Presidential debates are being held, pundits are handicapping candidates’ Super Tuesday chances, national parties are preparing for their conventions to choose a nominee—it is time for companies to take a closer look at their lobbying expenses and confirm that they are appropriately allocating costs to nondeductible lobbying expenses under a reasonable allocation methodology. The first step is to consider whether a company has developed a reasonable method for allocating costs to lobbying activities, consistent with Reg. 1.162-28. The regulations allow companies flexibility in choosing a method and the method used should be the most favorable method for the company, in light of the company’s compensation and overhead cost structure. This column reviews the methods for allocating costs to lobbying activities, and considers when each method is most beneficial. A key factor in the determination of which method will prove most beneficial to a company is the company’s compensation structure, as well as the extent and nature of its overhead costs.

Overview of the Tax Treatment of Lobbying Expenses

Lobbying expenses are not deductible—Section 162(e) prohibits a deduction for amounts paid or incurred in connection with (1) influencing legislation, (2) participating or intervening in political campaigns, (3) attempts to influence the general public on elections, legislative matters, or referendums, and (4) direct communications with a covered executive branch official in an attempt to influence that person’s official actions or positions (these activities are collectively referred to as “lobbying” in this column). While Section 162(e) contains some exceptions (such as for local legislation or de minimis in-house expenses), the key issue for most taxpayers with employees who spend a portion of their time lobbying is allocating costs to lobbying activities to determine the nondeductible amount of the taxpayer’s expenses.

Reg. 1.162-28 requires taxpayers to use a “reasonable method” to allocate costs to lobbying and provides a non-exclusive list of reasonable methods. A method is reasonable only if it is “consistently used” and meets certain special rules relating to de minimis lobbying contacts. Three reasonable methods of allocating costs are set forth in the regulations, although they are not the exclusive methods that can be used. Costs required by the regulations to be allocated to lobbying activities are labor costs, which “include all elements of compensation, such as basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay, payroll taxes, pension costs, employee benefits, and payments to a supplemental unemployment benefit plan,” and general and administrative costs, which include “de-
preciation, rent, utilities, insurance, maintenance costs, security costs, and other administrative department costs (for example, payroll, personnel, and accounting).”

Three methods for allocating costs to lobbying are identified in the regulations: (1) the ratio method, (2) the gross-up method, and (3) the Section 263A allocation method. In our experience, for many large companies, the gross-up method has been the most beneficial method. Nonetheless, we outline all three methods below.

The first method outlined in the regulations is the ratio method. Under the ratio method, a company allocates to nondeductible lobbying a portion of its total costs of operations based on the ratio of total hours spent on lobbying to total hours spent on all activities by company personnel. The regulations define “total costs of operation” to mean “the total costs of the taxpayer’s trade or business for a taxable year,” but give no further detail. According to the preamble to the regulations, the failure to include detailed rules defining “total cost of operations” was purposeful so that a taxpayer could use the term in a manner that made sense, and was simple to use, in the taxpayer’s business. In terms of the ratio for allocating these costs to lobbying, special de minimis rules apply. In determining the hours spent on lobbying activities, secretarial and administrative personnel with de minimis time spent on lobbying activities can be treated as having zero time spent on lobbying. However, there is no de minimis exception for personnel engaged in direct lobbying, such as making telephone calls to covered legislative and executive officials.

The second method described in the regulations is the gross-up method. The gross-up method also is formulaic, but it focuses on identifying basic lobbying labor costs, and grossing those costs up to account for other costs (non-basic labor costs, overhead, etc.). There are two options for applying the gross-up method. The general gross-up method begins with “basic lobbying labor costs” of all personnel, and grosses those costs up by 175%. However, taxpayers have a choice to use the alternative gross-up method, which begins with the basic lobbying labor costs of personnel other than those engaged in secretarial, clerical, support, and other administrative activities, and grosses those costs up by 225%.

Under both alternative ways of implementing the gross-up method, “basic lobbying labor costs” are defined as “wages or other similar costs of labor, including, for example, guaranteed payments for services. Basic costs do not include pension, profit-sharing, employee benefits, and supplemental unemployment benefits plan costs, or other similar costs.” The list of forms of compensation included in the definition of basic lobbying labor costs, and those excluded from the definition, was never particularly reflective of compensation practices, and has now become severely outdated. In other words, the definition does not expressly list as included in basic lobbying labor costs or excluded from such costs a number of forms of compensation that currently are widely used. As discussed more fully below, the definition thus results in a lack of certainty regarding, and planning opportunities involving, whether various forms of compensation should be treated as “basic lobbying labor costs” subject to gross up.

