Chapter 15: Domestic Production Activities Deduction

Corrections were made to this workbook through January of 2006. No subsequent modifications were made.

Caution. The IRS had not released IRC §199 regulations at the time this book went to press. There are indications that the regulations may not follow Notice 2005-14, which is the basis of the chapter. Readers are urged to read the regulations before making decisions which affect the domestic production activity deduction.

OVERVIEW

The World Trade Organization (WTO) ruled on January 14, 2002, that ETI of 2000 was "inconsistent with international trade agreements" and began imposing trade sanctions on U.S. goods shipped overseas beginning March, 2004. The American Jobs Creation Act (AJCA) of 2004[1] was signed into law on October 22, 2004. This bill repeals the Extraterritorial Income Exclusion Act of 2000 (ETI)[2] on a phased-out basis, and also enacts numerous other significant provisions.

AJCA repeals ETI effective for tax years beginning after December 31, 2004, subject to transitional rules for 2005 and 2006, and binding contracts in effect on September 17, 2003. The centerpiece of the statute is the new IRC §199, which permits taxpayers to claim a deduction from taxable income attributable to "domestic production activities." The new deduction allows a reduced tax rate on income from domestic production activities, whether or not the produced property is exported.

1. P.L. No. 108-257
2. P.L. No. 106-519

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EXTRATERRITORIAL INCOME EXCLUSION ACT OF 2000

The ETI of 2000 permitted a portion of income from export products to be excluded from income through 2006.[3] Under AJCA, taxpayers can claim 80% of their otherwise applicable ETI benefits for transactions during 2005, and 60% of their otherwise applicable ETI benefits for transactions during 2006.

> **Note.** The ETI of 2000 was enacted in response to a WTO ruling that foreign sales corporations (FSCs) were an illegal export subsidy. Congress responded to the WTO ruling by enacting the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000"

Effective for transactions taking place after September 30, 2000, the taxpayer's portion of gross income attributable to qualified foreign sales, termed "extraterritorial income," is excluded from gross income.[4] Extraterritorial income is defined as gross income attributable to "foreign trading gross receipts."[5]

> **Note.** No foreign tax credit is allowed for transactions utilizing the exclusion. However, the exclusion applies for alternative minimum tax (AMT) purposes.

The IRS later clarified the definition (at least for farmers) by taking the position that "fungible export property" must be physically segregated from nonexport property at all times to meet the foreign use, consumption or disposition definition.[6] Thus, it appears the exclusion can only be claimed if the involved commodity is actually exported outside the United States.

> **Observation.** If a seller or lessor fails to provide written proof that the property was ultimately delivered, directly sold, or directly consumed outside the United States, the property sold or leased is not considered export property.

FOREIGN TRADING GROSS RECEIPTS

Foreign trading gross receipts are gross receipts:

- From the sale, exchange, or other disposition of qualifying foreign trade property,
- From the lease of qualifying foreign trade property for use by the lessee outside the United States,
- For services related to such sale or lease,
- For engineering or architectural services for construction projects outside the United States, or
- For the performance of managerial services in the production of foreign trading gross receipts.[7]

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3. Ibid
4. IRC §114(a)
5. IRC §114(e)
6. Temp. Treas. Reg. §1.927(a)-1T(d)(1)
7. IRC §942

For businesses with foreign trading gross receipts of $5 million or less, qualifying foreign trade property:

- Is manufactured, produced, grown or extracted within or outside the United States;
- Is held for sale, lease or rental in the ordinary course of business for direct use, consumption, or disposition outside the United States; and
- Does not violate the foreign content test limits or the destination test.

Also, no more than 50% of the FMV of qualifying foreign trade property can be attributed to articles manufactured, produced, grown, or extracted outside the United States, and direct costs for labor performed outside the United States. If property is qualifying foreign trade property, but is manufactured, produced, grown or extracted outside the United States, it is treated as qualifying foreign trade property only if it is manufactured, produced, grown or extracted by:

- A domestic corporation,
- An individual who is a U.S. citizen or resident,
- A foreign corporation with a domestication election in effect, or
- A partnership or other pass-through entity whose partners or owners are as described in items 1–3.

For businesses with more than $5 million in foreign trading receipts, the IRS has two foreign economic process tests that must also be met:

1. The foreign sales transactions must have either solicitation of the contract, negotiation of the contract, or the making of the contract outside the United States, and
2. The company passes either a 50% or 85% test relating to foreign direct costs for the foreign sales transactions.

To meet the 50% test, 50% or more of total direct costs must be foreign direct costs. To meet the 85% test, 85% or more of two categories of direct costs must be foreign direct costs. For both tests, the categories include:

- Advertising and sales promotion
- Processing and delivery of orders
- Transportation outside the United States for delivery to customers
- Determination and transmittal of a final invoice, statement of account, or receipt of payment
- Assumption of credit risk

Definitions

For purposes of the ETI, "manufacturing" occurs if:

- Operations are substantial in nature and generally considered to constitute manufacturing.
- Purchased property is "substantially transformed" (an irreversible process).
- Property conversion costs are equal to 20% or more of cost of goods sold.

Certain types of property are specifically excluded from the definition of "qualifying foreign trade property." Specifically excluded are:

- Property ultimately used in the United States
- Property for use by the U.S. government if such use is required by law or regulation
- Government subsidized sales
- Property leased or rented for use by a related person
- Certain intangibles
- Oil and gas
- Unprocessed softwood timber
- Export-controlled products and short-supply products

Qualifying Foreign Trade Income

Qualifying foreign trade income is the amount of gross income for a particular transaction that, if excluded, would result in a reduction of taxable income equal to the greatest of the following:

- 30% of the taxpayer's foreign sale and leasing income for the transaction,
- 1.2% of the taxpayer's foreign trading gross receipts for the transaction, or
- 15% of the taxpayer's foreign trade income from the transaction.[8]

There are three methods for calculating the exclusion. Generally, a business should utilize the method that provides the largest exclusion.

> **Note.** The method utilizing the 1.2% calculation is limited to 200% of the exclusion provided by the 15% calculation.

IRS Form 8873, *Extraterritorial Income Exclusion,* is used to calculate and report the exclusion. The completed Form 8873 should be attached to the business' income tax return. The 2005 draft Form 8873 is shown on the following pages.

8. IRC §941(a)(1)(C)

Form **8873**

Department of the Treasury
Internal Revenue Service

Extraterritorial Income Exclusion

▶ Attach to your tax return.
▶ See separate instructions.

OMB No. 1545-1722
2005
Attachment Sequence No. **126**

Name(s) as shown on return | **Identifying number**

Part I Elections and Other Information

1 Check the box if you are electing under section 942(a)(3) to exclude a portion of your gross receipts from foreign trading gross receipts on line 15. Attach a schedule indicating which receipts are being excluded . . . ▶ ☐

2 Check the box if you are electing to apply the extraterritorial income exclusion provisions to certain transactions involving a FSC (see instructions). Attach a schedule listing the affected transactions . . . ▶ ☐

3 Check the box if the taxpayer is a foreign corporation electing to be treated as a domestic corporation (see instructions) . . ▶ ☐

4a Are you excepted from the foreign economic process requirements because your foreign trading gross receipts are $5 million or less? . . . ▶ ☐ Yes ☐ No

b If "No," check the applicable box to indicate how you met the foreign economic process requirements:

(1) ☐ You met the 50% foreign direct cost test (see instructions).

(2) ☐ You met the alternative 85% foreign direct cost test (see instructions).

5 See instructions before completing lines 5a through 5c. **Note:** *For transactions for which the exclusion is determined using the foreign sale and leasing income method (i.e., line 44 equals line 45), complete only lines 5a and 5c(1).*

a Business activity code .... **b** Product or product line ....

c Check the applicable box to indicate the basis of your reporting:

(1) Transaction-by-transaction:

(a) ☐ Aggregate on Form 8873 **(b)** ☐ Aggregate on tabular schedule **(c)** ☐ Tabular schedule of transactions

(2) ☐ Group of transactions (see instructions for an important change made to reflect the American Jobs Creation Act of 2004)

Part II Foreign Trade Income and Foreign Sale and Leasing Income

Caution: *If a related person is also eligible for an extraterritorial income exclusion, see* ***Excluded property*** *in the instructions.*

			(a) Foreign Trade Income	(b) Foreign Sale and Leasing Income
6	Sale, exchange, or other disposition of qualifying foreign trade property	6		
7	Enter the amount from line 6, column (a), attributable to the sale of property formerly leased or rented for use by the lessee outside the United States	7		
8	Lease or rental of qualifying foreign trade property for use by the lessee outside the United States. Enter the same amount in both columns . .	8		
9	Services related and subsidiary to the sale, exchange, or other disposition of qualifying foreign trade property . . .	9		
10	Enter the amount from line 9, column (a), attributable to the sale of property formerly leased or rented for use by the lessee outside the United States	10		
11	Services related and subsidiary to the lease of qualifying foreign trade property for use by the lessee outside the United States. Enter the same amount in both columns .	11		
12	Engineering or architectural services for construction projects outside the United States	12		
13	Managerial services provided to unrelated persons (see instructions) .	13		
14	Enter the sum of the amounts from lines 6, 9, 12, and 13 of column (a) attributable to foreign economic processes. **Do not** include any amounts already included on lines 7, 8, 10, or 11 in column (b) . . .	14		
15	**Foreign trading gross receipts.** Add lines 6 through 13 in column (a) .	15		
16	Add lines 7 through 14 in column (b) . . .	16		
17	**Cost of goods sold:**			
a	Inventory at beginning of year . . .	17a		
b	Purchases . . .	17b		
c	Cost of labor . . .	17c		
d	Additional section 263A costs (attach schedule) . . .	17d		
e	Other costs (attach schedule) . . .	17e		
f	Total. Add lines 17a through 17e . . .	17f		
g	Inventory at end of year . . .	17g		
h	Subtract line 17g from line 17f . . .	17h		
18	In column (a), subtract line 17h from line 15. In column (b), subtract line 17h from line 16 . . .	18		
19	Other expenses and deductions (see instructions) (attach schedule) .	19		
20	**Foreign trade income.** In column (a), subtract line 19 from line 18. If -0- or less, stop here. You do not qualify for the exclusion . . .	20		
21	**Foreign sale and leasing income.** In column (b), subtract line 19 from line 18	21		

For Paperwork Reduction Act Notice, see instructions. Cat. No. 30732F Form **8873** (2005)

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Part III Marginal Costing (**Note:** *If you are **not** using Marginal Costing, skip Part III and go to Part IV.*)

Section A — Foreign Trade Income Using Marginal Costing Method

22	Foreign trading gross receipts. Enter the amount from line 15			22	
23	Costs and expenses allocable to the amount reported on line 22:				
a	Cost of direct material attributable to property sold	23a			
b	Cost of direct labor attributable to property sold	23b			
c	Add lines 23a and 23b			23c	
24	Subtract line 23c from line 22			24	
25	Worldwide gross receipts from sales of the product or product line			25	
26	Costs and expenses allocable to the amount reported on line 25:				
a	Cost of goods sold attributable to property sold	26a			
b	Other expenses and deductions attributable to gross income	26b			
c	Add lines 26a and 26b			26c	
27	Subtract line 26c from line 25. (**Note:** *If -0- or less, stop here. You may not use Part III to determine your qualifying foreign trade income. Go to line 37.*)			27	
28	Overall profit percentage. Divide line 27 by line 25. Carry the result to at least three decimal places			28	
29	Overall profit percentage limitation. Multiply line 22 by line 28			29	
30	**Foreign trade income using marginal costing.** Enter the **smaller** of line 24 or line 29			30	

Section B — 15% of Foreign Trade Income Method

31	Multiply line 30 by 15% (.15)	31	
32	**Foreign trade income using full costing.** Enter the amount from line 20	32	
33	Enter the **smaller** of line 31 or line 32	33	

Section C — 1.2% of Foreign Trading Gross Receipts Method

34	Multiply line 22 by 1.2% (.012)	34	
35	Multiply line 30 by 30% (.30)	35	
36	Enter the **smallest** of lines 32, 34, or 35	36	

Part IV Extraterritorial Income Exclusion (Net of Disallowed Deductions)

37	Enter your foreign trade income from line 20			37	
38	Multiply line 37 by 15% (.15)			38	
39	Enter your foreign trading gross receipts from line 15	39			
40	Multiply line 39 by 1.2% (.012)	40			
41	Multiply line 38 by 2.0	41			
42	Enter the **smaller** of line 40 or line 41			42	
43	Enter your foreign sale and leasing income from line 21			43	
44	Multiply line 43 by 30% (.30)			44	
45	Enter the **greatest** of lines 33, 36, 38, 42, or 44. If you are using the alternative computation, see instructions for the amount to enter			45	
	Note. *If you do not have a reduction for international boycott operations, illegal bribes, kickbacks, etc. (see the instructions for line 50), skip lines 46 through 51 and enter on line 52 the amount from line 45.*				
46	If line 44 equals line 45, divide the amount on line 45 by the amount on line 43. Otherwise, divide the amount on line 45 by the amount on line 37. Carry the result to at least three decimal places.	46			
47	If line 44 equals line 45, enter the amount from line 19, column (b). Otherwise, enter the amount from line 19, column (a)	47			
48	Multiply line 46 by line 47			48	
49	Add lines 45 and 48			49	
50	Reduction for international boycott operations, illegal bribes, kickbacks, etc. (see instructions)			50	
51	**Qualifying foreign trade income.** Subtract line 50 from line 49. If -0- or less, stop here. You do not qualify for the exclusion			51	
52	**Extraterritorial income exclusion (net of disallowed deductions).** Subtract line 48 from line 51			52	
53a	Enter the amount from line 52 that is attributable to 100% transactions (see instructions)			53a	
b	Enter the amount from line 52 that is attributable to 80% transactions (see instructions)			53b	
c	Enter the amount from line 52 that is attributable to 60% transactions (see instructions)			53c	
54	Add lines 53a through 53c. Enter the result here and include it on the "other deductions" line of your tax return or schedule (see instructions)			54	

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Form **8873** (2005)

Calculating Foreign Trade Income (FTI)

Foreign trade income is calculated as follows:

FTI = foreign trading gross receipts – cost of goods sold

Qualifying foreign trade income is calculated on a **transaction-by-transaction basis** or on a **product grouping basis.** The calculation involves deducting allocated and/or apportioned expenses from foreign trading gross receipts.

> **Note.** The statutory basis for allocations and apportionments is located in the foreign sales corporations (FSC) regulations. Under Temp. Treas. Reg. §1.921-3T(b), deductions incurred by an FSC are allocated and apportioned under the rules found in Treas. Reg. §1.861-8. For mixed-use assets that generate FTI, apportionment should be based on sales.

For agricultural or horticultural cooperatives, patronage dividends or per-unit retain allocations allocable to qualifying foreign trade income in a written notice mailed to patrons are treated as qualifying foreign trade income of the patron.[9] The amount of any patronage dividend or per-unit retain allocation paid to a cooperative member and allocable to qualifying ETI is treated as qualifying ETI of the member and is excluded from the member's gross income. Thus, a cooperative should establish a price for particular products and pay "profit" to patrons as a patronage dividend. The exclusion is computed based on "net profit" without patronage dividend. This amount can be passed through to patrons or used by the cooperative.

> **Note.** The benefit of the exclusion is more difficult to calculate in the cooperative context because cost of raw product is not on the cooperative's books. Also, the cooperative may have a tax accounting method that treats some of the advance as a cost of goods sold.
>
> The exclusion can be obtained without requiring an economic presence outside the United States (except for the 30% exclusion) so long as the taxpayer's foreign gross receipts are less than $5 million.[10]

Example 1. Widget Co. has the following sales and financial data for 2004:

	Domestic	Export	Total
Sales/FTGR	$24,000	$1,000	$25,000
Cost of goods sold	(16,400)	(600)	(17,000)
Gross margin	$ 7,600	$ 400	$8,000
Direct expenses	(4,225)	(275)	(4,500)
Indirect expenses	(475)	(25)	(500)
Taxable income/FTI	$ 2,900	$ 100	$ 3,000

9. IRC §943(g)

10. IRC §942(c)(1)

Based on this data, Widget Co. has the following calculation:

Foreign trading gross receipts	$1,000
Cost of goods sold	(600)
Gross margin	$ 400
Direct expenses	(275)
Indirect expenses	(25)
Foreign trade income (FTI)	$ 100
(1) 15% of FTI	$ 15
(2) 1.2% of FTGR	12
(3) 30% of FTI	30

Widget Co. can exclude from income whichever is greater: 15% of FTI, or the lesser of 1.2% of foreign trade gross receipts, or 30% of FTI. Therefore, Widget Co. can exclude $15 from income for 2004. The exclusion is claimed on Form 8873.

