This Chief Counsel Advice responds to your request for assistance dated September 21, 2016, regarding the proper method of allocating and apportioning deductions for certain legal fees to domestic production gross receipts (“DPGR”), for purposes of determining Parent’s qualified production activities income (“QPAI”). The legal fees in question relate to legal fees incurred by Parent, Subsidiary, and other corporations and disregarded entities within Parent’s consolidated group to defend lawsuits filed against them alleging harm from the use of Products W and X, which were manufactured and sold by Subsidiary and a disregarded entity in years before the effective date of section 199.¹ QPAI is defined in section 199(c)(1). Treas. Reg. § 1.199-4(a) and (d) requires, for purposes of computing QPAI, that certain taxpayers use the rules under Treas. Reg. §§ 1.861-8 and 1.861-14 and Temp. Treas. Reg. §§ 1.861-8T and 1.861-14T (“the section 861 method”) to allocate and apportion deductions to gross income attributable to DPGR in computing QPAI. This memorandum does not address the allocation to DPGR under Treas. Reg. § 1.199-4(b) of costs that were capitalized into inventory under section 263A.

¹ Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986.
LEGEND
Parent = -----------------------
Subsidiary = ----------------------------------
Product W = ---------------
Product X = ---------------------------------------
Year 1 = -------
Year 2 = -------
Year 3 = -------
Year 4 = -------
$Amount A = --------------------------------------
$Amount B = -------------------
$Amount C = -------------------
$Amount D = -------------------

ISSUE

Are the legal fees in question allocated and apportioned under the section 861 method against Parent’s gross income attributable to DPGR for the Years 1 through 4 in computing Parent’s QPAI?

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 within that class of gross income. In our opinion, the submitted facts confirm that the deductions for the legal fees relating to defense of lawsuits filed against Parent, Subsidiary, other corporations, and disregarded entities within Parent’s consolidated group alleging harm from the use of Products W and X manufactured and sold by Subsidiary and a disregarded entity in years before the effective date of section 199 are definitely related to gross income from those product sales. Because those product sales all were made prior to the effective date of section 199, those sales did not generate DPGR, and the legal fees incurred to defend against the lawsuits that are properly allocated to the class of gross income attributable to those sales are under the section 861 method factually apportioned exclusively to the residual grouping of income that is not gross income attributable to DPGR. Accordingly, the deductions for the legal fees in question will not reduce Parent’s QPAI and its section 199 deduction in the year the legal fees were incurred.²

² In reaching our decision, we considered, but ultimately dismissed as unsupported by the facts in this case, other possible bases on which to allocate and apportion the legal fees. For example, we considered whether the legal fees should be allocated to all of the gross income of Parent's affiliated group because they are supportive in nature; whether the legal fees were incurred in connection with an
FACTS

Parent, a holding company, and its U.S. subsidiaries, including Subsidiary, filed a consolidated Federal income tax return for all relevant years. Subsidiary and a disregarded entity within Parent’s consolidated group manufactured and sold Products W and X in years preceding and after the enactment of section 199, which is effective for tax years beginning after December 31, 2004. Years 1 through 4 are post-2004 taxable years. During Years 1 and 4, substantially all of Subsidiary’s gross receipts were DPGR from the sale of Products W and X. However, during those years, Parent’s consolidated group’s gross receipts comprised both DPGR and non-DPGR. Parent determined its QPAI for Years 1 through 4 on a consolidated basis under Treas. Reg. § 1.199-7(d)(4)(ii). The legal fees in question are litigation legal fees incurred by Parent, Subsidiary, and other corporations and disregarded entities within Parent’s consolidated group to defend lawsuits filed against them alleging harm from the use of Products W and X manufactured and sold by Subsidiary and a disregarded entity in years before the effective date of section 199. The amounts of the legal fees at issue are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$Amount A</td>
</tr>
<tr>
<td>Year 2</td>
<td>$Amount B</td>
</tr>
<tr>
<td>Year 3</td>
<td>$Amount C</td>
</tr>
<tr>
<td>Year 4</td>
<td>$Amount D</td>
</tr>
</tbody>
</table>

Parent deducted these amounts on its consolidated Federal income tax return for Years 1 through 4; none of the legal fees at issue were capitalized under section 263A and the regulations thereunder. Parent submitted informal refund claims asserting that, under the section 861 method, the deduction for the legal fees in question should not be attributable to DPGR in computing Parent’s QPAI.

LAW AND ANALYSIS

Section 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 section 199(a)(1), a taxpayer is allowed a domestic production deduction (the section 199 deduction) equal to 9 percent (3 percent in the case of taxable years ongoing business of producing and selling Products W and X and therefore are factually related to gross income attributable to past, present and future sales of Products W and X, in which case a reasonable apportionment between prior sales that did not generate DPGR and prior, present, and future sales that generated or will generate DPGR would be required; and whether the legal fees were incurred to preserve Parent’s, Subsidiary’s, and other group members’ current assets, enhance the value of its brand, and generate future sales and therefore should be apportioned exclusively to gross income attributable to present and future sales of Products W and X that generate DPGR. Although the facts of this case present a strong factual connection between the legal fees and the gross income attributable to the specific sales of Products W and X which did not generate DPGR, on other facts a different basis of allocation and apportionment of the legal fees might be more reasonable and more appropriate.
beginning in 2005 and 2006; 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). Section 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. Section 199(b)(2)(B) limits W-2 wages to amounts that are properly allocable to DPGR.

