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subject: Generic Legal Advice Regarding the Computation of Qualified Production Activities Income under § 199(c) and the Exclusion of Certain Items of Gross Income under § 114 and Section 101(d) of the American Jobs Creation Act of 2004

This Chief Counsel Advice responds to your request for assistance dated December 12, 2008. This advice may not be used or cited as precedent.

ISSUES

1. Whether qualified production activities income ("QPAI"), as defined in § 199(c)(1) of the Internal Revenue Code ("Code"), should be reduced by the extraterritorial income ("ETI") exclusion or by the amount of gross income that is excluded under section 101(d) of the American Jobs Creation Act of 2004 (Pub. L. No. 108-357, 118 Stat. 1418) ("AJCA") under Prop. Treas. Reg. § 1.199-3 (the proposed § 199 regulations) or Treas. Reg. § 1.199-3 (the final § 199 regulations).

2. Whether the amount of ETI that is excluded from a taxpayer's gross income under § 114, or the amount of gross income that is excluded under section 101(d) of the AJCA, must take into account, and thus be reduced by an appropriate amount of, the § 199 deduction.

3. If the answer to both Issue 1 and Issue 2 is "yes," whether the computations under those issues must be accomplished by an iterative method, a simultaneous equations method, or another method.

CONCLUSIONS

1. Yes. QPAI, as defined in § 199(c)(1), should be reduced by the ETI exclusion or by the amount of gross income that is excluded under section 101(d) of the AJCA under both the proposed § 199 regulations and the final § 199 regulations.

2. The § 199 deduction must be taken into account for purposes of determining the taxpayer's ETI exclusion or the exclusion under section 101(d) of the AJCA. The effect of the § 199 deduction on such exclusions depends on the computation method, including the choice of full costing or marginal costing rules, used to determine the exclusions.

3. Taxpayers may use any reasonable method for making the interrelated ETI exclusion/§ 199 computations. For this purpose, the iterative method and the simultaneous equations method are presumed to be reasonable methods for making such interrelated computations.

FACTS

Taxpayers A and B are engaged in manufacturing in the United States All their respective gross receipts constitute domestic production gross receipts ("DPGR") and foreign trading gross receipts ("FTGR"). The taxable year in issue is 2005. Taxpayer A uses the proposed § 199 regulations to determine its § 199 deduction, and Taxpayer B uses the final § 199 regulations to determine its § 199 deduction.

LAW

I. § 199 Deduction: Background

Under § 199(a), the § 199 deduction is determined by applying a percentage to the lesser of the taxpayer's QPAI or taxable income (determined without regard to the § 199 deduction). The applicable percentage is 3% for taxable years beginning in 2005 and 2006, 6% for taxable years beginning in 2007 through 2009, and 9% for taxable years beginning after 2009.

Under § 199(c)(1), QPAI is determined by taking DPGR for the taxable year less cost of goods sold (“CGS”) allocable to such DPGR, less other expenses, losses, or deductions, which are properly allocable to such DPGR.

Section 199(c)(4)(A)(i) provides that DPGR means the gross receipts of the taxpayer that are derived from any lease, rental, license, sale, exchange, or other disposition of: (I) qualifying production property (“QPP”), which was manufactured, produced, grown or extracted by the taxpayer in whole or significant part within the U.S.; (II) any qualifying film produced by the taxpayer; or (III) electricity, natural gas, or potable water produced by the taxpayer in the United States. Section 199(c)(5) provides that QPP includes tangible personal property, any computer software, and any property described in § 168(f)(4) (qualified sound recordings).

Under § 199(c)(4)(A)(ii) and (iii), DPGR also includes gross receipts of the taxpayer derived from construction of real property by the taxpayer in the United States if the taxpayer is engaged in the active conduct of a construction trade or business; and engineering or architectural services performed by the taxpayer in the United States in the ordinary course of its trade or business with respect to the construction of real property in the United States if it actively conducts an engineering or architectural services trade or business.

Treas. Reg. § 1.199-1(b)(1) provides that the definition of taxable income under § 63 applies for purposes of § 199(a), except that taxable income is determined without regard to § 199 and without regard to any amount excluded from gross income pursuant to § 114 or pursuant to section 101(d) of the AJCA. The preamble to the final § 199 regulations provides:

> For purposes of section 199(a)(2)(B), taxable income is determined without regard to section 199 and without regard to section 114 of the Code or pursuant to section 101(d) of the [AJCA]. Thus, any extraterritorial income exclusion or amount excluded from gross income pursuant to section 101(d) of the [AJCA] does not reduce taxable income for purposes of section 199(a)(1)(B), even though such excluded amounts are taken into account in determining QPAI.

