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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Irwin Halpern
Senior Technical Reviewer, Branch 3
CC:INTL:Br3

SUBJECT:

This Field Service Advice responds to your memorandum dated December 22, 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:

Corporation A =

Corporation B =

Corporation C =

Corporation D =

Product =

Agency E	=
Country L	=
Possession M	=
Standard Industrial Classification Group N	=
$W	=
$X	=
$Y	=
$Z	=

ISSUES:

(1) Whether Corporation C properly allocated and apportioned research and development (R&D, also referred to as research and experimental) expenses for purposes of determining its intangible property income under the profit-split method of section 936(h).

(2) If, as a result of making adjustments to its R&D expenses, Corporation C's properly allocated and apportioned deductions exceed the relevant gross income from covered sales, can Corporation C's share of combined taxable income (CTI) be a negative amount? If so, can this negative amount reduce its qualified possession source investment income (QPSII)?

CONCLUSIONS:

(1) Based upon the facts as developed, Corporation C did not properly allocate and apportion R&D expenses for purposes of determining its intangible property income under the section 936(h) profit split method. In particular, Corporation C misconstrued the application of the sales method of apportionment for purposes of the profit split method. We also note certain factual issues with regard to the R&D expenses that Corporation C reported as "legally mandated."

(2) Corporation C's share of CTI can be a negative amount. This negative amount must be considered in the section 936(a)(1) computation and can reduce QPSII.

FACTS:

Corporation A, a domestic corporation, is the parent of an affiliated group of corporations. Corporation B, a subsidiary of Corporation A, develops, manufactures, and sells Product. Corporation B has a subsidiary located in Possession M, Corporation C, which also manufactures Product. Corporation C sells Product to Corporation B, which sells the Product that it purchases from Corporation C to third parties in the United States. Corporation C was incorporated in 1969 and regularly meets the requirements of section 936. For the tax years at issue, calendar years 1994 and 1995, Corporation C elected to use the profit split method to compute its intangible property income under section 936(h). For this purpose, the relevant members of Corporation C's affiliated group were Corporation B, Corporation C, and Corporation D. <u>See</u> section 936(h)(5)(C)(i)(I)(b).

Corporation B conducted substantial Product-related R&D during 1994 and 1995. In 1994 Corporation B incurred R&D expenses of $W; in 1995, it incurred R&D expenses of $Y. Of these amounts, Corporation B reported $X and $Z for 1994 and 1995, respectively, as legally mandated R&D. <u>See</u> §§1.861-8(e)(3)(i)(B) and 1.861-17(a)(4). These expenses, which were required by Agency E of Country L, related to specific Products other than the Product manufactured by Corporation C.

To the extent not governed by exclusive allocation, Corporation B elected to apportion its R&D expenses on the basis of the sales method. <u>See</u> §§1.861-8(e)(3)(ii)(A) and 1.861-17(c). These expenses all related to Standard Industry Classification (SIC) Group N, the relevant product category determined by reference to the Standard Industrial Classification Manual, 1987 (SIC Code).

In computing its 1994 and 1995 intangible property income under the profit split method, Corporation C took the position that none of Corporation B's 1994 and 1995 R&D expenses were properly allocated or apportioned to covered sales of its affiliated group. Consequently, Corporation C determined that its share of product area research determined under the cost-sharing method of section 936(h)(5)(C)(i)(I), as modified by section 936(h)(5)(C)(ii)(II), exceeded the R&D expenses allocated or apportioned under the primary profit split method and therefore utilized the modified cost-sharing amount in its CTI computation. <u>See</u> section 936(h)(5)(C)(ii)(II) (R&D and related deductions utilized in CTI computation shall not be less than modified cost-sharing amount). Your request asks whether Corporation C understated the R&D expenses properly allocated or apportioned to its affiliated groups' covered sales under the primary profit-split method by not taking proper account of Corporation B's 1994 and 1995 R&D expenses. In addition, you ask, in the event that the expenses properly allocated or apportioned to the affiliated group's covered sales exceed the gross income generated by those sales, whether Corporation C's share of this negative amount can offset its QPSII. Under the facts submitted, the sum of the amounts described in section 936(a)(1)(A) and (B) would in no event be less than zero.

LAW

Section 936(a)(1) authorizes an electing domestic corporation that satisfies certain conditions (a possessions corporation) to claim, subject to certain limitations, an income tax credit equal to the tax attributable to the sum of: (A) its foreign source taxable income from (i) the active conduct of a trade or business within certain possessions of the United States, or (ii) the sale or exchange of substantially all of the assets used in the active conduct of such trade or business, and (B) its qualified possession source investment income.

