INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =
F =
Partnership =
Industry L =
M =
N =

ISSUES:

1. May a foreign taxpayer's distributive share of gross income from a partnership be reduced by the foreign taxpayer's section 174 research and experimentation (R&E) expenses under the allocation and apportionment rules of Treas. Reg. §1.861-17?

2. Are a taxpayer's manufacturing and wholesaling activities with respect to a single industry aggregated for purposes of allocating and apportioning R&E expenses under Treas. Reg. §1.861-17?

CONCLUSIONS:

1. Because the section 861 regulations in general and Treas. Reg. §1.861-17 specifically take an aggregate approach to allocating and apportioning deductions to a

taxpayer's distributive share of partnership income, that distributive share of income may be reduced by the foreign taxpayer's section 174 R&E expense.

2. A taxpayer's manufacturing and wholesaling activities with respect to a single industry are aggregated for purposes of allocating and apportioning R&E expenses under Treas. Reg. §1.861-17.

FACTS:

Taxpayer is a foreign corporation that researches, develops, manufactures, and markets Industry L products. Taxpayer's products are sold in many countries. Taxpayer is an integrated Industry L company with activities primarily in Standard Industrial Classification code (SIC code) M, the manufacturing category for Industry L. Taxpayer conducts significant Industry L R&E in its home country as well as in many other countries around the world
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Prior to the tax years in issue, Taxpayer's U.S. operations were conducted principally through a wholly-owned U.S. subsidiary and
F, an unrelated U.S. Industry L company. During the tax years in issue, Taxpayer creating the Partnership.

During the tax years in issue, the Partnership performed marketing and wholesaling activities in the United States with respect to Industry L products created and manufactured by Taxpayer in its home country. In addition, the Partnership owned a manufacturing facility in the United States and manufactured Industry L products using licensed intangible property resulting from Taxpayer's worldwide R&E
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The Partnership also purchased certain Industry L products from
F, that F manufactured under licenses with Taxpayer, which had developed and owned the rights to intangible property resulting from worldwide R&E. The Partnership also conducted R&E on behalf of Taxpayer with respect to Taxpayer products, the nature and extent of which varied from product to product.

In summary, the Partnership's marketing and wholesaling activities in the United States involved Industry L products it purchased from Taxpayer, Industry L products manufactured by the Partnership itself, and Industry L products it purchased from F (collectively the "Products"). The Partnership's marketing and wholesaling activities with respect to the Products are described in SIC code N, the wholesaling category for Industry L.[1]

[1] As described in greater detail below, the SIC codes are segregated into two principal types,

For the tax years in issue, Taxpayer allocated its R&E expenses to all its income in the aggregated SIC codes M and N. Taxpayer filed a protective election with its Forms 1120-F to aggregate the product categories for which it conducts R&E activities with whatever product categories are determined to be applicable for the Partnership's income, as suggested by Treas. Reg. §1.861-17(a)(2)(i). Within that aggregated product category of gross income, Taxpayer apportioned its R&E expenses pursuant to the gross income method of Treas. Reg. §1.861-17(d). On audit, the IRS Exam team challenged Taxpayer's allocation of R&E expenses to any portion of its effectively connected income derived from its distributive share of partnership income.[2]

LAW AND ANALYSIS:

Section 882(a) provides that a foreign corporation is taxable in the same manner as a U.S. corporation on its taxable income which is effectively connected with the conduct of a trade or business within the United States (ECI). Under section 882(c), deductions are allowed to reduce the foreign corporation's ECI only if and to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States; the proper allocation and apportionment of deductions for this purpose are determined as provided in regulations. Section 875(1) considers a foreign corporation as engaged in a trade or business within the United States if the partnership of which such corporation is a member is so engaged.

Section 701 states that a partnership shall not be subject to the income tax imposed by Chapter 1. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities. Section 702(b) provides that the character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. Section 702(c) states that the gross income of a partner shall include its distributive share of the gross income of the partnership.

