Form 8903: Domestic Production Activities Deduction

Mastering Complex Determinations, Calculations and Reporting Challenges for the DPAD

THURSDAY, FEBRUARY 6, 2014, 1:00-2:50 pm Eastern

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Form 8903 Compliance Seminar

February 6, 2014

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Today’s Program

Overview Of Tax Technical Rules  
[Ronald G. Wainwright, Jr.]  

Recent Developments Of Note  
[Andrew Martin]

Current IRS Audit Issues  
[Ronald G. Wainwright, Jr.]

Planning Opportunities  
[Kathleen King]

Best Practices For Designing, Implementing, Defending Sect. 199 Methodology  
[Ronald G. Wainwright, Jr., Kathleen King]
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OVERVIEW OF TAX TECHNICAL RULES
Background

• Created by American Jobs Creation Act of 2004
  • Incentive for “production” activities in the U.S.

• Deduction, not a credit

• Permanent tax difference

• Complex calculation rules generate compliance issues for many taxpayers
Domestic Production Deduction

Acronyms

• QPAD – Qualified production activities deduction
• QPAI – Qualified production activities income
• DPGR – Domestic production gross receipts
• COGS – Cost of goods sold
• QPP – Qualified production property
• MPGE – Manufactured, produced, grown or extracted
• TPP – Tangible personal property
• EAG – Expanded affiliated group
Basic Calculation

• The Sect. 199 deduction is calculated by applying a statutory percentage (9% for 2010 and years after) to the lower of two income amounts:
  
  • Qualified production activities income (QPAI),
    • OR
  • Taxable income (TI) (after NOLs and before taking this deduction into account).

• **Limitation** - Capped at 50% of W-2 wages paid by the employer
Qualified Production Activities Income (QPAI)

QPAI equals:

• Domestic production gross receipts,
• Less: Cost of goods sold allocable to these receipts
• Less: Deductions that are directly allocable to these receipts
• Less: A ratable portion of indirectly allocable expenses

• Thus, DPD is calculated on “net income” basis.

• Whether gross receipts qualify as DPGR is determined on an “item-by-item” basis.
What Is A DPGR?

- Includes gross receipts from the lease, rental, license, sale, exchange or other disposition of:
  - Qualifying production property (QPP) manufactured, produced, grown or extracted (MPGE) by the taxpayer, in whole or significant part, in the U.S.
  - QPP includes tangible personal property, computer software and sound recordings.
  - The following are also qualified production activities:
    - Construction or substantial renovation or real property in the U.S. (includes residential and commercial property and infrastructure)
    - Engineering and architectural services performed in U.S. and relating to the construction of real property
    - Film production in certain circumstances
    - Production of electricity, natural gas, or potable water in the U.S.
Other DPGR Notes

• DPGR does not include gross receipts from the lease, license or rental of property for use by a related person (unless ultimately subleased to an unrelated person).

• DPGR does not generally include gross receipts derived from the performance of services (exception: embedded services).

• DPGR includes the sale of self-constructed property used by the taxpayer in its business before being sold.

• DPGR includes proceeds from business interruption insurance and payments not to produce (if they are substitutes for gross receipts that would qualify as DPGR).
Definition Of MPGE Is Broad

- Manufactured, produced, grown or extracted (MPGE) includes:
  - Activities relating to manufacturing, producing, growing, extracting, installing, developing, improving and creating QPP
  - Making QPP out of scrap, salvage or junk material or from new or raw material by processing, manipulating, refining or changing the form of an article or by combining or assembling two or more articles
  - Cultivating soil, raising livestock, fishing or mining materials
  - Storage, handling or other processing activities (other than transportation) within the U.S. related to the sale, exchange or other disposition of agricultural products; provided the products are consumed in connection with, or incorporated into, the MPGE of QPP, regardless of whether by the taxpayer
“In Significant Part”

• The MPGE performed by the taxpayer within the U.S. must be “substantial in nature.”
  • Facts-and-circumstances test looks at relative value and relative cost of MPGE activity, and nature of property and nature of MPGE.
  • Development activities are not substantial in nature (except for software and sound recordings QPP).
  • Packaging, repackaging, labeling and minor assembly are not considered MPGE.
• Safe harbor
• 20% or more of COGS are conversion costs (direct labor and related factory burden incurred by the taxpayer in the U.S.).
Allocation Of DPGR And Non-DPGR

- No single prescribed method
- Allocation base must be reasonable/accurately reflective
  - Available information used by management
- A taxpayer that has information readily available to use a specific identification method is required to use a specific identification method to determine DPGR, even if it does not use that method for any other purpose.
  - Use of a different, less accurate method is not generally considered reasonable/
- IRS notice safe harbor
  - If > 95% of gross receipts is DPGR, then you can consider all gross receipts DPGR.
  - Avoids cost allocations to non-DPGR
Allocable Other Deductions

• Must generally allocate and apportion deductions using the rules provided in the IRC Sect. 861 regulations

• Simplified deduction method applies to taxpayers with average annual gross receipts of $100 million or less. This allows deductions to be ratably apportioned between DPGR and other gross receipts, based on relative gross receipts.

