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Memorandum

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subject: Proper Method of Allocation and Apportionment of Prior Period Compensation Expense Deductions Under Treas. Reg. §§ 1.861-8 and 1.861-14, Temp. Treas. Reg. §§ 1.861-8T and 1.861-14T, and I.R.C. § 199

This memorandum addresses the proper method of allocation and apportionment under Treas. Reg. §§ 1.861-8 and 1.861-14 and Temp. Treas. Reg. §§ 1.861-8T and 1.861-14T of prior period compensation expense deductions for purposes of computing a taxpayer's qualified production activities income ("QPAI") as defined in I.R.C. § 199(c)(1). Treas. Reg. § 1.199-4(a) and (d) requires, for purposes of computing QPAI, that certain taxpayers use the "section 861 method," which incorporates Treas. Reg. §§ 1.861-8 and 1.861-14 and Temp. Treas. Reg. §§ 1.861-8T and 1.861-14T. Prior period compensation expense is compensation expense that is deductible by a taxpayer in the current taxable year that relates to labor or personal services performed for the taxpayer in a prior taxable year or years. This memorandum does not address the proper allocation and apportionment of other deductions, nor does it address the proper treatment of prior period compensation expense that is included in cost of goods sold under section 263A. This advice may not be used or cited as precedent.

ISSUE

What is the proper method for allocating and apportioning prior period compensation expense deductions under the section 861 method for purposes of computing a taxpayer's qualified production activities income ("QPAI") as defined in I.R.C. § 199(c)(1)?

CONCLUSION

The section 861 method requires the determination of the factual relationship of a deduction to a class of gross income and to the statutory and residual groupings of gross income. Accordingly, some currently deductible expenses that relate to a prior period (even if that period predates the effective date of section 199) may properly be allocated and apportioned to gross income attributable to domestic production gross receipts ("DPGR") ("I.R.C. § 199 gross income") in a taxable year in which the taxpayer generates DPGR.

FACTS

Corp X is an accrual-basis U.S. manufacturing corporation with a calendar taxable year and does not qualify to use one of the two simplified methods for allocating and apportioning deductions available to small taxpayers. From 2000 through 2005, Corp X produced, at various times, Products A, B, C, and D. Corp X manufactured Product A from 2000 to 2003 and recognized income from the sale of Product A only through December 31, 2004. Thus, Corp X's sales of Product A did not generate DPGR. During 2003 and 2004, employees of Corp X worked to develop Product B, which was initially offered for sale to the public in January of 2005. Corp X's sales of Product B generate DPGR. Corp X produced Product C both before and after January 1, 2005, but its sales of Product C do not generate DPGR because its activities with regard to the product only rise to the level of minor assembly and are not substantial in nature. Corp X produced Product D both before and after January 1, 2005. Corp X's sales of Product D occurring on or after January 1, 2005, generate DPGR.

Employee M managed Corp X's business planning department from 2003 through 2008. Employee M received deferred compensation of $20 in 2005 under a deferred compensation program, which related solely to services performed in 2004 regarding development, production, and sales of Products B and C. Based on time records, Employee M worked 80% of his time in 2004 with respect to services related to Product B, and 20% with respect to services related to Product C. Corp X has a prior period compensation expense deduction for 2005, which is after the effective date of I.R.C. § 199, with respect to the deferred compensation received by Employee M.

LAW AND ANALYSIS

Section 199: Background

I.R.C. § 199 was enacted as part of the American Jobs Creation Act of 2004, Pub. L. 108-357, 118 Stat. 1418, effective for taxable years beginning on or after January 1, 2005. Under I.R.C. § 199(a)(1), a taxpayer is allowed a deduction ("the I.R.C. § 199 deduction") equal to 9 percent (3 percent in the case of taxable years beginning in 2005 and 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of (a) the taxpayer's QPAI for the taxable year, or (b) the taxpayer's taxable income (determined without regard to section 199) for the taxable year (or, in the case of an individual, adjusted gross income). I.R.C. § 199(b)(1) limits the deduction for a taxable year to 50 percent of the W-2 wages paid by the taxpayer during the calendar year that ends in such taxable year.

QPAI is the excess of the taxpayer's DPGR for the taxable year over the sum of the taxpayer's cost of goods sold ("CGS") that is allocable to DPGR and the taxpayer's other expenses, losses, and deductions (other than the I.R.C. §199 deduction), that are properly allocable to DPGR ("deductions"). I.R.C. § 199(c)(1).

