

Part III

Administrative, Procedural, and Miscellaneous

[26 CFR 1.861-8]: Computation of taxable income from sources within the United States and from other sources and activities

Rev. Proc. 2006-42

SECTION 1. PURPOSE

This revenue procedure sets forth the administrative procedures for taxpayers described in §4 of this revenue procedure to obtain automatic approval to change certain elections relating to the apportionment of interest expense under §§1.861-8T(c)(2) and 1.861-9(i)(2) and research and experimental expenditures (R&E) under §1.861-17(e). A taxpayer complying with this revenue procedure will be deemed to have obtained the approval of the Commissioner of the Internal Revenue Service (Commissioner) to change those elections.

SECTION 2. BACKGROUND

.01 DEDUCTION ATTRIBUTABLE TO DOMESTIC PRODUCTION ACTIVITIES.

(1) IN GENERAL. Section 199 of the Internal Revenue Code (Code), enacted as part of the American Jobs Creation Act of 2004, provides for a deduction attributable to domestic production activities. The deduction is equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of (A) the qualified production activities income (QPAI) of the taxpayer for the taxable year, or (B) taxable income (determined without regard to section 199) for the taxable year (or, in the case of an individual, adjusted gross income (AGI)).

(2) DETERMINATION OF QPAI. To determine QPAI for a taxable year, a taxpayer must subtract from its domestic production gross receipts (DPGR) the cost of goods sold allocable to DPGR and other expenses, losses, or deductions (deductions) that are properly allocable to DPGR. Section 1.199-4(d) provides that a taxpayer generally must determine deductions allocable to DPGR, or to gross income attributable to DPGR, under the section 861 regulations.

.02 RULES FOR ALLOCATION AND APPORTIONMENT OF DEDUCTIONS.

(1) IN GENERAL. The section 861 regulations provide guidance for the allocation and apportionment of deductions in determining the taxable income of a taxpayer from specific sources and activities under sections of the Code, referred to as operative sections. Section 199 is treated as an operative section for purposes of the section 861 regulations. See §1.199-4(d)(1).

(2) CONFORMITY OF APPLICATION. Where more than one operative section

applies, the taxpayer may be required to apply the section 861 regulations separately for each applicable operative section. In that case, §1.861-8(f)(2)(i) provides that the taxpayer is required to use the same method of allocation and the same principles of apportionment for all operative sections. See also §1.199-4(d)(1).

.03 ALLOCATION AND APPORTIONMENT OF INTEREST EXPENSE.

(1) IN GENERAL. Taxpayers generally are required under §§1.861-8T(c)(2) and 1.861-9 to apportion interest expense on the basis of assets. Section 1.861-8T(c)(2) provides that the apportionment must be made either on the basis of the tax book value of the assets or on the fair market value of the assets. Section 1.861-9(i)(1) permits a taxpayer to elect to determine tax book value using the alternative tax book value method.

(2) BINDING ELECTION. Under §1.861-8T(c)(2), once the taxpayer uses the fair market value method, the taxpayer and all related persons must continue to use that method unless expressly authorized by the Commissioner to change methods. Similarly, under §1.861-9(i)(2)(i), if a taxpayer elects to use the alternative tax book value method, the taxpayer and all related persons may not, during the year of election and the four taxable years thereafter, determine tax book value under another method without the consent of the Commissioner. In Rev. Proc. 2005-28, 2005-1 C.B. 1093, the Commissioner provided automatic consent for taxpayers to change from the fair market value method to the alternative tax book value method, provided that certain requirements were met.

.04 ALLOCATION AND APPORTIONMENT OF RESEARCH AND

EXPERIMENTAL EXPENDITURES.

(1) IN GENERAL. Pursuant to §1.861-17, after allocating legally mandated R&E, if any, under §1.861-17(a)(4) and exclusively apportioning applicable R&E, if any, under §1.861-17(b)(1)(i), the remaining R&E of the taxpayer is apportioned under either the sales method of §1.861-17(c) or one of the two gross income methods of §1.861-17(d).

(2) BINDING ELECTION. Under §1.861-17(e), a taxpayer may choose either the sales method or the optional gross income methods for the original return for its first taxable year to which §1.861-17 applies. Once the method is elected, the taxpayer is required to use the method for that year and for the four taxable years thereafter. A taxpayer may not revoke its election of either method during the five-year period without the consent of the Commissioner.

.05 PREAMBLE OF FINAL REGULATIONS UNDER SECTION 199. The preamble to the final regulations under section 199 states that the Treasury Department and the IRS intend to issue a revenue procedure granting automatic consent to change elections under §§1.861-8T(c)(2) and 1.861-9(i)(1), respectively, to apportion interest expense and under §1.861-17(e) to apportion R&E expense. Accordingly, this revenue procedure provides rules for obtaining that automatic consent.

SECTION 3. SCOPE

This revenue procedure applies to any taxpayer requesting to change (1) from the fair market value method under §1.861-8T(c)(2) or from the alternative tax book value method under §1.861-9(i)(1) to apportion interest expense or (2) from the sales method or the optional gross income methods under §1.861-17(c) and (d) to apportion R&E expense. Notwithstanding these rules for obtaining automatic consent, a taxpayer may request under the regular ruling process the consent of the Commissioner to change one or more elections and, in the case of a taxpayer within the scope of Rev. Proc. 2005-28, obtain the consent of the Commissioner to change from the fair market value method by meeting the requirements of that revenue procedure.

