general*. The exclusive apportionment provided for in paragraph (b)(1) of this section reflects the view that research and experimentation is often most valuable in the country where it is performed, for two reasons. First, research and experimentation often benefits a broad product category, consisting of many individual products, all of which may be sold in the nearest market but only some of

which may be sold in foreign markets. Second, research and experimentation often is utilized in the nearest market before it is used in other markets, and in such cases, has a lower value per unit of sales when used in foreign markets. The taxpayer may establish to the satisfaction of the Commissioner that, in its case, one or both of the conditions mentioned in the preceding sentences warrant a significantly greater exclusive allocation percentage than allowed by paragraph (b)(1) of this section because the research and experimentation is reasonably expected to have very limited or long delayed application outside the geographic source where it was performed. Past experience with research and experimentation may be considered in determining reasonable expectations.

(ii) *Not all products sold in foreign markets*. For purposes of establishing that only some products within the product category (or categories) are sold in foreign markets, the taxpayer shall compare the commercial production of individual products in domestic and foreign markets made by itself, by uncontrolled parties (as defined under paragraph (c)(2)(i) of this section) of products involving intangible property which was licensed or sold by the taxpayer, and by those controlled corporations (as defined under paragraph (c)(3)(ii) of this section) that can reasonably be expected to benefit directly or indirectly from any of the taxpayer's research expense connected with the product category (or categories). The individual products compared for this purpose shall be limited, for nonmanufactured categories, solely to those enumerated in Executive Office of the President, Office of Management and Budget Standard Industrial Classification Manual, 1987 (or later edition, as available), and, for manufactured categories, solely to those enumerated at a 7-digit level in the U.S. Bureau of the Census, Census of Manufacturers: 1992, Numerical List of Manufactured Products, 1993, (or later edition, as available). Copies of both of these documents may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402.

(iii) *Delayed application of research findings abroad*. For purposes of establishing the delayed application of research findings abroad, the taxpayer shall compare the commercial introduction of its own particular products and

processes (not limited by those listed in the Standard Industrial Classification Manual or the Numerical List of Manufactured Products) in the United States and foreign markets, made by itself, by uncontrolled parties (as defined under paragraph (c)(2)(i) of this section) of products involving intangible property that was licensed or sold by the taxpayer, and by those controlled corporations (as defined under paragraph (c)(3)(i) of this section) that can reasonably be expected to benefit, directly or indirectly, from the taxpayer's research expense. For purposes of evaluating the delay in the application of research findings in foreign markets, the taxpayer shall use a safe haven discount rate of 10 percent per year of delay unless he is able to establish to the satisfaction of the Commissioner, by reference to the cost of money and the number of years during which economic benefit can be directly attributable to the results of the taxpayer's research, that another discount rate is more appropriate.

(c) *Sales method*—(1) *In general.* The amount equal to the remaining portion of such deduction for research and experimentation, not apportioned under paragraph (a)(4) or (b)(1)(i) of this section, shall be apportioned between the statutory grouping (or among the statutory groupings) within the class of gross income and the residual grouping within such class in the same proportions that the amount of sales from the product category (or categories) that resulted in such gross income within the statutory grouping (or statutory groupings) and in the residual grouping bear, respectively, to the total amount of sales from the product category (or categories).

(i) *Apportionment in excess of gross income.* Amounts apportioned under this section may exceed the amount of gross income related to the product category within the statutory grouping. In such case, the excess shall be applied against other gross income within the statutory grouping. See §1.861-8(d)(1) for instances where the apportionment leads to an excess of deductions over gross income within the statutory grouping.

(ii) *Leased property.* For purposes of this paragraph (c), amounts received from the lease of equipment during a taxable year shall be regarded as sales receipts for such taxable year.

(2) *Sales of uncontrolled parties.* For purposes of the apportionment under

paragraph (c)(1) of this section, the sales from the product category (or categories) by each party uncontrolled by the taxpayer, of particular products involving intangible property that was licensed or sold by the taxpayer to such uncontrolled party shall be taken fully into account both for determining the taxpayer's apportionment and for determining the apportionment of any other member of a controlled group of corporations to which the taxpayer belongs if the uncontrolled party can reasonably be expected to benefit directly or indirectly (through any member of the controlled group of corporations to which the taxpayer belongs) from the research expense connected with the product category (or categories) of such other member. An uncontrolled party can reasonably be expected to benefit from the research expense of a member of a controlled group of corporations to which the taxpayer belongs if such member can reasonably be expected to license, sell, or transfer intangible property to that uncontrolled party or transfer secret processes to that uncontrolled party, directly or indirectly through a member of the controlled group of corporations to which the taxpayer belongs. Past experience with research and experimentation shall be considered in determining reasonable expectations.