With regard to prior period expenses included in CGS, Treas. Reg. § 1.199-4(b)(2)(ii), provides:

> If a taxpayer … recognizes and reports gross receipts on a Federal income tax return for a taxable year, and incurs CGS related to such gross receipts in a subsequent taxable year, then regardless of whether the gross receipts ultimately qualify as DPGR, the taxpayer must allocate the CGS to—
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> (A) DPGR if the taxpayer identified the related gross receipts as DPGR in the prior taxable year; or
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> (B) Non-DPGR if the taxpayer identified the related gross receipts as non-DPGR in the prior taxable year or if the taxpayer recognized under the taxpayer's methods of accounting those gross receipts in a taxable year to which section 199 does not apply.

Treas. Reg. § 1.199-4(b)(2)(ii) applies only to CGS, and not to deductions. Treas. Reg. § 1.199-4(c) and (d) require taxpayers to use the section 861 method to allocate deductions to gross income attributable to DPGR unless the taxpayer qualifies for, and elects to use, one of the two simplified methods available to small taxpayers for allocating and apportioning deductions.

Section 861

Under the section 861 method, a deduction is allocated to a class of gross income, and then, if necessary, apportioned between the statutory and residual groupings of gross income within that class. Treas. Reg. § 1.861-8(a) and Temp. Treas. Reg. § 1.861-8T. The allocation and apportionment of the deduction is based on the factual relationship of the deduction to gross income. Treas. Reg. § 1.861-8(a)(2). If applicable, the allocation and apportionment must be made on an affiliated group basis. Treas. Reg. § 1.861-14 and Temp. Treas. Reg. § 1.861-14T. The statutory grouping of gross income means the gross income from a specific source or activity which must first be determined in order to arrive at taxable income from such specific source or activity under an operative section. Gross income from other sources or activities is referred to as the residual grouping of gross income. I.R.C. § 199(c)(1) is an operative section under Treas. Reg. § 1.861-8(f) and the relevant statutory grouping of gross income is I.R.C. § 199 gross income. Treas. Reg. § 1.199-4(d)(1).

Treas. Reg. § 1.861-8(b)(2) provides that a deduction is considered definitely related to a class of gross income, and, therefore allocable to such class, if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. The regulation also provides that if a deduction is definitely related to a class of gross income, the deduction will be allocated to that class even if the amount of the deduction exceeds the gross income in that class for the taxable year, including if there is no gross income in that class in the taxable year.

As with the allocation of a deduction to a class of gross income, the apportionment of a deduction to a statutory grouping of gross income must be made in a manner that reflects the factual relationship between the deduction and the statutory grouping of gross income. Temp. Treas. Reg. § 1.861-8T(c)(1). That regulation provides that a taxpayer may apportion the deduction using various bases and factors, such as the following, provided the basis or factor chosen by the taxpayer reasonably reflects the factual relationship between the deduction and the statutory grouping of gross income: 1) comparison of units sold; 2) comparison of the amount of gross sales or receipts; 3) comparison of the cost of goods sold; 4) comparison of profit contribution; 5) comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent related to the activities or properties giving rise to the class of gross income; and 6) comparison of the amount of gross income.

A taxpayer must furnish, if requested, information supporting the factual relationship, for purposes of both allocation and apportionment, of the deduction to the class of gross income and to the statutory grouping of gross income. Treas. Reg. § 1.861-8(f)(5).

Analysis

As stated, Corp X does not qualify to use either of the two simplified methods for allocating and apportioning deductions available to small taxpayers. Accordingly, Corp X must use the section 861 method to allocate and apportion its deductions for purposes of calculating QPAI. Under that method, Corp X must determine the factual relationship between each dollar of its current year compensation (including prior period) expense deduction and the purpose for which it was spent.