• Small business simplified overall method applies to taxpayers with average annual gross receipts of $5 million or less. This allows COGS and other deductions to be ratably apportioned between DPGR and other gross receipts, based on relative gross receipts.
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RECENT DEVELOPMENTS OF NOTE
Recent Developments

• Tiered management process formally eliminated by the IRS Large Business & International (LB&I) division – replaced with Issue Practice Groups (IPGs) and International Practice Networks (IPNs) – LB&I-04-0812-010 (August 17, 2012).
  - Issue tiering, established in 2006, involved separating exam issues into one of three tiers

• LB&I has issued three industry directors’ directives in the past two years providing guidance to IRS examiners in making determinations whether a taxpayer possesses the benefits and burdens of ownership under a contract manufacturing arrangement, for purposes of Section 199. LB&I-04-0112-001 (February 1, 2012); LB&I-04-0713-006 (July 24, 2013); and LB&I-04-1013-008 (October 29, 2013).
Recent Developments

• Section 199(c)(4) states that DPGR means the gross receipts of the taxpayer which are derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property (“QPP”) which was manufactured, produced, grown, or extracted (“MPGE”) by the taxpayer in whole or in significant part within the United States.

• Notice 2005-14 and Regs. Section 1.199-3(f) state that only the taxpayer that has the benefits and burdens of ownership of the QPP, under Federal income tax principles during the period in which the qualifying activity occurs is treated as engaging in the qualifying activity.

• Notice 2005-14 suggests that §263A and §936 may be informative when determining benefits and burdens of ownership.
Recent Developments

• February 1, 2012 Directive – three-step test for determining who possesses benefits and burdens – if two of three steps not satisfied, may still establish benefits and burden on basis of facts and circumstances.
• July 24, 2013 Directive – benefits and burdens established by a taxpayer benefits and burden statement, a statement that the taxpayer wasn’t required to record a reserve for financial statement purposes as well as certification by both the taxpayer and contract manufacturer under the penalty of perjury as to who has the benefits and burdens.
• October 29, 2013 Directive - benefits and burdens established by a taxpayer benefits and burden statement as well as certification by both the taxpayer and contract manufacturer under the penalty of perjury as to who has the benefits and burdens (reserve statement removed).
• Treasury and IRS officials have stated that these changes were made in order to reduce IRS administrative burden (2014 TNT 18-9).
  • Party with greatest bargaining power will receive deduction, not necessarily the party that would be found to possess the benefits and burdens under a facts and circumstances analysis.
Recent Developments

- **ADVO Inc. v. Commissioner**, 141 T.C. No. 9 (October 24, 2013) – Tax Court held that a direct mail advertiser was not entitled to the section 199 deduction for the production of its mailings by third-party printers, because it did not possess the benefits and burdens of ownership of the direct advertising materials.
- Tax Court analyzed the facts using a combination of the factors in *Grodt & McKay Realty Inv.*, 77 T.C. 1221 (1981) and those in section 936.
- The Tax Court distinguished *Suzy’s Zoo v. Commissioner*, 114 T.C. 1 (2000) because it was a section 263A case (even though Notice 2005-14 suggested that sections 263A and 936 would be useful in determining who possessed benefits and burdens).
- The Tax Court held that five of the nine factors were in favor of the third-party printers, but stated that no one factor is determinative.
- Limited Brands has a similar case pending before the Tax Court and submitted an amicus brief in *ADVO*, pointing out that the design and IP ownership are key factors in determining who has benefits and burdens.
Recent Developments

• *U.S. v. Dean*, No. 11-01977 (C.D. Cal. May 7, 2013) – the U.S. District Court for the Central District of California held that the activities of a gift basket company qualified as manufacturing activities under section 199.

• The taxpayer’s company purchased various items (e.g., pre-wrapped chocolates, cookies, etc.) from third parties and combined them into gift baskets or towers using machines and a large number of assembly-line workers.

• The court held that such activities were not merely packaging and repackaging of items, but that the activities changed the form and function of the individual items into a new product with a different demand (i.e., from a candy bar grocery item to a gift basket).

