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Memorandum

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subject: Allocation and Apportionment of Litigation Damages Award Payments Relating to Litigation Commenced in Years Prior to the Effective Date of Section 199 for Purposes of Computing Qualified Production Activities Income ("QPAI")

This Chief Counsel Advice responds to your request for assistance regarding the proper method of allocating and apportioning under Treas. Reg. §§ 1.861-8 and 1.861-14 and Temp. Treas. Reg. §§ 1.861-8T and 1.861-14T deductions for certain litigation damages award payments that relate to litigation that commenced in years before the effective date of section 199[1] for purposes of computing QPAI. 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 "section 861 method" for allocating and apportioning deductions in computing QPAI. The section 861 method incorporates Treas. Reg. §§ 1.861-8 and 1.861-14 and Temp. Treas. Reg. §§ 1.861-8T and 1.861-14T. This memorandum does not address the proper allocation and apportionment under the section 861 method of other deductions, including legal fees or other deductible expenses other than the court-ordered awards discussed herein, or the allocation to domestic production gross receipts ("DPGR") under Treas. Reg. § 1.199-4(b) of costs capitalized under section 263A.

This advice may not be used or cited as precedent.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986.

LEGEND

Parent =
Subsidiary =
Product W =
Product X =
Products Y
Year 1 =
Year 2 =
Product Z =
$Amount A =

$Amount B =

ISSUE

In computing QPAI in its affirmative claims, did Parent reasonably allocate and apportion deductions under the section 861 method for litigation damages award payments relating to litigation that commenced before the effective date of section 199?

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 facts confirm that the deductions for the litigation damages award payments in this case are definitely related to gross income from Subsidiary's sales of Product W to plaintiffs prior to commencement of the two suits for which Subsidiary paid the litigation damages award payments of $Amount A in Year 1 and $Amount B in Year 2, because the payments comprise damages attributable to sales of Product W . Because the product sales that gave rise to the lawsuits all were made prior to the effective date of section 199, those sales did not generate DPGR, and litigation damages award payments that are properly allocated to the class of gross income attributable to those sales are exclusively apportioned to the residual grouping of income that is not gross income attributable to DPGR ("section 199 gross income"). Accordingly, the deductions will not reduce Parent's QPAI and its section 199 deduction in the year paid.[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 litigation damages award payments. For example, we considered whether the payments should be allocated to all of the gross income of Parent's affiliated group because they are supportive in nature; whether the payments were incurred in connection with an ongoing business of producing and selling products and therefore are factually related to gross income attributable to past, present and future sales of Product W, 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

FACTS

Parent, a holding company, and its U.S. subsidiaries, including Subsidiary, filed a consolidated Federal income tax return for all relevant years. Subsidiary manufactured and sold Product W and Product X, , in years preceding and after the enactment of section 199, which is effective for tax years beginning after December 31, 2004. Years 1 and 2 are post-2004 taxable years.

. During Years 1 and 2, 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 and 2 on a consolidated basis under Treas. Reg. § 1.199-7(d)(4)(ii).

litigation

Subsidiary was a defendant in a lawsuit filed against it in a trial court in a year preceding the effective date of section 199. The plaintiffs asserted that they had suffered from caused by Product W

. In Year 1, after appeals, $Amount A, , was transferred to the trial court for distribution by the trial court to the plaintiffs according to rules of civil procedure. No portion of the damages award was calculated by reference to Product W that was purchased in years in which section 199 was effective or that gave rise to DPGR. Parent deducted $Amount A on its consolidated Federal income tax return for Year 1. Also on that return, Parent deducted that amount in calculating its QPAI for purposes of determining its Year 1 domestic production activities deduction ("section 199 deduction").

2nd Litigation

In a year preceding the effective date of section 199, Subsidiary was sued in a court by individual seeking damages allegedly caused by Subsidiary's Product W. A jury returned a verdict

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payments were incurred to preserve Subsidiary's 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 Product W that generate DPGR. Although the facts of this case present a strong factual connection between the litigation damages awards and the gross income attributable to the specific sales of Product W on which the litigation was based and which did not generate DPGR, on other facts a different basis of allocation and apportionment might be more reasonable and more appropriate.

awarding the plaintiff damages,
. No portion of the damages award was calculated by reference to
Product W that was purchased in years in which section 199 was effective or that gave rise to DPGR. After appeals, Subsidiary paid in Year 2 $Amount B to the plaintiff. Parent deducted $Amount B on its consolidated Federal income tax return for Year 2. Also on that return, Parent deducted that amount in calculating its QPAI for purposes of determining its Year 2 section 199 deduction.

Affirmative Claims

Parent filed affirmative claims for Years 1 and 2 to remove the litigation damages award payments (i.e., the $Amount A paid in Year 1 and the $Amount B paid in Year 2) from the determination of its Year 1 and Year 2 QPAI, thereby increasing its allowable section 199 deductions for those years.

LAW AND ANALYSIS

Section 199: Background

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 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.

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 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 and 2 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. The litigation award payments in this case are indirect costs similar to warranty and product liability costs described in Treas. Reg. § 1.263A-1(e)(3)(iii)(H) and are therefore not

required to be capitalized under section 263A as costs properly allocable to Product W inventory produced in the year the payments are made. Accordingly, Treas. Reg. § 1.199-4(b) does not apply to require the allocation of the deductions for the litigation award payments to Subsidiary's sales of Product W produced in Year 1 and Year 2, all of which generated DPGR; instead, the applicable rules for allocation and apportionment of those deductions are in Treas. Reg. § 1.199-4(c) and (d). 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.

Allocation and Apportionment of Litigation Damages Award Payments under the Section 861 Method

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 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 section 199 gross income.

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 and 2 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 litigation damages award payments of $Amount A and $Amount B 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 litigation damages award payments of $Amount A in Year 1 and $Amount B in Year 2 comprise damages arising from the class of gross income attributable to sales of Product W to plaintiffs made prior to commencement of the two suits for which Subsidiary paid the litigation damages award payments. In our opinion, the payments were incurred as a result of, or incident to, and so are properly allocated to, the class of gross income from the specific sales of Product W that gave rise to the litigation, all of which occurred in years prior to the effective date of section 199. In this case there is a strong factual relationship between the deductible litigation damages award payments and the class of gross income attributable to the specific sales to the plaintiffs of Product W. Because gross receipts from those sales did not generate section 199 gross income in the years the gross income was realized,

no portion of the deductions for the litigation damages award payments should be apportioned under the section 861 method to the statutory grouping of section 199 gross income in Years 1 and 2. Accordingly, $Amount A and $Amount B should not be taken into account in determining Parent's QPAI in Years 1 and 2, respectively.

Please call Richard Chewning at (202) 317-4912 if you have any questions.