(i) *Definition of uncontrolled party.* For purposes of this paragraph (c)(2) the term *uncontrolled party* means a party that is not a person with a relationship to the taxpayer specified in section 267(b), or is not a member of a controlled group of corporations to which the taxpayer belongs (within the meaning of section 993(a)(3) or 927(d)(4)).

(ii) *Licensed products.* In the case of licensed products, if the amount of sales of such products is unknown (for example, where the licensed product is a component of a large machine), a reasonable estimate based on the principles of section 482 should be made.

(iii) *Sales of intangible property.* In the case of sales of intangible property, regardless of whether the consideration received in exchange for the intangible is a fixed amount or is contingent on the productivity, use, or disposition of the intangible, if the amount of sales of products utilizing the intangible property is unknown, a reasonable estimate of sales shall be made annually. If necessary, appropriate economic analyses shall be used to estimate sales.

(3) *Sales of controlled parties.* For purposes of the apportionment under paragraph (c)(1) of this section, the sales from the product category (or categories) of the taxpayer shall be taken fully into account and the sales from the product category (or categories) of a corporation controlled by the taxpayer shall be taken into account to the extent provided in this paragraph (c)(3) for determining the taxpayer's apportionment, if such corporation can reasonably be expected to benefit directly or indirectly (through another member of the controlled group of corporations to which the taxpayer belongs) from the taxpayer's research expense connected with the product category (or categories). A corporation controlled by the taxpayer can reasonably be expected to benefit from the taxpayer's research expense if the taxpayer can be expected to license, sell, or transfer intangible property to that corporation or transfer secret processes to that corporation, either directly or indirectly through a member of the controlled group of corporations to which the taxpayer belongs. Past experience with research and experimentation shall be considered in determining reasonable expectations.

(i) *Definition of a corporation controlled by the taxpayer.* For purposes of this paragraph (c)(3), the term *a corporation controlled by the taxpayer* means any corporation that has a relationship to the taxpayer specified in section 267(b) or is a member of a controlled group of corporations to which the taxpayer belongs (within the meaning of section 993(a)(3) or 927(d)(4)).

(ii) *Sales to be taken into account.* The sales from the product category (or categories) of a corporation controlled by the taxpayer taken into account shall be equal to the amount of sales that bear the same proportion to the total sales of the controlled corporation as the total value of all classes of the stock of such corporation owned directly or indirectly by the taxpayer, within the meaning of section 1563, bears to the total value of all classes of stock of such corporation.

(iii) *Sales not to be taken into account more than once.* Sales from the product category (or categories) between or among such controlled corporations or the taxpayer shall not be taken into account more than once; in such a situation, the amount sold by the selling corporation to the buying corpo-

ration shall be subtracted from the sales of the buying corporation.

(iv) *Effect of cost-sharing arrangements.* If the corporation controlled by the taxpayer has entered into a bona fide cost-sharing arrangement, in accordance with the provisions of §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.

(d) *Gross income methods*—(1)(i) *In general.* In lieu of applying the sales method of paragraph (c) of this section, the remaining amount of the deduction for research and experimentation, not apportioned under paragraph (a)(4) or (b)(1)(ii) of this section, shall be apportioned as prescribed in paragraphs (d)(2) and (3) of this section, between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income.

(ii) *Optional methods to be applied to all research and experimental expenditures.* These optional methods must be applied to the taxpayer's entire deduction for research and experimental expense remaining after applying the exception in paragraph (a)(4) of this section, and may not be applied on a product category basis. Thus, after the allocation of the taxpayer's entire deduction for research and experimental expense under paragraph (a)(2) of this section (by attribution to SIC code categories), the taxpayer must then apportion as necessary the entire deduction as allocated by separate amounts to various product categories, using only the sales method under paragraph (c) of this section or only the optional gross income methods under this paragraph (d). The taxpayer may not use the sales method for a portion of the deduction and optional gross income methods for the remainder of the deduction separately allocated.