• The court also distinguished the taxpayer’s activities from the automobile “minor assembly” example in the regulations, stating that the customization of the auto did not change its form or function.

• The court gave no deference to CCA 201246030, which held that a taxpayer who bought pills in bulk and then packaged them into blister packs for sale to customers only engaged in packaging activities, not manufacture.
Recent Developments

• In a Chief Counsel Advice (CCA 201313020) released March 29, 2013, the IRS concluded that the activities of a book publisher that used third-party contract manufacturers to mass produce the publisher’s books from electronic versions resulted in the creation of intangible property and did not qualify as manufacturing under Section 199.

• The taxpayer created electronic versions of its books and provided the contract manufacturer with the electronic version for mass production. The contract manufacturer mass printed and assembled copies of the books, using its employees, machinery, and plant.

• The taxpayer’s activities – design, development, creation, materials analysis and section – did not constitute the manufacture of qualifying production property (QPP) according to the IRS.
Recent Developments

• In a legal advice memorandum (AM 2014-001) released January 10, 2014, the IRS considered circumstances under which cooperative advertising allowances that inventory retailers receive from product vendors for placing advertisements of the products in flyers may be treated as DPGR.

• In general, gross receipts from advertising do not qualify as DPGR except in the cases of some tangible personal property. The advertising exception in Regs. Section 1.199-3(i)(5)(ii) provides that a taxpayer’s gross receipts must be derived from the disposition of newspapers, magazines, telephone directories, periodicals, and other similar printed publications.

• The memorandum concludes that retail flyers are eligible as “other similar publications” under the advertising exception and that revenue is derived from the performance of services.

• Therefore, it is important that a retailers’ advertising services are tied to advertisements that appear in printed material – examples 1 and 2 in the memorandum illustrate this point by including a reference to the advertisements appearing in a weekly flyer.
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Common Issues In IRS Exams

• Industry director directive (IDD) for DPD, dated Dec. 14, 2006, originally designated Sect. 199 as a Tier 1 issue, due to the law’s complexity and possible revenue impact.
• The IDD outlines the issues agents should examine and the minimum audit checks to be completed.
  • Does the taxpayer’s business make sense with the activity requirements of the domestic production deduction (DPD)?
  • How does the domestic production gross receipts (DPGR) reported on Form 8903 compare with the gross receipts or sales less returns and allowances on the taxpayer’s tax return, line 1c of the Form 1120?
  • Is the taxpayer required to allocate gross receipts to remove non-qualified embedded service income, or determine the qualified income portion of a component of an item? If so, how did the taxpayer determine an allocation method?
  • If the taxpayer is required to use a Sect. 861 method to allocate and apportion deductions, has the taxpayer indeed used it, and is it consistent with the application of Sect. 861 for purposes of the foreign tax credit, if applicable?
  • Has the taxpayer applied the wage and taxable income limitations?
Common Issues In IRS Exams (Cont.)

• Contract manufacturing - Benefits and burdens (B&B) of ownership
  • On Oct. 8, 2010, the LB&I division hosted a meeting with technical advisers, IRS officials, Treasury and tax practitioners to discuss the application of the B&B test in a contract manufacturing arrangement for purposes of the Sect. 199 deduction. Following the meeting, the IRS circulated a list of nine potential factors:
    1. Title to work-in-process and finished goods
    2. Risk of loss
    3. Make-good obligations
    4. Procurement of raw materials
    5. Type of pricing (e.g., cost plus vs. fixed)
    6. Ownership of manufacturing equipment
    7. Employment of manufacturing workers
    8. Control of manufacturing employees
    9. Quality control responsibilities
  • The 2012 IDD discussed earlier was a by-product of these meetings.
Common Issues In IRS Exams (Cont.)

• Definition of DPAD activity
  • Often sent to IRS national office for interpretation

• Section 263A
  • IRS has argued that section 199 is dependent on having application of 263A
PLANNING OPPORTUNITIES

Kathleen King, Alvarez & Marsal
Opportunity Areas

Understand your DPD limitation

- Taxable income (TI)

- Qualifying production activity income (QPAI)

- W-2 wages
Taxable Income Limitation

• Some planning opportunities are available, if TI is your limitation.
  • Any planning must be consistent with current accounting methods, or a method change must be filed.
    • Note: Consider long-term impact, if a method change is required.
• Slow down expenditures
  • Depreciation and amortization
    • Asset life, asset class
  • Bonus and other amounts potentially accelerated for tax purposes
• Accelerate income recognition
  • Individual customer contracts
  • Non-core sales
• Recently issued Repair and Maintenance regulations could impact TI.
QPAI Limitation