In this case, Corp X has a prior period compensation expense deduction for taxable year 2005 with respect to the $20 of deferred compensation received by Employee M. The section 861 method requires that Corp X allocate the full $20 of that deductible amount to the class of gross income derived from sales of products manufactured by Corp X. Within that class of sales gross income, Corp X must then determine what portion, if any, of the $20 deduction is factually related to gross income attributable to

DPGR. It is not reasonable to assume that none of the $20 of current deductible expense is apportioned to I.R.C. § 199 gross income simply because the expense is attributable to services performed by Employee M prior to the enactment of section 199. Instead, Corp X must apportion the deduction based on the extent to which those services ultimately generated DPGR. Under these facts, Corp X's time records reasonably show that 80% of the current year deduction is factually related to the statutory grouping of I.R.C. § 199 gross income because Employee M performed 80% of his services in 2004 with respect to Product B, the sales of which in 2005 generated DPGR and I.R.C. § 199 gross income. Therefore, Corp X must apportion $16 (80% x $20) of its current prior period compensation expense deduction to I.R.C. § 199 gross income when computing its QPAI for 2005. The remaining $4 (20% x $20) of its current prior period compensation expense deduction is apportioned to gross income attributable to non-DPGR because Employee M performed 20% of his services in 2004 with respect to non-qualifying Product C.

We note that this approach is the same regardless of whether a taxpayer elects to rely on Prop. Treas. Reg. § 1.199-1(e)(1), 70 FR 67720, 67244 (November 4, 2005), which was later modified for unrelated reasons when finalized. The proposed regulations applied the same method of allocating and apportioning deductions (including prior period compensation expense deductions) under the section 861 method.

Additional examples of application of the section 861 method to allocate and apportion prior period compensation expense deductions are set forth below. These additional examples assume the same facts described above with respect to the taxpayer, Corp X, but involve the allocation and apportionment of prior period compensation deductions attributable to different individuals. Finally, each example illustrates a reasonable method of allocation and apportionment of prior period compensation deductions only to the extent the same number of hours was worked in each relevant year; deductions attributable to employees who work significantly different total hours in relevant years may merit hourly, rather than yearly, calculations.

1. Employee N retired from Corp X on December 31, 2003. Corp X pays health insurance premiums for a group health plan for its retirees. Actuarially, $10 of the annual premium is attributable to Employee N each year beginning in 2004 and continuing through 2008. Before retirement, Employee N's services related solely to the production of Product A, the sales of which have never generated DPGR. Corp X may reasonably apportion the full amount of its prior period health insurance compensation expense deductions for Employee N to the residual grouping of income; accordingly, Corp X's gross income attributable to DPGR is not reduced by such deductions for 2005, 2006, 2007, and 2008.

2. Employee O works for Corp X from 2003 through 2008, and receives a bonus of $20 in 2005 that relates to services performed by Employee O in 2004 with regard to Product C, which does not generate DPGR in 2005. Employee O's services do not generate DPGR and therefore, are not attributable to I.R.C. § 199 gross income because the services are not factually related to that gross income.

Corp X may reasonably apportion the full amount of its prior period bonus compensation expense deduction for Employee O to the residual grouping of income; accordingly, Corp X's gross income attributable to DPGR is not reduced by that deduction for 2005.

3. Corp X granted Employee P a stock option on January 1, 2004, with a three-year vesting period. Employee P exercised the option on January 1, 2008, and Corp X deducted $100 in taxable year 2008 with regard to that expense. Employee P's services with respect to the products manufactured by Corp X for 2004 through 2008 are as follows:

2004 and 2005:	50% on Product B
	50% on Product C
2006:	100% on Product C
2007 and 2008:	100% on Product B

All sales of Product B generate DPGR, while sales of Product C do not. Because Treas. Reg. § 1.861-4(b)(2)(ii)(F) provides that the period from grant to vesting is the generally applicable period to which compensation is attributable, Corp X may reasonably apportion $33.33 of its 2008 prior period stock option compensation expense deduction for Employee P to gross income attributable to DPGR. Employee P's services performed in 2007 and 2008 are not relevant because they were performed after the stock option had vested.

4. Employee Q works for Corp X during 2004 and 2005 exclusively with respect to Product D, the sales of which on or after January 1, 2005, generated DPGR. Corp X pays Employee Q a bonus of $20 in 2005 that relates to services performed in 2004 and 2005. Sixty percent of Corp X's aggregate gross income from sales of Product D in the two-year period (2004 and 2005) was I.R.C. § 199 gross income. Therefore, 60% of Employee Q's services are attributable to I.R.C. § 199 gross income because the services are factually related to that gross income. Corp X may reasonably apportion 60%, or $12, of its 2005 $20 Employee Q bonus expense deduction to I.R.C. § 199 gross income when computing its QPAI for 2005.

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