(2) *Option one.* The taxpayer may apportion its research and experimental expenditures ratably on the basis of gross income between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income in the same proportions that the amount of gross income in the statutory grouping (or groupings) and the amount of gross income in the residual grouping bear, respectively, to the total amount

of gross income, if the conditions described in paragraph (d)(2)(i) and (ii) of this section are both met.

(i) The amount of research and experimental expense ratably apportioned to the statutory grouping (or groupings in the aggregate) is not less than fifty percent of the amount that would have been so apportioned if the taxpayer had used the method described in paragraph (c) of this section; and

(ii) The amount of research and experimental expense ratably apportioned to the residual grouping is not less than fifty percent of the amount that would have been so apportioned if the taxpayer had used the method described in paragraph (c) of this section.

(3) *Option two.* If, when the amount of research and experimental expense is apportioned ratably on the basis of gross income, either of the conditions described in paragraph (d)(2)(i) or (ii) of this section is not met, the taxpayer may either—

(i) Where the condition of paragraph (d)(2)(i) of this section is not met, apportion fifty percent of the amount of research and experimental expense that would have been apportioned to the statutory grouping (or groupings in the aggregate) under paragraph (c) of this section to such statutory grouping (or to such statutory groupings in the aggregate and then among such groupings on the basis of gross income within each grouping), and apportion the balance of the amount of research and experimental expenses to the residual grouping; or

(ii) Where the condition of paragraph (d)(2)(ii) of this section is not met, apportion fifty percent of the amount of research and experimental expense that would have been apportioned to the residual grouping under paragraph (c) of this section to such residual grouping, and apportion the balance of the amount of research and experimental expenses to the statutory grouping (or to the statutory groupings in the aggregate and then among such groupings ratably on the basis of gross income within each grouping).

(e) *Binding election*—(1) *In general.* A taxpayer may choose to use either the sales method under paragraph (c) of this section or the optional gross income methods under paragraph (d) of this section for its original return for its first taxable year to which this section

applies. The taxpayer's use of either the sales method or the optional gross income methods for its return filed for its first taxable year to which this section applies shall constitute a binding election to use the method chosen for that year and for four taxable years thereafter.

(2) *Change of method.* The taxpayer's election of a method may not be revoked during the period referred to in paragraph (e)(1) of this section without the prior consent of the Commissioner. After the expiration of that period, the taxpayer may change methods without the prior consent of the Commissioner. However, the taxpayer's use of the new method shall constitute a binding election to use the new method for its return filed for the first year for which the taxpayer uses the new method and for four taxable years thereafter. The taxpayer's election of the new method may not be revoked during that period without the prior consent of the Commissioner.

(i) *Short taxable years.* For purposes of this paragraph (e), the term *taxable year* includes a taxable year of less than twelve months.

(ii) *Affiliated groups.* In the case of an affiliated group, the period referred to in paragraph (e)(1) of this section shall commence as of the latest taxable year in which any member of the group has changed methods.

(f) *Special rules for partnerships*—(1) *Research and experimental expenditures.* For purposes of applying this section, if research and experimental expenditures are incurred by a partnership in which the taxpayer is a partner, the taxpayer's research and experimental expenditures shall include the taxpayer's distributive share of the partnership's research and experimental expenditures.

(2) *Purpose and location of expenditures.* In applying the exception for expenditures undertaken to meet legal requirements under paragraph (a)(4) of this section and the exclusive apportionment for the sales method and the optional gross income methods under paragraph (b) of this section, a partner's distributive share of research and experimental expenditures incurred by a partnership shall be treated as incurred by the partner for the same purpose and in the same location as incurred by the partnership.

(3) *Apportionment under the sales method.* In applying the remaining

apportionment for the sales method under paragraph (c) of this section, a taxpayer's sales from a product category shall include the taxpayer's share of any sales from the product category of any partnership in which the taxpayer is a partner. For purposes of the preceding sentence, a taxpayer's share of sales shall be proportionate to the taxpayer's distributive share of the partnership's gross income in the product category.

(g) *Effective date.* This section applies to taxable years beginning after December 31, 1995. However, a taxpayer may at its option, apply this section in its entirety to all taxable years beginning after August 1, 1994.