Section 936(h)(3)(A) provides special rules for determining a possessions corporation's income attributable to intangible property. Pursuant to section 936(h)(3)(B), intangible property includes any patent, invention, formula, process, design, pattern, or know-how. Section 936(h)(1)(A) provides, in general, that intangible property income is included on a pro rata basis in the gross income of U.S. shareholders of a possessions corporation. Pursuant to this rule, intangible property income is excluded from the gross income of the possessions corporation and, as a result, is ineligible for the section 936 credit. See section 936(h)(1)(B). Alternatively, section 936(h)(5) allows possessions corporations to elect either the cost-sharing method or the profit-split method for computing its intangible property income. If a possessions corporation elects either of these methods, a portion of its intangible property income is not taxed to its U.S. shareholders and, as a result, is eligible for the section 936 credit. See, e.g., section 1.936-6(b)(1), Q/A 14, (the portion of CTI allocated to the possessions corporation treated as possession source income and as derived from the active conduct of a trade or business within the possession).

Congress enacted section 936(h) in 1982 in response to a Treasury Department report that pointed out an "unduly high revenue loss" attributable to certain taxpayers' allocations of intangible income between U.S. parent and subsidiary possessions corporations. The legislative history cites the following example and discussion:

> Under present law, some taxpayers have taken the position that they may make tax-free transfers of intangible assets created or acquired in the United States (such as patents, secret processes, and trademarks) to an electing section 936 corporation, and that no allocation of income generated by those intangibles to the U.S. parent is required....For instance, a U.S. pharmaceutical company may spend (and deduct or amortize and take a research and development tax credit for) large sums on research and development of new drugs. When it develops an effective drug, it may transfer the patent on the drug and the know-how to manufacture the drug to a section 936 subsidiary in a purportedly tax-free exchange. Thereafter, the 936

> company may manufacture the drug and claim for itself the extremely high profits which typically result from the sale of pharmaceutical products. It is the committee's understanding that high profits on certain pharmaceutical products must be realized because, according to the industry, the profits from the relatively few successful drugs must, in effect, amortize the development costs of all the unsuccessful products and finance the necessary research and development for future products. This results in the creation of extremely valuable intangibles (e.g., patents and trademarks) in the drug industry. If there is no allocation of income from the intangibles to their developer (the U.S. parent), a distortion of income results, with the parent obtaining deductions for its efforts while the 936 company realizes tax-free income.

S. Rep. No. 494, 97th Cong., 2d Sess. 158-59 (1982). See also Staff of the Joint Committee on Taxation, 97th Cong., 2d Sess. General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982 82-83 (1982) (TEFRA Blue Book). Congress thus enacted section 936(h) with the intent of correcting this distortion of income. Accordingly, a possessions corporation can only claim a section 936 credit with regard to intangible property income according to the formulaic cost-sharing or profit-split methodology.

Section 936(h)(5)(C)(ii) describes the profit-split method. Under this method, an electing corporation's taxable income derived from each possession product is equal to 50 percent of the CTI derived from covered sales of the possession product by the electing corporation and its U.S. affiliates. Covered sales is defined in section 936(h)(5)(C)(ii)(IV) as sales by U.S. members of the affiliated group to persons who are not members of the affiliated group or to foreign affiliates. Affiliated group is defined in section 936(h)(5)(C)(i)(I)(b) as the possessions corporation and all other organizations, trades or businesses owned or controlled, directly or indirectly, by the same interests, within the meaning of section 482.

Section 936(h)(5)(C)(ii)(II) states that CTI is computed separately for each possession product produced by the possessions corporation. CTI is computed by deducting from the gross income of the U.S. members of the affiliated group from covered sales all expenses, losses, and other deductions properly apportioned or allocated thereto, plus a ratable part of all expenses, losses, or other deductions of the affiliated group that cannot definitely be allocated to some item or class of gross income. However, in computing CTI for each possession product, the R&D expenses and related deductions for the taxable year cannot be less than the possession corporation's share of product area research, with certain modifications, computed under the cost-sharing alternative.