71 F.R. 31268, 31270 (June 1, 2006).

Treas. Reg. § 1.199-8(h) addresses disallowed losses or deductions, and provides, in part, except as provided by publication in the Internal Revenue Bulletin, that losses or deductions of a taxpayer that otherwise would be taken into account in computing the taxpayer’s § 199 deduction are taken into account only if and to the extent the deductions are not disallowed by § 465 or § 469, or any other provision of the Code.

II. ETI Exclusion: Background

The FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (Pub. L. No. 106-519, 114 Stat. 2423) ("ETI Act") repealed the foreign sales corporation ("FSC") provisions under §§ 921 through 927 ("FSC regime") and enacted the ETI exclusion provisions under §§ 114 and 941 through 943 ("ETI regime").

Under § 114(a) and (b), the gross income of a taxpayer does not include ETI that is also qualifying foreign trade income ("QFTI") as determined under §§ 941 through 943. Thus, the ETI regime provides a partial exclusion for ETI. Under § 114(c)(2), any deduction that is properly allocated and apportioned to ETI must be further allocated between the excluded ETI and the non-excluded ETI on a proportionate basis. Under § 114(c)(1), any deduction of a taxpayer allocated under § 114(c)(2) to excluded ETI is disallowed.

Under § 941(a), for purposes of § 114, QFTI generally means, with respect to any transaction, the amount of gross income that, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to the greatest amount yielded by one of the following three calculation methodologies: (1) the foreign sale and leasing income ("FSLI") method under § 941(a)(1)(A); (2) the gross receipts method under § 941(a)(1)(B); and (3) the foreign trade income ("FTI") method under § 941(a)(1)(C).

The gross receipts and FTI methods in § 941(a)(1)(B) and (C) are materially similar to the gross receipts and combined taxable income ("CTI") methods in § 925(a)(1) and (2), respectively, of the FSC regime. See also §§ 923(a)(3) and 291(a)(4)(B) and Temp. Treas. Reg. § 1.923-1T(b)(1)(i). The FSLI method in § 941(a)(1)(A) replaced the non-administrative pricing method in § 925(a)(3) of the FSC regime. See also §§ 923(a)(2) and 291(a)(4) and Temp. Treas. Reg. § 1.923-1T(b)(1)(ii).

A. The gross receipts method under § 941(a)(1)(B). Reduction of taxable income equal to 1.2% of the FTGR derived by the taxpayer from the transaction.

Under § 942(a)(1), FTGR means the gross receipts of the taxpayer from certain transfers of property and the provision of certain services. This FTGR definition from the ETI regime is materially similar to the definition of FTGR under § 924(a) of the FSC regime. Section 941(a)(1)(flush language) provides that the amount of reduction of taxable income determined under the gross receipts method shall not exceed 200% of the amount of reduction of taxable income determined under the FTI method. This 200% limitation is materially similar to the limitation provided in § 925(d) of the FSC regime.

B. The FTI method under § 941(a)(1)(C). Reduction of taxable income equal to 15% of the FTI derived by the taxpayer from the transaction.

Under § 941(b)(1), FTI is generally defined as the taxable income of the taxpayer attributable to the FTGR of the taxpayer. Under § 941(a)(4), FTI may be computed for purposes of the FTI method using marginal costing rules that the Secretary shall prescribe. Section 925(b)(2) provides materially similar rules for computing CTI under the FSC regime.

C. The FSLI method under § 941(a)(1)(A). Reduction of taxable income equal to 30% of the FSLI derived by the taxpayer from the transaction.

Under § 941(c)(1)(A) and (B) and (2)(A), FSLI is defined in terms of three subsets of FTI: (a) FTI properly allocable to certain foreign economic processes (§ 941(c)(1)(A)); (b) FTI from certain leases or rentals (§ 941(c)(1)(B)); and (c) FTI from certain sales (§ 941(c)(2)(A)). For purposes of determining FSLI, only directly allocable expenses are taken into account in computing FTI. See § 941(c)(3)(B).