Treas. Reg. §1.882-4(a)(1) states that a foreign corporation that is engaged in, or receives income treated as effectively connected with, a trade or business within the United States is allowed the deductions which are properly allocated and apportioned to the foreign corporation's gross income which is effectively connected, or treated as effectively connected, with its conduct of a trade or business within the United States. Treas. Reg. §1.882-4(b) provides that deductible expenses other than interest are

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manufacturing and nonmanufacturing. Thus, an integrated business that both manufactures and sells (either as a wholesaler or retailer) a single product line will have activities that fall into two separate and distinct SIC codes.

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properly allocated and apportioned to effectively connected gross income in accordance with the rules of §1.861-8.[3]

Treas. Reg. §1.861-8(f) lists the operative sections that require the determination of taxable income of the taxpayer from specific sources or activities and that give rise to statutory groupings to which section 861 is applicable. Under Treas. Reg. §1.861-8(f)(1)(iv), foreign corporations engaged in a trade or business within the United States are taxed, as provided in section 882(a)(1), on taxable income which is effectively connected with the conduct of a trade or business within the United States. Pursuant to section 882(c), §1.861-8 is applicable for purposes of determining the deductions from such gross income that are to be taken into account in determining effectively connected taxable income.

Treas. Reg. §1.861-17 provides specific rules for the allocation and apportionment of section 174 R&E expenses.[4] Treas. Reg. §1.861-17(a)(1) states that the methods of allocation and apportionment of R&E set forth in the regulations reflect the fact that R&E is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful R&E must bear the cost of unsuccessful R&E. Expenses for R&E 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 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 broad product category.

Treas. Reg. §1.861-17(a)(2)(i) and (ii) provide that, ordinarily, a taxpayer's R&E expenses may be divided between the relevant product categories, which are determined by reference to the three digit classification (SIC code) of the Standard Industrial Classification Manual (SIC Manual). Where R&E is conducted with respect to more than one product category, the taxpayer may aggregate the categories for purposes of allocation and apportionment; however, the regulations provide that the taxpayer may not subdivide the categories (below a three-digit category). Where R&E is not clearly identified with any product category (or categories), it is considered conducted with respect to all the taxpayer's product categories. Treas. Reg. §1.861-17(a)(2)(iv) provides that the 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; Treas. Reg. §1.861-17(a)(2)(v) provides a similar rule for “Retail trade.”

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[3] Treas. Reg. §1.882-4 was promulgated in T.D. 7749, 1981-1 C.B. 390, when the R&E regulations were included in Treas. Reg. §1.861-8. Treas. Reg. §1.861-8(e)(3) now provides a cross reference to Treas. Reg. §1.861-17 with respect to rules regarding the allocation and apportionment of R&E expenses.

[4] While the analysis under Treas. Reg. §1.861-17 includes consideration of whether any portion of R&E expenditures is allocated under the legally mandated rules of §1.861-17(a)(4) or is subject to the exclusive apportionment rules of §1.861-17(b), this memorandum does not address those provisions [footnote added pursuant to 26 C.F.R. §301.6110-3(b)].

The SIC system was developed by the Office of Management and Budget, part of the Executive Office of the President, to classify establishments by type of activity; to facilitate the collection and analysis of data relating to establishments; and to promote uniformity and comparability in statistical data collected by various agencies of the U.S. Government, state agencies, and other organizations.[5] SIC codes are segregated into two primary types: manufacturing and wholesale. For example, the Manufacturing Division is defined in the SIC Manual as including establishments engaged in the mechanical or chemical transformation of materials or substances into new products. These establishments are usually described as plants, factories, or mills and characteristically use power driven machines and materials handling equipment. Manufacturing production is usually carried on for the wholesale market, for interplant transfer, or to order for industrial users, rather than for direct sale to the consumer.[6]