Section 1.936-6(b)(1), Q/A 1(i), provides that, in determining CTI from sales of a possession product, expenses, losses, and other deductions are to be allocated and apportioned on a "fully-loaded" basis under §1.861-8 to the combined gross income of the possessions corporation and other members of the affiliated group (other than foreign affiliates). As the legislative history to section 936(h) explains:

> The combined taxable income of the island affiliate and its mainland affiliates from the sale of the product produced in whole or in part in the possession is the excess of the gross receipts from the sale of such product to third parties or foreign affiliates over the total costs relating to such product incurred by the island affiliate and its mainland affiliates. Costs which are treated as relating to a product produced in whole or in part in the possession are all direct and indirect expenses, losses, and other deductions (including marketing expenses) with respect to sales of such product; i.e., the expenses will be 'fully-loaded.'

H.R. Rep. 760, 97th Cong., 2d Sess. 511 (1982). See also TEFRA Blue Book at 92.

Section 1.936-6(b)(1), Q/A 1(i), provides that the amount of R&D expenses allocated and apportioned to combined gross income is determined under §1.861-8(e)(3). Section 1.936-6(b)(1), Q/A 3 states that the allocation and apportionment of product area research required by section 936(h) and described in Q/A 1 overrides the moratorium provided by section 223 of the Economic Recovery Act of 1981 (ERTA) and any subsequent similar moratorium.

Section 1.861-8(a)(1) explains that the regulations under §1.861-8 provide specific guidance on how to allocate and apportion expenses, losses, and other deductions. These rules apply in determining taxable income from within and without the United States under sections 861, 862, and 863, as well as in determining taxable income from specific activities under other sections of the Code, referred to as operative sections. Section 1.861-8(f)(1) provides a list of operative sections and states that the regulations apply in determining, among other amounts, the section 936 tax credit.

Section 1.861-8(a)(2) provides a general description of the allocation and apportionment of deductions. A taxpayer to which the §1.861-8 rules apply is required to allocate deductions to a class of gross income and, then, if necessary to make the determination required by the operative section of the Code, to apportion deductions within the class of gross income between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income. Except for deductions, if any, which are not definitely related to gross income and which, therefore, are ratably apportioned to all gross income, all deductions of the taxpayer must be so allocated and apportioned. Allocations and apportionments are made on the basis of the factual relationship of deductions to gross income.

Section 1.861-8(a)(3) states that the gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of items of gross income enumerated in section 61, such as gross income derived from business. Section 1.861-8(a)(4) states that the term "statutory grouping of gross income" or "statutory grouping" means the gross income from a specific source or activity that must first be determined in order to arrive at taxable income from such specific source of activity under an operative section. Gross income from other sources or activities is the "residual grouping of gross income" or "residual grouping."

Section 1.861-8(b) provides rules concerning allocation. The rules emphasize the factual relationship between the deduction and a class of gross income. Allocation is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to such class of gross income (without regard to the taxable year in which such gross income is received or accrued or is expected to be received or accrued). A deduction is considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. Where a deduction is incurred as a result of, or incident to, an activity or in connection with property, which activity or property generates, has generated, or could reasonably have been expected to generate gross income, such deduction shall be considered definitely related to such gross income as a class whether or not there is any item of gross income in such class which is received or accrued during the taxable year and whether or not the amount of deductions exceeds the amount of the gross income in such class.

Section 1.861-8T(c)(1) provides rules concerning apportionment. When a deduction is allocated to a class of gross income that includes more than one statutory and/or residual grouping, the deduction must be apportioned between the groupings. A deduction is apportioned by attributing the deduction to gross income (within the class to which the deduction has been allocated) which is in one or more statutory groupings and to gross income (within the class) which is in the residual grouping. Such attribution must be accomplished in a manner that reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income.

Section 1.861-8(d)(1) provides rules concerning excess of deductions. Each deduction that bears a definite relationship to a class of gross income is to be allocated to that class even though, for the taxable year, taxpayer received or accrued no gross income in that class or the amount of the deduction exceeds the amount of gross income in that class. In apportioning deductions, it may be that, for the taxable year, taxpayer has no gross income in the statutory (or residual) grouping, or that deductions exceed the gross income in the statutory (or residual) grouping. In these circumstances, the effects of an excess of deductions over gross income are determined under the operative Code section.

The allocation and apportionment of R&D expenses has been governed by several, somewhat overlapping, sets of rules over the years. Section 1.861-8(e)(3) was promulgated in 1977. It provided the following general methodology for allocating and apportioning R&D expenses:

(A) Expenses for R&D that is undertaken solely to meet legal requirements imposed by a political entity with respect to the improvement or marketing of specific products or processes (legally-mandated R&D), the results of which cannot reasonably be expected to generate amounts of gross income (beyond de minimis amounts) outside a single geographic source are allocable only to the grouping (or groupings) of gross income within that geographic source as a class. Section 1.861-8(e)(3)(i)(B); see also section 864(f)(1)(A) and §1.861-17(a)(4) (articulating similar rules).

