



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

OFFICE OF  
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR CONNECTICUT-RHODE ISLAND DISTRICT COUNSEL  
CC:NER:CTR:HAR

FROM: SENIOR TECHNICAL REVIEWER CC:INTL:BR03

SUBJECT:

This Field Service Advice responds to your undated memorandum that was received in this office on August 5, 1998. Additional information was received on December 29, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Taxpayer =

Product =

FCo =

Standard Industry Classification Category X =

Activity Y =

ISSUE:

Whether Taxpayer's revised return position properly allocates and apportions its research and development (R&D) expenditures for purposes of computing its allowable foreign tax credit.

CONCLUSION:

Based on the facts as developed, Taxpayer's revised return position does not properly allocate and apportion its R&D expenditures for purposes of computing its allowable foreign tax credit. In particular, Taxpayer's application of the gross sales method of apportionment should be adjusted to consider its nonmanufacturing controlled foreign corporations' sales.

FACTS:

We understand the facts as follows. Taxpayer is a consolidated group of domestic corporations that develops, manufactures, markets, and services Product. Taxpayer holds leading market shares within its specific market segments.

Taxpayer held stock in 15 controlled foreign subsidiaries during the years at issue. Taxpayer wholly owned 14 of these subsidiaries; it owned 60 percent of the remaining subsidiary. These foreign subsidiaries constitute controlled foreign corporations ("CFCs") within the meaning of section 957(a) of the Internal Revenue Code.

During calendar years 1992 and 1994, the tax years at issue, Taxpayer sold Product to customers within the United States. Taxpayer also sold Product to its CFCs who, in turn, sold Product to customers abroad. With the exception of FCo, Taxpayer's CFCs did not engage in any developmental or manufacturing activities.

Taxpayer also conducted a substantial service business during the years at issue. This service business, which grew out of Product's sophisticated and complex nature, included product maintenance, repair, and refinement. Many of Taxpayer's customers purchased separate service contracts that included field service, customer support, applications assistance, and extensive training. Taxpayer's CFCs conducted similar service businesses.

Taxpayer conducted substantial Product-related R&D during the years at issue. Taxpayer did not have any formal agreement to licence or to sell any intangible property generated by its R&D to its nonmanufacturing CFCs.

Taxpayer's originally filed Forms 1118 allocated and apportioned its R&D expenditures for purposes of computing its allowable foreign tax credit. To the extent not governed by exclusive geographic allocation, Taxpayer allocated its R&D

expenditures to Standard Industry Classification Group (“SIC Code”) X, a major group within the manufacturing division. SIC Code X refers to Activity Y. See Executive Office of the President Office of Management and Budget, Standard Industry Classification Manual, 1987.

Taxpayer then apportioned these expenses between domestic and foreign source income on the basis of gross sales. Taxpayer applied the gross sales method in a manner that considered all of its CFCs’ sales.

Upon examination, Taxpayer proposes to revise the apportionment of its 1992 and 1994 R&D expenses. In particular, Taxpayer has requested an adjustment that reflects a revised application of the gross sales method that does not consider its nonmanufacturing CFCs’ sales. (Taxpayer’s revised computation continues to consider FCo’s sales.) At issue is the correctness of Taxpayer’s revised return position.

#### LAW AND ANALYSIS

The foreign tax credit provisions require Taxpayer to utilize various categories of foreign source taxable income. See, e.g., section 904(a) and (d). To compute these amounts, Taxpayer must allocate its deductions between U.S. source, foreign source, and worldwide classes of gross income and, as necessary, apportion the worldwide and foreign source amounts. The allocation and apportionment rules emphasize the factual relationship between deductions and classes of gross income. In the case of R&D, the rules recognize that R&D is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful R&D must bear the cost of unsuccessful R&D. See Treas. Reg. §§ 1.861-8(a)(2) and (e)(3)(i)(A).

For calendar years 1992 and 1994, Taxpayer allocated and apportioned its R&D expense deductions in accordance with either section 864(f) or Rev. Proc. 92-56, 1992-2 C.B. 409. (Section 864(f) governs the first 6 months of Taxpayer’s 1992 taxable year, as well as all of 1994. See section 864(f)(5) (as if effect for 1992) and section 864(f)(6). Rev. Proc. 92-56 controls the final 6 months of 1992. Rev. Proc. 92-56, sec. 3.01.) These authorities state the following general methodology:

1. R&D expenses that are incurred solely to meet legal requirements and that cannot reasonably be expected to generate gross income (beyond de minimus amounts) outside that jurisdiction are allocated to the jurisdiction legally mandating the expenditure. Section 864(f)(1)(A); Rev. Proc. 92-56, sec. 3.02. Taxpayer had no legally mandated expenditures and made no such allocations in either tax year.

2. Next, a portion of R&D expenditures attributable to research activities conducted in the U.S. is allocated directly to U.S. source income and a portion of

R&D expenditures attributable to research activities conducted outside the U.S. is allocated to foreign source income. Section 864(f)(1)(B); Rev. Proc. 92-56, sec. 3.03(ii). Pursuant to this rule, Taxpayer allocated 64 percent of its 1992 R&D expenses and 50 percent of its 1994 R&D expenses to U.S. source income. These allocations are not in issue.

3. Finally, the remaining R&D expenses are apportioned on the basis of gross sales revenue or gross income. Section 864(f)(1)(C); Rev. Proc. 92-56, sec. 3.04. Taxpayer elected to apportion its residual R&D expenditures based upon the gross sales method. This amount is in issue.