- Definition of DPGR
  - Step One: Understand streams of revenue
    - Production vs. service
    - Situs of production activity (offshore vs. U.S. activity)
    - Drop-ship
    - Inter-company transactions
    - Non-core sales
    - De minimis service amounts
  - Step Two: Are Non-DPGR revenue streams profitable?
  - Step Three: Analyze Non-DPGR categories
    - Is it really a service?
      - Software (maintenance agreements, contract software development, embedded software)
      - Repair and maintenance
      - Assembly
      - Architectural and engineering
      - Advertising revenues
      - R&D services
    - In whole or significant Part (what is the nature of U.S. work?)
## Industry Specific Opportunities

<table>
<thead>
<tr>
<th>Industry</th>
<th>Common Opportunity Area</th>
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<tbody>
<tr>
<td>Manufacturing</td>
<td>• Contract manufacturing</td>
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<tr>
<td></td>
<td>• Assembly</td>
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<td></td>
<td>• Software</td>
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<td>Retail</td>
<td>• Photo labs</td>
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<td>• Private label</td>
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<td>• Distribution center activities</td>
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<td>• Circulars</td>
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<td>High Technology</td>
<td>• Software development for customers</td>
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<td>• R&amp;D</td>
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<tr>
<td>Construction</td>
<td>• Architectural and engineering</td>
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<tr>
<td></td>
<td>• Refurbishment</td>
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<tr>
<td>Sports And Entertainment</td>
<td>• Event booklets (and related advertising)</td>
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<td>• Broadcast or sound recording revenue</td>
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</table>
Allocation And Apportionment

• Direct and indirect expenditures
  • Step One: Understand how the company reporting links COS and other G&A to revenue streams
  • Step Two: Understand your indirect expenditures
    • Have you accounted for all expenditures?
      • Corporate headquarters
      • Are they really indirect?
      • R&D
  • Step Three: Review your allocation methods
    • Are they consistent with other areas requiring 861?
    • Do they make sense relative to DPGR vs. non-DPGR?
W-2 Wage Limitation

• Step One: How are W-2 wages being computed?
  • Identify the method that results in the largest wage base
    • Unmodified box 1,
    • Modified box 1, or
    • Tracking wages method

• Step Two: How are W-2 wages being allocated?
  • Direct wages
    • Direct wages are not necessarily just manufacturing wages.
      • Sales force, R&D
    • Consider method used to allocate wage amounts between DPGR and non-DPGR
  • What method is being used to allocate indirect wages?
    • Is there another more favorable method that is appropriate?
BEST PRACTICES FOR DESIGNING, IMPLEMENTING, DEFENDING SECT. 199 METHODOLOGY

Ronald Wainwright, Cherry Bekaert LLP
Kathleen King, Alvarez & Marsal
Tax Compliance Dimensions

I. Goals of improved tax compliance
   A. Improved quality
   B. Improved timelines
   C. Added value
   D. Reduced risk

II. Key questions to answer in order to achieve goal
   A. What information do I need?
   B. When do I need the information?
   C. How do I get the relevant information?
   D. What do I do with the information?
   E. How do I document my work?
Best Practices

I. Detailed work program

II. Standardized work tools for data-gathering

III. Calculation tools for processing

IV. Detailed workpapers regarding methodology, documentation sources, assumption and results
Designing An Efficient Work Program

I. Understand the compliance prep timeline
   
   A. The Sect. 199 calculation is often one of the last items finalized for the tax return.
      1. Taxable income and M-1s must be final before completing the DPD calculation.
   
   B. Identify tasks that can be completed in advance of compliance season
      1. Review of DPGR activities can be done anytime during the year.
   
   C. Understand what data is available and who must provide them.
      1. Look to existing books and records
         a. What report modification are required to satisfy DPD requirements?
      2. Understand the lowest level of data necessary to create an accurate number
# Getting Started

## I. Overall design and planning

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<table>
<thead>
<tr>
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<tbody>
<tr>
<td>A.</td>
<td>Determine scope of expanded affiliated group (EAG)</td>
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<tr>
<td>B.</td>
<td>Identify key finance and accounting contacts</td>
</tr>
<tr>
<td>C.</td>
<td>Identify, at a high level, the most profitable divisions, contracts and product lines</td>
</tr>
<tr>
<td>D.</td>
<td>Assess EAG W-2 wage limitation and impact</td>
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<tr>
<td>E.</td>
<td>Understand EAG estimated taxable income</td>
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<tr>
<td>F.</td>
<td>Understand existing tax accounting practices that affect Sect. 199 deduction.</td>
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<tr>
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<td>1. 263A/inventory cost capitalization</td>
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<td>2. Sect. 861 allocation and apportionment</td>
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<td>3. Long-term contract accounting</td>
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<td>4. 482 determinations</td>
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<td>5. Inter-company transactions</td>
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<td></td>
<td>6. MPGE characterization for other purposes</td>
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</tbody>
</table>
## II. QPAI analysis