The preamble to the regulations describes the gross-up method as allowing taxpayers to allocate costs to lobbying by multiplying the taxpayer’s basic labor costs for lobbying hours by 175%. Taxpayers complained that the method was not simple because it required tracking lobbying hours for clerical and support staff. The alternative gross-up method was introduced into the regulations to address this concern. For taxpayers who found it too difficult to track the hours of support staff, in lieu of tracking these lobbying hours, the gross-up method could be used with a larger gross-up percentage (225%) with the additional gross-up covering the support staff costs. The preamble also was very clear that the gross-up factors “are intended to approximate the average gross-up factors for all taxpayers.” If a taxpayer did not like the gross-up factors, as applied to its business, it could use another method.

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1 Reg. 1.162-28(b)(1).
2 Reg. 1.162-28(c).
3 Reg. 1.162-28(d)(3).
4 TD 8602 (July 20, 1995). The preamble states as follows: “As indicated above, the final regulations clarify that taxpayers may use any reasonable method of allocating costs to lobbying activities. The regulations set forth the ratio method as one simplified method that taxpayers have the option of using. If the regulations were modified to provide a specific definition of total costs of operations encompassing a complex set of exclusions designed to suit the circumstances of all businesses, the ratio method would no longer be a simplified method and would require complex analysis by taxpayers and the IRS. Therefore, the definition of total costs of operations is not changed in the final regulations. Taxpayers who do not find the simple ratio method appropriate to their circumstances may use another reasonable method.”
5 Reg. 1.162-28(e)(3).
Finally, the gross-up method is only available for use by taxpayers who pay or incur reasonable labor costs for persons engaged in lobbying activities.  

For purposes of both the ratio and gross-up methods, amounts paid to third parties for lobbying are not covered, but are separately disallowed. Third-party costs are defined as “amounts paid or incurred in whole or in part for lobbying activities conducted by third parties (such as amounts paid to taxpayers subject to Section 162(e)(5)(A) or dues or other similar amounts that are not deductible in whole or in part under Section 162(e)(3)).” To the extent this regulatory definition references Sections 162(e)(3) and (e)(5)(A), both of which place the deduction disallowance on the taxpayer paying third parties (either a lobbying firm or a trade group that conducts lobbying efforts on behalf of its members), the concept of third-party costs being separately disallowed makes sense and is consistent with the statute. However, the regulation goes on to treat as separately disallowed as “third-party costs” amounts paid or incurred for travel (including meals and lodging while away from home) and entertainment relating in whole or in part to lobbying activities.” This latter category of “travel” items that the regulations treat as separately disallowed is not supported by the statute in the way that third-party costs are. Further, as discussed below, the application of the regulation is unclear when the travel expenses are also covered by the definition of “general and administrative costs” that are expressly required to be allocated under the regulations, such as depreciation and rent.

The final of the three reasonable methodologies set forth in the regulations references the principles in Section 263A. Section 263A contains rules governing capitalization of the costs of producing, acquiring, and holding property either purchased or manufactured for resale. Section 263A requires both the direct costs of merchandise inventory and indirect costs allocable to the inventory to be taken into account. While this Section 263A method of allocating costs to lobbying is available for all taxpayers, not just those that use it already for inventory purposes, given its complexity, very few taxpayers use this method and it is not discussed at length here.

In summary, the regulations and the explanation in the preamble to the regulations make clear that any reasonable method of allocating costs to nondeductible lobbying activities is acceptable, the three methods set forth in the regulations are not exclusive, and the methods in the regulations are meant to be simplified methods. Further, with respect to the gross-up factor, the factors set forth in the regulations are “meant to approximate the average gross-up factors for all taxpayers” and “are the appropriate factors as averages for all taxpayers.” The preamble strongly suggests that taxpayers who find the gross-up factors to be favorable for them, because their basic lobbying labor costs are relatively low, and their overhead and labor benefits in excess of basic labor costs are relatively high, are welcome to choose and apply that method, as long as they pay at least “reasonable” labor costs to their personnel conducting lobbying activities.

### Issues Raised by the Definition of Basic Labor Lobbying Costs—FSA 200102003

As discussed above, Reg. 1.162-28(e)(3) applies a gross-up percentage to a taxpayer’s “basic lobbying labor costs” to determine costs allocable to lobbying activities. And, basic lobbying labor costs are defined as “basic costs of lobbying hours.” Specifically, basic costs of lobbying labor hours are “wages or similar costs of labor, including, for example, guaranteed payment for services.” By contrast, basic labor costs do not include “pension, profit sharing, employee benefits and supplemental unemployment benefits plan costs, or other similar costs.” The regulation does not expressly mention many common forms of incentive compensation, such as annual and long-term bonuses, stock options, restricted stock, restricted stock units, and non-qualified deferred compensation. However, these common forms of incentive compensation are commonly understood to be extras that can be earned under certain circumstances over and above base pay. Notwithstanding that the