Note. Because the provision is effective for tax years beginning after December 31, 2004, taxpayers need to act immediately to assess the extent to which they can benefit from the new provision. Additional information on the Extraterritorial Income Exclusion can be found in the *2004 University of Illinois Federal Tax School Workbook* on pages 421–428.

DOMESTIC PRODUCTION ACTIVITIES[11]

IRC §199 contains many new terms which may not be familiar to tax preparers. The following table lists acronyms used in this chapter and their meaning.

Acronym	Term
QPAI	Qualified production activities income
QPP	Qualified production property
DPGR	Domestic production gross receipts
NAICS	North American Industry Classification System
QPAD	Qualified production activities deduction
CGS	Cost of goods sold
EAG	Expanded affiliated groups
MPGE	Manufactured, produced, grown, or extracted

INCOME DEDUCTION

While manufacturers that exported products were the primary beneficiaries of the ETI exclusion, it is clear from the statutory language of IRC §199 that the new law provides benefits to a much larger group of businesses than those traditionally considered manufacturers, and it is not limited to those taxpayers who previously benefited from the ETI. **The new law applies to all businesses with production income, not just exporters.** It also applies to C corporations, S corporations, partnerships, sole proprietorships, cooperatives and limited liability companies.

11. IRC §199

The new deduction impacts every type of business entity except for personal service corporations and agricultural cooperatives, although patrons of agricultural cooperatives may qualify if they can otherwise meet the tests (particularly the W-2 wage test). A patron cannot use the cooperative's W-2 wages for purposes of the deduction. The deduction applies to any business that manufactures, produces, grows or extracts qualifying production property in the United States.

For tax years beginning in 2005 and 2006, the deduction equals 3% of the lesser of:

- The "qualified production activities income" (QPAI) of the taxpayer for the taxable year, or
- Taxable income for the taxable year.

Therefore, the deduction cannot create a net operating loss.[12] The deduction increases to 6% for taxable years beginning in 2007, 2008 and 2009, and 9% for taxable years beginning after 2009.

The deduction is **limited** to 50% of the W-2 wages paid by the taxpayer during the calendar year to common-law employees.[13] The limitation has the effect of making the deduction largely unavailable for agricultural employers (except for wages paid in-kind) and self-employed persons.

The deduction is allowed for alternative minimum tax (AMT) purposes. The deduction is allowable for purposes of computing minimum taxable income (including adjusted current earnings). The AMT deduction is determined by reference to the lesser of the QPAI (as determined for regular tax) or the alternative minimum taxable income without regard to this deduction.[14]

Observation. For clients that qualify for the deduction, those paying tax at the highest marginal rate can potentially drop their marginal tax rate by 1% in one year, and eventually by more than 3% by 2010.

CALCULATING THE DEDUCTION

Taxpayers who want to claim the qualified production activities deduction (QPAD) must document and determine items under the following formula:

Allowable deduction in 2005 (and 2006) equals 3% multiplied by the lesser of:

- QPAI, or
- Taxable income

The deduction is limited to 50% of W-2 wages paid by the taxpayer for the tax year.

The statute defines QPAI in terms of "domestic production gross receipts" (DPGR) which, in turn, is based on gross receipts derived from "qualified production property" (QPP) that is used in "qualified production activities" (QPA).

Importance of IRS Notice 2005-14. IRS Notice 2005-14,[15] is a lengthy notice that provides a fairly comprehensive set of definitions and rules to be used as the basis for the forthcoming proposed regulations on the new deduction. It provides key guidance on the statutory language on many points, even though some issues remain unresolved.

12. In effect, the taxable income limitation excludes taxpayers with current year net operating losses (NOLs) or with NOL carryovers that eliminate current year taxable income. See IRC §§63, 172.

13. The deduction applies to W-2s for the calendar year ending within the taxpayer's tax year. The term "W-2 wages" includes amounts required to be included on statements under IRC §6051(a)(3),(8). That includes — (1) wages as defined in IRC §3401(a) (which does not include any remuneration other than cash for agricultural labor) and (2) elective deferrals (within the meaning of IRC §§402(g)(3), 457).

14. IRC §199(d)(6)

15. IRS Notice 2005-14, January 19, 2005

DOMESTIC PRODUCTION GROSS RECEIPTS

Qualifying Activities

The first step in calculating the §199 deduction is to segregate activities among qualified and nonqualified production activities. Qualified production activities involve qualified production property and generate domestic production gross receipts (DPGR). This is then used to determine the taxpayer's QPAI. For 2005 and 2006, a taxpayer is entitled to claim a deduction equal to 3% of the lesser of QPAI or taxable income.

QPAI for any particular tax year equals the excess (if any) of the taxpayer's DPGR over:

- The cost of goods sold that are allocable to such receipts,
- Other deductions, expenses or losses directly allocable to such receipts, and
- A ratable portion of other deductions, expenses and losses that are not directly allocable to such receipts or another class of income.[16]

Note. The notice provides that QPAI is determined on an item-by-item basis (not a division-by-division, product line-by-product line, or transaction-by-transaction basis). Neither the statute nor the notice address how gains and losses from hedging transactions should be taken into account in determining QPAI. One approach might be to treat hedging transactions involving inventory for purposes of §199 consistent with the treatment required under Treas. Reg. §1.446-4(e).

The statute[17] provides that DPGR is defined in terms of the taxpayer's gross receipts derived from any lease, rental, license, sale, exchange or other disposition of qualified property derived from the following qualified activities that are attributable to the conduct of a trade or business:[18]

- The manufacture, production, growth or extraction in whole or in significant part within the United States of tangible personal property, computer software or sound recordings;
- Construction performed in the United States;
- Engineering and architectural services performed in the United States for construction projects in the United States;
- Film production in certain circumstances; and
- The production of electricity, natural gas or water in the United States[19]

Note. IRC §199(c)(7)(A) excludes from the definition of "domestic production gross receipts" a taxpayer's gross receipts derived from property that the taxpayer leases, licenses, or rents to any related person. IRC §199(c)(7)(B) contains a special definition of "related person" for this purpose that refers to IRC §§52(a) or (b), or IRC §414(m) or (o).

16. IRC §199(c)(1). However, IRC §199(c)(3)(A) provides that any item or service brought into the U.S. is treated as acquired by purchase at a cost not less than its fair market value immediately after entering the U.S., and that a similar rule is applied to determine the adjusted basis of leased property when the lease "gives rise to domestic production gross receipts." IRC §199(c)(3)(B) provides that in the case of property previously exported by the taxpayer for further manufacture, the increase in cost or adjusted basis will not exceed the difference between the value of the property when it was exported and the value of the property when re-imported into the U.S. after the additional manufacturing activity.

17. IRC §199(c)(4)

18. The "trade or business" requirement is contained in IRC §199(d)(5).

19. IRC §199(c)(4)(A)(i-iii)

DPRG does not include gross receipts derived from:

- The sale of food or beverages prepared by the taxpayer at a retail establishment,
- The transmission or distribution of electricity, natural gas, or potable property, or
- Property that is leased, licensed, or rented by the taxpayer for use by any related person.

What Does "Trade or Business" Mean?

The statute states that "this section is applied by only taking into account items which are attributable to the actual conduct of a trade or business."[20] The notice mirrors the statute with identical language. Consequently, the trade or business test could be problematic for taxpayers who are not materially participating under a lease. Unfortunately, neither the statute nor the notice indicate which meaning of "trade or business" is to be used in implementing the new deduction. Several different definitions of the term "trade or business" are in use.

The least demanding trade or business test is used for purposes of income averaging for farmers and fishermen.[21] Under that provision, rental income under a share-rent lease is treated as income from a farming business (eligibility for income averaging is hinged on the taxpayer being engaged in a farming business). Whether the landlord is participating in the operation is immaterial.[22] Thus, if this is the test to be used for purposes of §199, a nonmaterially participating share-rent (in the context of agriculture) landlord appears to be eligible.

Another possible test might be the requirement for purposes of expense method depreciation. That requirement specifies that the taxpayer must "meaningfully participate" in the management or operations of the trade or business.[23] The regulations point out that it is a facts and circumstances test.[24]

A third possibility is the use of the standard test of material participation for purposes of the §199 trade or business requirement. That test is imposed for several purposes including liability for self-employment tax,[25] special use valuation,[26] and recapture under the family-owned business deduction.[27] The test is not met by a nonmaterially participating farm landlord, such as one who normally reports the rental income on Form 4835 rather than Schedule F.

Note. Under the standard test, the activity of an agent cannot be imputed to the principal.[28]

Another alternative is the "active management" test created by Congress in 1981. It substitutes for material participation in the case of surviving spouses who acquire real property from a deceased spouse for purposes of special use valuation.[29]

Perhaps the more demanding meaning of the term "material participation" that was imposed in 1986 for purposes of determining whether an activity is considered a passive activity under the passive loss rules[30] is the test utilized for purposes of §199. That meaning of the term requires that the taxpayer be involved in the activity on a basis that is "regular, continuous, and substantial."[31]

20. IRC §199(d)(5)
21. IRC §1301
22. Treas. Reg. §1.1301-1(b)(2)
23. Treas. Reg. §1.179-2(c)(6)(ii)
24. Ibid
25. IRC §1402(a)(1)
26. IRC §2032A(e)(6)
27. IRC §§2057(b)(1)(D)(ii), 2057(f)(1)(A)
28. IRC §1402(a)(1)
29. IRC §2032A(b)(5)
30. IRC §469(c)(1)
31. IRC §469(h)(1)

For nonmaterially participating landlords, including those in retirement, those who are disabled, and those who simply choose not to be substantially involved in the activity under the lease, the question of which meaning of the term "trade or business" will be imposed under §199 is important. Rendering nonmaterial participation landlords ineligible for the deduction imposes a 3% (eventually growing to 9%) "tax" on the decision to operate under a nonmaterial participation lease. Hopefully, the IRS will clarify the matter with further guidance.

What is Considered "Manufactured in the United States"?

The statute does not define "manufacturing" or provide further guidance as to when a taxpayer is considered to have "manufactured, produced, grown or extracted" (MPGE) property for purposes of the deduction.

The notice provides that property is treated as manufactured by the taxpayer "in significant part within the United States" if the taxpayer can either satisfy a broad substantial-in-nature test or meet an objective-cost safe harbor test. According to the notice, the two categories of activities or costs that are generally not taken into account in applying either the substantial-in-nature test or the cost safe harbor test are:

1. Packaging, repackaging, labeling, and minor assembly, and
2. Design, development, or creation (or licensing) of intangible property.

Observation. The exclusion of those activities or costs is likely to be controversial, given that they are the basis for millions of U.S. jobs and have traditionally been regarded as part and parcel of many U.S. manufacturing operations.

Note. The notice generally provides that a taxpayer that manufactures, produces, grows or extracts qualifying production property for purposes of the deduction should also treat itself as a "producer" under IRC §263A. However, a taxpayer that is treated as a "producer" for §263A purposes does not necessarily qualify for the §199 deduction.

The notice states that the terms "manufactured, produced, grown, or extracted" include activities relating to:

- Manufacturing, producing, growing, extracting, installing, developing, improving, and creating qualified production property (QPP);
- Making QPP out of scrap, salvage, or junk material, as well as 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; and
- Cultivating soil, raising livestock, fishing, and mining minerals.

The terms also include storage, handling, or other processing activities (other than transportation activities) within the United States 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 whether or not by the taxpayer.

Example 2. Abe, Bob and Chuck are unrelated. Abe owns grain storage bins in Illinois. Abe stores Bob's corn in the bins and charges a storage fee. Bob grew his corn in Illinois. Bob sells his corn to Chuck, a processor of corn. Chuck processes Bob's corn into corn syrup in Illinois. Chuck stores corn syrup in Don's warehouse until it is sold to a local grocery store. The gross receipts from Abe's storage activity, Bob's corn farming activity, and Chuck's processing activity are DPRG from the manufacturing, production, growth or extraction of qualified production property. Don's income from the storage of the syrup in his warehouse is not DPRG. Don's activity does not involve the rental of a grain production facility.

Example 3. Tex places his cattle in the Pokey-Lokey feedlot. The fees Pokey-Lokey collects on Tex's cattle are not DPRG. Only income attributable to cattle owned by Pokey-Lokey generates DPRG. To constitute DPRG, the taxpayer must bear the burdens and benefits of ownership.

What Does "By The Taxpayer" Mean?

Taxpayers wishing to claim the deduction for QPP must establish that the QPP was manufactured, produced, grown, or extracted "by the taxpayer in whole or in significant part within the United States."[32] The language seems to imply that a taxpayer should not be able to benefit from the deduction unless the taxpayer is engaged directly in MPGE of the underlying QPP. **This has implications for products manufactured under contract.**

The notice provides that if one taxpayer performs manufacturing activities for another taxpayer, only the taxpayer with the benefits and burdens of ownership of the tangible personal property during the manufacturing process is treated as the manufacturer. For a taxpayer entering into a contract manufacturing arrangement with a third party, the availability of the deduction likely depends on whether the arrangement is structured as a buy-sell arrangement, or as a consignment arrangement from a tax perspective. Whether one of the parties is entitled to the deduction for its own manufacturing activities depends on if it bears the economic risk of loss on the raw materials and work-in-process while the goods are processed by the third party.

For example, if the taxpayer allows the third party to bear the economic risk of loss on the raw materials and work-in-process, the third party is eligible for the deduction for its profits on its production activities. On the other hand, if the taxpayer itself bears the economic risk of loss on the raw materials and work-in-process (in a consignment, or toll manufacturing arrangement), the taxpayer is eligible for the deduction and the third party is not, regardless of the fact that the third party owns a factory in the United States and incurs substantial labor costs in manufacturing the product in that factory. The distinction between these two scenarios depends entirely on the fairly minor matter of which party bears the economic risk of loss on the raw materials and work-in-process. Essentially, it depends on which party funds the carrying costs and insurance costs associated with the inventory.

Example 4. Mary enters into an agreement with Bill (an unrelated customer) to manufacture 500 widgets for Bill. Under the statute, either Mary or Bill (but not both) are treated as having manufactured the widgets for purposes of manufacturing, producing, growing or extracting qualified production property.

If Mary owns the widgets (bears the burdens and benefits of ownership) during the period the qualifying activity occurs, the widgets are treated as manufactured by Mary. However, if Bill is treated as the owner of the widgets during the period the qualifying activity occurs, the widgets are treated as manufactured by Bill.

Note. The notice not only makes the rule applicable to qualifying transactions involving QPP but also to transactions involving

1. Qualified film produced "by the taxpayer," and
2. Electricity, natural gas, or potable water produced "by the taxpayer" in the United States.

In consignment manufacturing settings, the consignor deducts, as cost of goods sold or otherwise, the full consignment fee in computing its taxable income. Consequently, the consignor is not eligible to claim the deduction for the manufacturing profit associated with the consignee's production activity. Likewise, the consignee is not entitled to the deduction for the manufacturing profit.

32. IRC §199(c)(4)(A)(i)(I)

However, when a taxpayer allows a third party to have tax ownership over the raw materials and work-in-process, the third party is entitled to the deduction on its own profits, but the taxpayer may earn significant additional profits attributable to its own MPGE activities carried out either before the goods were transferred to the third party or after the goods were acquired (or reacquired) from the third party. Unfortunately, the notice leaves open the question of whether the taxpayer would also be eligible for the deduction to the extent the taxpayer independently engages in qualifying activities regarding the QPP. The notice seems to suggest that those qualifying activities would not give rise to a deduction for the taxpayer simply because contract manufacturing was undertaken as part of the process.