(h) *Examples.* The following examples illustrate the application of this section:

Example 1—(i) Facts. X, a domestic corporation, is a manufacturer and distributor of small gasoline engines for lawn mowers. Gasoline engines are a product within the category, Engines and Turbines (SIC Industry Group 351). Y, a wholly owned foreign subsidiary of X, also manufactures and sells these engines abroad. During 1996, X incurred expenditures of \$60,000 on research and experimentation, which it deducts as a current expense, to invent and patent a new and improved gasoline engine. All of the research and experimentation was performed in the United States. In 1996, the domestic sales by X of the new engine total \$500,000 and foreign sales by Y total \$300,000. X provides technology for the manufacture of engines to Y via a license that requires the payment of an arm's length royalty. In 1996, X's gross income is \$160,000, of which \$140,000 is U.S. source income from domestic sales of gasoline engines and \$10,000 is foreign source royalties from Y, and \$10,000 is U.S. source interest income.

(ii) *Allocation.* The research and experimental expenditures were incurred in connection with small gasoline engines and they are definitely related to the items of gross income to which the research gives rise, namely gross income from the sale of small gasoline engines in the United States and royalties received from subsidiary Y, a foreign manufacturer of gasoline engines. Accordingly, the expenses are allocable to this class of gross income. The U.S. source interest income is not within this class of gross income and, therefore, is not taken into account.

(iii) *Apportionment.* (A) For purposes of applying the foreign tax credit limitation, the statutory grouping is general limitation gross income from sources without the United States and the residual grouping is gross income from sources within the United States. Since the related class of gross income derived from the use of engine technology consists of both gross income from sources without the United States (royalties from Y) and gross income from sources within the United States (gross income from engine sales), X's deduction of \$60,000 for its research and experimental expenditure must be apportioned between the statutory and residual grouping before the foreign tax credit limitation

may be determined. Because more than 50 percent of X's research and experimental activity was performed in the United States, 50 percent of that deduction can be apportioned exclusively to the residual grouping of gross income, gross income from sources within the United States. The remaining 50 percent of the deduction can then be apportioned between the residual and statutory groupings on the basis of sales of small gasoline engines by X and Y. Alternatively, X's deduction for research and experimentation can be apportioned under the optional gross income method. The apportionment for 1996 is as follows:

(1) *Tentative Apportionment on the Basis of Sales.*

(i) Research and experimental expense to be apportioned between residual and statutory groupings of gross income: \$60,000

(ii) Less: Exclusive apportionment of research and experimental expense to the residual grouping of gross income (\$60,000 × 50 percent): \$30,000

(iii) Research and experimental expense to be apportioned between residual and statutory groupings of gross income on the basis of sales: \$30,000

(iv) Apportionment of research and experimental expense to the residual grouping of gross income ($\$30,000 \times \$500,000 / (\$500,000 + \$300,000)$): \$18,750

(v) Apportionment of research and experimental expense to the statutory grouping of gross income ($\$30,000 \times \$300,000 / (\$500,000 + \$300,000)$): \$11,250

(vi) Total apportioned deduction for research and experimentation: \$60,000

(vii) Amount apportioned to the residual grouping ($\$30,000 + \$18,750$): \$48,750

(viii) Amount apportioned to the statutory grouping: \$11,250

(2) *Tentative Apportionment on the Basis of Gross Income.*

(i) Exclusive apportionment of research and experimental expense to the residual grouping of gross income ($\$60,000 \times 25$ percent): \$15,000

(ii) Research and experimental expense apportioned to sources within the United States (residual grouping) ($\$45,000 \times \$140,000 / (\$140,000 + \$10,000)$): \$42,000

(iii) Research and experimental expense apportioned to sources within country Y (statutory grouping) ($\$45,000 \times \$10,000 / (\$140,000 + \$10,000)$): \$3,000

(iv) Amount apportioned to the residual grouping: \$57,000

(v) Amount apportioned to the statutory grouping: \$3,000

(B) The total research and experimental expense apportioned to the statutory grouping (\$3,000) under the gross income method is approximately 26 percent of the amount apportioned to the statutory grouping under the sales method. Thus, X may use option two of the gross income method (paragraph (d)(3) of this section) and apportion to the statutory grouping fifty percent (50%) of the \$11,250 apportioned to

that grouping under the sales method. Thus, X apportions \$5,625 of research and experimental expense to the statutory grouping. X's use of the optional gross income methods will constitute a binding election to use the optional gross income methods for 1996 and four taxable years thereafter.