III. Exclusion under Section 101(d) of the AJCA

Section 101(a) and (c) of the AJCA provides that the ETI regime was generally repealed for transactions after December 31, 2004. Section 101(d) of the AJCA provides:

> (d) TRANSITIONAL RULE FOR 2005 AND 2006.--
> (1) IN GENERAL.--In the case of transactions during 2005 or 2006, the amount includible in gross income by reason of the amendments made by this section shall not exceed the applicable percentage of the amount which would have been so included but for this subsection.
> (2) APPLICABLE PERCENTAGE.--For purposes of paragraph (1), the applicable percentage shall be as follows:
> (A) For 2005, the applicable percentage shall be 20 percent.
> (B) For 2006, the applicable percentage shall be 40 percent.

Thus, for transactions entered into during calendar year 2005 or 2006 that generate gross receipts during such year, section 101(d) of the AJCA provides an exclusion from gross income equal to 80% (for 2005 gross receipts) or 60% (for 2006 gross receipts) of the exclusion that would have been permitted under § 114 had the ETI regime not been repealed for that year.

IV. FSC Regime: Background

As noted above, some of the provisions under the ETI regime are materially similar to predecessor FSC provisions. The legislative history that accompanied the enactment of the ETI regime and the repeal of the FSC regime states:

> The Committee recognizes that there may be a gap in time between the enactment of the bill and the issuance of

> detailed administrative guidance. It is intended that during this gap period before administrative guidance is issued, taxpayers and the Internal Revenue Service may apply the principles of present-law regulations and other administrative guidance under sections 921 through 927 to analogous concepts under the bill.

S. Rep. No. 106-416, at 18 (2000) ("Senate Report"). The administrative guidance under the FSC regime includes rules for determining full costing CTI and marginal costing CTI.

A. Full Costing CTI Method. Temp. Treas. Reg. § 1.925(a)-1T(c) provides rules "for computing the allowable price for a transfer from a related supplier to a FSC in the case of a sale. . . ." Temp. Treas. Reg. § 1.925(a)-1T(c)(3) provides:

> Under the combined taxable income method of pricing, described in section 925(a)(2), the transfer price for a sale by the related supplier to the FSC is the price as a result of which the profit derived by the FSC from the sale will not exceed 23 percent of the full costing combined taxable income (as defined in paragraph (c)(6) of this section) of the FSC and the related supplier attributable to the foreign trading gross receipts from such sale.

Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(i) provides that

> the full costing combined taxable income of the FSC and related supplier from the sale is the excess of the foreign trading gross receipts of the FSC from the sale over the total costs of the FSC and related supplier including the related supplier's cost of goods sold and its and the FSC's noninventoriable costs (see § 1.471-11(c)(2)(ii)) which relate to the foreign trading gross receipts.

Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii) provides rules for determining the gross receipts and costs for purposes of Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(i). In particular, Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(C) and (D) provides, in relevant part:

> (C) Cost of goods sold shall be determined in accordance with the provisions of §1.61-3. See sections 471 and 472 and the regulations thereunder with respect

> to inventories. . . .
>
> (D) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are the expenses, losses, and deductions definitely related, and therefore allocated and apportioned thereto, and a ratable part of any other expenses, losses, or deductions which are not definitely related to any class of gross income, determined in a manner consistent with the rules set forth in §1.861-8. The deduction for depletion allowed by section 611 relates to gross receipts from sales of export property and shall be taken into account in computing the combined taxable income of the FSC and its related supplier.

B. Marginal Costing Rules. A taxpayer may elect to use marginal costing rules to compute CTI in lieu of the full costing rules in certain cases. See Temp. Treas. Reg. § 1.925(b)-1T(a)(2nd sentence) and (c)(1). Temp. Treas. Reg. § 1.925(b)-1T(b)(1) provides:

> Marginal costing is a method under which only direct production costs of producing a particular item, product, or product line are taken into account for purposes of computing the combined taxable income of the FSC and its related supplier under section 925(a)(2). The costs to be taken into account are the related supplier's direct material and labor costs (as defined in § 1.471-11(b)(2)(i)). . . . If the related supplier is not the manufacturer or producer of the export property that is sold, the related supplier's purchase price shall be taken into account.

The fourth sentence of Temp. Treas. Reg. § 1.925(b)-1T(a) provides that the marginal costing rules may be used to compute CTI for purposes of determining the limitation on the gross receipts method under § 925(d). Temp. Treas. Reg. § 1.925(b)-1T provides several limitations (i.e., two no loss rules and an overall profit percentage limitation) on the amount of FSC profit that may be computed under the marginal costing rules. These rules are summarized in Temp. Treas. Reg. § 1.925(b)-1T(b)(4)(i) through (iii) as follows:

> The effect of these no-loss rules and of the overall profit percentage limitation of paragraph (c)(2) of this section is that the FSC's profit under these marginal costing rules is limited to the lesser of the following:

> (i) 23% of maximum combined taxable income determined under the marginal costing rules,
>
> (ii) 23% of the overall profit percentage limitation, or
>
> (iii) for FSC taxable years beginning after December 31, 1986, 100% of the full costing combined taxable income determined under the full costing combined taxable income method of Temp. Treas. Reg. § 1.925(a)-1T(c)(3) and (6).