(B) Next, where an apportionment based upon geographic sources of income is necessary, a portion of R&D expenses attributable to research activities conducted in the United States is allocated directly to U.S. source income and a portion of R&D expenses attributable to research activities conducted outside the United States is allocated to foreign source income (exclusive apportionment R&D). Section 1.861-8(e)(3)(ii)(A); see also section 864(f)(1)(B) and §1.861-17(b)(1).

(C) Finally, the remaining qualified R&D expenditures (residual R&D) are apportioned on the basis of gross sales or gross income. Section 1.861-8(e)(3)(ii)(B); see also section 864(f)(1)(C) and §1.861-17(b)(1). Under the sales method, residual R&D expenditures are apportioned between statutory and residual groupings within the class of gross income based on the relative amounts of sales within the statutory and residual groupings to total sales within the class. Section 1.861-8(e)(3)(ii)(B); see also §1.861-17(c)(1). Amounts apportioned under the sales method may exceed the amount of gross income related to the class of gross income within the statutory grouping. In this case, the excess amount is applied against other gross income within the statutory grouping. The regulation cross-references to §1.861-8(d)(1) for the rules applicable when the apportioned deductions exceed gross income within the statutory grouping. Id.

An important concept underlying these rules is the recognition 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. Expenditures for R&D that a taxpayer conducts under section

174 are ordinarily 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). See sections 1.861-8(e)(3)(i)(A) and 1.861-17(a)(1).

As part of the Economic Recovery Tax Act of 1981, Congress provided that, for a two-year period, all expenses related to R&D conducted in the U.S. were to be allocated or apportioned entirely against U.S. source income. H.R. Rep. 201, 97th Cong., 1st Sess. 130-131 (1981). But see §1.936-6(b)(1), Q/A 3 (moratorium does not apply for purposes of computing CTI under section 936(h)). Including extensions, this moratorium remained in effect for taxable years beginning after August 31, 1981 and on or before August 1, 1986. Deficit Reduction Act of 1984, P.L. 98-369; Consolidated Omnibus Budget Reconciliation Act of 1985, P.L. No. 99-272 §13211.

Underlying the moratorium was a concern that the 1977 R&D rules had a detrimental effect on U.S. R&D activities. The regulations mandated the apportionment of some U.S.-based R&D expenses to foreign source income, notwithstanding the fact that some foreign countries did not allow a deduction for these offshore expenses. As a result, U.S. taxpayers' foreign tax credit were reduced and taxpayers argued that there was an incentive to shift research activities to foreign countries that allow a deduction for locally incurred R&D expenses. Congress also directed Treasury to study the impact of §1.861-8(e)(3) on domestic R&D activities and the availability of the foreign tax credit. See H.R. Rep. 247, 101st Cong., 1st Sess. 1205-06 (1989).

The Tax Reform Act of 1986 allowed the moratorium on the application of the 1977 rules to expire. Tax Reform Act of 1986, §1216, P.L. No. 99-514. As a result, for taxable years beginning after August 1, 1986, and on or before August 1, 1987, the 1986 Act generally reinstated the rules in §1.861-8(e)(3). There were, however, several liberalizations made to the 1977 regulations that were effective during this period.

In 1988, Congress implemented temporary allocation rules for R&D (Technical and Miscellaneous Revenue Act of 1988 §4009, P.L. No. 100-647 102 Stat. 3342, 3653), which were subsequently enacted as new subsection 864(f) in the Omnibus Budget Reconciliation Act (OBRA) of 1989, effective for tax years beginning after August 1, 1989. Omnibus Budget Reconciliation Act of 1989 §7111, P.L. No. 101-239 103 Stat. 2106, 2326. Section 864(f) was extended to apply to R&D expenses incurred during the first six months of a taxpayer's first taxable year beginning after August 1, 1991. The Tax Extension Act of 1991, Pub. L. No. 102-227, §101. Thereafter, the IRS issued Rev. Proc. 92-56, which allowed taxpayers to elect to apply rules similar to section 864(f) to the last six months of tax years beginning after August 1, 1991 and the following tax year. 1992-2 C.B. 409. The Revenue Reconciliation Act of 1993 further extended section 864(f) for the first taxable year starting on or before August 1, 1994, following the taxpayer's last taxable year to which Revenue Procedure 92-56 applies or would have applied had the taxpayer elected its benefits. Section 864(f)(6). Final regulations under §1.861-17 were issued in 1995, effective for taxable years beginning after December 31, 1995; taxpayers, however, had the option to apply §1.861-17 to taxable years beginning after August 1, 1994. Section 1.861-17(g).