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6 Reg. 1.162-28(b)(2).
7 Regs. 1.162-28(d)(4), (5).
8 Field Service Advice (“FSA”) memoranda are a form of Chief Counsel advice, which is “written advice … prepared by any national office component of the Office of Chief Counsel which is issued to field or service center employees of the Service … and convey any legal interpretation of a revenue provision, any Internal Revenue Service or Office of Chief Counsel position or policy concerning a revenue provision….” Section 6110(b)(1). Chief Counsel advice is not binding on Examination or Appeals, is not a final case determination, and is not entitled to deference from a court.
9 Interestingly, the 2001 FSA also takes the position that ISO disqualifying disposition income is basic lobbying labor costs, for the same reason, but it has since been made clear in Section 421(b) that disqualifying disposition income is not subject to federal income tax withholding.
regulation does not expressly mention these forms of compensation, the regulation does incorporate the concept that basic costs of lobbying labor includes only base wages, and does not include extras like pension or profit sharing-type benefits. Thus, the regulation seems clearly to have been meant to apply a gross-up percentage to base compensation, and take additional benefits beyond base compensation into account by means of the gross-up. However, the only guidance to have addressed the definition of “basic lobbying labor costs,” FSA 200102003 (October 3, 2001) (the “2001 FSA”), takes a different view.8

Under the facts of the 2001 FSA, a taxpayer offered its employees incentive stock options (“ISOs”) and nonstatutory stock options (“NSOs”), which did not have readily ascertainable fair market values when they were granted. In the years at issue in the 2001 FSA, some of the employees exercised their NSOs or made a disqualifying disposition of the stock obtained through the ISOs and, as a result, recognized income. The taxpayer included this income in its employees’ Forms W-2 and deducted the compensation expense.

Some of these employees with option income engaged in lobbying activities. The taxpayer used the gross-up method described in the regulations to calculate the amount that was allocable to lobbying and, thus, nondeductible. In calculating the nondeductible amount, the taxpayer determined that the compensation from the disqualifying disposition of ISO stock, and the exercise of NSOs, was an “employee benefit” and a form of profit sharing, and therefore was not part of “basic lobbying labor costs.” The IRS disagreed and concluded that the compensation from the options was “basic lobbying labor costs.”

The conclusion in the 2001 FSA is incorrect. It disregards the plain language of the regulations and inserts words and concepts into the regulation that are simply not there. The analysis in the 2001 FSA begins with the faulty premise that, when basic lobbying labor costs are defined by reference to “wages,” the definition incorporates the definition of wages in Section 3401 that is used for purposes of federal income tax withholding, without regard to any concept of “basic” wages and “extra” wages. Accordingly, the FSA concludes that, since stock option exercise income is wages for federal income tax withholding purposes, that compensation must be basic labor lobbying costs.9 However, the gross-up regulations do not refer to the Section 3401 definition of wages when they use the term wages in defining basic lobbying labor costs, and there is no indication in the regulations that the status of an amount as wages for purposes of federal income tax withholding has any bearing on whether the amount is a part of “basic lobbying labor costs.” Moreover, Section 3401 does not distinguish between base wages and extra types of compensation, which is at the core of the basic lobbying labor cost concept, but instead, broadly defines wages in order to assure income tax withholding occurs.

The 2001 FSA further compounds its mistake in concluding that basic lobbying labor costs are defined by reference to Section 3401 wages by inaccurately stating that the items that are specifically excluded from “basic lobbying labor costs” are not wages for purposes of Section 3401. Unfortunately for the IRS, this statement is not true—the items excluded from the definition of “basic labor lobbying costs” (i.e., pensions, profit-sharing, and employee benefits) can be wages under Section 3401 in some circumstances and can be excluded from wages under Section 3401 in other circumstances. For example, employee benefits are excluded from “basic lobbying labor costs,” but, depending on the type of employee benefit, they may or may not be wages under Section 3401. The general rule under Section 61(a)(1) is that employee fringe benefits are income under Section 61(a) and, consequently, are wages under Section 3401 unless a narrow statutory exclusion applies. The Code excludes from the definition of wages for purposes of Section 3401 specific types of employee benefits, such as educational and dependent care assistance under Sections 127 and 129, respectively, (Section 3401(a)(18)); prizes and awards under Section 74, qualified scholarships under Section 117, and the fringe benefits addressed in Section 132 (Section 3401(a)(19)); and medical expense reimbursements under Section 105 (Section 3401(a)(20)). The same is true of pension and profit sharing plans—they can be established in a manner that makes them Section 3401 wages or in a manner that makes them not Section 3401 wages. Thus, the list of items excluded from the definition of basic lobbying labor costs in no way supports the FSAs conclusion that basic lobbying labor costs include all amounts that are wages under the broad definition in Section 3401 for federal income tax withholding purposes, and excludes only those amounts that are not Section 3401 wages. Instead, the distinction between what is properly treated as basic lobbying labor
costs and non-basic costs taken into account in the gross up is exactly that—the nature of the labor costs as basic or more than basic—not the status of the costs as federal income tax withholding wages under Section 3401.