Temp. Treas. Reg. § 1.925(b)-1T(b)(2) provides that the overall profit percentage limitation is the product of the overall profit percentage and the FSC's foreign trading gross receipts. Temp. Treas. Reg. § 1.925(b)-1T(c)(2)(i) provides that the overall profit percentage is a fraction the numerator of which is the CTI of the FSC and related supplier from all sales of a product or product line during a taxable year using the full costing rules. Thus, if the marginal costing rules are used under the CTI or gross receipts method of the FSC regime, and if the CTI computation is limited to 23% of the overall profit percentage limitation or 100% of CTI determined using the full costing rules, a full costing CTI computation involving allocation and apportionment under Treas. Reg. § 1.861-8 is necessary.

V. Allocation and Apportionment of Deductions under Treas. Reg. § 1.861-8 and Temp. Treas. Reg. §1.861-8T

Under Treas. Reg. § 1.861-8 and Temp. Treas. Reg. §1.861-8T, 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).

A. Allocation of deductions to classes of gross income. Under Treas. Reg. § 1.861-8(a)(2) and (b)(2), a taxpayer is required to allocate each deduction to the class (or classes) of gross income to which the deduction "definitely relates." Treas. Reg. § 1.861-8(b)(2) provides that a deduction is considered "definitely related" to a class of gross income 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." A deduction may be definitely related to one or more items of gross income as well as to one or more subdivisions of those items of gross income. Treas. Reg. § 1.861-8(a)(3). If a deduction does not bear a definite relationship to a class of gross income constituting less than all of gross income, such deduction will generally be treated as definitely related to all of the taxpayer's gross income (and thus ratably allocable to all of the taxpayer's gross income) unless otherwise provided in Treas. Reg. § 1.861-8(e). Treas. Reg. § 1.861-8(b)(5).

B. Apportionment of deductions between statutory and residual groupings of income. Under Treas. Reg. § 1.861-8 and Temp. Treas. Reg. §1.861-8T, after a deduction has been allocated to a class of gross income, it must be apportioned between the statutory and residual groupings of gross income within that class. "Statutory grouping of gross income" is defined as the gross income from a specific source or activity that must first be determined in order to arrive at taxable income from such specific source or activity under an "operative section" of the Code. Treas. Reg. § 1.861-8(a)(4). Gross income from other sources or activities within such class is referred to as the residual grouping of gross income in that class of gross income.

The ETI exclusion provisions are not referenced as "operative sections" under Treas. Reg. § 1.861-8(f). However, section 925 of the predecessor FSC regime is explicitly cited as an operative section under Treas. Reg. § 1.861-8(f)(1)(iii), which provides:

> Section 925. . . provide[s] rules for determining the taxable income of a FSC. . . . In the FSC context, the taxable income of the FSC equals 23 percent of the combined taxable income of the FSC and the related supplier. Pursuant to regulations under [section] 925. . . this section provides rules for determining the deductions to be taken into account in determining combined taxable income, except to the extent modified by the marginal costing rules set forth in the regulations under [section] 925(b)(2). . . if used by the taxpayer. In addition, the computation of combined taxable income is necessary to determine the applicability of section 925(d). . . .

As with the allocation of a deduction to a class of gross income, the apportionment of a deduction between a statutory and a residual 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).

ANALYSIS

As a threshold matter, we note that exclusions under section 101(d) of the AJCA are determined by applying the relevant ETI exclusion provisions as though they were still in effect (subject to the "haircut" imposed by section 101(d)(2) of the AJCA). Accordingly, all determinations under Issues 1, 2, and 3 below regarding ETI exclusion computations are also applicable to exclusions computed pursuant to section 101(d) of the AJCA. Therefore, we do not separately address exclusions under section 101(d) of the AJCA further in this memorandum.