Example 5. Jones Steel Fabricators produces steel which it fabricates into automobile frames and sells to an automobile manufacturer. As a part of the process, it sells the steel to U.S. Steel Bending, Co. which shapes the steel so it can be manufactured into a completed frame. U.S. Steel then sells the bent steel back to Jones who completes the process. Because both Jones and U.S. Steel have had ownership of the product, each can include their revenue in DPGR.

If Jones only contracted with U.S. Steel, and U.S. Steel never had burden of ownership, U.S. Steel's revenue would not qualify as DPGR.

Inconsistency with IRC §263A

The notice indicates a taxpayer that manufactured, produced, grew, or extracted QPP for the tax year is treated as a producer under IRC §263A regarding the QPP for the tax year, unless the taxpayer is not subject to §263A.

Note. IRC §263A contains rules requiring the capitalization and inclusion in inventory costs of particular expenses associated with certain real or tangible personal property. Important exceptions apply to taxpayers engaged in a farming business related to animals and plants with a pre-productive period of two years or less.

The notice states that the tax ownership standard is based on the principles of IRC §§936 and 263A. The regulations under §263A regard one as a producer if the taxpayer is a tax owner of the property being produced. The IRS interpreted the regulations to allow more than one party to be an owner of property at the same time. Therefore, when one taxpayer performs production activities under a contract with another taxpayer, both taxpayers may be regarded as tax owners of the property being produced, and both must capitalize costs under §263A.[33] However, during the May 2004 debate on the Senate bill, Senator Grassley (R-Iowa; Chair of the Senate Finance Committee) commented that the manufacturing deduction was not available to taxpayers that outsourced their manufacturing needs in order to avoid a double dipping of the deduction. Thus, it appears that in contract manufacturing settings only one of the contracting parties are entitled to a deduction under IRC §199.[34]

Observation. If the IRS insists on focusing on who is the "owner," it should recognize that there can be more than one owner for purposes of §199. Any test trying to find the "one true owner" will likely be impossible to implement. There is no duplication of benefits under the statute — any profit earned by the contractor would be eliminated by the manufacturer in calculating its profits as cost of goods sold.

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33. IRC §263A(g)(2) provides that a taxpayer is treated as producing any property produced for the taxpayer under a contract with the taxpayer. Clearly, under IRC §263A a producer need not manufacture its own products. See, e.g., *Suzy's Zoo v. Commr.,* 273 F.3d 875 (9th Cir. 2001), November 21, 2001.

34. However, the Statement of Managers that accompanied the Jobs Bill provides in a footnote that, "The Secretary shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining income attributable to domestic production activities. Where appropriate, such rules shall be similar to and consistent with relevant present-law rules (e.g., §263A, in determining the cost of goods sold, and IRC §861, in determining the source of such items)."

In addition, §263A treats a taxpayer as the producer of the property if it has property produced under a contract even if the taxpayer is not a tax owner of the property during the production period. Thus, the taxpayer is required to capitalize costs under §263A, but is ineligible for a deduction under §199.

> **Note.** While it is beneficial to be treated as a producer for purposes of §199, it is not beneficial to be treated as a producer for purposes of the cost capitalization rules of §263A. A taxpayer that reaps the benefit of the deduction by virtue of being treated as a producer must also bear the burdens of treatment as a producer for purposes of IRC §263A. However, the converse is not true.

While there can be two tax owners for purposes of §263A, there can be only one tax owner at a particular time under §199.

Section 263A treats a customer that is not the tax owner of property produced under a contract as a producer, but §199 does not. Taxpayers engaged in packaging and minor assembly operations are regarded as producers for purposes of §263A, but may not be regarded as producers under §199.

Sections 263A and 199 both attempt to exclude certain de minimis activities from being regarded as production. However, §263A employs a 10% test, while §199 provides for a 20% safe harbor.

> **Note.** Taxpayers should consider all of their activities within the broad coverage provided by the term "manufactured, produced, grown, or extracted."

At the present time, it appears that the IRS may be leaning toward §263A in structuring guidance for the deduction in contract manufacturing settings. That may mean taxpayers that have the benefits and burdens of ownership will be treated as a "manufacturer" for purposes of §199, and attribution of production activities that occur under contractual arrangements would likely qualify as domestic production activities.

Contracts as Part of a Production Chain

Many goods are produced under numerous contracts as part of a chain of production. In the production process, one producer's finished product becomes the input in another producer's production process, and so on throughout the chain of production. Each producer in the chain adds value to the product and QPAI is the added value in excess of the producer's cost.

> **Example 6.** Acme Mining Co. extracts minerals which it sells to Acme Steel Co. that renders the minerals into metals. Acme Steel Co. sells the metals to Acme Equipment Co. that molds the metal into farm equipment. Acme Equipment Co. then sells the farm equipment to Acme Farm Wholesale Co. which sells the farm equipment to the public at retail. Acme Mining Co., Acme Steel Co. and Acme Equipment Co. (but not Acme Farm Wholesale Co.) are producers that derive QPAI by reason of their presence in the chain of production.

What Does "In Whole or Significant Part" Mean?

Under the statute, taxpayers wishing to claim a deduction for QPP must establish that such property was manufactured, produced, grown, or extracted by the taxpayer "in whole or a significant part within the United States."[35]

The notice provides that property is treated as manufactured by the taxpayer in significant part within the United States if the taxpayer can either satisfy at least one of two tests that were adopted (in substantial part) from the Treasury Regulations underlying IRC §954 for establishing that a controlled foreign corporation is the manufacturer of property when the activity involves the assembly of component parts.

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35. IRC §199(c)(4)(A)(i)(I)

Test 1: "Substantial In Nature." Based on all of the taxpayer's facts and circumstances, if the MPGE activity performed by the taxpayer in the United States is substantial in nature, the first test is satisfied. The notice provides that the determination of whether the taxpayer's activity within the United States is "substantial in nature" must be made by taking into account "all the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer's activity in the United States, the nature of the property, and the nature of the activity the taxpayer performs in the United States."

> **Example 7.** Tom imports QPP that is partially manufactured and completes the manufacture of the QPP in the United States. If Tom satisfies the "in significant part" requirement, then Tom's gross receipts from the sale of the QPP qualify as DPGR (assuming all other requirements of the statute are satisfied).

If the production of the QPP is performed by the taxpayer within the United States and is substantial in nature, the QPP is treated as MPGE in the United States. This is true even if a component part is MPGE by the taxpayer outside of the United States or by an unrelated party within the United States.

Likewise, if a taxpayer manufactures QPP in significant part in the United States and exports the goods for further manufacture outside the United States, the taxpayer meets the in-significant-part requirement regardless of whether the QPP is imported back into the United States before the lease, rental, license, sale, exchange, or other disposition of that property.

> **Note.** The notice specifically provides that if the taxpayer purchases unrefined oil extracted outside the United States from an unrelated party and the taxpayer refines the oil in the United States, the refining of the oil by the taxpayer is treated as MPGE that is substantial in nature within the United States.

Test 2: Cost Safe Harbor. Under this test, the "in whole or significant part" requirement is satisfied if the conversion costs (direct labor and related factory burden) incurred by the taxpayer in the United States for the MPGE of the QPP are at least 20% of the taxpayer's total cost for the property.

> **Example 8.** John Dear Toy Co. buys a small engine and various parts and materials for $100. It incurs $30 in labor costs at its factory in East Ipswitch, Iowa, to fabricate a plastic tractor body from the materials and to assemble a toy tractor. John Dear Toy Co. also incurs packaging, selling and other costs of $3 and sells the toy tractor in 2005 for $145. The toy tractor is considered manufactured by the taxpayer in "significant part" because John Dear Toy Co.'s labor costs are more than 20% of the total cost for the tractor ($30 ÷ ($30 + $100) = 23.1%). John Dear Toy Co.'s deduction is 3% of the $12 profit on the tractor or 36¢.

> **Note.** The notice explains that two categories of activities or costs are generally not taken into account in applying either the substantial-in-nature test or the cost safe harbor test:
>
> 1. Packaging, repackaging, labeling, and minor assembly activities or costs, and
> 2. Design and development activities or costs, and the costs of the creation or licensing of intangible property for production of tangible QPP.
>
> However, these activities or costs can be taken into account when the QPP is computer software or sound recordings, because these types of QPP are regarded as intangible property.

For purposes of the cost safe harbor, development costs and the cost of any intangibles do not qualify as conversion costs for any QPP other than computer software and sound recordings.

Implications for Packaging Activities

The notice is confusing for excluded activities/costs. For example, the notice explains that "packaging, repackaging, labeling, and minor assembly operations do not qualify as substantial in nature." The explanatory section of the notice says it is the Treasury's desire to prevent qualification when a taxpayer's U.S. activities consist "solely of affixing a label to a plastic bottle otherwise manufactured entirely outside the United States." So, a taxpayer generally cannot qualify for the deduction if the taxpayer's only activities in the United States are packaging and labeling property produced outside of the United States.

Example 9. Connie Superstar's U.S. activities consist solely of affixing a label to a fancy glass bottle of perfume that is otherwise manufactured entirely outside the United States. Connie's activities are not regarded as having met the "in whole or significant part" requirement, regardless of the value added to the bottle by the label or the relative cost incurred by the taxpayer for the labeling activity. However, a question exists concerning whether the label operation could be taken into account in combination with other U.S. activities in determining whether the overall U.S. operations are substantial in nature.

Note. Under §263A, packaging is regarded as a production activity. Moreover, the "production" of packaging materials and the use of those materials in packaging property is regarded as production within the meaning of IRC §263A.[36] Therefore, companies engaged in packaging and minor assembly might be regarded as "producers" for purposes of §263A, but not for §199. Likewise, under §263A, a taxpayer that engages in more than de minimis production activities (pursuant to a 10% test) is regarded as a producer. However, that same taxpayer may not meet the 20% safe harbor test for purposes of §199.

Design and Development. Under the notice, design and development activities do not constitute manufacturing activities for purposes of the significant part test for all tangible personal property (except for computer software and sound recordings) because those activities produce an intangible asset (the design) rather than tangible personal property.

Observation. This notice suggests that a manufactured product should be broken down into a tangible component and an intangible component for purposes of applying §199. However, it is generally accepted that profits from the sale of goods with embedded intangibles are treated in their entirety as profits from the sale of tangible goods. Therefore, the IRS took a position in the notice that tends to favor manufacturing not associated with product design. This is a different approach from that taken under the ETI Act of 2000 where the exclusion could be claimed for property produced largely outside the United States, but for which value was attributable to U.S.-based intangibles (i.e., design, trademarks or trade names).

What does "In the United States" Mean?

While the statute does not define "United States" for purposes of the deduction, the notice defines the term as the 50 states, the District of Columbia, the territorial waters of the United States, and the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, for the exploration and exploitation of natural resources. The notice provides that the term "United States" does not include possessions and territories of the United States or the airspace over the United States.

36. In Letter Ruling 200328002, (March 24, 2003), the IRS ruled that taxpayers providing packaging services to unrelated customers were producers within the meaning of IRC §263A.

> **Note.** The Senate bill specifically provided that property would be treated as produced in "significant part" by the taxpayer within the United States if more than 50% of the aggregate development and production costs were incurred by the taxpayer in the United States. However, the House bill contained no such guidance and the conference bill follows the House version.

TANGIBLE PERSONAL PROPERTY

Definition

Under the notice, "tangible personal property" is any tangible property other than land, buildings, and structural components of buildings. Intangible property such as patents, copyrights, and subscription lists are also excluded. The definition is derived primarily from the investment tax credit rules in Treas. Reg. §1.48-1(c). Local law is not controlling for purposes of determining whether property is tangible personal property under the statute.

Exclusions

Intellectual and Creative Property. "Tangible personal property" excludes any property otherwise given specific treatment under §199. Consequently, qualified films, computer software, and sound recordings are not tangible personal property for purposes of the deduction. However, the tangible medium on which that property is fixed is tangible personal property (for example, video cassettes, computer diskettes, or other similar tangible items). Likewise, books, magazines, newspapers, and similar intellectual or creative property embodied on any tangible medium and mass distributed may meet the definition of tangible personal property as well.

> **Observation.** All types of tangible property held for sale, investment, or use by a taxpayer in its trade or business generally meets the definition of qualifying production property as long as the property is manufactured, produced, grown, or extracted by the taxpayer within the United States and the taxpayer's level of activity meets the in-whole or in-significant part threshold. This is the case even if the property was not used in a qualified production activity.

For qualified films, computer software, and sound recordings, the means by which the property is distributed may control whether the taxpayer qualifies for the production activity deduction. For example, gross receipts derived from the sale of magazine subscriptions and related advertising qualifies as domestic production gross receipts provided the words are embodied on a tangible medium. However, income from online subscriptions and advertising to the very same publication likely fails to qualify because the intellectual or creative property is not affixed to a tangible medium.

Computer Software. "Computer software" means any program, routine or any sequence of machine-readable code that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine. Computer software also includes the machine-readable coding for video games and similar programs, regardless of whether the program is designed to operate on a "computer" (as the term is defined in IRC §168 (i)(2)(B)).

> **Note.** Computer programs of all classes meet the definition of computer software, including operating systems, executive systems, monitors, compilers and translators, assembly routines, utility programs and application programs.

If the medium in which the software is contained (whether written, magnetic, or otherwise) is tangible, the medium is considered tangible personal property for purposes of IRC §199.

Example 10. Billy Gotes develops a software program that he reproduces and sells on diskettes. The program fixed on the diskette is treated as computer software, and the diskette is treated as tangible personal property.

Incidental and Ancillary Rights. The term "computer software" also includes any incidental and ancillary rights that are necessary to affect the acquisition of the title to, the ownership of, or the right to use the computer software, and that are used only in connection with that specific computer software.

Note. A trademark or trade name acquired to affect the acquisition (or right to use) a specific program in a taxpayer's trade or business is considered computer software for purposes of the deduction, provided the computer program is not acquired for the purpose of marketing the software.

Certain Databases Excluded. "Computer software" does not include any data or information base unless the database or item is in the public domain and is incidental to a computer program. For that purpose, copyrighted or proprietary data or information is treated as in the public domain if its availability through the computer program does not contribute significantly to the cost of the program.

Observation. If a word processing program includes a dictionary feature that may be used to check the spelling of a document, the entire program (including the dictionary feature) is computer software regardless of the form in which the dictionary feature is maintained or stored.

Taxpayers Engaged in Software Development and Manufacturing of the Tangible Medium. In the case of a taxpayer engaged in both software development and the manufacture of the distributable tangible medium, each production activity must separately meet the "MPGE in whole or significant part within the United States" requirement. Consequently, design and development activities associated with the production of the tangible medium are disregarded, while design and development activities associated with the software are taken into account.

Sound Recordings. Under the notice, the term "sound recordings" means any work that results from the fixation of a series of musical, spoken, or other sounds. Not included in the definition is the creation of copyrighted material in a form other than a sound recording, such as lyrics or written music or other similar material.

If the medium (such as compact discs, tapes, or other phonorecordings) in which the sounds are embodied is tangible, the medium is considered tangible personal property for purposes of IRC §199.

Example 11. Violinist Dave records music that he reproduces and sells on compact disc. The music fixed on the compact disc is treated as sound recordings, and the compact disc is treated as tangible personal property.

Observation. The need to separate the tangible medium from the sound recording may have a significant effect on companies that do not produce the sound recording but merely mass produce and sell copies of the recordings.

Note. It is unclear whether the manner in which sound recordings are utilized or distributed (e.g., downloads, MP3, digital remastering, etc.) affect their qualification under §199. IRC §168(f)(4) suggests that the nature of the material in which the sound is embodied is immaterial. Therefore, while it is likely that digital music, audio and other sound recordings are qualified property, further guidance is necessary.

Film Production. The notice defines "qualified film" as any motion picture film, videotape, or live or delayed television programming (excluding some sexually explicit films), if at least 50% of the total compensation relating to the production of the film is compensation for services performed in the United States by actors, production personnel, directors, and producers.

