DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR CC:LM:RFPH:STP
ASSOCIATE AREA COUNSEL LMSB

FROM: Chief, CC:INTL:BR3

SUBJECT: Allocation and apportionment of research and experimentation (R&E) expenses, duty of consistency, and estoppel

This Chief Counsel Advice responds to your memorandum dated March 18, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

B =

Agreement =

x =
y =
z =

ISSUES

1. Are dividends paid by B's controlled foreign corporations (CFCs) in the relevant product category properly excluded from the class of gross income to which R&E expenses are allocated, if the CFCs paying the dividends also pay royalties to B?

2. Because the Internal Revenue Service (Service) took the position on audit in a previous cycle that dividend income received from royalty-paying CFCs should be excluded from the relevant class of gross income in determining DISC or FSC

benefits, is the Service equitably and/or collaterally estopped for the years at issue from including dividend income from royalty-paying CFCs in the class of gross income to which R&E expense is allocated for purposes of computing the foreign tax credit limitation?

CONCLUSIONS

1. B must include both dividends and royalties from CFCs that are connected with the relevant product category in the class of gross income to which R&E expense is allocated.

2. The position taken by the Service with respect to the exclusion of dividend income from the relevant class of gross income for DISC/FSC purposes in the prior tax years does not contain the elements of any form of estoppel and does not preclude the Service from taking the correct position on Issue #1.

FACTS

B is a large multinational corporation that incurs significant amounts of R&E expenses, a portion of which is allocated and apportioned to its foreign source income for purposes of computing the foreign tax credit limitation. B controls a large number of CFCs located in various parts of the world. The CFCs are involved in all of B's businesses and each CFC generally manufactures and sells all of B's products in a given market. B and its CFCs produce income in a number of different product categories classified in the Standard Industrial Classification Manual (SIC Code product categories). The CFCs do not resell a significant amount of products purchased from unrelated parties.

Being the owner of a vast array of intangible property, B has entered into what it calls Agreements with its CFCs and charges a license fee based upon the use of its technical know-how. The standard or model Agreement calls for payment of a royalty of a fixed percentage of the net selling price of each licensed product locally manufactured by the CFC for the CFC's use of B's technology, patents, trademarks, and similar property. B has no cost-sharing arrangements with any CFC within the meaning of Treas. Reg. §1.861-17(c)(3)(iv) and Treas. Reg. §1.482-7.

For 1996, 1997, and 1998, B first determined the amount of legally-mandated R&E expenses to be allocated under Treas. Reg. §1.861-17(a)(4). Next, B apportioned 25 percent of its remaining R&E expenses to U.S. source income in accordance with the exclusive geographic apportionment rule of Treas. Reg. §1.861-17(b)(1)(ii). B used the optional gross income method under Treas. Reg. §1.861-17(d) to apportion its remaining R&E expenses to U.S. and foreign source income. B apportioned total R&E expenses of $x, $y, and $z to foreign source income for the 1996, 1997, and 1998 tax years, respectively.

B treats all license fee payments from its CFCs as royalty income for book and tax purposes. Each CFC prepares a tax information package (TIP) that has a spreadsheet that shows how the CFC arrived at its license fee expense; the TIP is primarily used for purposes of the foreign tax credit determinations and preparation of Forms 5471. For the three years under consideration, B made adjustments to foreign source gross income in the relevant SIC Code product categories by backing out the dividends paid by B's CFCs that had also paid license fees to B. The Service proposes to adjust the class of gross income and the gross income apportionment ratio determined under Treas. Reg. §1.861-17(d) to include the dividends from the royalty-paying CFCs.