The allocation and apportionment rules enacted by section 864(f) applied for purposes of sections 861(b), 862(b), and 863(b). Section 864(f)(1). As stated in its legislative history:

> The bill establishes a new Code provision, section 864(f), which supersedes the Treasury's research and experimentation expense allocation regulation for purposes of determining the source of taxable income, and makes permanent for these purposes the statutory rules for allocation of such expenses contained in the 1988 Act. These rules do not apply, for example, in the allocation and apportionment of deductions for research and experimental expenditures for purposes of computing the taxable income of a foreign taxpayer effectively connected with its conduct of a trade or business in the United States.

H.R. Rep. 247, 101st Cong., 1st Sess. 1209 (1989).

Section 864(f)(4)(A) articulates and applies the general rule that the allocation and apportionment of R&D under section 864(f) is to be determined as if all members of the affiliated group were a single corporation. See section 864(e). Section 864(f)(4)(B) provides an exception to this rule: sales and gross income from products produced in whole or in part in a possession by a possessions corporation that has elected either the cost sharing or profit-split method of computing intangible property income and dividends paid by such company, are not taken into account. Underlying this rule is the concept that, to the extent gross income and sales are eligible for a section 936 credit, these amounts should not also be considered for purposes of geographic sourcing under sections 861(b), 862(b), and 863(b). See H.R. Rep. 247, 101st Cong., 1st Sess. 1210 (1989). Section 1.861-17(a)(3)(ii)(A) articulates a similar rule.

ISSUE 1

TAXPAYER'S POSITION:

We understand Taxpayer's position to have two, related bases: (1) an extension of the holding in St. Jude Medical, Inc. v. Comm'r, 34 F. 3d 1394 (8th Cir. 1994), rev'g in part 97 T.C. 457 (1991), to the computation of CTI for purposes of the section 936(h) profit split, and (2) an interpretation and application of the R&D rules as applied to its facts.

St. Jude considered the interaction between the computation of CTI under the Domestic International Sales Corporation (DISC) provisions and the allocation and apportionment of R&D expenses under §1.861-8(e)(3). The Eighth Circuit held §1.861-8(e)(3) to be unreasonable, and thus invalid, to the extent that it required taxpayers to utilize SIC categories to consider indirect product area R&D expenses in DISC CTI computations. The court held that mandatory use of the SIC categories conflicted with Congressional intent to allow costs to be allocated on a product-by-product basis or on the basis of product lines. 34 F. 3d at 1401. By analogy, Taxpayer seems to assert that the section 936(h)(5)(C)(ii)(II) requirement that CTI be computed separately for each possession product implies that the section 936 CTI computation can only consider costs that are directly and specifically related to the possession product. Stated otherwise, Taxpayer would cite St. Jude for the proposition that the rules governing the allocation and apportionment of R&D expenses are invalid to the extent that they require any reduction of the gross income from covered sales by expenses that are attributed to those sales by reference to SIC categories.

Taxpayer's second point addresses the specific application of the allocation and apportionment rules. It points out that none of Corporation B's legally mandated R&D related to the possessions products at issue and, as a result, that none of these expenses should reduce the affiliated group's gross income from covered sales. Moreover, Taxpayer asserts that legally mandated R&D expenses are properly allocated to the single geographic source in which it is expected to generate income. Because CTI involves a calculation that does not yield income from a single geographic source, legally mandated expenses are not properly apportioned to gross income from covered sales for purposes of the CTI computation.

With regard to exclusive apportionment R&D, Taxpayer asserts that §1.936-6(b), Q/A 3 precludes any such apportionment with regard to CTI because the exclusive apportionment rules are similar to the 1981 moratorium. Alternatively, it asserts, as in the case of legally mandated R&D, that the requirement that exclusive apportionment R&D be apportioned to a single geographic source is incongruous with the computation of CTI. Accordingly, as a result, exclusive apportionment R&D expenses are not properly apportioned to gross income from covered sales for purposes of the CTI computation.

Finally, Taxpayer applies the sales method to its residual R&D expenses. Taxpayer relies on the language in section 864(f)(4)(B) and §1.861-17(a)(3) that "sales...from products produced in whole or in part in a possession by an electing corporation...shall not be taken into account..." for the proposition that the sales method does not permit any of Corporation B's residual R&D expenses to be apportioned to gross income from covered sales for purposes of the CTI computation.

