

taxpayer determines its tax liability under § 1.469-4, rather than under the rules of Project PS-1-89, the taxpayer may regroup its activities without regard to the manner in which the activities were grouped in the preceding taxable year and must regroup its activities if the grouping in the preceding taxable year is inconsistent with the rules of § 1.469-4.

(iii) *Regrouping when taxpayer is first subject to section 469(c)(7)*. For the first taxable year beginning after December 31, 1993, a taxpayer may regroup its activities to the extent necessary or appropriate to avail itself of the provisions of section 469(c)(7) and without regard to the manner in which the activities were grouped in the preceding taxable year.

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Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved: December 12, 1995.

Leslie Samuels,

Assistant Secretary of the Treasury (Tax Policy).

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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) 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