As indicated, there is a simple and straightforward way to read Reg. 1.162-28(e)(3) that the IRS ignores in the 2001 FSA. When the regulation defines "basic lobbying labor costs" as "wages or other similar costs of labor," it is referring to wages in the everyday sense of an amount that is paid to an employee for work done. To the extent the amounts paid for work done are "basic costs" of the labor, they are included in basic lobbying labor costs. By contrast, if the amounts are extras, like bonuses, stock compensation, deferred compensation, etc., they are not "basic costs" of labor, but are taken into account in the gross-up formula.

The regulation makes a distinction between basic pay and extra benefits paid in addition to basic pay, and explicitly includes only basic pay in "basic lobbying labor costs." Although stock options are an amount paid an employee for work done, they are not part of basic pay, but are extra benefits paid in addition to basic compensation, just as pension benefits, profit-sharing plans, and employee benefits such as health insurance are. Under this straightforward reading, benefits received through stock options are not included in "basic lobbying labor costs."

Notwithstanding the 2001 FSA, taxpayers that have relatively low rates of base pay (i.e., salary or hourly wages) compared to annual bonuses, long-term bonuses, equity compensation, deferred compensation, and other employee benefits, should consider using the gross-up method to allocate costs to their lobbying activities. In our experience, in the rare cases when a taxpayer's allocation of costs to lobbying activities is examined and challenged, the tenuous reasoning and conclusions of the 2001 FSA are given little or no weight during the IRS administrative appeals process.

**Issues Raised by the Definition of Third-Party Costs**

As mentioned, both the ratio method and the gross-up method specifically exclude third-party costs. This makes sense in the case of amounts incurred for lobbying by an unrelated lobbying firm or a trade organization. Sections 162(e)(3) and (e)(5) make clear that expenses of such firms and trade groups are deductible by the organizations, and the deduction disallowance is passed through to the client or member of the trade group. However, the definition of third-party costs that cannot be allocated under these methods goes on to cover, in addition, "amounts paid or incurred for travel (including meals and lodging while away from home) and entertainment relating in whole or in part to lobbying activities." The treatment of travel costs as "third-party costs" that cannot be taken into account by means of the ratio or gross-up method is perplexing. This is especially the case where the travel is not purchased through a third party, like an airline, hotel, or restaurant. For example, where a taxpayer owns its own corporate aircraft and the aircraft is used both for general business activities, as well as lobbying activities, the airplane costs would appear to also be covered by the definition of "general and administrative costs" that are required to be allocated to lobbying activities under the methods set forth in the regulations, or another, reasonable method. The same would be true of an apartment rented for both general business activities and lobbying activities. In such a case, the costs of the travel take the form of "depreciation, rent, utilities, insurance, maintenance costs," etc. that are covered by the definition of general and administrative costs required to be allocated to lobbying under the regulations. Further, such depreciation, rent, and utility costs of property the taxpayer owns more naturally fall within the category of general and administrative costs than within the category of amounts paid to third parties. Accordingly, taxpayers with corporate aircraft or other property used for travel, including travel in connection with lobbying activities, would be justified in treating the costs of those properties as general and administrative costs required to be allocated to lobbying under the methods set forth in the regulations, rather than as third-party costs that are separately disallowed.

**Conclusion**

As lobbying activities pick up during the election season, taxpayers should review the methodology they use to allocate costs to lobbying activities. If this has not been done before, the first step is for taxpayers to choose a reasonable method, and to consistently implement the method chosen. The 175% and 225% gross-up percentages, which are average gross-up factors, will generally

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10 Reg. 1.162-28(d)(5).
prove beneficial to taxpayers with a compensation structure heavily weighted away from base pay and towards bonuses, equity compensation, and other benefits. Notwithstanding the 2001 FSA, the far better reading of the gross-up method regulations is that such benefits are not part of basic lobbying labor costs and, thus, are not included in the basic labor costs to which the gross-up percentage applies. Taxpayers who are not well-advised may be misled by the 2001 FSA and inappropriately include stock options in “basic lobbying labor costs.”

Similarly, taxpayers that own corporate aircraft or own or rent corporate apartments that are used for business travel, including travel on lobbying activities, will need to consider whether these costs are properly treated as “third-party costs” that are separately disallowed as lobbying costs, rather than being included in the pool of costs allocable to lobbying. Given that the costs of such corporate property clearly are covered by the definition of general and administrative costs that are required to be allocated to lobbying activities under the regulations, the regulation should be interpreted to include in third-party costs only those travel costs that are incurred by payment to a third party, such as an airline, hotel, or restaurant. Certainly, such an interpretation should be treated as consistent with a “reasonable method of allocating costs,” which is all that the regulations require.