According to the notice, "compensation for services" includes all payments for services performed by actors, production personnel, directors, and producers, including participations and residuals. "Production personnel" includes those people who are directly involved in the production of the film, such as writers, choreographers, and composers providing services during the production of the film, as well as casting agents, camera operators, set designers, lighting technicians, make-up artists, and similar personnel. Not included as production personnel for purposes of determining compensation for services in the United States are individuals whose activities are ancillary to the production, such as advertisers and promoters, distributors, studio administrators and managers, studio security personnel, and personal assistants to actors.

ELECTRICITY, NATURAL GAS, OR POTABLE WATER

Activities related to the **production** of electricity, natural gas, and potable water are included under §199. Specifically, DPGR includes the gross receipts of the taxpayer that are derived from any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States. But the statute places a limitation on electricity, natural gas, and potable water that is inapplicable to the other categories of tangible personal property. Although the income related to the production of electricity, natural gas, and potable water is included in DPGR, the income related to the transmission or distribution of electricity, natural gas, and potable water may not be included in DPGR.

Income Segregation Required

The notice recognizes that an integrated producer that produces and delivers electricity, natural gas, or potable water must allocate its gross receipts between:

- Production, which qualifies as DPGR; and
- Distribution and transmission, which do not qualify as DPGR.

The notice establishes a de minimis rule for integrated producers when gross receipts attributable to transmission and distribution of electricity, natural gas, and potable water are less than 5% of the gross receipts from the sale of such property. In these cases, gross receipts attributable to the transmission and distribution of the property are considered DPGR for purposes of §199.

Example 12. Dade Water Company produces potable water. Part of the water is sold to distributors who pick up the water at the plant and then sell the water for residential swimming pools. The remainder of the water is transported by pipeline to customers in South Florida. The water sold to South Florida customers is sold at a much higher price due to the cost of pumping and maintaining the pipeline.

Dade includes the sales to distributors in DPGR, but must reduce the revenue of the pipeline water to account for transmission costs before including it in DPGR

Electricity Generation

The Conference Committee states, as to electricity – "In the case of a taxpayer who owns a facility for the production of electricity, whether the taxpayer's facility is part of a regulated utility or an independent power facility, the taxpayer's gross receipts from the production of electricity at that facility are QDGR. However, to the extent that the taxpayer is an integrated producer that generates electricity to end users, any gross receipts properly attributable to the transmission of electricity from the generating facility to a point of local distribution, and any gross receipts properly attributable to the distribution of electricity to final customers are not QDGR."

Natural Gas

For purposes of the deduction, the notice defines the term "natural gas" in a manner consistent with IRC §613A(e)(2) and includes only natural gas extracted from a natural deposit. It does not include methane gas extracted from a landfill. Natural gas production activities include all activities involved in extracting natural gas from the ground and processing the gas into pipeline-quality gas. Gross receipts attributable to the transmission of pipeline-quality gas from a natural gas field (or from a natural gas processing plant) to a local distribution company's city gate (or to another customer) are not DPGR. Likewise, gross receipts of a local gas distribution company attributable to distribution from the city gate to the local customers are not DPGR.

> **Note.** While gross receipts must be allocated between qualified production activities and transmission and distribution of electricity, natural gas, and potable water, the notice does not specifically suggest a method for making the allocation. Because some utilities both produce electricity or gas, and acquire electricity or gas for resale, allocations between produced and purchased property is necessary. Some utilities also have electricity or gas produced for them under a contract and are treated as the producers of the property for purposes of §263A. A determination of whether, under the same facts, those utilities are producers for purposes of the deduction requires a benefits-and-burdens-of-ownership analysis.

Potable Water

The term "potable water" means unbottled drinking water. Production activities include the:

- Acquisition, collection, and storage of raw water (untreated water)
- Transportation of raw water to a treatment facility
- Treatment of the water at the facility.

However, after the water has been treated, storage and delivery of the water is not considered qualified production activities.

> **Observation.** The production of bottled water is treated as the production of tangible personal property and not the production of potable water.

CONSTRUCTION PERFORMED IN THE UNITED STATES

The statute defines the term "domestic production gross receipts" to include the gross receipts of the taxpayer derived from construction performed in the United States.[37]

Under the notice, four requirements must be met to obtain a qualified production activity deduction (QPAD) related to construction activities:

1. The construction must relate to "real property."
2. The construction must be performed by a taxpayer engaged in a construction trade or business.
3. The taxpayer must engage in "construction activities."
4. The gross receipts must be "derived from" construction.

> **Note.** The notice provides that only construction activity by a taxpayer in a trade or business is considered construction for purposes of the North American Industry Classification System (NAICS) is eligible for the QPAD for construction activities.

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37. IRC §199(d)(4)

Real Property

The notice explains that to qualify as construction under §199, the construction must be of real property, which is defined as:

- Residential and commercial buildings (including the structural components of such buildings)
- Inherently permanent structures other than tangible personal property in the nature of machinery (i.e., walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators)
- Inherently permanent land improvements (i.e., swimming pools, roads, bridges, tunnels, paved parking areas and other pavements, special foundations, wharves and docks, fences, inherently permanent advertising displays, inherently permanent outdoor lighting facilities, railroad tracks and signals, telephone poles, power generation and transmission facilities, permanently installed telecommunications cables, broadcasting towers, oil and gas pipelines, derricks and storage equipment, grain storage bins and silos)
- Infrastructure

Note. The notice provides that DPGR derived from the construction of real property does not include gross receipts attributable to the sale or other disposition of land. Therefore, taxpayers are required to perform valuations of land before construction activities begin to substantiate DPGR derived from construction.

As for land improvements, they are considered "construction" only if they are performed in connection with the erection or substantial renovation or real property. The notice defines "substantial renovation" as the renovation of a major component or substantial structural part, or real property that materially increases the value of the property, substantially prolongs the property's useful life, or adapts the property to a new or different use. For example, this could include swimming pools, paved parking areas, wharves and docks, bridges, and fences.

The notice defines "infrastructure" to include roads, power lines, water systems, railroad spurs, communications facilities, sewers, sidewalks, cable, and wiring. Inherently permanent oil and gas platforms are also specifically identified as infrastructure for purposes of §199.

Observation. The notice appears to have rejected the inclusion of plant equipment in real property while including heating and ventilation systems. Production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs are all defined as tangible personal property in the notice.

The notice includes structural components of buildings in the definition of real property. In accordance with the statutory definitions of structural components contained in IRC §§48 and 263A, heating and ventilation systems, as well as walls, partitions, doors, wiring, plumbing, pipes and ducts, elevators and escalators, and similar property are structural components that satisfy the definition of real property under §199.

The notice does not provide a definition of inherently permanent structures. Presumably, this category would be defined at least as broadly as it is in §263A, and perhaps as broadly as it is in §48. Thus, inherently permanent structures should include property that is affixed to real property and that ordinarily remains affixed for an indefinite period of time, such as special foundations, inherently permanent advertising displays, inherently permanent outdoor lighting facilities, railroad tracks and signals, telephone poles, power generation and transmission facilities, permanently installed telecommunications cables, broadcasting towers, oil and gas pipelines, derricks and storage equipment, and grain storage bins and silos. The notice specifies that inherently permanent structures do not include property in the nature of machinery, such as gasoline pumps, hydraulic car lifts, and automatic vending machines.

De Minimis Rule for Construction Industry

Although tangible personal property (for example, appliances, furniture, and fixtures) is not real property for purposes of §199, the notice establishes a de minimis rule for gross receipts derived from construction. If more than 95% of the total gross receipts derived from a construction project are derived from real property,[38] the total gross receipts derived by the taxpayer from the construction project can be treated as DPGR from construction. The rule effectively relieves the taxpayer of the burden of separating out the tangible property relating to the construction project to the extent that the tangible property accounts for less than 5% of the gross receipts.

Example 13. Tom is a home builder and sells homes containing appliances. Tom completes construction on a home that he sells for $250,000. Tom may treat the entire sales proceeds as DPGR provided that less than 5% of the gross receipts are derived from the appliances (and any other tangible personal property).

> **Observation.** The notice does not explain how a home builder is to determine the amount of the gross receipts "derived from" the tangible personal property.

Construction Trade or Business

Even though there appears to be no support for it in either the statute or the legislative history, the notice allows only taxpayers that are engaged in a trade or business that is considered construction for purposes of the NAICS to claim the benefit of a QPAD related to construction activities. Under the NAICS definitions, the construction sector includes establishments that are primarily engaged in a variety of activities, including land development, land subdivision, general contracting, infrastructure construction, and many specialty subcontracting trades.

> **Note.** It is not clear whether the reference to NAICS codes means that a taxpayer's primary trade or business must be construction, or whether the taxpayer must have construction as one of its trades or businesses.

Specifically excluded from the NAICS construction sector are companies that are primarily engaged in businesses other than construction that also engage in construction using their own employees, for their own account and use. For example, a specialty contractor installing telecommunications and utility networks is included in the construction sector. However, telecommunication companies or utilities performing the same work on their own account are not included in the construction sector.

The notice does not explain why the construction activities to which §199 might apply is limited. The result is that a taxpayer that self-constructs real property is not eligible for a QPAD for its construction activities, while a taxpayer constructing identical real property on behalf of a customer may be entitled to a QPAD for its construction activities. To the extent that a portion of those tax savings is passed from the contractor to the customer, it could create a disparity between self-constructed and purchased assets. This seems inconsistent inasmuch since the Tax Reform Act of 1986 (TRA86) attempted to eliminate such a disparity. Specifically, §263A, enacted as part of the TRA86, was intended to place purchased assets on equal footing with self-constructed assets. Before the TRA86, fewer costs were generally capitalized into self-constructed assets than were included in the basis of purchased assets. As a result, some taxpayers were motivated by tax considerations to self-construct, rather than purchase, property even though this did not result in the most efficient allocation of economic resources. The government's interpretation of §199 might cause the reverse to occur. If a portion of the contractor's tax savings is passed to the customer, tax considerations might motivate taxpayers to contract for work that they might be able to perform more efficiently in-house.

38. As defined in Treas. Reg. §1.263A- 8(c)

For taxpayers engaged in multiple activities, the IRS may look to a "principal business activity" test such as set forth in Rev. Proc. 2002-28.[39] This revenue procedure extends the availability of the cash method of accounting to small taxpayers engaged in businesses described in certain NAICS costs. Under Rev. Proc. 2002-28, a taxpayer must "reasonably determine" whether its "principal business activity" is described in certain NAICS codes. The revenue procedure indicates the principal business activity is determined by the source of gross receipts under either a prior-year or three-year average test.

> **Observation.** The notice may result in an increased importance placed on the selection of the NAICS code. Companies ought to anticipate scrutiny of §199 construction benefits claimed by companies that selected a nonconstruction NAICS code and select an NAICS code reflecting a construction activity.

Construction Activities by Multiple Taxpayers. More than one taxpayer may qualify as performing construction activities related to the same project. Indeed, the same construction activity may be used to qualify the income of two different taxpayers as QPAI. Consequently, both a general contractor and a subcontractor may qualify for a QPAD for the same project.

Example 14. Marilyn (who is not in the trade or business of construction) owns a building and hires Joe (a general contractor) to oversee a "substantial renovation" of the building. Joe retains Frank (a subcontractor) to install a new electrical system in the building as part of that substantial renovation. The amount that Joe receives from Marilyn, and the amount that Frank receives from Joe qualify as DPGR. The proceeds that Marilyn receives from the subsequent sale of the building do not qualify as DPGR because Marilyn did not engage in any activity constituting construction.

> **Observation.** This is an extremely significant issue to the construction industry. Home builders and general contractors derive their income directly from the sale of constructed homes or contracts to construct property. The statute specifically does not require the taxpayer to do the actual constructing.

Land Developers. The notice does not explicitly resolve the issue of whether land developers may qualify for the QPAD. The notice provides an example involving a land owner, a general contractor, and a subcontractor. The notice explains that while the general contractor and subcontractor may qualify for a QPAD, a landowner who does not engage in construction activities does not qualify. However, if a general contractor contracts with an electrical contractor who, in turn, subcontracts specialty electrical contracting to another contractor, all three parties could qualify for a QPAD. Presumably, a land developer engaged in activities considered construction for purposes of the NAICS codes would similarly qualify for the QPAD.

Qualifying Construction Activities. Activities performed in connection with a project to erect or substantially renovate real property qualify as construction for purposes of §199. But according to the notice, tangential services, such as hauling trash and debris and delivering materials, do not qualify as a construction activity unless the taxpayer performing construction is also performing those tangential services in connection with the construction project. In other words, a taxpayer engaged solely in the tangential services of a construction project cannot claim gross receipts from those services as DPGR. However, if the taxpayer performing construction, in connection with the construction project, also provides tangential services such as delivering materials to the construction site and removing its construction debris, the gross receipts derived from the tangential services are DPRG.

According to the notice, activities, such as improving land (for example, grading and landscaping) and painting, constitute construction only if those activities are performed in connection with other activities (whether or not by the same taxpayer) that constitute the erection or substantial renovation of real property. It is up to the taxpayer performing those activities to make a reasonable inquiry as to whether the activity relates to the erection or substantial renovation of real property.

39. Rev. Proc. 2002-28, April 12, 2002

Substantial renovation includes structural improvements, but not mere cosmetic changes, such as painting. The appropriate standard in determining whether there has been a substantial renovation of real property, according to the IRS, is the standard applied under IRC §263(a) to determine whether a taxpayer's activities result in permanent improvements or betterments of property, such that the cost of the activities must be capitalized. In following the IRC §263(a) standard, the notice specifically defines "substantial renovation" as the renovation of a major component or substantial structural part of real property that materially increases the value of the property, substantially prolongs the useful life of the property, or adapts the property to a new or different use.

To the extent that a particular activity is included in the definition of "engineering and architectural services," the activity does not qualify as construction for purposes of IRC §199(c)(4)(A)(ii).

Gross Receipts Derived from Construction. Regarding gross receipts "derived from construction" performed in the United States, there is no requirement that there be a "lease, rental, license, sale, exchange, or other disposition of" property as required by IRC §199(c)(4)(A)(i).[40] The notice explains that gross receipts may be derived from construction only if derived from:

- A sale, exchange, or other disposition of the property constructed, or
- The performance of construction services.

Lease or rental income related to property constructed by the taxpayer is not "derived from construction." However, the notice explains that a sale, exchange, or other disposition of property need not occur immediately on completion of construction. Thus, a taxpayer that constructs a building and leases it for several years before selling it may qualify for a QPAD on the ultimate sale.

Observation. The exclusion of lease or rental income is surprising. A taxpayer constructing a building for sale looks to the sales proceeds for its recovery of costs and profit, while a taxpayer constructing a building for lease looks to the stream of rental income for recovery of costs and profit. In either instance, the taxpayer is engaged in construction activities resulting in U.S. jobs. One wonders whether the notice's exclusion of lease and rental income is consistent with the objectives of the statute.

Example 15. Hall's Construction Company builds "spec" houses in Marlboro, Ohio. If the company does not have a purchaser for the home upon completion, it may rent the home until a buyer is located. While the ultimate sale of the home by Hall qualifies as DPGR, any rental income received prior to the sale does not qualify.

ENGINEERING AND ARCHITECTURAL SERVICES

"Domestic production gross receipts" includes the taxpayer's gross receipts that are derived from engineering or architectural services performed in the United States for construction projects in the United States.[41]

For purposes of §199, the definitions of the terms "engineering services" and "architectural services" generally follow the definitions in the Treasury Regulations associated with IRC §924.

Engineering services in connection with any construction project include any professional services requiring engineering education, training, and experience, and the application of special knowledge of the mathematical, physical, or engineering sciences to those professional services, such as consultation, investigation, evaluation, planning, design, or responsible supervision of construction for the purpose of assuring compliance with plans, specifications, and design.

40. IRC §199(c)(4)(A)(ii)

41. IRC §199(c)(4)(A)(iii)

Architectural services in connection with any construction project include the offering or furnishing of any professional services, such as consultation, planning, aesthetic and structural design, and drawings and specifications, or responsible supervision of construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project.

Limitation to Services Provided in the United States for U.S. Real Property Construction Projects

In general, the notice requires that the engineering or architectural services must relate to real property and must be performed in the United States, and that the taxpayer providing those services must be able to substantiate that the services relate to a construction project within the United States. The notice also provides that DPGR includes gross receipts derived from engineering or architectural services even if the planned construction project is not undertaken or is not completed.