Example 2—(i) Facts. Assume the same facts as in *Example 1* except that X also spends \$30,000 in 1996 for research on steam turbines, all of which is performed in the United States, and X has steam turbine sales in the United States of \$400,000. X's foreign subsidiary Y neither manufactures nor sells steam turbines. The steam turbine research is in addition to the \$60,000 in research which X does on gasoline engines for lawnmowers. X thus has a deduction of \$90,000 for its research activity. X's gross income is \$200,000, of which \$140,000 is U.S. source income from domestic sales of gasoline engines, \$50,000 is U.S. source income from domestic sales of steam turbines, and \$10,000 is foreign source royalties from Y.

(ii) *Allocation.* X's research expenses generate income from sales of small gasoline engines and steam turbines. Both of these products are in the same three digit SIC code category, Engines and Turbines (SIC Industry Group 351). Therefore, the deduction is definitely related to this product category and allocable to all items of income attributable to it. These items of X's income are gross income from the sale of small gasoline engines and steam turbines in the United States and royalties from foreign subsidiary Y, a foreign manufacturer and seller of small gasoline engines.

(iii) *Apportionment.* (A) For purposes of applying the foreign tax credit limitation, the statutory grouping is general limitation gross income from sources outside the United States and the residual grouping is gross income from sources within the United States. X's deduction of \$90,000 must be apportioned between the statutory and residual groupings. Because more than 50 percent of X's research and experimental activity was performed in the United States, 50 percent of that deduction can be apportioned exclusively to the residual grouping, gross income from sources within the United States. The remaining 50 percent of the deduction can then be apportioned between the residual and statutory groupings on the basis of total sales of small gasoline engines and steam turbines by X and Y. Alternatively, X's deduction for research and experimentation can be apportioned under the optional gross income methods. The apportionment for 1996 is as follows:

(1) *Tentative Apportionment on the Basis of Sales.*

(i) Research and experimental expense to be apportioned between residual and statutory groupings of gross income: \$90,000

(ii) Less: Exclusive apportionment of the research and experimental expense to the residual grouping of gross income ($\$90,000 \times 50$ percent): \$45,000

(iii) Research and experimental expense to be apportioned between the residual and statutory groupings of gross income on the basis of sales: \$45,000

(iv) Apportionment of research and experimental expense to the residual grouping of gross income ($\$45,000 \times (\$500,000 + \$400,000) / (\$500,000 + \$400,000 + \$300,000)$): \$33,750

(v) Apportionment of research and experimental expense to the statutory grouping of gross income ($\$45,000 \times \$300,000 / (\$500,000 + \$400,000 + \$300,000)$):

\$11,250

(vi) Total apportioned deduction for research and experimentation:

\$90,000

(vii) Amount apportioned to the residual grouping ($\$45,000 + \$33,750$):

\$78,750

(viii) Amount apportioned to the statutory grouping:

\$11,250

(2) *Tentative Apportionment on the Basis of Gross Income.*

(i) Exclusive apportionment of research and experimental expense to the residual grouping of gross income ($\$90,000 \times 25$ percent):

\$22,500

(ii) Research and experimental expense apportioned to sources within the United States (residual grouping) ($\$67,500 \times \$190,000 / (\$140,000 + \$50,000 + \$10,000)$):

\$64,125

(iii) Research and experimental expense apportioned to sources within country Y (statutory grouping) ($\$67,500 \times \$10,000 / (\$140,000 + \$50,000 + \$10,000)$):

\$3,375

(iv) Amount apportioned to the residual grouping:

\$86,625

(v) Amount apportioned to the statutory grouping:

\$3,375

(B) The total research and experimental expense apportioned to the statutory grouping (\$3,375) under the gross income method is 30 percent of the amount apportioned to the statutory grouping under the sales method. Thus, X may use option two of the gross income method (paragraph (d)(3) of this section) and apportion to the statutory grouping fifty percent (50%) of the \$11,250 apportioned to that grouping under the sales method. Thus, X apportions \$5,625 of research and experimental expense to the statutory grouping. X's use of the optional gross income methods will constitute a binding election to use the optional gross income methods for 1996 and four taxable years thereafter.