Treas. Reg. §§ 1.861-8(e)(3)(ii)(B), (C), and (D) describe the proper application of the gross sales method. See Rev. Proc. 92-56, sec. 3.04. In the context of the foreign tax credit computation, section 1.861-8(e)(3)(ii)(B) apportions R&D deductions within each product category, see section 1.861-8(e)(3)(i)(A) (allocating R&D deductions to classes of gross income reasonably connected with two-digit SIC Code product categories), between foreign and U.S. source income based on a comparison of the relative amounts of foreign and U.S. sales within each product category to total sales within that category. Section 1.861-8(e)(3)(ii)(C) and (D) state look-through rules that consider certain controlled and uncontrolled party sales for purposes of the gross sales method computation. These sales include uncontrolled party sales that involve intangible property licensed or purchased from the taxpayer. With regard to controlled party sales, section 1.861-8(e)(3)(ii)(D) provides as follows:

For purposes of the [gross sales method of apportionment], 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 . . . if such 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. . . . 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 or secret processes to that corporation . . . .

All of Taxpayer's CFCs qualified as controlled parties. See section 1.861-8(e)(3)(ii)(C) and (D) (defining "a corporation controlled by the taxpayer" and "uncontrolled party" by reference to section 267(b) or section 993(a)(3)).

Taxpayer asserts that its nonmanufacturing CFCs are pure distributors that did not purchase, license, or otherwise receive transfer of the intangibles created by its R&D expenses. Thus, taxpayer argues that these controlled corporations could not

reasonably be expected to benefit (within the meaning of section 1.861-8(e)(3)(ii)(D)) from its R&D conducted within its product category and, as a result, the CFC sales should not be considered for purposes of its gross sale method computation.

Applications of the R&D allocation and apportionment rules are highly fact specific. For the reasons stated below and based on the facts as developed, most notably Product's sophisticated and complex nature and the integral role of intangible property in the CFCs' service business, we believe that the nonmanufacturing CFCs' sales should be considered in Taxpayer's gross sales method computation. The following discussion also clarifies that the CFCs' "sales" should include all of the CFCs' Product-related income, including their service revenues.

1. The CFCs' benefit from Taxpayer's R&D expenses. The CFCs' participation in Taxpayer's service business indicates that they could reasonably have been expected to utilize taxpayer's intangible property and to benefit from its R&D expenses. Moreover, to the extent that the CFCs' sales activities included modifying and adapting Product to suit particular customers' requirements, these activities also imply a reasonable expectation of benefit from Taxpayer's R&D. The fact that Taxpayer did not formally transfer any intangible property to the CFCs does not affect these conclusions: section 1.861-8(e)(3)(ii)(D) applies to stated as well as unstated transfers of intangibles to controlled corporations. See, e.g., section 1.861-8(g), Example 3 (gross sales method computation includes sales by controlled corporation that receives technology as a contribution to capital, for which no royalty is paid).

2. The CFCs' "sales" include both their Product sales and service revenues. The facts indicate that Taxpayer may be construing section 1.861-8(e)(3)(ii)(D) in a manner that would exclude the CFCs' service income from its gross sales computation, regardless of whether or not the CFCs benefitted from the Taxpayers R&D expenses. Presumably, this position relies on a narrow, literal reading of the term "sales" that somehow excludes services revenue for purposes of section 1.861-8(e)(3)(ii)(D).

To the extent Taxpayer has asserted this position, we do not believe that it is correct. Read in context, section 1.861-8(e)(3)(ii)(D) addresses sales from a taxpayer's product category, as defined by the SIC Codes. These SIC Code "product" categories include 29 categories that refer to service activities. See Executive Office of the President Office of Management and Budget, Standard Industry Classification Manual, 1987 (Categories 70 through 89). The only reasonable manner in which to apply the gross sales method to "products" within these service activity categories is to consider the service revenues to be the "sales" attributable to that activity. See also section 1.861-8(e)(3)(ii)(B) (lease payments

treated as sales receipts under the allocation and apportionment rules). Accordingly, for purposes of section 1.861-8(e)(3)(ii)(D), the CFCs' sales include their Product-related sales and service income.

3. The CFCs' sales within Taxpayer's product category. Section 1.861-8(e)(3)(ii)(D) requires a taxpayer's gross sales method computation to consider all of its controlled subsidiaries' "sales from the [taxpayer's] product category." In this case, all of the CFCs' Product-related sales fell within Taxpayer's product category.

It should be noted, however, that this conclusion assumes that Taxpayer determined its SIC Code product category X in a manner that includes its manufacturing, sales, and service businesses. While the SIC Codes differentiate manufacturing from sales activities, the regulations require taxpayers that manufacture and sell their products to group all of these activities under the appropriate manufacturing SIC Code. See section 1.861-8(e)(3)(i)(A). As stated, the SIC Code categories also separately describe service activities. While, as a general rule, the regulations do not require service income to be subsumed under any related manufacturing category, section 1.861-8(e)(3)(i)(A) directs taxpayers to allocate R&D expenses to a single class of gross income that includes multiple SIC categories or all SIC categories when the R&D cannot be clearly identified with a single SIC category. Based on the facts as developed, Taxpayer's Product-related R&D related to all of its Product-related activities. Accordingly, Taxpayer's SIC Code X should include its Product-related manufacturing, sales, and service businesses.

If you have any further questions, please call (202) 622-3850.

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