The notice provides a de minimis exception for performance of services in the United States. If gross receipts derived from engineering or architectural services:

- Performed outside the United States, or
- Related to property other than real property for a construction project inside the United States

…total less than 5% of the total gross receipts of the taxpayer derived from engineering or architectural services performed by the taxpayer regarding the same construction project, the receipts are treated as DPGR.

> **Note.** The statute provides that the engineering and architectural services must be performed for "construction projects in the United States." The statute and legislative history do not specify whether "construction projects" refers only to the construction of real property or whether it also includes the construction of tangible personal property. In a separate section related to construction activities performed in the United States, the legislative history provides "for this purpose, construction activities include activities directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure." Because the provision addressing construction activities is limited to real property construction, the provision addressing engineering and architectural services related to construction projects will likely be limited to real property construction.

EXCEPTION FOR SALES OF FOOD AND BEVERAGES

Food processing is a qualified production activity, but DPGR does not include gross receipts derived from the sale of food or beverages prepared by the taxpayer at a retail establishment.[42] The notice defines a "retail establishment" as real property leased, occupied, or otherwise used by the taxpayer in its trade or business of selling food or beverages to the public at which retail sales are made. The notice explains that this definition is similar to the definition of "retail space" under IRC §110 (relating to qualified lessee construction allowances for short-term leases).

> **Note.** Retail establishments used in the trade or business of selling food are not limited to dine-in establishments.

If a taxpayer's facility is a retail establishment, it appears that the taxpayer can allocate its gross receipts between gross receipts derived from the retail sale of the food and beverages prepared and sold at the retail establishment (which are non-DPGR) and gross receipts derived from the wholesale sale of the food and beverages prepared at the retail establishment (which are DPGR).

42. IRC §199(c)(4)(B)(i)

Example 16. Juan buys coffee beans and roasts the beans at his facility where he roasts and packages roasted coffee. Juan sells the roasted coffee through a variety of unrelated third-party vendors and also sells the roasted coffee at his own retail establishments. The retail establishments also sell other foods in addition to the brewed coffee.

To the extent that Juan's gross receipts are from the sale of the roasted coffee beans, the receipts are DPGR. However, to the extent that the gross receipts represent receipts from the sale of brewed coffee or food, the receipts are not DPGR. Juan may be able to include in DPGR the value of the beans which are used to produce the brewed coffee.

Note. The legislative history provides that "retail establishment" includes carry-out restaurants as well as in-store bakeries at grocery stores.

5% De Minimis Rule

A facility is not treated as a retail establishment if less than 5% of the food or beverages sold at that facility during the year are sold at retail.

Example 17. Hard Crust Shop bakes bread to sell at wholesale and also operates a "day-old" shop on the plant premises. Hard Crust is not treated as a retail establishment if less than 5% of the bread baked at the plant during the year is sold at the "day-old" shop. Hard Crust needs to maintain records to establish qualification for this exception. However, if more than 5% of the prepared bread is sold through the "day-old" shop, Hard Crust will be regarded as a retail establishment. Hard Crust may allocate its gross receipts between gross receipts derived from wholesale activities (DPGR) and retail activities (non-DPGR).

Note. Although not specifically discussed in the notice, costs are also allocated between the DPGR and non-DPGR. The general cost allocation rules apply. Therefore, it may be possible that a simple allocation of costs based on gross receipts might be regarded as reasonable under the §861 method. Perhaps the IRS will use a dual-function rule similar to that for dual-function storage facilities under IRC §263A. Under that provision, storage costs associated with a dual-function storage facility are allocated between what is effectively the retail and non-retail functions based on the ratio of retail sales to total sales.

ADDITIONAL ISSUES INVOLVING DPGR

Inability to Group Transactions

The statute provides no direction regarding whether a single taxpayer must treat all of its qualifying activities together for calculation purposes or whether a taxpayer can separate its qualifying activities into individual separate business lines or individual product lines. However, the notice states that grouping is not permitted. According to the notice, QPAI is to be determined on an item-by-item basis and is the sum of QPAI derived by the taxpayer from each item. Thus, QPAI is not determined on a division-by-division, product line-by-product line, or transaction-by-transaction basis. QPAI calculated for each item may be positive or negative, but those amounts are netted to arrive at a single QPAI amount for the taxpayer. Unfortunately, the item-by-item approach may not lead to an easy calculation of QPAI in contract manufacturing settings. Hopefully, future guidance will provide taxpayers with the ability to use any reasonable method to define item (e.g., based on product numbers, part numbers, and so on) and permit the flexibility to change the definition of item in determining QPAI without requiring the Commissioner's consent.

Observation. The inability to group transactions eliminates any possibility of isolating losses to maximize the deduction.

Gross Receipts

Segregation. The notice requires a taxpayer to separate its qualifying gross receipts from its nonqualifying gross receipts using a "reasonable method" that is "satisfactory" to the IRS and that "accurately identifies" its qualifying gross receipts.

> **Note.** Different types of ordinary business income receive different tax treatment. Practitioners need to examine client business transactions carefully to determine if new approaches for entering into contractual arrangements and accounting for associated profits should be utilized.

Allocation. When a taxpayer engages in transactions that create both DPGR and non-DPGR, the taxpayer must allocate gross receipts based on a "reasonable method" that is "satisfactory" to the IRS and that "accurately identifies the gross receipts that constitute DPGR." The notice sets forth the following factors to be taken into account in determining whether the taxpayer's allocation method is reasonable:

- Whether the taxpayer uses the most accurate information available
- The relationship between gross receipts and the chosen apportionment base
- The accuracy of the chosen method as compared with other possible methods
- Whether the method is used by the taxpayer for internal management or other business purposes
- Whether the method is used for other federal, state, or foreign income tax purposes
- The time, burden, and cost of using various methods
- Whether or not the taxpayer applies the method consistently from year to year

The notice provides a de minimis **safe harbor** applicable when small amounts of non-DPGR are present. Under this de minimis rule, if the taxpayer's non-DPGR is less than 5% of its total gross receipts, the taxpayer may treat all gross receipts as DPGR. This 5% de minimis approach is used in several other places in the notice where the IRS addresses specific situations in which it is necessary to allocate gross receipts to both qualifying and nonqualifying aspects of a single business activity or transaction.

Advance Payment Rule. A special rule applies when a taxpayer has gross receipts in the form of advance payments received in a tax year earlier than when the related qualifying activities are actually conducted. The rule requires that the taxpayer accurately identify, based on a reasonable method that is satisfactory to the IRS, whether the receipts (and corresponding expenses) qualify as DPGR. Guidance on the reasonable method can be found in Rev. Proc. 2004-34.

> **Observation.** Many taxpayers have to deal with the fact that different types of ordinary business income receives different tax treatment. In many cases, taxpayers want to adopt new approaches to entering into their contractual arrangements and new ways to account for many of their transactions. Some taxpayers may want to begin negotiating for consideration separately for qualifying transactions that in the past were included in a lump-sum consideration received for both qualifying and nonqualifying activities. Also, many taxpayers with both qualifying and nonqualifying business activities will want to ensure that they are properly determining and accounting for the respective market-rate profit for each activity.

For the special rule to apply, the advance payment must be for:

- Services
- The sale of goods
- The use of intellectual property
- The occupancy or use of property if the occupancy or use is ancillary to the provision of services
- The sale, lease or license of computer software, and guaranty or warranty contracts ancillary to items for which advance payments qualify under the special rule

An advance payment **does not include** rent, insurance premiums governed by Subchapter L, payments for financial instruments, and service warranty contracts where a third party is the primary obligor.

When Must Production Activities Occur to Give Rise to DPRG? There is no guidance in either the statute or the notice concerning the time period during which the production activities must occur to give rise to DPGR. Consequently, qualifying property produced before 2005 can give rise to DPGR.

> **Example 18.** Moonshine, Inc., produced its most popular brand, "White Lightning," from 1990-2004. Any amount of "White Lightning" sold after 2004 could create DPGR.

The open-ended time period for production activities is also important for companies that have produced qualified products that remained unsold as of the beginning of 2005, but where the company has changed the location of the production activities to outside of the United States.

What are "Gross Receipts"? The notice defines the term "gross receipts" generally as "the taxpayer's receipts for the tax year that are recognized under the taxpayer's method of accounting used in that tax year for federal income tax purposes." The notice provides a series of examples of items that qualify as gross receipts under that definition. These include:

- Total sales (net of returns and allowances)
- All amounts received from services
- Any income from investments such as interest, dividends, rents, royalties, and annuities, regardless of whether the amounts are derived in the ordinary course of the taxpayer's business

Examples of items that **do not qualify** as gross receipts include amounts derived from repayment of a loan or from nonrecognition transactions (such as an IRC §1031 exchange), and sales or similar taxes, when the tax is imposed on the customer under applicable state or local law.

> **Observation.** The notice specifies that tax accounting concepts determine gross receipts for §199 purposes.

What Does "Derived From" Various Activities Mean? The statute provides that DPGR "means gross receipts of the taxpayer which are derived from any lease, license, sale, exchange, or other disposition" of QPP.[43] However, the statute does not provide a definition or method for purposes of determining what constitutes gross receipts "derived from" those types of transactions.

The notice limits qualifying gross receipts to direct proceeds from the lease, rental, license, sale, exchange, or other disposition of QPP. The notice also indicates that the proceeds from business interruption insurance and payments not to produce are treated as gross receipts "derived from the lease, rental, license, sale, exchange, or other disposition" of QPP to the extent the payments are substitutes for gross receipts that would qualify as DPGR.

43. IRC §199(c)(4)(A)(i)

The notice further explains that existing federal income tax law principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition, or whether it is a service.

Note. The notice cites as an example Rev. Rul. 88-65 which treats a short-term lease as a service.

Observation. Gross receipts of a taxpayer that are considered derived from "any lease, license, sale, exchange, or other disposition" can qualify for the QPAD, but gross receipts that are considered derived from a service cannot. Therefore, pressure will be placed on the characterization of transactions as either services or sales of goods, or, conversely, as either services or leases or licenses.

Embedded Services Allocation. The statute does not provide any rules regarding the treatment of transactions with "embedded services." Embedded services are transactions in which the price of a service is included in the amount charged for a lease, rental, license, sale, exchange, or other disposition of property.

However, the notice explains that for an embedded service, DPGR includes only the receipts from the lease, rental, license, sale, exchange, or other disposition of the property, and not any receipts attributable to the embedded service; with two exceptions:

Exception #1: The Qualified Warranty Exception. A taxpayer may include in DPGR (assuming all requirements of §199 are met) gross receipts from a "qualified warranty." A "qualified warranty" is any warranty provided in connection with the sale of qualifying production property if:

- In the normal course of its business, the charge for the warranty is included in the price charged for lease, rental, license, sale, exchange, or other disposition of the QPP, and
- The warranty is neither separately offered by the taxpayer nor separately bargained for with the customer (i.e., the customer cannot purchase the qualifying production property without the warranty).

Example 19. In order to increase sales, Kathy's Ugo Sales includes with the purchase of every new Ugo an "all costs" warranty at no charge. Because the buyer does not pay for the warranty, the entire sale price of the new Ugo is included in DPGR.

Exception #2: The De Minimis Exception. If the amount of gross receipts from embedded services is less than 5% of the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the property, the amount of gross receipts from embedded services qualifies as DPGR. For purposes of the de minimis test, gross receipts from qualified warranties are not treated as gross receipts for services.

Example 20. If Kathy's Ugo Sales charged the customer for the "all costs" warranty, the revenue from the warranty sales would not be a part of DPGR, unless the total warranty sales were less than the 5% de minimis exception.

Note. Many taxpayers conduct transactions that are best characterized as a lease, license, sale, exchange, or other disposition, but that involve an embedded service. Under the general rule, those taxpayers are required to allocate gross receipts between the qualifying components of their transactions and the nonqualifying components. Unfortunately, the notice does not address the critical question regarding the scope of activities that constitute an embedded service. It is suggested that the IRS, in future guidance, specify that an activity is not deemed to be an embedded service if the activity is ancillary, incident, necessary or attributable to gross receipts of qualifying production property.

Advertising Income. While the statute does not provide any special rules regarding advertising receipts, the notice provides that advertising income attributable to the sale or other disposition of newspapers and magazines should be considered "derived from" the sale or other disposition of the newspaper and magazine. The notice acknowledges that the advertising income is "inextricably linked" to the gross receipts derived from the lease, rental, sale, exchange, or other disposition of the newspapers and magazines.

Example 21. The Edgemont "Screaming Daily Bugle" collects receipts from customers placing ads in the newspaper for display or classified advertising. The receipts qualify as DPGR.

Observation. It is believed that the specific reference to newspapers and magazines does not necessarily restrict this rule from applying in the qualified film context (for example, to television shows and movies). Further guidance on the matter is anticipated.

COMPUTER SOFTWARE INCOME

The statute indicates that "computer software" qualifies as QPP.[44] As previously discussed, "computer software" broadly includes "…any program or routine or any sequence of machine-readable code that is required to subscribe and maintain that program or routine." The notice specifies that "computer software" also includes the machine-readable coding for video games and similar programs, regardless of whether the program is designed to operate on a computer.[45]

The statute does not provide any special rules regarding when gross receipts can be considered derived from the lease, license, sale, exchange, or other disposition of computer software. The notice provides that the determination of whether gross receipts can be considered derived from the lease, license, sale, exchange, or other disposition of computer software generally depends on all the facts and circumstances. Therefore, the form adopted by the parties to the transaction, the classification of the transaction under copyright law, and the physical or electronic medium used to effectuate the transfer are not necessarily determinative of the issue.

However, the notice explains that DPGR derived from computer software does not include gross receipts from Internet access services, online services, customer support, telephone services, games played through a website, provider-controlled software online access services, and other services that do not constitute the lease, rental, license, sale, exchange, or other disposition of computer software that was developed by the taxpayer. The notice characterizes receipts from those transactions as receipts from services. But, receipts from transactions in which software is sold to customers who download the software from the Internet qualify as DPGR.

Note. For Internet software transactions, the notice appears to focus on the question of whether an installation or download takes place on the customer's computer. It is not clear whether that factor would also be determinative when an installation is more than momentary but less than permanent, and thus when the transaction might be characterized as a lease or license of the software. Whether the download distinction is intended to be the critical distinction in all cases is also not clear. It is hoped that further guidance will be provided.

Observation. Taxpayers currently providing access to data, information, games, or utilities over the Internet may want to consider modifying their business practice so that it is clear that gross receipts are derived from the provision of computer code that will reside on a customer's computer at least temporarily.

44. IRC §199(c)(5)(B)

45. The notice references the IRC §168(i)(2)(B) definition of a computer. There is no regulatory guidance concerning the circumstances when an item of equipment would be considered an integral part of other property which is not a computer, and the notice is silent on the issue.

The term "computer" does not include:

- Any equipment which is an integral part of other property which is not a computer
- Typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment
- Equipment of a kind used primarily for amusement or entertainment of the user

QUALIFIED FILMS

Films produce several different types of revenue streams: income from film rentals; income from film sales (that is, when a film producer sells copies of film directly to the public); income from licensing of film; income from the licensing of film characters; and income from the sale of film-themed merchandise. In determining DPGR, the notice specifically includes some of those revenue streams, with some limitations, and specifically excludes other revenue streams. Specifically excluded is revenue from film-themed merchandise and the license of the right to use film characters.

The taxpayer needs to bifurcate between the master copy and the tangible personal property embodying the film. The IRS explains that qualified film is limited to the master copy of the film (or other copy from which the holder is licensed to make and produce copies). Qualified film does not include the tangible personal property embodying the film, such as DVDs or video cassettes. Examples provided by the IRS follow.

Example 22. Ace Productions produces qualified film, attaches the film to a tangible medium purchased from an unrelated taxpayer, and leases or licenses the qualified film and medium containing the qualified film to unrelated commercial theaters. Ace's gross receipts from the lease or license of the qualified film are "derived from" the:

- Lease of tangible personal property (tangible property on which the copy is affixed), and
- License of the qualified film (the right to publicly display the film).