In contrast, the Wholesale Trade Division includes establishments or places of business primarily engaged in selling merchandise to retailers; to industrial, commercial, institutional, farm, construction contractors, or professional business users; and bringing buyer and seller together. The principal types of establishments include merchant wholesalers and sales branches and sales offices (but not retail stores) maintained by manufacturing, refining or mining enterprises apart from their plants or mines for the purpose of marketing their products.[7]

Treas. Reg. §1.861-17(f)(1) through (3) provide special rules for partnerships that incur R&E expenses. If R&E expenses are incurred by a partnership in which the taxpayer is a partner, the taxpayer's R&E expenses shall include the taxpayer's distributive share of the partnership's R&E expenses. Further, in applying the exception for legally mandated expenses under §1.861-17(a)(4) and the exclusive apportionment for the sales method and the optional gross income methods under §1.861-17(b), a partner's distributive share of R&E expenses incurred by a partnership is to be treated as incurred by the partner for the same purpose and in the same location as incurred by the partnership. Finally, in applying the remaining apportionment for the sales method under §1.861-17(c), 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.

ISSUE 1: May a foreign taxpayer's distributive share of gross income from a partnership be reduced by the foreign taxpayer's section 174 R&E expenses under the allocation and apportionment rules of Treas. Reg. §1.861-17?

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[5] Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual 11 (1987).

[6] Id. at 67.

[7] Id. at 287.

Partnership taxation is a hybrid of provisions that treat the partnership as an aggregate of its members or as a separate entity. Under a pure aggregate approach, each partner is treated as the owner of an undivided interest in partnership assets and operations. Under a pure entity approach, the partnership is treated as a separate entity in which partners have no direct interest in partnership assets and operations. In enacting subchapter K, Congress indicated that aggregate, rather than entity, concepts should be applied if the concepts are more appropriate in applying other provisions of the Code. S.Rep. No. 1622, 83d Cong., 2d Sess. 89 (1954) and H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954); see also Treas. Reg. § 1.701-2(e) (1994) and Rev. Rul. 99-57, 1999-2 C.B. 678. The aggregate theory, for example, results in the imposition of Federal income tax on the partners and not on the partnership. The entity theory is employed, among other purposes, to characterize items of income, gain, loss, deduction, or credit.[8]

The IRS Exam team asserts that whether a partnership is treated as an aggregate of its partners or as an entity distinct from its partners should be based on the characterization most appropriate for the situation. We agree. However, we do not agree that Treas. Reg. §1.861-17, requires the Partnership to be treated as a separate entity from Taxpayer for purposes of allocating and apportioning Taxpayer's R&E expenses. In this particular instance, the more appropriate characterization is to treat the Taxpayer as engaged in the activities of the Partnership and to apply the allocation and apportionment rules at the partner (Taxpayer) level between gross ECI and the residual grouping of income.

Furthermore, section 875(1) provides that a foreign corporation is considered as being engaged in a trade or business within the United States if the partnership of which such corporation is a member is so engaged. When section 875(1) applies, the foreign partner is taxable on its distributive share of the partnership's income that constitutes ECI in the hands of the partnership. Accordingly, because the Partnership is engaged in the business of developing, manufacturing, marketing, distributing, and selling Industry L products in the United States, the Taxpayer is treated as so engaged for purposes of treating Taxpayer as engaged in a U.S. trade or business. Taxpayer's items of income and deduction are characterized at the Partnership level, and are then taken into account by Taxpayer for purposes of determining ECI subject to U.S. tax.

The section 861 regulations also provide some guidance with respect to the appropriate treatment of partnership income and deductions. Treas. Reg. §1.861-17(f)(1), although not determinative with respect to this situation, is informative in that it clarifies that the party subject to tax is the partner rather than the partnership, a result generally

[8] There are, however, exceptions to this general principle. For example, whether or not an item of income is treated as income from a passive activity for purposes of the § 469 passive activity loss limitation is generally determined with reference to activities of the partner. See § 469(a)(2). These exceptions are not relevant to Taxpayer's situation.

consistent with the overall approaches of both the section 861 regulations in general[9] and section 701. In contrast, departures from that general aggregate approach to allocation and apportionment in the partnership context are specifically provided in the section 861 regulations.[10] There is no such specific provision with respect to R&E.