ANALYSIS

St. Jude Medical Inc. v. Commissioner

The Service has published an Action on Decision that does not acquiesce to the St. Jude decision. The Service's nonacquiescence specifically relates to the application of §1.861-8(e)(3) to DISC CTI computations and states that this issue should continue to be litigated. AOD CC-1995-001 (Feb. 13, 1995); see also 1995-2 C.B. 2, fn. 13 and accompanying text. However, although we disagree with the St. Jude decision, we recognize its precedential effect on cases appealable to the Eighth Circuit, and therefore will follow it with respect to cases within that Circuit that cannot be meaningfully distinguished. Chief Counsel Notice N(35)(12)43-1, February 19, 1999.

We do not agree with Taxpayer's assertion that the holding and opinion in St. Jude inform the current matter. The computation of CTI for purposes of the section 936(h) profit split can be meaningfully distinguished from the computation of CTI under the DISC provisions. The section 936 computation is implemented through different operative rules with different underlying policies. For example, in the case of the section 936(h) profit split, section 936(h)(5)(C)(ii)(II) provides that the R&D and related expenses deducted from the gross income of the U.S. members of the affiliated group from covered sales is the greater of (1) the properly apportioned or allocated R&D and related expenses, and (2) the possession corporation's share of product area research, with certain modifications, computed under the cost-sharing alternative. Section 936(h)(5)(C)(i)(I)(e) defines "product area" by reference to three-digit SIC Codes. This comparison between the allocated or apportioned R&D and related deductions and the modified share of product area research implies that both amounts must be computed with respect to the same base; that is, with respect to three-digit SIC Codes. It would have been incongruous for Congress to require taxpayers to compare a cost-sharing amount computed with respect to a three-digit SIC Code with a profit-split amount computed on a product-by-product basis.

Further, §1.936-6(b)(1), Q/A 1, requires that expenses be allocated and apportioned on a "fully-loaded" basis to the combined gross income of the possessions corporation and other U.S. members of the affiliated group. As discussed above, this regulatory language originated in the legislative history of section 936, which uses the term to describe "all direct **and indirect** expenses, losses, and other deductions ... with respect to the sales of such product...." H.R.

Rep. 760, 97th Cong., 2d Sess. 511 (1982) (emphasis added). See also TEFRA Blue Book at 92.

Finally, the policy reasons underlying the enactment of section 936(h) do not indicate that Congress intended taxpayers to narrowly define the R&D expenses allocated or apportioned to intangible property income under the profit-split method. On the contrary, the legislative history emphasizes the need for successful products to fund unsuccessful R&D. Section 936(h) was enacted specifically to address the "distortion of income" that can result when successful sales within a product line are separated from unsuccessful R&D related to that line. S. Rep. No. 494, 97th Cong., 2d Sess. 158-59 (1982) (excerpted and discussed above). See also TEFRA Blue Book at 82-83.

Allocation and Apportionment of R&D Expenses

Applicable Rules

The tax years at issue are calendar years 1994 and 1995. Section 864(f) applies to 1994. Section 864(f)(6). However, section 864(f) only applies "for purposes of sections 861(b), 862(b), and 863(b)," that is, for purposes of determining taxable income from sources within and without the United States. Section 864(f)(1); see also H.R. Rep. 247, 101st Cong., 1st Sess. 1209 (1989). The computation of CTI for purposes of the section 936(h) profit split does not involve these "geographic sourcing" rules. It requires an apportionment of R&D expenses between the statutory grouping of gross income from covered sales and other gross income. See § 1.861-8(a)(4). Thus, section 864(f) does not govern the allocation and apportionment of R&D expenses for purposes of determining CTI under section 936(h). As a result, the rules of §1.861-8(e)(3) apply to the determination of Taxpayer's 1994 CTI amount. For 1995, we understand that Taxpayer filed an election pursuant to §1.861-17(g). As a result, the rules of §1.861-17 apply to the determination of Taxpayer's 1995 CTI amount.