Gross receipts received from the lease of the tangible personal property do not constitute DPGR because Ace did not produce the tangible property. However, gross receipts from the license of the qualified film do constitute DPGR, because Ace produced the film.

Example 23. Orion Co. licenses qualified film to WishingBone Inc., an unrelated taxpayer. WishingBone, Inc. reproduces the film onto DVDs and video cassettes that they manufacture in the United States. WishingBone's gross receipts from the sale of the DVDs and video cassettes are derived from the sale of:

- Tangible personal property (DVDs and video cassettes), and
- The qualified film (the motion picture affixed on the DVDs and video cassettes).

For WishingBone, gross receipts from the sale of the DVDs and video cassettes constitute DPGR, because WishingBone produced the tangible property. But gross receipts received from the sale of the qualified film affixed to the DVDs and video cassettes do not constitute DPGR, because WishingBone did not produce the qualified film.

Observation. The requirement to bifurcate the intangible from the tangible medium in which it is embodied stands in stark contrast to the rules for the production of other items of tangible personal property. A question remains whether taxpayers that mass produce the tangible medium are considered producers under §199.

It is not immediately clear from the notice how the bifurcation is applied to a taxpayer that does not produce the film, but manufactures the mass-produced copies under a licensing agreement.

Example 24. Truman Capote licenses a qualified film to Harrison Ford. Harrison manufactures DVDs containing popular films as well as blank DVDs. Under the terms of the license, Harrison pays Truman $8 each time it affixes the film to a DVD. Harrison's cost of manufacturing a DVD is $4 and the cost of affixing a film to the DVD is $3. Thus, Harrison's cost of manufacturing DVDs containing popular films is $15. Harrison sells each finished product for $20. Blank DVDs are sold for $4.50.

Result. Under the notice, the revenue attributable to the sale of the DVD is DPGR, but the revenue attributable to the sale of the licensed film is not DPGR because Harrison did not produce the film. Harrison has a $5 profit from selling the DVD on which the popular film is recorded. Because the blank DVDs are manufactured for $4 and sold for $4.50, it would appear that the 50¢ of profit attributable to the manufacture of the DVD is DPGR. Presumably, an additional portion of the profit is attributable to the activities related to the recording of the film on the DVD. Assuming those activities constitute production, the profit attributable to them should be DPGR.

Note. The IRS could take the position that some portion of the profit is attributable to the markup on the sale of the film that was not produced by Harrison, and is, therefore, not DPGR. It is the taxpayer's burden to establish the portion of the gross receipts qualifying as DPGR. If this interpretation of the bifurcation rule is ultimately adopted, taxpayers in the position of Harrison would receive only a partial QPAD even if 100% of their activities related to the production of mass-produced DVDs in the United States.

Observation. It should be noted that Harrison manufactured DVDs and recorded films on the DVDs. Harrison is regarded as a producer. The notice does not address whether a taxpayer that purchases rather than produces DVDs and records film on them is regarded as a producer for purposes of §199.

The bifurcation rule does not apply to the manufacture of property other than property containing software, sound recordings, or film. For example, a car manufacturer is not required to bifurcate its sales proceeds between the portion of the car that it manufactured and the components of the car.

Example 25. Camshaft Co. manufactures car engines that it sells to Carriage Co. for $500. Carriage Co. includes the engine in a car that it manufactures. Carriage Co. expends an additional $7,500 manufacturing the car. The car is sold for $10,000.

Result. The entire profit of $2,000 ($10,000 – ($500 + $7,500)) qualifies for the QPAD. Even when the cost of the component at issue is significant in comparison to the sales price, bifurcation is not required in situations involving purely tangible personal property.

Example 26. Diamond Jim, Inc. is a jewelry manufacturer. It purchases a diamond for $1,000 and spends $500 to produce a ring containing the diamond. It then sells the ring for $2,500.

Result. Presumably the entire $1,000 profit is treated as DPGR.

Similarly, a book publisher is not required to allocate gross receipts between the tangible medium (the book) and the underlying manuscript.

Observation. It is not clear why the license of the film, for example, is not treated the same as the acquisition of any other raw material used in a production process. The cost of the license, like the cost of the engine, diamond, or manuscript should offset DPGR as part of the CGS. There should not, however, be a disqualification of a portion of the profit from DPGR.

The bifurcation of the intangible and the tangible medium also results in complex issues regarding the allocation of expenses.

The notice does not contain specific rules related to when a taxpayer is treated as the producer of a film when it hires a third party to assist in the production.

> **Note.** The contract manufacturing rules set forth in the notice regarding tangible personal property are also applicable to film. Under common industry practice, a film studio hires an independent production company to produce a film. Generally, the studio retains ownership of the screenplay and rights to the film, including exploitation and distribution rights. All financing of the production, as well as all material production decisions, are made solely by the studio. The foregoing appears to be sufficient benefits and burdens of ownership to establish that the studio ought to be regarded as the producer, and therefore eligible for the QPAD. On the other hand, the production company is not entitled to the QPAD.

Regarding residuals and participations, if a taxpayer uses the income forecast method of IRC §167(g) and capitalizes residuals and participations into the adjusted basis of the qualified film, the taxpayer must use the same estimate of residuals and participations for §199 that is used for IRC §167(g). If a taxpayer excludes participations and residuals from the adjusted basis of the qualified film, the taxpayer must determine the compensation expected to be paid as residuals and participations based on the total forecasted income used in determining income forecast depreciation.

The notice does not provide a specific allocation method for compensation relating to the production of the film within and outside of the United States. Instead, the notice permits the taxpayer to use any reasonable method for making the allocation, as long as it is used consistently.

TELEVISION PROGRAMMING

The notice is silent on whether the advertising revenue related to television programming is included in DPGR. However, advertising revenue is included in DPGR if it relates to the production of newspapers.

COST ALLOCATION

A company's DPGR must be offset by three categories of costs:

1. The cost of goods sold that are allocable to those receipts (but, DPGR is not reduced by cost of goods sold or by the cost of property sold if such property is — stock in trade, depreciable property used in the trade or business, real property, a copyright, literary, musical or artistic composition, accounts or notes receivable or a publication of the U.S. government)
2. Other deductions, expenses, or losses directly allocable to those receipts
3. A ratable portion of other deductions, expenses, and losses that is not directly allocable to those receipts or another class of income

> **Observation.** IRC §199(c)(2) states that the Treasury shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining income attributable to domestic production activities.

The notice provides a multiple-step process for dealing with the expense allocation question and provides multiple possible methods within each step.

COST OF GOODS SOLD

The notice explains that a taxpayer engaged in the sale of qualifying production property should allocate its expenses to cost of goods sold (CGS) in accordance with the general principles of §263A. Direct costs and, with few exceptions, indirect costs that "directly benefit or are incurred by reason of" a production activity are required to be capitalized. Typically, a manufacturer would capitalize into inventory its direct material, direct labor, factory overhead, and a portion of "mixed service costs" (for example, general and administrative costs and non-IRC §174 engineering and design costs).

The notice contains a special rule for imported items or services. The cost of any item or service brought into the United States cannot be less than its value at the time it enters the United States. If the item is exported from the United States for further manufacture and then re-imported, the increase in cost may not exceed the difference between the value of the property when exported and the value of the property when brought back into the United States.[46]

Note. The notice also provides that if a taxpayer cannot specifically identify the CGS allocable to the DPGR, the taxpayer may make the allocation using a reasonable method. Situations in which a taxpayer might not be able to specifically identify CGS could include when the taxpayers produces QPP and:

1. Also produces property in another country,
2. Engages in the packaging, repackaging, labeling, or minor assembly of other property,
3. Acquires property for resale, and
4. Sells it in connection with more-than-de minimis services.

Taxpayers using the §263A method usually cannot specifically identify CGS. Therefore, if they are engaging in both qualifying and nonqualifying activities, they must make a reasonable allocation of CGS. If the taxpayer uses a method to determine the allocable portion of its gross receipts derived from qualified production activities, the taxpayer must use the same method to determine the allocable CGS.

Observation. Although CGS is an inventory concept, the notice explains that for purposes of the deduction, CGS also refers to the adjusted basis of noninventory QPP.

Small taxpayers (those with average annual gross receipts of $5 million or less) may use a single simplified method to allocate its CGS and other deductions, expenses, and losses.

DEDUCTIONS, EXPENSES, AND LOSSES

The costs that are not allocated to CGS under §263A may include IRC §174 costs. Those costs include costs associated with selling, marketing, advertising, warranties and policymaking. Also included is the portion of the mixed service costs that were not allocated to noncapitalizable activities, interest, losses, and charitable contributions.

Methods for Allocation and Apportionment of Deductions

The notice provides three methods for allocating deductions (other than CGS) to offset qualifying DPGR. These methods presumably are used both by taxpayers not engaged in qualifying activities that do not involve the sale of goods, and by taxpayers who sell goods but who have deductions to allocate and apportion other than deductions that factor into the cost of goods sold.

1 — §861 Method. The §861 method is available to all taxpayers (and must be used by taxpayers with average annual gross receipts over the three prior years of more than $25 million). It generally follows existing rules applicable to taxpayers required to determine taxable income from within and outside the United States. The notice provides that a taxpayer generally must allocate and apportion its deductions using the rules provided in the Treasury Regulations for IRC §199. The notice states that, under this method, §199 is treated as an "operative section" described in Treas. Reg. §1.861-(8)(f). Accordingly, the taxpayer applies the rules of the IRC §861 regulations to allocate and apportion deductions to gross income attributable to DPGR. In general, the §861 regulations are applied on a single-entity basis, although the rules are applied on the basis of the affiliated group (as determined under the regulations) for certain expenses, such an interest expense and research and experimental expenses.

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46. "Value" means customs value as defined in IRC §1059A(b)(1).

It should be noted that the §861 method of computing the deduction is complicated, and would place a huge burden on taxpayers that are required to use the method.

> **Note.** According to the notice, a taxpayer using a particular method for allocating and apportioning costs under §861 for purposes other than determining its QPAI (for example, for purposes of calculating its foreign tax credit limitation) must use the same particular method for allocating and apportioning those costs for purposes of §199. This consistency rule mimics the consistency rule already present under the IRC §861 Treasury Regulations. There are two special allocation rules under the §861 method. Charitable deductions must be ratably apportioned based on the relative amount of DPGR gross income and other gross income. Research and experimentation expenses must be allocated and apportioned in accordance with Treas. Reg. §1.861-17 without reference to the exclusive apportionment rule of Treas. Reg. §1.861-17(b).

2 — Simplified Deduction Method. The simplified deduction method is available only to taxpayers with average annual gross receipts (over the three prior years) of $25 million or less. It provides a simplified formula that allocates deductions based on the ratio of the taxpayer's income derived from QPAs as compared to the taxpayer's income from all sources. A taxpayer electing this simplified deduction method must use the method for all deductions.

3 — Small-Business Simplified Overall Method. Under the small business simplified overall method, both CGS and all other deductions are allocated based on the same ratio applicable under the simplified deduction method. This method is available only to taxpayers with average annual gross receipts (over the three prior years – or, if fewer, the taxable years the taxpayer was in existence) of $5 million or less, and certain other small taxpayers that are permitted to use the cash method of accounting (that is, any taxpayer with average annual gross receipts of $10 million or less that is not prohibited from using the cash method under IRC §448, including a partnership, an S corporation, a C corporation, or an individual).

Specific Treatment of Certain Deductions

Four special rules apply to all three methods for allocating and apportioning deductions:

1. An IRC §165 loss related to property is allocated or apportioned to DPGR only if the proceeds from the sale of the property are, or would have been, DPGR.
2. An IRC §172 net operating loss is not allocated or apportioned to DPGR.
3. A deduction that is not attributable to the actual conduct of a trade or business (for example, the standard deduction or deduction for personal exemptions) is not allocated or apportioned to DPGR.
4. If non-DPGR is treated as DPGR under a safe harbor or de minimis rule under the notice, the deductions related to such non-DPGR must be allocated or apportioned to DPGR.

Wages-Paid Limitation

The deduction for any tax year is limited to 50% of the "W-2 wages" paid by the employer during the calendar year that ends in that tax year.[47] Therefore, fiscal year taxpayers will look to the wages paid throughout the calendar year ending within their fiscal year when determining this limitation.

For those purposes, the term "W-2 wages" generally means the sum of the aggregate amounts that are required to be reported on Form W-2 by the employer or those acting as agents for the employer (e.g., common paymasters) for:

- Total wages, tips, and other compensation
- Employee salary reduction contributions to 401(k) arrangements and similar plans
- Designated Roth IRA contributions for tax years beginning after December 31, 2005

47. IRC §199(b)(1)

Methods for Calculating W-2 Wages. For payroll or income tax purposes, taxpayers do not currently determine an amount that can be used for calculating the wage limit requirement for purposes of the new deduction without making some adjustments (i.e., the §199 definition of W-2 wages cannot be satisfied by a box on Form W-2). As a result, the notice provides three alternative methods for making the required calculations:

1. **Unmodified Box Method.** The taxpayer can treat as "wages" the lesser of the aggregate amount reported as (1) Wages, Tips, and Other Compensation (Box 1), or (2) Medicare Wages and Tips (Box 5) on all Forms W-2 filed with the Social Security Administration for all employees during the year.

2. **Modified Box 1 Method.** The taxpayer can calculate wages by subtracting from the total amounts reported as Wages, Tips, and Other Compensation (Box 1) amounts that are not wages for federal income tax withholding purposes and amounts that are merely treated as wages for withholding purposes (for example, supplemental unemployment compensation benefits and certain forms of sick pay, among others). The result is then increased by employee salary reduction contributions to 401(k) arrangements and similar plans (i.e., elective deferrals that are reported in Box 12 of Forms W-2 with Codes D, E, F, G and S.

   Summary of the Calculation Procedure:

   Step One: Total the amounts in Box 1 of Forms W-2 for all employees of the taxpayer for employment by the taxpayer;

   Step Two: Subtract from the total of Step 1 amounts that are included in Box 1 of Forms W-2 that are not wages for federal income tax withholding purposes and amounts included in Box 1 of Forms W-2 that are treated as wages under IRC §3402(o); and

   Step Three: Add to the result of Step Two any amounts that are reported in Box 12 of Forms W-2 for employees of the taxpayer for employment by the taxpayer and that are coded as D, E, F, G or S.

3. **Tracking Wages Method.** The taxpayer can track the actual amount of wages subject to federal income tax withholding, subtract supplemental unemployment compensation benefits that were included in that amount, and then add employee salary reduction contributions to 401(k) arrangements and similar plans (i.e., elective deferrals reported in Box 12 of Forms W-2 with Codes D, E, F, G and S). This method must be used if a short tax year is involved.

   Summary of the calculation procedure:

   Step One: Add the amounts of wages subject to federal income tax withholding that are paid to employees of the taxpayer for employment by the taxpayer and that are reported on Forms W-2 for the calendar year;

   Step Two: Subtract from the result of Step One the supplemental unemployment compensation benefits that were included in the Step One calculation; and

   Step Three: Add to the result of Step Two amounts that are reported in Box 12 of Forms W-2 for employees of the taxpayer for employment by the taxpayer and that are properly coded as D, E, F, G or S.

Note. Amounts that are treated as W-2 wages for a tax year under any method may not be treated as W-2 wages of any other tax year. For example, an amount of nonqualified deferred compensation that is treated as W-2 wages under the Unmodified Box Method for any tax year may not later be treated as W-2 wages in any other tax year.

> **Observation.** Although the Unmodified Box Method is the easiest method available to determine the deduction limit, it usually results in the lowest deduction limit. Taxpayers using the Modified Box 1 or Tracking Wages Methods generally have a higher deduction limit. For example, under the Unmodified Box Method, employee salary reduction contributions to a 401(k) arrangement are not included in taxable wages, the amount that is usually less than the Medicare wages amount on the Form W-2. However, both the Modified Box 1 and Tracking Wages Methods would increase the limitation for this amount. The Unmodified Box Method disregards all 401(k) deferrals, making the W-2 wages and the deduction limit lower than if these amounts were taken into account.

