

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 generate 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,