Chapter 13: Qualified Production Activities Deduction

Corrections were made to this workbook through January of 2007. No subsequent modifications were made.

INTRODUCTION

In 2005, many practitioners weren't convinced the §199 deduction was applicable or cost-effective for their clients. Consequently, many practitioners failed to evaluate the applicability of the deduction to their clients.

The §199 deduction offers a significant tax benefit for a wide range of taxpayers. It is critical that potentially eligible taxpayers conduct a thorough analysis of their activities to determine exactly what qualifies for the deduction. 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 allow qualified production activities income (QPAI) to be identified. This may require developing 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 income from selected activities, related deductions, and related wages must all be isolated to compute the deduction. 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 conclude that the new deduction will be an administrative nightmare. The IRS may 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 are made. Undoubtedly, the provision adds tremendous complexity to the income tax system.

A further consideration is whether a particular state allows the 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 ensure the ability to claim the deduction.

There are certain basic steps that a taxpayer should take to prepare for the possibility of claiming the deduction.

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 records to substantiate the claimed deduction. This is likely to include information that was not 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. The new deduction affects 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.[1] The deduction applies to any business that manufactures, produces, grows or extracts qualifying production property in the United States.

The following are examples of some types of businesses and business activities which apply to this deduction:

- Traditional manufacturers of personal property
- Home builders, excluding the cost of land
- Subcontractors on new real estate construction projects such as:
    - Electricians
    - Plumbers
    - Heating and air conditioning contractors
    - Concrete contractors
    - Landscapers
    - Road construction
    - Carpet installation
    - Drywall contractors
    - Bricklayers
- Condo conversion projects
- Agricultural production including crops, livestock, and dairy
- Furniture manufacturers
- Trailer manufacturing
- Equipment leasing

1. A patron of a cooperative cannot use the cooperative's W-2 wages for purposes of the deduction.

- Slaughterhouses that sell wholesale
- Video production
- Oil production
- T-shirt shops that purchase T-shirts and screen print images
- Print shops that print and sell calendars
- Newspapers
- Book printers
- Tire production
- Ammunition manufacturers

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, producing, growing, extracting? Are they computer software, sound recordings, or 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, do the activities qualify for the manufacturing deduction?

Note. A helpful qualified production activity deduction evaluation tool is found on the University of Illinois Tax School website at **www.ace.uiuc.edu/taxschool/tools.htm.**

Form **8903**

Department of the Treasury
Internal Revenue Service

Domestic Production Activities Deduction

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

OMB No. 1545-1984

2006

Attachment Sequence No. 143

Name(s) as shown on return | Identifying number

1	Domestic production gross receipts (DPGR)		1
2	Allocable cost of goods sold. If you are using the small business simplified overall method, skip lines 2 and 3	2	
3	If you are using the section 861 method, enter deductions and losses definitely related to DPGR. Estates and trusts, see instructions. All others, skip line 3	3	
4	If you are using the section 861 method, enter your pro rata share of deductions and losses not definitely related to DPGR. All others, see instructions	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—	Then enter the total qualified production activities income from—
a Shareholder	Schedule K-1 (Form 1120S), box 12, code Q
b Partner	Schedule K-1 (Form 1065), box 13, code U
	Schedule K-1 (Form 1065-B), box 9, code S2
c Beneficiary	Schedule K-1 (Form 1041), box 14, code C

7		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—	Then enter the total Form W-2 wages from—
a Shareholder	Schedule K-1 (Form 1120S), box 12, code R
b Partner	Schedule K-1 (Form 1065), box 13, code V
	Schedule K-1 (Form 1065-B), box 9, code S3
c Beneficiary	Schedule K-1 (Form 1041), box 14, code D

13		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

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QUALIFIED PRODUCTION ACTIVITIES DEDUCTION (IRC §199)

Note. For the convenience of the reader, changes to the §199 qualified domestic production activity deduction are incorporated into last year's material. Therefore, portions of this chapter may look similar to the 2005 workbook. Paragraphs describing changes in the law and regulations are identified by a flag icon like the one shown at left. This may help readers quickly determine what's new.

HISTORY

The American Jobs Creation Act of 2004 (AJCA) enacted IRC §199, a new deduction, on a phased-in basis through 2009. The §199 deduction is related to certain production activities that occur in the United States. It replaces an export tax benefit which the World Trade Organization (WTO) determined was in violation of international trade agreements. The AJCA repealed the Extraterritorial Income Exclusion Act of 2000 (ETI), with transition rules that allowed taxpayers to receive 80% of their otherwise applicable ETI benefits for transactions entered into in 2005, and 60% for transactions entered into in 2006. However, the AJCA allowed the full ETI exclusion for binding contracts between taxpayers and any unrelated persons for contracts in effect on September 17, 2003, and at all times thereafter.