While there is currently no provision that would prohibit taxpayers from changing from one method of calculating W-2 wages to another in any given tax year, taxpayers making those changes will need to make additional calculations.

Because the W-2 wage limitation is computed on the taxpayer's entire wage base and the production activities deduction is based on a limited percentage of a net income number related only to qualified production activities, most taxpayers will not "bump into" the wage limitation.

Employees of Taxpayer. According to the notice, the Forms W-2 used in determining the amount of the taxpayer's total W-2 wages under the methods described above include wages paid to employees or former employees of the taxpayer for employment by the taxpayer. Employees would include corporate officers and common-law employees, but not independent contractors.

Also, the determination of total W-2 wages may take into account any wages paid by another entity and reported by the other entity on Forms W-2, provided that the wages were paid to employees of the taxpayer for employment by the taxpayer. Consequently, an agent or statutory employer cannot use those amounts in its deduction limitation. For example, if the taxpayer is not the common-law employer of the payee but rather the statutory employer because of control of the payment of wages, that payment of wages may not be included in determining W- 2 wages of the taxpayer. Likewise, if the taxpayer is paying wages as an agent of another entity to individuals who are not employees of the taxpayer, the wages may not be included in determining the W-2 wages of the taxpayer.

Essentially, the notice looks to the common-law employer to determine the taxpayer that can include payee wages for purposes of the W-2 limitation. Compensation paid to independent contractors (and by those acting as agents or statutory employers) is excluded for those purposes. But, wages of all common-law employees counts toward the limit, including wages paid to:

- Temporary employees from an employment agency
- Contract employees working under the supervision and control of the taxpayer
- Certain employee-leasing arrangements

> **Observation.** The notice uses the common-law standard to coordinate W-2 wages for employment by the taxpayer with the taxpayer undertaking the qualified production activities.

Corporate Acquisitions. The notice provides guidance when a taxpayer purchases another business if the taxpayer (the successor) acquires a major portion of a trade or business, or a major portion of a separate unit of a trade or business, from another taxpayer (the predecessor). The successor may not take into account wages paid to common-law employees of the predecessor employer for services rendered to the predecessor employer, even if those wages are reported on Forms W-2 furnished by the successor.

SPECIAL RULES

EXPANDED AFFILIATED GROUPS

In general, all members of an expanded affiliated group (EAG) are treated as a single corporation for purposes of §199. An EAG is an affiliated group of includable corporations as defined in IRC §1504(a) determined by substituting "50%" for "80%" each place it appears, and includes insurance companies and corporations that have made an election under the possessions tax credit rules.

Example 27. Corporation A owns 100% of Corporation B and they file a consolidated return. Corporation B owns 75% of Corporation C, so Corporations A, B, and C are an EAG for IRC §199 purposes. In 2005, the A-B-C group determines that it is entitled to a deduction of $12. The separate company taxable incomes and QPAIs are as follows:

	Corp. A	Corp. B	Corp. C
Taxable income	$300	($200)	$300
QPAI	300	(100)	200

The deduction must be allocated to group members in proportion to each member's respective amount (if any) of QPAI. Under the special rule, the A-B group is treated as a single EAG member, and that member's QPAI is 200. Consequently, the $12 deduction is allocated $6 to A-B and $6 to C. The entire $6 allocated to A-B is then allocated to Corporation A, the only consolidated group member with QPAI. Without the special rule, the allocation would be different. The deduction would be allocated between Corporations A and C based on their amounts of QPAI. Corporation A is allocated $7.20 (300 ÷ 500 × 12). Corporation C is allocated $4.80 (200 ÷ 500 × 12). Corporation B has no allocation.

Note. A single deduction is computed for the EAG, and is then allocated among members of the EAG. The statute provides that, except as provided in regulations, the deduction is allocated among the members of the group in proportion to each member's respective amount (if any) of QPAI.

Computation of EAG's QPAD

Under the notice, the QPAD for an EAG is determined by aggregating each member's taxable income or loss, QPAI, and W-2 wages. For that purpose, a member's QPAI is the member's DPGR less the sum of the CGS allocable to such receipts and other costs required to be allocated under the notice. A member's QPAI may be positive or negative. A member's taxable income or loss and QPAI are determined by reference to the member's method of accounting. Under a special rule, for purposes of §199, a consolidated group is treated as a single member of the EAG. That rule applies for all purposes, and is used to compute the taxable income limitation and QPAI, and in allocating the QPAD to members of the EAG.

Based on the statutory exception in §199(c)(7), DPGR does not include any gross receipts derived from related-party transactions if the property that is leased, licensed, or rented stays in the group. The notice does not explicitly address the treatment of other transactions between group members.

Observation. The treatment of transactions between members of an EAG should be further developed in regulations. Transactions between EAG members other than related-party leases, apparently will be recognized even when the property remains in the EAG. If the EAG members do not file a consolidated return, then the sale should result in taxable income and QPAI, both taken into account in the year of the sale. IRC §267 likely defers any losses. If a sale occurs between EAG members who are members of a consolidated group, the resulting gain or loss is not taken into account in determining the selling member's income until a subsequent event occurs.[48] Consequently, the gain or loss should not be taken into account in determining the group's (or the member's) taxable income or QPAI. Specific guidance regarding the treatment of QPAI in that situation would be helpful.

Attribution of Activities

According to the notice, the IRS believes that each member of an EAG should be treated as conducting the activities conducted by each other member for purposes of determining whether gross receipts are DPGR. Therefore, the notice establishes an attribution of activities rule under which "[e]ach member of an EAG is treated as conducting the activities conducted by each other member of the EAG." As a result, production activities engaged in by one member are attributed to another member even if the second member does not engage in qualified production activities.

Example 28. Corporation A and B are members of an EAG. Corporation A manufactures QPP and sells it to Corporation B for $100 in 2005. Corporation A's total costs allocated to the QPP are $50. Corporation B resells the property to unrelated party C in 2005 for $110. Corporation B incurs selling costs and other expenses of $1. Corporation A's sale to Corporation B produces DPGR, because A is selling property that it manufactured. Ordinarily, Corporation B's sale to C would not produce DPGR, because B is merely a reseller. However, under the attribution-of-activities rule, Corporation B is considered to be conducting the qualifying activities of fellow group member A. Consequently, both Corporations A and B have DPGR, assuming all other requirements of §199 are satisfied. Corporation A has QPAI of $50 ($100 - $50 costs) and Corporation B has $9 ($110 - $101 costs).

Anti-Avoidance Rule. The notice states that EAGs cannot engage in transactions "with a princip[al] purpose of qualifying for, or modifying the amount of, the [QPAD]." If it is determined that those transactions have been entered into, adjustments must be made to eliminate the effect of the transaction on the computation of the QPAD.

Allocation of Expanded Affiliated Group's QPAD. The EAG's QPAD is allocated among members of the EAG in proportion to each member's QPAI, if any, regardless of whether the EAG member has taxable income or loss for the tax year and regardless of whether the EAG member has W-2 wages for the tax year. For allocation purposes, if a member has negative QPAI, the QPAI of the member is treated as zero. Under the special rule mentioned above, if the EAG includes members of a consolidated group, the consolidated group is treated as a single corporation for allocation purposes. Once the QPAD is allocated between nongroup members and the consolidated group, a further allocation of the group's portion of the deduction must be made among members of the consolidated group.

Partial-Year Members of the EAG. Under the notice, a corporation must determine whether it is a member of an EAG on a daily basis. If a corporation becomes or ceases to be a member of an EAG, the corporation is treated as becoming or ceasing to be a member of the EAG at the end of the day on which its status as a member changes.

48. Treas. Reg. §1.1502-13

Allocation of Income and Loss: Partial-Year Members. A partial-year member of an EAG is required to allocate its taxable income or loss, QPAI, and W-2 wages between the portion of the tax year during which it is an EAG member and the portion of the tax year during which it is not an EAG member.

The corporation may use one of two allocation methods:

1. **Pro Rata Allocation Method.** Under the pro rata allocation method (the default method), an equal portion of each of the taxable income or loss, QPAI, and W-2 wages for the tax year is assigned to each day of the corporation's tax year. Then items assigned to those days during which the corporation was a member of the EAG are aggregated.

2. **Closing-of-the-Books Method.** Under the closing-of-the-books method, taxable income or loss, QPAI, and W-2 wages for the period during which the corporation was an EAG member are computed by treating the corporation's tax year as two separate tax years. The first tax year ends at the close of the day on which corporation's status as an EAG member changes and the second tax year begins at the beginning of the day after the corporation's status as an EAG member changes. The closing of the books election is irrevocable and is made by filing a prescribed statement with a timely filed (including extensions) federal income tax return.

Coordination with Consolidated Return Allocation Rules. Special allocation rules under Treas. Reg. §1.1502-76 apply in the context of a consolidated group in which a subsidiary becomes or ceases to be a member during a consolidated return year. Those rules take precedence and are applied before any allocation is made under the rules of §199.

Computation for EAG Members with Different Tax Years. If EAG members have different tax years, when determining the QPAD of a member (the computing member) for each EAG member, the computing member is required to take into account the taxable income or loss, QPAI, and W-2 wages that are both:

- Attributable to the period during which the EAG member and the computing member are both EAG members, and

- Taken into account in a tax year that begins after the effective date of IRC §199, and ends with or within the tax year of the computing member for which the QPAD is computed.

Application to Pass-through Entities

The notice specifies that in the case of a partnership, S corporation, estate, trust or other pass-through entity, the deduction is determined at the partner, shareholder, or similar level. According to the notice, the statute is applied in a manner consistent with the economic arrangement of the owners of a pass-through entity. Apparently, this means an owner of a pass-through entity calculates the amount of its deduction by taking into account the owner's distributive or proportionate share of the items allocated or attributable to the entity's qualified production activities, provided those items are not otherwise disallowed by other Code sections. The owner then aggregates items of income or expense (including W-2 wages) allocated or attributable to the entity's qualified production activities, including those expenses directly incurred by the owner that are allocated to the entity's qualified production activities, and the owner's items of income or expense (including W-2 wages) allocated or attributable to its other qualified production activities.

Observation. While the notice does not explicitly provide that the character of an item as a production item passes through to the partner or shareholder, it seems logical that the character should pass through to the partner or shareholder. The notice does not explicitly explain how to determine when a partnership's activities are qualifying activities. But, it is clear that a partnership's items are production items if the partnership's activities are production activities. What is not clear is whether the partnership's nonproduction activities can be combined with someone else's activities to add up to a production activity.

Treatment of Expenses. Each partner or shareholder must take into account its distributive share of expenses allocated to the qualified production activities of the partnership or S corporation, regardless of whether the partnership or S corporation otherwise has taxable income. To the extent there are disallowed losses or deductions because of a lack of basis, the at-risk rules, or the passive activity rules, a proportionate share of the losses or deductions that reflect expenses allocated to qualified production activities are suspended as well. Subsequently, when those losses or deductions are "freed up," the partner or shareholder takes into account (in the year they are freed up) its proportionate share of production activity losses or deductions previously suspended.

Special Allocations. A partnership may specially allocate items of income, gain, loss, or deduction allocated or attributable to the partnership's qualified production activities, subject to the normal IRC §704(b) rules, including the rules for determining substantial economic effect.

W-2 Limitation. While §199 is generally applied at the shareholder, partner or beneficiary level for purposes of applying the wage limitation, each shareholder, partner or similar person that is allocated QPAI from a pass-through entity is treated as having been allocated W-2 wages from the entity equal to the lesser of the person's allocable share of such wages or two times the applicable percentage of the person's QPAI computed taking into account only the items of the pass-through entity allocated to the person for the tax year.[49]

> **Observation.** The special limitation to two times the applicable percentage of the partner or shareholder's QPAI is based only on items allocated from the entity in question. A partner or shareholder who is not allocated any positive QPAI from the entity may not take into account any W-2 wages of the entity for purposes of computing the deduction.

The "50% of W-2 wage" limitation is applied at the entity level first. At the shareholder, partner, or similar person level, each person who is allocated QPAI also is treated as having been allocated wages from such entity in an amount equal to the lesser of:

- Such person's allocable share of wages (as to be determined under forthcoming Regulations), or
- Twice the appropriate deductible percentage of QPAI that is allocated to such person for the taxable year.

Gain or Loss from Disposition of Interests. Because the sale of an interest in a pass-through entity does not reflect the realization of QPAI by that entity, QPAI generally does not include gain or loss recognized on the sale, exchange, or other disposition of an interest in the entity. Nevertheless, some sales or exchanges of a partnership interest (or distributions treated as a sale or exchange) under IRC §751 might give rise to an item of QPAI being taken into account for purposes of the deduction. The notice is not clear on how to determine when items of QPAI are generated when IRC §751 applies.

Effective Date. For pass-through entities, the notice indicates that §199 applies only to tax years that begin on or after January 1, 2005.

> **Observation.** It is important to note that this effective date can cause a partner with a different tax year than the partnership's tax year to lose a portion of that partner's QPAD. While a January 1, 2005, effective date is easier to administer, it is not consistent with the aggregate approach.

[49] IRC §199(d)(1)(B)

Additional K-1 Reporting Requirements. The notice states that the IRS intends to provide rules relating to information reporting by pass-through entities in future guidance.

Overall, the IRS has generally taken an aggregate approach for IRC §199. Essentially, each partner or shareholder separately takes into account its distributive or proportionate share of items of income, gain, loss, or deduction (including gross receipts, costs of goods sold, and W-2 wages) allocable or attributable to qualified production activities performed by the entity. Those items are then aggregated at the partner or shareholder level with other QPAI for the purpose of computing the allowable deduction under IRC §199.

The Schedule K-1 for S corporations is shown on the following page. The items relating to the §199 deduction appear in Box 12 and show the following codes:

- O — Domestic production activities information
- P — Qualified production activities income
- Q — Employer's W-2 wages

671105

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0130

Schedule K-1 (Form 1120S) **2005**

Department of the Treasury
Internal Revenue Service

For calendar year 2005, or tax year beginning ________, 2005 ending ________, 20__

Shareholder's Share of Income, Deductions, Credits, etc.

► See back of form and separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number

B Corporation's name, address, city, state, and ZIP code

C IRS Center where corporation filed return

D ☐ Tax shelter registration number, if any ________

E ☐ Check if Form 8271 is attached

Part II Information About the Shareholder

F Shareholder's identifying number

G Shareholder's name, address, city, state and ZIP code

H Shareholder's percentage of stock ownership for tax year . . . . ________ %

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	13	Credits & credit recapture
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income		
5a	Ordinary dividends		
5b	Qualified dividends	14	Foreign transactions
6	Royalties		
7	Net short-term capital gain (loss)		
8a	Net long-term capital gain (loss)		
8b	Collectibles (28%) gain (loss)		
8c	Unrecaptured section 1250 gain		
9	Net section 1231 gain (loss)		
10	Other income (loss)	15	Alternative minimum tax (AMT) items
11	Section 179 deduction	16	Items affecting shareholder basis
12	Other deductions		
		17	Other information

* See attached statement for additional information.

For Privacy Act and Paperwork Reduction Act Notice, see Instructions for Form 1120S. Cat. No. 11520D **Schedule K-1 (Form 1120S) 2005**

This list identifies the codes used on Schedule K-1 for all shareholders and provides summarized reporting information for shareholders who file Form 1040. For detailed reporting and filing information, see the separate Shareholder's Instructions for Schedule K-1 and the instructions for your income tax return.