B's position concerning the exclusion of those dividends from foreign source gross income was consistent with a proposed Service position taken on a previous audit of B's Domestic International Sales Corporation (DISC) during the 1983-1984 audit cycle and of B's Foreign Sales Corporation (FSC) during the 1985-86 audit cycle. At that time, the examining agent argued that R&E expense should be allocated exclusively to gross income from sales and royalties and that dividends should not be included in the class of income to which R&E expense was allocated where a royalty had also been paid. The effect of this position was to decrease combined taxable income and the allowable DISC/FSC commission. B asserted that, under Treas. Reg. §1.861-8(e)(3) (the R&E regulation in effect for 1983-1984 and 1985-86), dividends should be included in combined taxable income for purposes of determining DISC/FSC benefits. B requested and received Appeals Office consideration for all unagreed issues, including this one. The issue became moot when B switched from the gross income method to the sales method for those taxable years for purposes of apportioning R&E expenses in determining the DISC/FSC commission.

ALLOCATION AND APPORTIONMENT OF R&E EXPENSES

LAW AND ANALYSIS

To determine the allowable amount of foreign taxes creditable under section 901(a), a taxpayer must determine its foreign tax credit limitation under section 904(a). Section 904(a) provides that the total amount of the credit taken under section 901(a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year. Taxable income from sources without the United States is defined in section 862(b) as foreign source gross income less the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

The regulations under section 861 provide specific guidance on how to allocate and apportion expenses, losses, and other deductions 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. Treas. Reg. §1.861-8 requires taxpayers, to the extent necessary to determine taxable income from a specific source or activity required by an operative Code section, to allocate deductions to a class of gross income and to apportion deductions within the class between statutory and residual groupings of gross income. Treas. Reg. §1.861-8(a)(2). Operative Code sections include the geographic sourcing rules of sections 861(b), 862(b), and 863(b) of the Code, as applicable for purposes of section 904 limitation. Treas. Reg. §1.861-8(f)(1). For this purpose the statutory grouping is foreign source taxable income, and the residual grouping is U.S. source taxable income.

Treas. Reg. §1.861-17 specifically addresses the allocation and apportionment of research expenses. Under Treas. Reg. §1.861-17(a)(1) and (2), expenditures 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 three-digit SIC Code 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). Treas. Reg. §1.861-17(a)(4) provides a limited exception permitting a direct allocation of R&E that is undertaken solely to meet legal requirements imposed by a political entity and that cannot reasonably be expected to generate amounts of gross income (beyond de minimis amounts) outside a single geographic source to gross income within that geographic source as a class (legally-mandated R&E).

After the R&E expenses other than legally-mandated R&E are allocated to the proper class of gross income in the SIC Code product category, they must be further apportioned between U.S. and foreign source income in that class for purposes of determining the foreign tax credit limitation. Treas. Reg. §1.861-17(b)(1) provides that a portion of R&E expenses attributable to research activities conducted in the United States is apportioned directly to U.S. source income and a portion of R&E expenses attributable to research activities conducted outside the United States is allocated to foreign source income (exclusive geographic apportionment). The remaining qualified R&E expenditures may be apportioned on the basis of either gross income, under Treas. Reg. §1.861-17(d), or sales, under Treas. Reg. §1.861-17(c).

For purposes of determining the apportionment ratio under the sales method, sales by both controlled and uncontrolled parties of products involving intangibles licensed or purchased from the taxpayer are included if the seller can reasonably be expected to benefit directly or indirectly from the research expense connected with the product category. Treas. Reg. §1.861-17(c)(2) and (3). Treas. Reg. §1.861-17(c)(3)(iv) provides that if a controlled corporation enters into a cost-sharing arrangement in accordance with Treas. Reg. §1.482-7 for the purpose of developing intangible property, then that corporation shall not reasonably be expected to benefit from the taxpayer's share of the R&E expense. In this case, the controlled corporation's sales in the relevant product category are not taken into account in determining the apportionment ratio under the sales method.