Legally Mandated R&D

The regulations state the prerequisites that R&D expenses must satisfy in order to qualify as legally mandated. The R&D: (1) must be undertaken solely to meet legal requirements imposed by a political entity with respect to improvement of specific products or processes, and (2) the results cannot reasonably be expected to generate amounts of gross income (beyond de minimis amounts) outside a single geographic source. §§1.861-8(e)(3)(i)(B) and 1.861-17(a)(4). Thus, the fact that Agency E of Country L required certain R&D is insufficient, in and of itself, to qualify Corporation B's 1994 and 1995 expenses of $X and $Z as legally mandated under the regulations. Accordingly, further factual development is required to determine whether, or the extent to which, the expenses that Corporation B reported as legally mandated met all of the factual requirements articulated by §§1.861-8(e)(3)(i)(B) and 1.861-17(a)(4). To the extent these regulatory requirements were not met, Corporation B's 1994 and 1995 R&D expenses of $X and $Z should be considered in the same manner (described below) as its other non-legally mandated R&D expenses.

R&D expenses that qualify as legally mandated are, in general, allocable to a class of gross income comprised of all income related to the (tested) specific products or processes within the geographic source that required the testing. See §§1.861-8(e)(3)(i)(B) and 1.861-17(a)(4); see also §1.861-8(b)(1) ("Allocation is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related...."). Corporation B's legally mandated R&D (assuming that it qualifies as such) related to specific Products other than the Product manufactured by Taxpayer. Under these circumstances, none of Corporation B's legally mandated R&D would reduce the Taxpayer affiliated group's gross income from covered sales for purposes of its CTI computation.

We disagree, however, with Taxpayer's assertion that legally mandated R&D is never taken into account in computing CTI. When legally mandated R&D relates to a product sold by a possessions corporation, that R&D would be taken into account in computing CTI to the extent it is allocated to covered sales that arose within the geographic source that mandated the expenses.

Exclusive Apportionment R&D Expenses

The exclusive apportionment rules apply when the operative section of the Code requires an apportionment of R&D expenses based upon geographic sources of income. §§1.861-8(e)(3)(ii)(A) and 1.861-17(b)(1). The apportionment required by section 936(h)(5)(C)(ii)(II) distinguishes between gross income from covered sales and other gross income. This apportionment is not based upon geographic sources of income and, as a result, the exclusive apportionment rules do not apply to the computation of CTI under section 936(h). Thus, all of Corporation B's non-legally mandated R&D expenses must be considered under the below-described rules applicable to residual R&D expenses. See also § 936-6(b)(1), Q/A 3 (allocation and apportionment of R&D expenses for purposes of CTI made without regard to exclusive apportionment rules of 1981 moratorium and any subsequent similar moratorium).

Residual R&D Expenses

The regulations require R&D expenses that are not allocated or apportioned under the legally mandated or exclusive apportionment rules to be (1) allocated to classes of gross income reasonably connected with the relevant SIC Code, and (2) apportioned on the basis of sales or gross income. Section 1.863-8(e)(3)(i)(A), (ii)(B), and (iii); §1.861-17(a)(1), (a)(2), (c), and (d).

The Corporation B R&D expenses at issue all related to SIC Group N, a three-digit SIC Code. On this point, we note an apparent conflict for 1994 between § 1.863-8(e)(3)(i)(A)'s utilization of two-digit SIC Codes and §1.936-6(b)(1), Q/A 1(ii)'s reference to three-digit SIC Codes as the relevant reference for purposes of allocating R&D expenses. We resolve this apparent conflict in favor of the more specifically applicable section 936 regulation. <u>See also</u> section 936(h)(5)(C)(i)(I)(e) (defining "product area" by reference to three-digit SIC Codes).

Corporation B apportioned its R&D expenses based on the sales method. Under this method, R&D expenses are apportioned between statutory and residual groupings of gross income based upon the relative amounts of sales within each grouping compared to total sales within the class. Sections 1.861-8(e)(3)(i)(B) and 1.861-17(c)(1).

Section 864(f)(4) states special rules applicable to the allocation and apportionment of R&D expenses under section 864(f). As applied to the apportionment of residual R&D expenses, section 864(f)(4)(B) provides that, for purposes of the allocation and apportionment required by section 864(f)(1), sales and gross income from products produced in whole or in part by a possessions corporation that has elected to compute its intangible property income under either the cost-sharing or profit-split method are not taken into account. Section 1.861-17(a)(3)(ii)(A) states a similar rule. In computing the CTI amount, Taxpayer relied upon this rule for the proposition that the sales method does not permit any of Corporation B's residual R&D expenses to be apportioned against its affiliated group's gross income derived from covered sales.