1. Ordinary business income (loss). You must first determine whether the income (loss) is passive or nonpassive. Then enter on your return as follows:

	Enter on
Passive loss	See the Shareholder's Instructions
Passive income	Schedule E, line 28, column (g)
Nonpassive loss	Schedule E, line 28, column (h)
Nonpassive income	Schedule E, line 28, column (j)
2. Net rental real estate income (loss)	See the Shareholder's Instructions
3. Other net rental income (loss)	
Net income	Schedule E, line 28, column (g)
Net loss	See the Shareholder's Instructions
4. Interest income	Form 1040, line 8a
5a. Ordinary dividends	Form 1040, line 9a
5b. Qualified dividends	Form 1040, line 9b
6. Royalties	Schedule E, line 4
7. Net short-term capital gain (loss)	Schedule D, line 5, column (f)
8a. Net long-term capital gain (loss)	Schedule D, line 12, column (f)
8b. Collectibles (28%) gain (loss)	28% Rate Gain Worksheet, line 4 (Schedule D instructions)
8c. Unrecaptured section 1250 gain	See the Shareholder's Instructions
9. Net section 1231 gain (loss)	See the Shareholder's Instructions

10. Other income (loss)

Code		
A	Other portfolio income (loss)	See the Shareholder's Instructions
B	Involuntary conversions	See the Shareholder's Instructions
C	Sec. 1256 contracts & straddles	Form 6781, line 1
D	Mining exploration costs recapture	See Pub. 535
E	Other income (loss)	See the Shareholder's Instructions

11. Section 179 deduction — See the Shareholder's Instructions

12. Other deductions

A	Cash contributions (50%)	Schedule A, line 15
B	Cash contributions (30%)	Schedule A, line 15
C	Noncash contributions (50%)	Schedule A, line 16
D	Noncash contributions (30%)	Schedule A, line 16
E	Capital gain property to a 50% organization (30%)	Schedule A, line 16
F	Capital gain property (20%)	Schedule A, line 16
G	Investment interest expense	Form 4952, line 1
H	Deductions—royalty income	Schedule E, line 18
I	Section 59(e)(2) expenditures	See the Shareholder's Instructions
J	Deductions—portfolio (2% floor)	Schedule A, line 22
K	Deductions—portfolio (other)	Schedule A, line 27
L	Reforestation expense deduction	See the Shareholder's Instructions
M	Preproductive period expenses	See the Shareholder's Instructions
N	Commercial revitalization deduction from rental real estate activities	See Form 8582 Instructions
O	Domestic production activities information	See Form 8903 Instructions
P	Qualified production activities income	Form 8903, line 7
Q	Employer's W-2 wages	Form 8903, line 13
R	Other deductions	See the Shareholder's Instructions

13. Credits & credit recapture

Code		Enter on
A	Low-income housing credit (section 42(j)(5))	Form 8586, line 4
B	Low-income housing credit (other)	Form 8586, line 4
C	Qualified rehabilitation expenditures (rental real estate)	Form 3468, line 1
D	Qualified rehabilitation expenditures (other than rental real estate)	Form 3468, line 1
E	Basis of energy property	Form 3468, line 2
F	Other rental real estate credits	See the Shareholder's Instructions
G	Other rental credits	See the Shareholder's Instructions
H	Undistributed capital gains credit	Form 1040, line 70, check box a
I	Credit for alcohol used as fuel	Form 6478, line 4
J	Work opportunity credit	Form 5884, line 3
K	Welfare-to-work credit	Form 8861, line 3
L	Disabled access credit	Form 8826, line 7
M	Empowerment zone and renewal community employment credit	Form 8844, line 3
N	Credit for increasing research activities	Form 6765, line 40
O	New markets credit	Form 8874, line 2
P	Credit for employer social security and Medicare taxes	Form 8846, line 5
Q	Backup withholding	Form 1040, line 64
R	Recapture of low-income housing credit (section 42(j)(5))	Form 8611, line 8
S	Recapture of low-income housing credit (other)	Form 8611, line 8
T	Recapture of investment credit	See Form 4255
U	Other credits	See the Shareholder's Instructions
V	Recapture of other credits	See the Shareholder's Instructions

14. Foreign transactions

A	Name of country or U.S. possession	Form 1116, Part I
B	Gross income from all sources	Form 1116, Part I
C	Gross income sourced at shareholder level	Form 1116, Part I
	Foreign gross income sourced at corporate level	
D	Passive	Form 1116, Part I
E	Listed categories	Form 1116, Part I
F	General limitation	Form 1116, Part I
	Deductions allocated and apportioned at shareholder level	
G	Interest expense	Form 1116, Part I
H	Other	Form 1116, Part I
	Deductions allocated and apportioned at corporate level to foreign source income	
I	Passive	Form 1116, Part I
J	Listed categories	Form 1116, Part I
K	General limitation	Form 1116, Part I
	Other information	
L	Total foreign taxes paid	Form 1116, Part II
M	Total foreign taxes accrued	Form 1116, Part II
N	Reduction in taxes available for credit	Form 1116, line 12
O	Foreign trading gross receipts	Form 8873
P	Extraterritorial income exclusion	Form 8873
Q	Other foreign transactions	See the Shareholder's Instructions

15. Alternative minimum tax (AMT) items

A	Post-1986 depreciation adjustment	See the Shareholder's Instructions and the Instructions for Form 6251
B	Adjusted gain or loss	
C	Depletion (other than oil & gas)	
D	Oil, gas, & geothermal—gross income	
E	Oil, gas, & geothermal—deductions	
F	Other AMT items	

16. Items affecting shareholder basis

A	Tax-exempt interest income	Form 1040, line 8b
B	Other tax-exempt income	See the Shareholder's Instructions
C	Nondeductible expenses	See the Shareholder's Instructions
D	Property distributions	See the Shareholder's Instructions
E	Repayment of loans from shareholders	See the Shareholder's Instructions

17. Other information

A	Investment income	Form 4952, line 4a
B	Investment expenses	Form 4952, line 5
C	Look-back interest—completed long-term contracts	See Form 8697
D	Look-back interest—income forecast method	See Form 8866
E	Dispositions of property with section 179 deductions	See the Shareholder's Instructions
F	Recapture of section 179 deduction	
G	Section 453(l)(3) information	
H	Section 453A(c) information	
I	Section 1260(b) information	
J	Interest allocable to production expenditures	
K	CCF nonqualified withdrawal	
L	Information needed to figure depletion—oil and gas	
M	Amortization of reforestation costs	
N	Other information	

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Application to Cooperatives

An §199 deduction is allowed to cooperatives engaged in manufacturing, production, growth or extraction, and to cooperatives engaged in the marketing of agricultural or horticultural products.[50] A marketing cooperative is treated as having manufactured, produced, grown or extracted the product at issue if its patrons manufactured, produced, grew or extracted the product (this is known as the "cooperative attribution rule").

> **Note.** It is believed that the cooperative attribution rule is intended to apply only to crops received from patrons who are entitled to share in patronage dividends and per-unit retain allocations from the cooperative. If a cooperative obtains a portion of the crop that it markets from others, then the cooperative attribution rule does not apply to them.

If a marketing cooperative has entered into a joint venture with another partnership, LLC or other type of pass-through entity, and the other pass-through entity is not engaged in qualifying activities, the cooperative attribution rule still allows the cooperative to treat its allocable share of the pass-through entity's income and expense as attributable to qualifying activities that give rise to QPAI.

Similarly, the notice provides that the terms "marketing, produced, grown or extracted" also include storage, handling or other processing activities (other than transportation activities) within the United States related to the sale, exchange or other disposition of agricultural products, provided the products are consumed in connection with, or incorporated into the marketing, production, growing or extraction of qualified production property, whether or not by the taxpayer.

Example 29. Sam, Clyde, Jayco Milling, Inc., Super Fresh Bakers and Early Morning Distributors are unrelated taxpayers and all work only in the United States. Sam is a Kansas wheat farmer who stores his wheat in grain bins owned by Clyde. At a later date, Sam sells his wheat to Jayco who produces flour which it sells to Super Fresh. Super Fresh uses the flour to produce bread which it sells to Early Morning Distributors who then wholesales the bread to various supermarkets. When Early Morning delivers the bread to the supermarkets, it picks up unsold bread and takes it to its Day Old stores.

All of the above taxpayers are considered producers and their revenue qualifies as DPGR. The exception might be the day-old bread sales which Early Morning sells in its Day Old stores. However, if the day-old sales are less than 5% of Early Morning's total revenue, they meet the de minimis exception and also qualify as DPGR.

> **Observation.** The rule applies to marketing cooperatives as well as other taxpayers and operates in conjunction with the cooperative attribution rule to determine whether a cooperative is engaged in marketing, production, growing or extraction activities.

The deduction earned by a cooperative is computed based on the cooperative's QPAI without taking into account any of the deductions allowable under IRC §§1382(b) and (c).[51] Cooperatives are allowed to pass some or all of the cooperative's deduction through to patrons if it chooses. This raises a question (which is not answered by either the statute or the notice) of whether the deduction for a cooperative is subject to the W-2 wages limitation at the cooperative level only or whether it is also subject to a second W-2 wages limitation at the patron level if the deduction is passed through to patrons.

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50. IRC §199(d)(3)

51. IRC §199(d)(3)(B)(i) states that "any deduction allowable under IRC §§1382(b) and (c) (related to patronage dividends, per-unit retain allocations, and nonpatronage distributions)" are not taken into account for purposes of computing the deduction.

Both the cooperative and its members are engaged in activities that give rise to QPAI, and both are entitled to the deduction (provided the other requirements of §199 are met). Because a cooperative can pass some or all of the cooperative's deduction through to patrons, a question is raised as to whether patronage dividends are counted as crop receipts at the patron level and thereby enter into the computation of the patrons' QPAI, or whether they are excluded to the extent that they were taken into account in determining the cooperative's IRC §199 deduction.

Note. Neither the statute nor the notice specify how a cooperative's §199 deduction is allocated among its patrons in a pooling arrangement. Hopefully, forthcoming regulations will address the issue.

The statute provides that the portion of the §199 deduction that a cooperative wishes to pass through to a patron must be "designated as such by the organization in a written notice mailed to its patrons during the payment period described in section 1382(d)."[52] The payment period for a year is the "period beginning on the first day of a year and ending with the fifteenth day of the ninth month following the close of such year."[53]

Observation. It is likely that many cooperatives will not know the precise amount of their §199 deduction for a year when patronage dividends are paid, especially for cooperatives that pay patronage dividends relatively soon after year end. To determine the deduction amount, a cooperative's tax return must be substantially complete. IRC §6072(d) provides cooperatives with an extended due date for their tax returns (eight and one-half months after year end).

SUMMARY

Clearly, the new domestic production activity deduction of IRC §199 offers a significant tax benefit for a wide range of taxpayers. It is now critical that potentially eligible taxpayers conduct a thorough analysis of their activities to determine exactly what qualifies for the deduction. Under the guidance provided in the notice, many nontraditional manufacturers engaged in a broad array of production activities may qualify for the deduction in addition to traditional manufacturers. For those taxpayers that can identify qualifying activities, revenue and expense data need to be sufficiently detailed to identify QPAI. That may require the development of new accounting processes and procedures so that the information necessary to substantiate the claimed deduction is preserved.

The new deduction illustrates the issues that arise whenever income from one type of activity is singled out for special treatment. The problems are compounded because, to compute the deduction, income from selected activities, related deductions, and related wages must all be isolated. Apart from the accounting issues, there are special rules to deal with pass-through entities, related taxpayers and groups that are partially domestic and partially foreign. Therefore, it is easy to speculate that the new deduction will be an administrative nightmare. It is also likely the IRS will be forced to police domestic corporations and other potentially eligible taxpayers more closely to ensure that the proper distinction between production activities and other nonqualifying activities. Undoubtedly, the provision adds tremendous complexity to the income tax system.

A further consideration is whether a particular state allows the §199 deduction for state and local tax purposes. How a state handles the new federal deduction could result in additional records that have to be collected and maintained to assure the ability to claim the deduction.

In any event, there are certain basic steps that a taxpayer should take to prepare for the possibility of claiming the deduction.

52. IRC §199(d)(3)(A)(ii)

53. IRC §1382(d)

1. Determine what activities qualify for the deduction. This requires a complete analysis of the activities in which the taxpayer is engaged. The statute is drafted broadly and includes many possible production activities.
2. Collect the necessary data to allow QPAI to be computed. Revenue and expense data must be collected. It is necessary to segregate financial data between qualifying and nonqualifying activities. Therefore, it may be necessary to develop new systems and procedures to properly collect and segregate this information.
3. Develop methods that utilize the cost allocation methods. It is likely that most small businesses can utilize one of the simplified methods that the statute authorizes.
4. Collect and maintain records. Clearly, the deduction requires the collection and maintenance of a great deal of records to substantiate the deduction claimed. This is likely to include a great deal of information that has not been maintained before.
5. Determine the cost associated with claiming the deduction. Because there are substantial costs associated with claiming the deduction, a cost-benefit calculation should be used to determine whether it is worth claiming the deduction.

The new deduction has potentially wide application to many businesses. It is not possible to list all of the business activities that might potentially qualify for the deduction. Perhaps the best way to determine whether a taxpayer is potentially eligible for the deduction is to utilize a checklist for making an initial determination. The following is a suggested approach that incorporates all the primary issues that must be addressed in making an initial determination:

1. Describe the taxpayer's activities that are under consideration for the deduction.
2. What is the level of the taxpayer's anticipated taxable income for the tax year?
3. What do the taxpayer's activities involve? Are they manufacturing, production, growth, extraction, computer software, sound recordings, qualified films? Is the activity a real property construction activity? If so, does the taxpayer sell land? Are architectural or engineering services involved?
4. Does the client own the product being produced? If not, how is the product owned?
5. Do the taxpayer's production activities occur, in whole or in significant part, within the United States?
6. Do the taxpayer's activities result in substantial modification of the products involved?
7. Is the taxpayer presently subject to IRC §263A and in compliance with the cost allocation rules? If not, Form 2553, *Election by a Small Business Corporation,* is required.
8. Does the taxpayer provide services as a part of the sale of the products involved? If so, how?
9. Is the taxpayer a member of an expanded affiliated group?
10. Does the taxpayer provide a warranty for the products involved? If so, what type of warranty is involved?
11. Does the taxpayer pay W-2 wages associated with the activity? If so, what is the level of W-2 wages?
12. Based on items 1-11, is it believed that the activities involved qualify for the manufacturing deduction?

The instructions for Form 8903, *Domestic Production Activities Deduction*, have not been released. Therefore, if O is shown in Box 12, it is not known what information will be included.

Form **8903**

Department of the Treasury
Internal Revenue Service

Domestic Production Activities Deduction

▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-xxxx

2005

Attachment Sequence No. 143

Name(s) as shown on return | Identifying number

1	Domestic production gross receipts	1	
2	Allocable cost of goods sold	2	
3	Directly allocable deductions, expenses, or losses	3	
4	Indirectly allocable deductions, expenses, or losses	4	
5	Add lines 2 through 4	5	
6	Subtract line 5 from line 1	6	
7	Qualified production activities income from pass-through entities: If you are a— **a** Shareholder / **b** Partner. Then enter the total qualified production activities income from— Schedule K-1 (Form 1120S), box 12, code P; Schedule K-1 (Form 1065), box 13, code T; Schedule K-1 (Form 1065-B), box 9, code S2	7	
8	**Qualified production activities income.** Add lines 6 and 7. If zero or less, enter -0- here, skip lines 9 through 15, and enter -0- on line 16	8	
9	Income limitation (see instructions): • Individuals, estates, and trusts. Enter your adjusted gross income figured without the domestic production activities deduction • All others. Enter your taxable income figured without the domestic production activities deduction (tax-exempt organizations, see instructions)	9	
10	Enter the smaller of line 8 or line 9. If zero or less, enter -0- here, skip lines 11 through 15, and enter -0- on line 16	10	
11	Enter 3% of line 10	11	
12	Form W-2 wages (see instructions)	12	
13	Form W-2 wages from pass-through entities: If you are a— **a** Shareholder / **b** Partner. Then enter the total Form W-2 wages from— Schedule K-1 (Form 1120S), box 12, code Q; Schedule K-1 (Form 1065), box 13, code U; Schedule K-1 (Form 1065-B), box 9, code S3	13	
14	Add lines 12 and 13	14	
15	Form W-2 wage limitation. Enter 50% of line 14	15	
16	Enter the smaller of line 11 or line 15	16	
17	Domestic production activities deduction from cooperatives. Enter deduction from Form 1099-PATR, box 6	17	
18	Expanded affiliated group allocation (see instructions)	18	
19	**Domestic production activities deduction.** Combine lines 16 through 18 and enter the result here and on Form 1040, line 35; Form 1120, line 25; Form 1120-A, line 21; or the applicable line of your return	19	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 37712F Form **8903** (2005)

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