Example 3 of Treas. Reg. §1.861-17(h) (Example 3) illustrates the application of the R&E allocation and apportionment rules to royalties from controlled foreign subsidiaries and to dividends from subsidiaries with cost-sharing arrangements with their parent. The example provides, in relevant part, that X is a manufacturer and distributor of small gasoline engines for lawn mowers, a product within the SIC Code category for Engines and Turbines. Y and Z, controlled foreign subsidiaries of X, also manufacture and sell these engines abroad and pay royalties to X. X has an arm's length cost-sharing arrangement with its controlled foreign subsidiary C to share the funding of all of X's research activity. In 1997, X incurs $60,000 of non-legally-mandated R&E expense and performs an additional $15,000 of research on gasoline engines that is funded by the cost-sharing arrangement with C.

Example 3 concludes that the $60,000 in non-legally-mandated R&E expenses incurred by X is definitely related to all gasoline engines and is therefore allocable to the class of gross income to which the engines give rise: gross income from sales of gasoline engines in the United States, royalties from Y, and royalties from Z. No part of the $60,000 research expense is allocable to dividends from C, because C has already paid, through its cost-sharing arrangement, for research activity performed by X which may benefit C.

B argues that the royalties paid by its CFCs are essentially similar to the cost-sharing arrangement described in Example 3 in paying for the benefits it may derive from the research, so that dividends from those CFCs should similarly be excluded from the class of gross income to which B's R&E expense is allocated. B's argument overlooks an essential difference between a cost-sharing arrangement and a royalty arrangement. A cost-sharing agreement involves a sharing of intangible development costs in proportion to anticipated benefits. In contrast, a royalty payment is compensation for the use of existing intangible property. B's royalty income constitutes payment for the use of its developed intangibles, not a sharing of its section 174 R&E expenses. Thus, no portion of the royalties paid by the CFCs is in payment for the research activity conducted by B in the year the royalties are paid. A portion of B's currently deductible R&E expense is properly allocable to both dividends and royalties paid with respect to existing intangibles that contributed to the CFCs' production of income in the relevant SIC Code product category, because the earnings and profits available for distribution after the CFC deducts royalty and other expenses have not been reduced by any portion of the current R&E expense.

A cost-sharing arrangement differs from a royalty in that, rather than paying for the use of existing property, the payor shares the costs and risks of developing intangible property in return for a specified interest in any intangible property that may be produced. R&E cost-sharing payments are not income to the recipient, but reduce the amount of deductible R&E expense of the recipient subject to allocation. The R&E cost-sharing payment is deductible by the payor. Treas. Reg. §1.482-7(h). Because a CFC in a cost-sharing arrangement directly incurs and deducts a portion of the section 174 R&E expenses, the CFC's share of those R&E expenses has already reduced its earnings available for distribution as a dividend, so that no further allocation of the parent corporation's share of the currently deductible R&E expense is made to dividends paid by the CFC in that year.
B and its CFCs are not parties to a cost-sharing arrangement, and neither B nor the examining agent have suggested that B's license agreements should be characterized in substance as cost-sharing arrangements, which would have the effect of reducing B's foreign source royalty income and deductible R&E expense. Instead, the CFCs compensate B for the use of B's intangibles by making royalty payments. Dividends from the royalty-paying CFCs are income reasonably connected with B's appropriate SIC Code product categories and must be included in the class of gross income to which R&E is allocated and apportioned under Treas. Reg. §1.861-17.

DUTY OF CONSISTENCY AND ESTOPPEL ARGUMENTS

LAW AND ANALYSIS

B has advanced the argument that the Service should be equitably and/or collaterally estopped from asserting that dividends must be included in the class of gross income to which R&E is allocated and apportioned because that position is contrary to the position taken by the Service with respect to the determination of DISC/FSC benefits in the 1983-84 and 1985-86 audit cycles. Alleging reliance, B states that the Service should be estopped from acting contrary to its prior position. B has cited or alluded to three theories as support for its claim - the duty of consistency or quasi-estoppel, equitable estoppel, and collateral estoppel.