We disagree with Taxpayer's construction and application of section 864(f)(4)(B) and §1.861-17(a)(3)(ii)(A). As discussed above, section 864(f)(1) applies for purposes of geographic sourcing under sections 861(b), 862(b), and 863(b). Thus, read in context, section 864(f)(4)(B) provides that sales considered under the cost-sharing or profit-split method are not again considered for purposes of operative sections that utilize geographic sourcing, <u>e.g.</u>, the section 904 foreign tax credit limitation. Section 1.861-17(a)(3)(ii)(A) must be similarly construed. It would be unreasonable to construe these provisions as prohibiting consideration of sales and gross income from possession products for purposes of the section 936(h) CTI computation. Such a reading would effectively preclude application of the residual R&D rules to the allocation and apportionment of expenses for purposes of determining CTI, thereby preventing substantial amounts of relevant product category R&D from being apportioned to covered sales. This result would directly conflict with section 936(h)(5)(C)(ii)(II)'s requirement that taxpayers compute CTI by deducting from covered sales gross income "all expenses, losses, and other deductions properly apportioned or allocated" thereto, as well as the directive that, in determining CTI, expenses, losses, and other deductions are to be allocated and apportioned on a "fully-loaded" basis. As stated in the legislative history: "[c]osts which are treated as relating to a product produced in whole or in part in the possession are **all** direct and indirect expenses, losses, and other deductions...." S. Rep. No. 494, 97th Cong., 2d Sess. 158 (1982) (emphasis added). See also TEFRA Blue Book at 92 and §1.936-6(b)(1), Q/A 1(i).

Thus, an application of the sales method under §§1.861-8(e)(3)(ii)(B) and 1.861-17(c)(1) requires an apportionment of Corporation B's residual R&D expenses within SIC Group N between the statutory grouping of gross income from covered sales and the residual grouping of other income based upon a comparison of the relative amounts of covered and other sales within SIC Group N by the U.S. members of Taxpayer's affiliated group to their total sales within SIC Group N. See also §§1.861-8(e)(3)(ii)(C) and (D) and 1.861-17(c)(2) and (3) (stating circumstances when sales by controlled and uncontrolled parties should be considered for purposes of the sales method computation).

ISSUE 2

The allocation and apportionment rules recognize that deductions may exceed their related class or grouping of gross income. When R&D deductions exceed total gross income within the statutory grouping, the regulations provide that the effects of this excess of deductions are determined under the operative Code section. §§1.861-8(e)(3)(ii)(B), 861-17(c)(1)(i), and 1.861-8(d)(1).

Under a plain reading of section 936, the combined taxable income computation can yield a negative amount. Section 936(h)(5)(C)(i)(II) provides that CTI is computed by deducting from the gross income of the U.S. members of the affiliated group from covered sales the greater of its allocated or apportioned deductions or the modified cost-sharing amount. No provision provides that this deduction cannot yield a negative amount. To the contrary, it has long been acknowledged that possessions corporations can operate at a loss. See, e.g., H.R. Rep. No. 658, 94th Cong., 1st Sess., 253-59 (1976) (explaining the prohibition on possessions corporations joining a consolidated return as related to the potential double benefit that could otherwise be derived by losses of a possessions corporation offsetting U.S. income of the consolidated group).

Thus, a possession corporation's share of its affiliated group's CTI can be a negative amount. Under section 936(h)(5)(C)(ii)(I) and §1.936-6(b)(1), Q/A 14, this amount is treated as possession source income and as derived from the active conduct of a trade or business within the possession. Accordingly, this negative amount must be taken into account in the section 936(a)(1) computation and combined with any other possession source income derived from the active conduct of a trade or business in the possession. Any negative amount derived from such combination should then be applied to reduce the possession corporation's QPSII.

This statutory reading is also supported by the nature of the section 936 credit. Section 936(a)(1) provides that, subject to certain conditions and limitations, "there shall be allowed as a credit against the tax imposed by this chapter an amount equal to the portion of the tax attributable to the sum of" possession trade or business income, income from the sale of possession trade or business assets, and QPSII. Accordingly, the section 936 credit cannot exceed the possession corporation's pre-credit U.S. tax. Because losses are taken into account in computing the possession corporation's pre-credit U.S. tax, it follows that losses must be considered in computing the amount of the section 936 credit. In allocating these losses, it seems most reasonable, consistent with the statutory language and purposes of section 936, to net positive and negative amounts of eligible possession income for purposes of allocating the pre-credit U.S. tax between possession income and any other income. As applied to the current matter, this principle requires combining Corporation C's share of the negative CTI amount with any other possession trade or business income described in section 936(a)(1)(A), and then reducing Corporation C's QPSII by any negative amount derived from such combination.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

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

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