Example 3—(i) Facts. Assume the same facts as in *Example 1* except that in 1997 X continues its sales of the new engines, with sales of \$600,000 in the United States and \$400,000 abroad by subsidiary Y. X also acquires a 60 percent (by value) ownership interest in foreign corporation Z and a 100 percent ownership interest in foreign corporation C. X transfers its engine technology to Z for a royalty equal to 5 percent of sales, and X enters into an arm's length cost-sharing arrangement with C to share the funding of all of X's research activity. In 1997, corporation Z has sales in country Z equal to \$1,000,000. X incurs expense of \$80,000 on research and experimentation in 1997, and in addition, X performs \$15,000 of research on gasoline engines which was funded by the cost-sharing arrangement with C. All of Z's sales are from the product category, Engines and Turbines (SIC Industry Group 351). X performs all of its research in the United States and \$20,000 of its expenditure of \$80,000 is made solely to meet pollution standards mandated by law. X establishes, to the satisfaction of the Commissioner, that the expenditure in response to

pollution standards is not expected to generate gross income (beyond *de minimis* amounts) outside the United States.

(ii) *Allocation.* The \$20,000 of research expense which X incurred in connection with pollution standards is definitely related and thus allocable to the residual grouping, gross income from sources within the United States. The remaining \$60,000 in research and experimental expenditure incurred by X is definitely related to all gasoline engines and is therefore allocable to the class of gross income to which the engines give rise, gross income from sales of gasoline engines in the United States, royalties from country Y, and royalties from country Z. No part of the \$60,000 research expense is allocable to dividends from country C, because corporation C has already paid, through its cost-sharing arrangement, for research activity performed by X which may benefit C.

(iii) *Apportionment.* For purposes of applying the foreign tax credit limitation, the statutory grouping is general limitation gross income from sources without the United States, and the residual grouping is gross income from sources within the United States. X's deduction of \$60,000 for its research and experimental expenditure must be apportioned between these groupings. Because more than 50 percent of the research and experimentation was performed in the United States, 50 percent of the \$60,000 deduction can be apportioned exclusively to the residual grouping. The remaining 50 percent of the deduction can then be apportioned between the residual and the statutory grouping on the basis of sales of gasoline engines by X, Y, and Z. (If X utilized the optional gross income methods in 1996, then its use of such methods constituted a binding election to use the optional gross income methods in 1996 and for four taxable years thereafter. If X utilized the sales method in 1996, then its use of such method constituted a binding election to use the sales method in 1996 and for four taxable years thereafter.) The optional gross income methods are not illustrated in this *Example 3* (see instead *Examples 1* and 2). Since X has only a 60 percent ownership interest in corporation Z, only 60 percent of Z's sales (60% of \$1,000,000, or \$600,000) are included for purposes of apportionment. The allocation and apportionment for 1997 is as follows:

(A) X's total research expense: \$80,000

(B) Less: Legally mandated research directly allocated to the residual grouping of gross income: \$20,000

(C) Tentative apportionment on the basis of sales:

(1) Research and experimental expense to be apportioned between residual and statutory groupings of gross income: \$60,000

(2) Less: Exclusive apportionment of research and experimental expense to the residual grouping of gross income ($\$60,000 \times 50$ percent): \$30,000

(3) Research and experimental expense to be apportioned between the residual and the statutory groupings on the basis of sales: \$30,000

(4) Apportionment of research and experimental expense to gross income from sources within the United States (residual grouping) ($\$30,000 \times \$600,000 / (\$600,000 + \$400,000 + \$600,000)$): \$11,250

(5) Apportionment of research and experimental expense to general limitation gross income from countries Y and Z (statutory grouping) ($\$30,000 \times \$400,000 + \$600,000 / (\$600,000 + \$400,000 + \$600,000)$): \$18,750

(6) Total apportioned deduction for research and experimentation ($\$30,000 + \$30,000$): \$60,000

(7) Amount apportioned to the residual grouping ($\$30,000 + \$11,250$): \$41,250

(8) Amount apportioned to the statutory grouping of gross income from sources within countries Y and Z: \$18,750