I. Issue 1: Reduction of QPAI by ETI Exclusion in Calculating § 199 Deduction

QPAI under § 199(c)(1) is a taxpayer's gross income attributable to DPGR (DPGR less CGS allocable to DPGR) less other expenses, losses, or deductions that are properly allocable to DPGR. Section 61 defines gross income as all income from whatever source derived, including gross income derived from business. § 61(a)(2). Treas. Reg. § 1.61-3(a) provides that in a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from any investments and from incidental or outside operations or sources. Sales correspond to gross receipts. The ETI exclusion, as defined in § 114, is an item that is specifically excluded from gross income. Numerous provisions of the final § 199 regulations refer to gross income attributable to DPGR, including: Treas. Reg. § 1.199-4(a), (b)(1) and (7), Ex. 1, (c)(2), and (d)(1), (2), (4), and (6), Ex. 1 and 2.

To the extent QPAI includes a taxpayer's gross income attributable to FTGR, a taxpayer's ETI exclusion attributable to the same transactions (or other permitted basis) that generates DPGR should be excluded from QPAI because the ETI exclusion is an exclusion from gross income under § 114(a). Section 199 does not include any language to limit the application of any of the exclusion sections under Part VIII, Subchapter B, Part III (Items Specifically Excluded from Gross Income) including § 114.[1] Regardless of whether a taxpayer applies Notice 2005-14, 2005-1 C.B. 498, the proposed § 199 regulations, or the final § 199 regulations, exclusions from gross income such as § 114(a) must be taken into account in determining QPAI.

[1] For purposes of determining DPGR, Treas. Reg. § 1.199-3(c) provides, in part, that gross receipts include any income from investments and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of section 103). Gross receipts do not include amounts received in repayment of a loan or similar instrument (for example, a repayment of the principal amount of a loan held by a commercial lender), and, except to the extent of gain recognized, do not include gross receipts from a non-recognition transaction. Treas. Reg. § 1.199-3(c) does not provide a basis to exclude gross receipts that are included in a taxpayer's ETI exclusion from DPGR because that provision defines gross receipts broadly and that definition of gross receipts includes DPGR and non-DPGR.

Additionally, any deduction of a taxpayer that is properly allocated and apportioned to ETI that is excluded from gross income under § 114(c)(2) is disallowed. See § 114(c)(1). Under Treas. Reg. § 1.199-8(h), disallowed deductions factor into a taxpayer's § 199 computation (if based on QPAI) by operation of another Code section. Because § 114(c)(1) disallows deductions used in calculating the amount of the ETI exclusion, and Treas. Reg. § 1.199-8(h) requires disallowed deductions not to be taken into account for calculating QPAI, then the corresponding amount of gross income excluded under the ETI exclusion also should be excluded from the calculation of QPAI.

Accordingly, because the QPAI calculation under § 199(c)(1) relates to gross income (DPGR less CGS allocable to DPGR), taxpayers must reduce QPAI by the amount of the ETI exclusion related to transactions that give rise to both FTGR and DPGR. This determination applies for taxpayers subject to the final § 199 regulations or taxpayers relying on the proposed § 199 regulations. Treas. Reg. § 1.199-1(b)(1) provides that taxable income is not reduced by the ETI exclusion, but QPAI is so reduced.

Although the ETI exclusion rules and rules under § 199 are similar in many ways (in the sense of sales of qualifying items that give rise to qualifying gross receipts), it is likely that some transactions that generate FTGR may not generate DPGR and vice versa. Consequently, to the extent that the sale of an item in a transaction generates FTGR and also generates DPGR, then the ETI exclusion associated with such a transaction should reduce QPAI. If a transaction that generates FTGR does not generate DPGR, then that ETI exclusion amount should not be used to reduce QPAI.

Accordingly, under the proposed facts, both Taxpayers A and B should take the ETI exclusion into account in determining QPAI and the § 199 deduction (if derived from QPAI).

II. Issue 2: Allocating and Apportioning the § 199 Deduction under Treas. Reg. § 1.861-8 to Determine FTI under the ETI Regime

A. Full costing FTI method

FTI is defined as the taxable income of the taxpayer attributable to FTGR of the taxpayer and, thus, requires the reduction of FTGR by deductions. § 941(b)(1). As discussed above, the Secretary did not prescribe rules for determining FTI or for applying the FTI method under the ETI regime. Nonetheless, as stated above, the Senate Report indicates that regulatory and other administrative guidance under the FSC regime should be used with respect to analogous concepts under the ETI regime in the absence of new guidance. Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(D) and Treas. Reg. § 1.861-8(f)(1)(iii) provide that CTI for FSC purposes is generally computed on a full costing basis and that the § 861 regulations apply for purposes of allocating and apportioning deductions to arrive at full costing CTI. Therefore, the full costing rules under Temp. Treas. Reg. § 1.925(a)-1T(c) and the § 861 regulations generally apply for purposes of the full costing FTI method.