The IRS Exam team points out that Example 4 of Treas. Reg. §1.861-17(h) can be read to provide some support for an entity approach to partnership allocation and apportionment by apparently treating the U.S. parent and its foreign branch as separate entities. We believe the facts of Example 4 appear to respect the transfer solely for purposes of attributing a portion of the income to the parent and the branch. Example 4 does not in any way imply an overarching entity approach to partnership taxation in the allocation and apportionment rules.

Accordingly, the foreign Taxpayer's distributive share of gross income from the Partnership may be reduced by the foreign Taxpayer's section 174 R&E expenses under the allocation and apportionment rules of Treas. Reg. §1.861-17.

ISSUE 2: Are a taxpayer's manufacturing and wholesaling activities with respect to a single industry aggregated for purposes of allocating and apportioning R&E expenses under Treas. Reg. §1.861-17?

The section 861 regulations governing the allocation and apportionment of R&E expenses recognize that such expense is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful R&E must bear the cost of unsuccessful R&E. Accordingly, §1.861-17 provides that R&E expenses described within section 174 ordinarily shall be considered deductions that are definitely related to, and thus allocated to, all income reasonably connected with the relevant SIC code product category or categories. The regulations acknowledge that R&E may be conducted with respect to more than one product category and in such cases, provide for aggregation of more than one SIC code. Subdivision of SIC codes (below the three-digit level), on the other hand, is explicitly prohibited under the regulations. Treas. Reg. §1.861-17(a)(2); see also Boeing Co. v. United States, 537 U.S. 437 (2003). Where R&E is not clearly identified with any SIC code (or codes), the R&E is considered conducted with respect to all of the taxpayer's SIC codes.

Consistent with the broad approach to allocating R&E deductions to "all income reasonably connected" with SIC code categories, the wholesale trade rule of Treas. Reg. §1.861-17(a)(2)(iv) states that the two digit SIC code category "Wholesale trade" is not applicable with respect to sales by the taxpayer of goods and services from any

[9] Other instances in which the regulations confirm that the allocation and apportionment rules are generally applicable on an aggregate basis include Temp. Treas. Reg. §1.861-9T(e) (interest expense of a partnership), and Treas. Reg. §1.861-16(e) (partnership income from leased aircraft).

[10] See Temp. Treas. Reg. §1.861-9T(e)(4); Temp. Treas. Reg. §1.861-9T(e)(7).

other of the taxpayer's product categories. Thus, with respect to a single product, although the SIC Code Manual distinguishes between manufacturing activities on the one hand and wholesaling activities (wholesale and retail) on the other hand, R&E expenses associated with manufacturing must be allocated to income from both manufacturing and wholesale trade activities involving those goods. In other words, if a taxpayer incurs R&E expenses with respect to a product and sells that product, then the R&E should be allocated to all income attributable to that product, regardless of whether the income qualifies as manufacturing income or sales income for SIC code purposes.

Taxpayer is required to aggregate its wholesaling SIC code N income with its manufacturing SIC code M income for purposes of allocating its R&E. The wholesale trade rule of Treas. Reg. §1.861-17(a)(2)(iv) provides that taxpayers that both manufacture and wholesale products may not separate the manufacturing income from the wholesale income and then allocate their R&E solely to the manufacturing income. Since Taxpayer and the Partnership both manufacture and sell goods in the product category with respect to which the Industry L R&E is conducted, the wholesale trade rule applies to Taxpayer's income, including its share of Partnership L income. Accordingly, Treas. Reg. §1.861-17 requires that Taxpayer allocate its section 174 deductible R&E expenses associated with the Industry L Products to all income attributable to both manufacturing and sales of such Products, including its distributive share of Partnership income.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.