<table>
<thead>
<tr>
<th>A.</th>
<th>Schedule conference calls and communicate with finance or accounting contacts</th>
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<tbody>
<tr>
<td>B.</td>
<td>Based on discussions with division accounting contacts, identify significant revenue streams and break into major product lines, contracts or activity types</td>
</tr>
<tr>
<td>C.</td>
<td>Identify division accounting system capabilities for quantifying key financial data, using a basis of accounting that is adequate for this analysis: Tax, GAAP, or other</td>
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<tr>
<td></td>
<td>1. Revenue, COS, ODC, indirect and W-2 wages</td>
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<td>D.</td>
<td>Capture costs by significant revenue streams</td>
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<td>E.</td>
<td>Interview operating personnel in order to understand “activity” performed for underlying major revenue streams (product line/contracts)</td>
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<tr>
<td>F.</td>
<td>If necessary, review terms for significant customers or contract manufacturers</td>
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<tr>
<td>G.</td>
<td>Investigate potentially qualifying activities</td>
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<tr>
<td>H.</td>
<td>Estimate whether significant revenue streams utilize components that are MPGE:</td>
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<tr>
<td></td>
<td>1. Self-manufactured parts</td>
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<td></td>
<td>2. Purchased parts</td>
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<td></td>
<td>3. Furnished parts</td>
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<tr>
<td>I.</td>
<td>Assess whether significant revenue streams include stated services, embedded services or computer software</td>
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<tr>
<td>J.</td>
<td>Assess whether revenue streams may fail the “significant part test” (20% safe harbor, substantial in nature, foreign content)</td>
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<tr>
<td>III. Summary calculation and delivery</td>
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<tr>
<td>A. Complete cost allocation and apportionment to major revenue streams, in order to show profitability</td>
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<tr>
<td>B. Group revenue streams by division and activity</td>
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<td>C. Identify significant loss revenue streams</td>
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<tr>
<td>D. Bifurcate significant revenue streams into qualifying and non-qualifying</td>
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<tr>
<td>E. Document relevant assumptions and workpaper sources</td>
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<tr>
<td>F. Assess impact of qualification of revenue streams on the overall deduction.</td>
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<td>G. Deliver summary level calculation ranges and report</td>
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Typical Work Papers

I. Calculation template
   A. Form 8903
   B. Adjustments for book-to-tax differences (M-1 allocations)
   C. Source general ledger/cost data for revenue, cost of sale and expense information

II. Conclusion and support for DPGR determination

III. Cost methodology memorandum
   A. Minimum checks
      1. Source of data (name of report and person providing the report)
      2. Reconciliation of taxable income to return
      3. Support for W-2 wage calculation
      4. 861 allocation methodologies
Other Compliance Considerations

1. Taxpayers are allowed to use statistical sampling for purposes of calculating the DPAD. See Rev. Proc. 2007-35
Common Issues With Sect. 861

I. Using different allocation or apportionment methodologies for the same expense when making computations for more than one “operative section”

II. Not allocating expenses to the relevant class of gross income before apportionment

III. Not appropriately eliminating intra-company items before determining the amount of expense subject to the allocation and apportionment rules

IV. Netting interest income and interest expense before determining the amount of expense subject to apportionment

V. Improperly computing the amount of assets for the apportionment base
   A. The mistakes in this area depend upon the valuation method elected by the taxpayer, but a few common ones include:
      1. Using book basis to compute assets as opposed to either the tax basis or fair market value, if applicable;
      2. Not including a portion of the assets used to generate IRC Sect. 863(b) income as foreign assets;
      3. Including assets that either do not produce income or produce tax-exempt income in the apportionment fraction; and
      4. Including the improper asset value of a related entity (e.g., use of the investment in a greater-than-10%-owned partnership rather than the partner’s pro rata share of the partnership assets).

VI. Limiting the amount of R&E subject to allocation and apportionment to “qualifying research expenses” used in the computation of the R&D credit under IRC Sect. 41

VII. Method used to allocate state income taxes to U.S.-source income

VIII. Averaging annual asset values