Under the § 861 regulations as applied to the full costing FTI method, the § 199 deduction is factually related, and therefore directly allocable and apportionable, to gross income attributable to FTGR to the extent that such gross income includes gross income attributable to DPGR that gives rise to the § 199 deduction. A taxpayer may reasonably allocate its § 199 deduction to the class of gross income attributable to DPGR and then apportion on a pro rata basis the deduction so allocated between gross income attributable to FTGR and gross income attributable to non-FTGR. Only the portion of the § 199 deduction that is apportioned to gross income attributable to FTGR will reduce the taxpayer's FTI.

B. Marginal costing rules and gross receipts method

Taxpayers that elect to apply the marginal costing rules for computing FTI or use the gross receipts method instead of the FTI method generally are not required to take the § 199 deduction into account because the marginal costing rules and the gross receipts method limit the relevant deductions. However, taxpayers must take into account the §199 deduction in determining certain limitations relevant to the marginal costing rules and the gross receipts method as explained below.

Because the Secretary did not prescribe rules for marginal costing, the marginal costing rules in the FSC regime are applicable to marginal costing authorized by § 941(a)(4) in the ETI regime. Under the marginal costing rules in the FSC regime, only direct material and labor costs (as defined in Treas. Reg. § 1.471-11(b)(2)(i)) are taken into account in computing maximum CTI, which was the base for determining the FSC's profit unless limited by the overall profit percentage limitation. The taxpayer uses a full costing calculation of all of the taxpayer's income and deductions is used to determine the overall profit percentage limitation. With respect to the calculation of maximum FTI, because only direct material and labor costs are taken into account, a taxpayer will not reduce its gross income attributable to FTGR by the § 199 deduction. Temp. Treas. Reg. § 1.925(b)-1T(b)(1) and Treas. Reg. §1.861-8(f)(1)(iii). However, the taxpayer will take into account its § 199 deduction in determining its overall profit percentage limitation because this limitation is calculated on a full costing basis. Temp. Treas. Reg. § 1.925(b)-1T(c)(2). Similarly, if marginal costing FTI is limited by the no loss rule in Temp. Treas. Reg. § 1.925(b)-1T(b)(4)(iii), the taxpayer will take into account its § 199 deduction in determining whether the no loss rule applies because the no loss limitation is calculated on a full costing basis.

With respect to the gross receipts method, the primary computation provided for in § 941(a)(1)(B) requires only a gross receipts calculation, rather than a full costing FTI calculation. Therefore, the § 199 deduction is not relevant to that primary computation. However, the taxpayer must take the § 199 deduction into account in determining whether the "no more than 200% of the amount determined under the FTI method" limitation in the flush language under § 941(a)(1) applies. The taxpayer may use either the full costing FTI method or the marginal costing FTI method (if applicable) for determining that limitation.

C. FSLI method

With respect to the FSLI method, taxpayers must take into account only directly allocable expenses. § 941(c)(3)(B). In this context, the § 861 regulations apply to determine the expenses that are factually related to gross income attributable to FSLI. Because the § 199 deduction is directly associated with gross income attributable to DPGR, the taxpayer must reduce that portion of gross income attributable to DPGR that also qualifies as gross income attributable to FTGR for purposes of calculating FSLI with the §199 deduction. The taxpayer may use any reasonable method to determine that portion. See § 1.861-8T(c).

III. Issue 3: Methodology for Interrelated Computations

Taxpayers may use any reasonable method for making the interrelated ETI exclusion/§ 199 computations. For this purpose, the iterative method (i.e., repeatedly re-determining the ETI exclusion and § 199 deduction until there is little or no variance in the ETI exclusion and the § 199 deduction) and the simultaneous equations method (i.e., solving for both the ETI exclusion and the § 199 deduction at the same time using multiple variables)[2] are presumed to be reasonable methods for making such interrelated computations.

Please call David McDonnell at (202) 622-3040 regarding the § 199 deduction, Joseph Tobin at (202) 435-5265 regarding the ETI exclusion, and Richard Chewning at (202) 622-3850 regarding the § 861 regulations if you have any further questions.

[2] An example of the simultaneous computation method is described in Rev. Rul. 79-347, 1979-2 C.B. 122. See also Shell Oil Co. v. Commissioner, 89 T.C. 371 (1987), rev'd. in part and remanded in part, 952 F.2d 885 (5th Cir. 1992).