Duty of Consistency and Equitable Estoppel

In the present case, neither the duty of consistency nor the doctrine of equitable estoppel applies to the Service. The duty of consistency, which is a modified form of equitable estoppel, has been narrowly tailored to apply to taxpayers' actions in cases arising under federal tax laws. See United States v. Matheson, 532 F.2d 809 (2d Cir. 1976); Beltzer v. United States, 495 F.2d 211 (8th Cir. 1974); Lefever v.

Commissioner, 103 T.C. 525 (1994) aff'd, 100 F.3d 778 (10th Cir. 1996); Unvert v. Commissioner, 72 T.C. 807 (1979) aff'd, 656 F.2d 483 (9th Cir. 1981). Where a taxpayer made a representation or reported an item for tax purposes in one year, and the Service acquiesced in or relied on the representation or report for that year, the duty of consistency prohibits the taxpayer from changing that representation or report in a later year if the Service is prevented from recalculating or assessing tax liability stemming from the earlier year due to the expiration of statutes of limitation. Lefever, 103 T.C. at 543.

As the duty of consistency has been almost exclusively applied to taxpayers, the theory more often asserted against the Service is that of equitable estoppel, which prevents any party from profiting from an action that induced reliance by another party. The elements of estoppel are as follows: "(1) There must be a false representation or wrongful misleading silence; (2) the error must be in a statement of fact and not in an opinion or a statement of law; (3) the person claiming the benefits of estoppel must be ignorant of the true facts; and (4) he must be adversely affected by the acts or statements of the person against whom an estoppel is claimed." Emerson v. Commissioner, 67 T.C. 612, 617-18 (1977). However, the law is clear that the Commissioner is not estopped from taking an alternate position in a subsequent tax year where the agent acted beyond his authority or made a mistake of law in the prior tax year, even where there has been detrimental reliance by the taxpayer. Dickman v. Commissioner, 465 U.S. 330, 343 (1984); Dixon v. Commissioner, 381 U.S. 68, 72-75 (1965); Emerson, 67 T.C. at 618.

In addition, the Supreme Court has stated that it is "well settled that the Government may not be estopped on the same terms as any other litigant." Heckler v. Community Health Services, 467 U.S. 51, 60 (1984). When estoppel is asserted against the government, some courts of appeal have required additional elements to be proven by petitioners. Purcell v. United States, 1 F.3d 932, 939 (9th Cir. 1993) (the aggrieved party must demonstrate affirmative conduct going beyond mere negligence and must also show that the government's act will cause a serious injustice and that the imposition of estoppel will not unduly harm the public interest). These additional elements serve as threshold issues that must be satisfied before examining the traditional elements of estoppel. Id. In cases involving the Service, federal courts have said that estoppel, including the duty of consistency, is to be applied against the Service only with restraint and caution. Shuster v. Commissioner, 312 F.2d 311, 317 (9th Cir. 1962); Emerson, 67 T.C. at 617. This restraint is based on the premise that the policy of the estoppel doctrine is outweighed by the need for efficient collection of public revenue by the Commissioner. Schuster, 312 F.2d at 317. A court will apply estoppel to prevent the government from correcting a mistake of law only where the equitable interest of the party asserting estoppel against the Service is considered "'compelling' and the loss which it would sustain is 'unwarrantable' and 'unconscionable.'" Emerson, 67 T.C. at 618 (quoting Schuster, 312 F.2d at 317, 318).

B advances the argument that the position of the examining agent in prior tax years, as expressed solely through proposed adjustments that were rendered moot in Appeals because B changed its apportionment methodology, equitably estops the Service from assuming a different position for the present tax years. Such a claim cannot be a duty of consistency matter, as the necessary elements are not present and, even if they were, this theory does not apply to the Service. Nor does this claim satisfy the basic elements of equitable estoppel, as the Service position in the prior tax years involved an interpretation of law. This case does not satisfy the additional threshold elements of estoppel that apply to those who would estop the government. Finally, this case presents less compelling facts than other cases where estoppel claims have failed against the Service.