Example 4—Research and Experimentation—

(i) *Facts.* X, a domestic corporation, manufactures and sells forklift trucks and other types of materials handling equipment in the United States. The manufacture and sale of forklift trucks and other materials handling equipment belongs to the product category, Construction, Mining, and Materials Handling Machinery and Equipment (SIC Industry Group 353). X also sells its forklift trucks to a wholesaling subsidiary located in foreign country Y (but title passes in the United States), and X manufactures forklift trucks in foreign country Z. The wholesaling of forklift trucks to country Y also belongs to X's product category Transportation equipment and, therefore, may not belong to the product category, Wholesale trade (SIC Major Group 50 and 51). In 1997, X sold \$7,000,000 of forklift trucks to purchasers in the United States, \$3,000,000 of forklift trucks to the wholesaling subsidiary in Y, and transferred forklift truck components with an FOB export value of \$2,000,000 to its branch in Z. The branch's sales of finished forklift trucks were \$5,000,000. In response to legally mandated emission control requirements, X's United States research department has been engaged in a research project to improve the performance and quality of engine exhaust systems used on its products in the United States. It incurs expenses of \$100,000 for this purpose in 1997. In the past, X has customarily adapted the product improvements developed originally for the domestic market to its forklift trucks manufactured abroad. During the taxable year 1997, development of an improved engine exhaust system is completed and X begins installing the new system during the latter part of the taxable year in products manufactured and sold in the United States. X continues to manufacture and sell forklift trucks in foreign countries without the improved engine exhaust systems.

(ii) *Allocation.* X's deduction for its research expense is definitely related to the income to which it gives rise, namely income from the manufacture and sale of forklift trucks within the United States and in country Z. Although the research is undertaken in response to a legal mandate, it can reasonably be expected to generate gross income from the manufacture and sale of trucks by the branch in Z. Therefore, the deduction is not allocable solely to income from X's domestic sales of forklift trucks. It is allocable to income from such sales and income from the sales of X's branch in Z.

(iii) *Apportionment.* For the method of apportionment on the basis of either sales or gross income, see *Example 3*. However, in determining the amount of research apportioned to income from foreign and domestic sources, the net sales of the branch in Z are \$3,000,000 (\$5,000,000 less \$2,000,000) and the sales within the United

States are \$12,000,000 (\$7,000,000 plus \$3,000,000 plus \$2,000,000). See §1.861-17(c)-(3)(iii).

Example 5—(i) *Facts.* X, a domestic corporation, is a drug company that manufactures a wide variety of pharmaceutical products for sale in the United States. Pharmaceutical products belong to the product category, Drugs (SIC Industry Group 283). X exports its pharmaceutical products through a foreign sales corporation (FSC). X's wholly owned foreign subsidiary Y also manufactures pharmaceutical products. In 1997, X has domestic sales of pharmaceutical products of \$10,000,000, the FSC has sales of pharmaceutical products of \$3,000,000, and Y has sales of pharmaceutical products of \$5,000,000. In that same year, 1997, X incurs expense of \$200,000 on research to test a product in response to requirements imposed by the United States Food and Drug Administration (FDA). X is able to show that, even though country Y imposes certain testing requirements on pharmaceutical products, the research performed in the United States is not accepted by country Y for purposes of its own licensing requirements, and the research has minimal use abroad. X is further able to show that FSC sells goods to countries that do not accept or do not require research performed in the United States for purposes of their own licensing standards.

(ii) *Allocation.* Since X's research expense of \$200,000 is undertaken to meet the requirements of the United States Food and Drug Administration, and since it is reasonable to expect that the expenditure will not generate gross income (beyond *de minimis* amounts) outside the United States, the deduction is definitely related and thus allocable to the residual grouping.

(iii) *Apportionment.* No apportionment is necessary since the entire expense is allocated to the residual grouping, gross income from sales within the United States.

Example 6—(i) *Facts.* X, a domestic corporation, is engaged in continuous research and experimentation to improve the quality of the products that it manufactures and sells, which are floodlights, flashlights, fuse boxes, and solderless connectors. X incurs and deducts \$100,000 of expenditure for research and experimentation in 1997 that was performed exclusively in the United States. As a result of this research activity, X acquires patents that it uses in its own manufacturing activity. X licenses its floodlight patent to Y and Z, uncontrolled foreign corporations, for use in their own territories, countries Y and Z, respectively. Corporation Y pays X an arm's length royalty of \$3,000 plus \$0.20 for each floodlight sold. Sales of floodlights by Y for the taxable year are \$135,000 (at \$4.50 per unit) or 30,000 units, and the royalty is \$9,000 (\$3,000 + \$0.20 × 30,000). Y has sales of other products of \$500,000. Z pays X an arm's length royalty of \$3,000 plus \$0.30 for each unit sold. Z manufactures 30,000 floodlights in the taxable year, and the royalty is \$12,000 (\$3,000 + \$0.30 × 30,000). The dollar value of Z's floodlight sales is not known and cannot be reasonably estimated because, in this case, the floodlights are not sold separately by Z but are instead used as a component in Z's manufacture of lighting equipment for theaters. The sales of all Z's products, including the lighting equipment for theaters, are \$1,000,000. Y and Z each sell the floodlights exclusively within their respective countries. X's sales of floodlights for the taxable

