



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR GORDON L. GIDLUND
ASSOCIATE AREA COUNSEL (LMSB) CC:LM:CTM:SD

FROM: Anne O'Connell Devereaux
Senior Technical Reviewer CC:INTL:BR3

SUBJECT:

This Chief Counsel Advice responds to your memorandum received April 4, 2001, in which three issues were presented. On October 10, 2001, you withdrew your request for assistance under what was previously described as Issues 1 and 2. In accordance with I.R.C. §6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Corp X =

FSCsub =

Corp Y =

Product A =

Year M =

Year N =

Tax Year O =

Tax Year P =

Tax Year Q =

ISSUE

For purposes of determining FSC income, was Corp X reasonable in apportioning certain deductions for compensation paid according to estimated time spent by certain key employees on United States and foreign activities?

CONCLUSION

For purposes of determining FSC income, Corp X may apportion its deductions for compensation according to estimated time spent by certain key employees on United States and foreign activities only if this method reflects to a reasonably close extent the factual relationship between the deductions and the groupings of gross income. Whether a method of apportionment is reasonable in any given set of circumstances is a question of fact.

FACTS

Corp X, a publicly-traded United States corporation, is an accrual-basis taxpayer. Corp X designs and manufactures Product A. Corp X manufactures all of Product A in the United States. The tax years in issue are Tax Years O, P, and Q. Corp X formed FSCsub in Year M to handle its export sales, and formed Corp Y in Year N to handle its domestic sales. All foreign sales of Corp X are made through FSCsub and Corp X sells the same products both domestically and internationally. FSCsub uses the combined taxable income (CTI) method of transfer pricing provided for by section 925(a)(2) of the Internal Revenue Code (Code) and Temp. Treas. Reg. §1.925(a)-1T(c)(6).

For general and administrative, manufacturing, and research and development department employees, Corp X generally apportioned salaries, bonuses, 401(k) plan, and stock option deductions to FSC income based on a "weighted average foreign sales percentage" that closely resembled the percentage of foreign and US gross income figures. However, for certain senior executives, Corp X apportioned salaries, bonuses, stock option deductions, and 401(k) plan deductions at different rates, some of which reflected estimated time spent on foreign activities. To determine estimated time spent, Corp X relied on the recollection of the applicable executives. Contemporaneous records were generally not kept or maintained.

LAW AND ANALYSIS

The determination of CTI under section 925 of the Code requires the computation of taxable income from specific sources or activities. This computation is governed by the regulations under Treas. Reg. §1.861-8. The regulations under Treas. Reg. §1.861-8 generally require taxpayers to allocate deductions to a class of gross income and, to the extent necessary to make the determination required by an operative Code section (see Treas. Reg. §1.861-8(f)(1)(iii) relating to the computation of CTI), to apportion deductions within the class between statutory and residual groupings of gross income. Treas. Reg. §1.861-8(a)(2).

The apportionment of a deduction must be accomplished in a manner that reflects to a reasonably close extent the factual relationship between the deduction and the

grouping of gross income. Examples of bases and factors that may be used for apportionment include: (i) comparison of units sold; (ii) comparison of the amount of gross sales or receipts; (iii) comparison of cost of goods sold; (iv) comparison of profit contribution; (v) comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent which are attributable to the activities or properties giving rise to the class or gross income; and (vi) comparison of the amount of gross income. Temp. Treas. Reg. §1.861-8T(c)(1).

For the tax years in issue, Corp X apportioned certain compensation deductions for various executives and key employees between statutory and residual groupings on a "time spent" basis,¹ while using different apportionment methods for other types of compensation paid to those same key employees and for other employees' compensation. While time spent on activities that give rise to gross income is one example of the factors that may be used to apportion deductions within a class of gross income, Temp. Treas. Reg §1.861-8T(c)(1) provides that a method of apportionment may not be used when it does not reflect, to a reasonably close extent, the factual relationship between the deduction and the groupings of income.

It is not unreasonable that different employees' compensation deductions be treated differently if such deductions relate to different classes of gross income. The deduction for compensation paid to an employee who generates only United States source income may reasonably be apportioned wholly to United States source income. If, however, another employee generates both foreign and domestic income, apportionment between the statutory and residual groupings is generally appropriate. The activities of senior executives are largely general and administrative in nature and relate to the production of all gross income. For an apportionment to be acceptable, the method chosen must reflect to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. The determination of whether the method of apportionment chosen by the taxpayer is reasonable is a question of fact. Since allocations and apportionments are made on the basis of the factual relationship between the deduction and the gross income to which it relates, the taxpayer must provide information from which such factual relationships can reasonably be determined. Treas. Reg. §1.861-8(f)(5).

As a general matter, the time spent by an employee on various activities can be an acceptable basis of apportionment if it is reasonably substantiated and reasonably relates the deduction to the groupings of gross income. See Treas. Reg. §1.861-8(g),

¹ It is not clear from the facts submitted whether Corp X's CTI includes both domestic and foreign source income. We note, however, that because CTI is not based on geographic source of income principles, CTI may comprise multiple sources of income (when, for example, a taxpayer manufactures property in one country and sells it in another, section 863(b) provides that 50 percent of the income is foreign source and 50 percent is United States source). To the extent that Corp X's CTI comprises domestic source income, it may not be reasonable for Corp X to apportion compensation deductions to CTI based on employees' time spent on foreign activities.

Exs. 19 and 20. The adequacy of a taxpayer's time records is a question of fact. Certain time records that may be reasonably acceptable in one situation may not be acceptable in another situation given the particular facts and circumstances of each situation. Time factors to be considered might include phone records, meeting minutes, or travel schedules. The apportionment factor chosen by a taxpayer does not need to be the best method, it need only be a method that reasonably reflects the factual relationship between the deduction and the groupings of gross income.

Corp X must provide the Service with facts sufficient to establish that a time basis apportionment reflects to a reasonably close extent the factual relationship between the key employee's compensation deduction and the groupings of gross income in this situation. The fact that the apportionment fraction may differ when using different apportionment factors (i.e., time as opposed to sales percentage) is not determinative of the reasonableness of an apportionment method but may be a factor in determining the reasonableness of the relationship of the deduction to the grouping of gross income. Furthermore, different treatment of different elements of key employees' compensation (i.e., the 401(k) plan deduction) may call into question the reasonableness of the apportionment method chosen by the taxpayer. Similarly, if Corp X uses different methods of apportionment from year to year for the same employee who is doing substantially the same work during each year, such different treatment may call into question the reasonableness of the method chosen. It is incumbent upon Corp X to explain why such different treatment is reasonable in this situation.

Please call if you have any further questions.

ANNE O'CONNELL DEVEREAUX
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