QPAI is the excess of a 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 section 199 deduction) that are properly allocable to DPGR ("deductions"). Section 199(c)(1). Each member of an expanded affiliated group computes its own QPAI, and the section 199 deduction of the expanded affiliated group is then determined by aggregating the QPAI, taxable income or loss, and W-2 wages of each member. Treas. Reg. § 1.199-7(a) and (b)(1).

However, if every member of an expanded affiliated group is also a member of the same consolidated group, the consolidated group’s section 199 deduction is determined using the consolidated group’s QPAI. Treas. Reg. § 1.199-7(d)(4)(ii). As stated, Parent determined its QPAI for Years 1 through 4 on a consolidated basis under Treas. Reg. § 1.199-7(d)(4)(ii).

Treas. Reg. § 1.199-4(b) provides special rules for allocating CGS to DPGR. As stated, none of the legal fees at issue were capitalized under section 263A and the regulations thereunder. For section 199 purposes, CGS is determined under the methods of accounting that the taxpayer uses to compute taxable income pursuant to section 263A. See Treas. Reg. § 1.199-4(b)(1). Because the legal fees at issue were not capitalized into CGS, the applicable rules for allocation and apportionment of the fees are the rules in Treas. Reg. § 1.199-4(c) and (d) applicable to deductions. Those regulations require a taxpayer to use the section 861 method to allocate and apportion deductions to gross income attributable to DPGR for purposes of determining QPAI unless the taxpayer qualifies for, and elects to use, one of the two simplified methods available to small taxpayers for allocating and apportioning deductions. Parent here does not qualify to use the simplified methods.

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 a class of gross income and to the statutory and residual groupings of income in that class. Treas. Reg. § 1.861-8(a)(2). The statutory grouping of gross income means the gross income from a specific source or activity which must first be

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3 For purposes of this request for advice, we have been asked to assume that none of the legal fees are properly capitalizable under section 263A and the regulations thereunder; accordingly, we express no opinion on this matter.
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. Treas. Reg. § 1.861-8(a)(4) and (f). In this case, the relevant statutory grouping of gross income is gross income attributable to DPGR.

Treas. Reg. § 1.861-8(b)(1) provides that the classes of gross income are not predetermined but must be determined on the basis of the deductions to be allocated and that some deductions may be factually related to all of the taxpayer’s gross income, rather than to a particular class of gross income.

If applicable, the allocation and apportionment of certain expenses must be made on an affiliated group basis. Treas. Reg. § 1.861-14 and Temp. Treas. Reg. § 1.861-14T. Among the expenses the allocation and apportionment of which must be made on an affiliated group basis are expenses related to certain supportive expenses (including advertising, marketing, and other sales expenses) where if, were all members of the affiliated group treated as a single corporation, the expense would not be considered definitely related to the class of gross income derived solely by the member incurring the expense. Temp. Treas. Reg. § 1.861-14T(e)(1) and (3).

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 gross income amounts.

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).

As stated, Parent must use the section 861 method to allocate and apportion its deductions for purposes of calculating its QPAI for Years 1 through 4 on a consolidated
basis under Treas. Reg. § 1.199-7(d)(4)(ii). Under the section 861 method, Parent must determine the factual relationship between the deduction for the legal fees at issue and its gross income. As provided in Treas. Reg. § 1.861-8(b)(2), a deduction incurred as a result of, or incident to, an activity or in connection with property that generates, has generated, or may reasonably be expected to generate gross income shall be considered definitely related to that gross income as a class whether or not any item of gross income in that class is accrued during the taxable year. Therefore, the fact that a deduction accrues in a year in which all of a taxpayer’s gross income in the relevant class is gross income in the statutory grouping does not compel the conclusion that the deduction is factually related to gross income in that statutory grouping, if in fact the deduction is factually related to gross income in the class generated in a prior year that was in the residual grouping.

In this case, the legal fees at issue are factually related to the class of gross income attributable to manufacture and sales of Products W and X made prior to the effective date of section 199. In our opinion, those fees were incurred as a result of, or incident to, and so are properly allocated to, the class of gross income from the specific sales, all of which occurred in years prior to the effective date of section 199, of Products W and X that gave rise to the lawsuits. In this case, there is a strong factual relationship between the deductible legal fees at issue and the class of gross income attributable to the specific sales to the plaintiffs in the lawsuits of Products W and X. Because gross receipts from those sales did not generate gross income attributable to DPGR in the years the gross income was realized, no portion of the deductions for the legal fees at issue should be apportioned under the section 861 method to the statutory grouping of section 199 gross income in Years 1 through 4. Accordingly, the legal fees at issue should not be taken into account in determining Parent’s QPAI in Years 1 through 4.

Please call (202) 317-6936 if you have any questions.