year are \$500,000 and its sales of its other products, flashlights, fuse boxes, and solderless connectors, are \$400,000. X has gross income of \$500,000, consisting of gross income from domestic sources from sales of floodlights, flashlights, fuse boxes, and solderless connectors of \$479,000, and royalty income of \$9,000 and \$12,000 from foreign corporations Y and Z respectively. X utilized the optional gross income methods of apportionment for its return filed for its first taxable year to which this section applies.

(ii) *Allocation.* X's research and experimental expenses are definitely related to all of the products that it produces, which are floodlights, flashlights, fuse boxes, and solderless connectors. All of these products are in the same three digit SIC Code category, Electric Lighting and Wiring Equipment (SIC Industry Group 364). Thus, X's research and experimental expenses are allocable to all items of income attributable to this product category, domestic sales income and royalty income from the foreign countries in which corporations Y and Z operate.

(iii) *Apportionment.* (A) The statutory grouping of gross income is general limitation income from sources without the United States. The residual grouping is gross income from sources within the United States. X's deduction of \$100,000 for its research expenditures must be apportioned between the groupings. For apportionment on the basis of sales in accordance with paragraph (c) of this section, X is entitled to an exclusive apportionment of 50 percent of its research and experimental expense to the residual grouping, gross income from sources within the United States, since more than 50 percent of the research activity was performed in the United States. The remaining 50 percent of the deduction can then be apportioned between the residual and statutory groupings on the basis of sales. Since Y and Z are unrelated licensees of X, only their sales of the licensed product, floodlights, are included for purposes of apportionment. Floodlight sales of Z are unknown, but are estimated at ten times royalties from Z, or \$120,000. All of X's sales from the entire product category are included for purposes of apportionment on the basis of sales. Alternatively, X may apportion its deduction on the basis of gross income, in accordance with paragraph (d) of this section. The apportionment is as follows:

(1) *Tentative Apportionment on the basis of sales.*

(i) Research and experimental expense to be apportioned between statutory and residual groupings of gross income: \$100,000

(ii) Less: Exclusive apportionment of research and experimental expense to the residual groupings of gross income (\$100,000 × 50 percent): \$50,000

(iii) Research and experimental expense to be apportioned between the statutory and residual groupings of gross income on the basis of sales: \$50,000

(iv) Apportionment of research and experimental expense to the residual groupings of gross income (\$50,000 × \$900,000/(\$900,000 + \$135,000 + \$120,000)): \$38,961

(v) Apportionment of research and experimental expense to the statutory

grouping, royalty income from countries Y and Z (\$50,000 × \$135,000 + \$120,000/(\$900,000 + \$135,000 + \$120,000)): \$11,039

(vi) Total apportioned deduction for research and experimentation: \$100,000

(vii) Amount apportioned to the residual grouping (\$50,000 + \$38,961): \$88,961

(viii) Amount apportioned to the statutory grouping of sources within countries Y and Z: \$11,039

(2) *Tentative apportionment on gross income basis.*

(i) Exclusive apportionment of research and experimental expense to the residual grouping of gross income (\$100,000 × 25 percent): \$25,000

(ii) Apportionment of research and experimental expense to the residual grouping of gross income (\$75,000 × \$479,000/\$500,000): \$71,850

(iii) Apportionment of research and experimental expense to the statutory grouping of gross income (\$75,000 × \$9,000 + \$12,000/\$500,000): \$3,150

(iv) Amount apportioned to the residual grouping: \$96,850

(v) Amount apportioned to the statutory grouping of general limitation income from sources without the United States: \$3,150

(B) Since X has elected to use the optional gross income methods of apportionment and its apportionment on the basis of gross income to the statutory grouping, \$3,150, is less than 50 percent of its apportionment on the basis of sales to the statutory grouping, \$11,039, it must use Option two of paragraph (d)(3) of this section and apportion \$5,520 (50 percent of \$11,039) to the statutory grouping.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved December 13, 1995.

Leslie Samuels,
Assistant Secretary of the Treasury.

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