SECTION 4. GENERAL APPLICATION PROCEDURES

.01 APPROVAL. The consent of the Commissioner is hereby granted, provided the taxpayer complies with all the applicable provisions of this revenue procedure, to any taxpayer within the scope of this revenue procedure to change its election:

(1) INTEREST EXPENSE. From the fair market value method under §1.861-8T(c)(2) or the alternative tax book value method under §1.861-9(i) of apportioning interest expense to another method; or

(2) R&E EXPENSE. From the sales method or the optional gross income methods under §1.861-17(c) and (d) of apportioning R&E expense to another method.

.02 STATEMENT REQUIREMENT.

(1) A corporation shall request to change an election within the scope of this revenue procedure on a Form 1118 by attaching to Form 1118 the applicable statement

set forth in §4.02(b) of this revenue procedure. In the case of such taxpayers electronically filing Form 1118, the statement must be included in the electronic version of Form 1118. A taxpayer, other than a corporation, shall request to change an election within the scope of this revenue procedure on Form 1116 by attaching to Form 1116 one of the three statements, whichever is applicable, set forth in §4.02(b) of this revenue procedure. In the case of such taxpayers electronically filing Form 1116, the statement must be entered into the Election Explanation Record of the electronic version of Form 1040, Form 1041, or other relevant form.

(2) The statement referred to in §4.02(a) of this revenue procedure shall provide as follows:

(i) INTEREST EXPENSE FROM FAIR MARKET VALUE METHOD. "For the immediately preceding taxable year, [name of taxpayer] valued assets for purposes of interest expense apportionment using the fair market value method. Pursuant to Rev. Proc. 2006-XX, [name of taxpayer] is changing from the fair market value method to the tax book value [alternative tax book value] method of asset valuation. This change to the tax book value [alternative tax book value] method applies beginning with [name of taxpayer]'s [XXXX] taxable year,"

(ii) INTEREST EXPENSE FROM ALTERNATIVE TAX BOOK VALUE METHOD. "For the immediately preceding taxable year, [name of taxpayer] valued assets for purposes of interest expense apportionment using the alternative tax book value method. Pursuant to Rev. Proc. 2006-XX, [name of taxpayer] is revoking its election to determine tax book value using the alternative tax book value method. This change to

the tax book value method applies beginning with [name of taxpayer]'s [XXXX] taxable year," and/or

(iii) R&E EXPENSE. "For the immediately preceding taxable year, [name of taxpayer] apportioned R&E expense using the sales method as described in §1.861-17(c)[one of the optional gross income methods as described in §1.861-17(d)].

Pursuant to Rev. Proc. 2006-XX, [name of taxpayer] is changing from the sales method [one of the optional gross income methods] to one of the optional gross income methods [sales method]. This change applies beginning with [name of taxpayer]'s [XXXX] taxable year.

.03 DOCUMENTATION. Any taxpayer that changes methods under this revenue procedure must maintain all documentation necessary to establish its change in method or methods and its eligibility for the benefits of this revenue procedure.

SECTION 5. REVIEW OF STATEMENT

The appropriate director of the Internal Revenue Service (within the meaning of §1.01(3) of Rev. Proc. 2006-1, 2006-1 I.R.B. 1) may ascertain if the taxpayer changed its election(s) in compliance with all the applicable provisions of this revenue procedure.

A taxpayer changing its election(s) pursuant to this revenue procedure without complying with all the provisions (including the terms and conditions) of this revenue procedure ordinarily will be deemed to have initiated the change in election(s) without the approval of the Commissioner. Upon examination, a taxpayer that has initiated an unauthorized change of election(s) may be denied the change. For example, the taxpayer may be required to redetermine its apportioned interest and/or R&E expense

in accordance with its former election(s).

SECTION 6. EFFECTIVE DATE, DEADLINE, AND TRANSITION RULE

.01 EFFECTIVE DATE. This revenue procedure is effective for either:

(1) a taxpayer's first taxable year beginning after December 31, 2004 (the taxpayer's 2005 taxable year); or

(2) a taxpayer's first taxable year immediately following the taxpayer's 2005 taxable year, but only with respect to elections that first took effect in a taxable year preceding the taxpayer's 2005 taxable year.

.02 DEADLINE. This revenue procedure is effective only if the taxpayer submits the statement(s) required by §4.02 of this revenue procedure by the later of (i) one year after October 30, 2006, or (ii) the due date (including extensions) of the taxpayer's income tax return to which the statement(s) relates.

.03 TRANSITION RULE. If a taxpayer within the scope of this revenue procedure filed an application to change an election(s) to which the revenue procedure applies with the national office and the application is pending with the national office on October 30, 2006, the taxpayer may obtain approval under this revenue procedure. However, the national office will process the application in accordance with the authority under which it was filed, unless the taxpayer notifies the national office that the taxpayer wants to use this revenue procedure before the national office issues the letter ruling granting or denying approval for the change. If the taxpayer timely notifies the national office that it wants to use this revenue procedure, the national office will close out the previously filed application. In addition, any user fee that was submitted with the

previously filed application will be refunded to the taxpayer.

SECTION 7. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-XXXX. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number. The collections of information in this revenue procedure are found in §4.02 and .03 of this revenue procedure. The information is required in order to determine whether the taxpayer properly obtained automatic approval to change an election within the scope of this revenue procedure. The likely respondents are the following: corporations, partnerships, S corporations, and individuals. The estimated total annual reporting burden for the requirements contained in §4.02 and .03 of this revenue procedure is 100 hours: the estimated annual burden per respondent is 30 minutes; the estimated number of respondents is 200; and the estimated frequency of response is occasional. Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. § 6103.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Richard L. Chewing of the Office of Associate Chief Counsel (International). For further information regarding this

revenue procedure contact Richard L. Chewning at (202) 622-3850 (not a toll free call).