The factual situation in the instant case can be compared to those in Frische v. Commissioner, T.C. Memo. 2000-237, 80 T.C.M. (CCH) 143 (2000) and Emerson, 67 T.C. 612, two cases in which the Tax Court declined to apply equitable estoppel to bar the Service from correcting a mistake of law. In Frische, the petitioner asserted that the Service should be estopped from disallowing certain recurring expenses for the years 1995 and 1996, where petitioner had been audited for five prior tax years and the same expenses were allowed in a final resolution. T.C. Memo. 2000-237, 80 T.C.M. (CCH) at 146. In Emerson, the petitioner asked that the Service be estopped from pleading that certain property should be included in petitioner's gross estate because the Service had signed a formal settlement with petitioner three years earlier treating such property as having been gifted to petitioner's children. 67 T.C. at 615-16. The taxpayer's position in the present case is even weaker than that of the unsuccessful litigants, since the prior position was never incorporated in any formal administrative conclusion, signed settlement, or other final resolution of the prior cycles.

Collateral Estoppel

Unlike duty of consistency and equitable estoppel theories, collateral estoppel does not require the court to analyze notions of fairness, reliance or other possibly subjective considerations. Collateral estoppel requires only an objective analysis of prior legal proceedings of one party involving the same or similar issues. Generally under collateral estoppel, if the disputed issue has been actually litigated on the merits, it may not be relitigated. Arizona v. California, 530 U.S. 392, 415 (2000); Commissioner v. Sunnen, 333 U.S. 591, 598 (1948). As there was no judicial resolution or even settlement of the disputed issues in this matter in earlier tax years, collateral estoppel is inapplicable.

Despite the absence of any judicial resolution of the 1983-84 and 1985-86 audit cycles, B argues that the agent's analysis of the DISC/FSC allocation issue in prior years should bar the Service from taking a different position for subsequent tax years on the foreign tax credit limitation issue. This argument is contrary to well-settled case law confirming that each taxable year stands on its own, and collateral estoppel does not prevent the Commissioner or the taxpayer from taking a different position in other years. Sunnen, 333 U.S. at 599 ("[e]ach year is the origin of a new liability and of a separate cause of action.... But if the later proceeding is concerned with a similar or unlike claim relating to a different tax year, the prior judgment acts as a collateral estoppel only as to those matters in the second proceeding which were actually presented and determined in the first suit."); Knights of Columbus Council #3660 v. United States, 783 F.2d 69 (7th Cir. 1986); Hawkins v. Commissioner, 713 F.2d 347, 351-52 (8th Cir 1983) ("it is settled that even if the Commissioner erroneously may have accepted the tax treatment of certain items in previous years, he is not precluded from correcting that error in a subsequent year."). These cases confirm that the Service, when deciding an issue for an open tax year, is not bound by a position taken on that same issue for a prior tax year, especially where there is a correction of a legal error.

B's claims that the Service should be so constrained fails for several reasons. First, there was no formal judicial or administrative decision made on the allocation of R&E expenses in the earlier tax years; rather, the Service advanced a proposal that was rendered moot by B's election to change its apportionment methodology from the gross income method to the sales method. Second, the sole expression of a position by the Service on the allocation issue in the prior tax years comes from a proposed adjustment by the examining agent. Third, the proposals made by the agent regarding the prior tax years were based on an erroneous interpretation of relevant law. Fourth, the Service's current position reflects the correct interpretation of the applicable law. Without anything more conclusive and authoritative than a proposed adjustment, B cannot say that the allocation issue was "actually presented and determined" with finality in the earlier audit cycles. Nor can B seek to prevent the Service from correcting a prior mistake of law on the grounds of collateral estoppel.

Please call (202) 622-3850 if you have any further questions.

BARBARA A. FELKER
Chief, Branch 3
Associate Chief Counsel
(International)