In February of 2006, the WTO's Appellate Body ruled that the ETI transitional rule and the exception for certain binding contracts remained in violation of international trade agreements. That ruling was formally adopted in March 2006. Thus, the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) repealed the grandfathered binding contract provision of ETI and Foreign Sales Corporation which were created under AJCA. The TIPRA was effective for tax years beginning after May 17, 2006.

Note. For a full discussion of the Extraterritorial Income Exclusion Act of 2000, see Chapter 15 of the *2005 University of Illinois Federal Tax Workbook*, pages 598–604. In addition, see the *2004 University of Illinois Federal Tax Workbook*, pages 421–428.

The AJCA, signed on October 22, 2004, was the most sweeping piece of tax legislation since 1986. The most significant part of the AJCA is the qualified production activities deduction (QPAD), created under Section 102 of the AJCA. Newly enacted IRC §199 creates a phased-in deduction for many domestic manufacturing and production businesses, as well for many businesses engaged in activities that have not traditionally been viewed as manufacturing.

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. IRC §199 applies to **all** businesses with qualified production income. It also applies to C corporations, S corporations, partnerships, sole proprietorships, cooperatives, and limited liability companies.

A variety of clarifications regarding how to apply the deduction were made by the Treasury between January 19, 2005 and May 25, 2006.

Date	Pronouncement	Purpose
January 19, 2005	Notice 2005-14	To assist taxpayers in calculating the deduction in lieu of regulations
October 21, 2005	Proposed Treasury Regulations	Included many of the rules contained in the notice
December 6, 2005	Tax Technical Corrections Act of 2005	Contained several technical corrections to the underlying statute
May 17, 2006	Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA)	Changed information on W-2 wages and pass-through entities
May 25, 2006	Final Treasury Regulations	Made regulations applicable to tax years beginning on or after June 1, 2006

IRC §199 Application Dates	Application
Tax years on or before May 17, 2006	Taxpayer may apply Temp. Treas. Reg. §§1.199-1 through 1.199-9, provided the taxpayer applies all the provisions in the treasury regulations.
Tax years after May 17, 2006, but before June 1, 2006	Taxpayer may apply Temp. Treas. Reg. §§1.199-1 through 1.199-8. Taxpayer may not rely on the Notice, the final regulations, or any other guidance that is inconsistent with the amendments to the statute made by TIPRA. Taxpayer who chooses not to rely on the final treasury regulations for a tax year beginning before June 1, 2006, may rely on the Notice as well as the proposed regulations.

IRC §199 contains many new terms which may be unfamiliar to tax preparers. The following acronyms are used throughout this chapter.

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

CALCULATING THE DEDUCTION

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

- The qualified production activities income (QPAI) for the taxable year, or
- Taxable income (determined without regard to IRC §199) for the taxable year — or, in the case of an individual, the lesser of the individual's QPAI or modified adjusted gross income (MAGI).[2]

The deduction is not taken into account in computing net operating loss (NOL) or the amount of NOL carryback or carryover. Thus, the deduction cannot create or increase the amount of an NOL deduction.[3]

The deduction increases to 6% for taxable years beginning in 2007, and continues through 2009. After 2009, the deduction is 9%.

The deduction is limited to 50% of W-2 wages paid during the calendar year to common law employees. The deduction applies to W-2 wages 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). This 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) and 457.[4]

The deduction is allowed for alternative minimum tax (AMT) purposes. The AMT deduction is determined by reference to the lesser of the qualified production activities income (QPAI), as determined for regular tax or the alternative minimum taxable income (AMTI) without regard to this deduction.[5]

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

DOMESTIC PRODUCTION GROSS RECEIPTS (DPGR)

Qualifying Activities

The first step in calculating the §199 deduction is to segregate activities among qualified and nonqualified production activities. Qualified production activities (QPA) involve qualified production property (QPP) and generate domestic production gross receipts (DPGR).

DPGR is used to determine the taxpayer's qualified production activity income (QPAI). For both 2006 and 2005, a taxpayer is entitled to claim a deduction equal to 3% of the lesser of QPAI **or** taxable income (AGI for an individual taxpayer).

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2. For individuals, MAGI is AGI after application of IRC §§86, 135, 137, 199, 219, 221, 222, and 469.

3. 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.

4. IRC §199(d)(6)

5. IRC §199(d)(6) provides that, for purposes of determining AMTI under IRC §55, QPAI shall be determined without regard to any adjustments under IRC §§56-59.

QPAI 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 is not directly allocable to such receipts or another class of income.[6] However, any item or service brought into the United States is treated as acquired by purchase at a cost not less than its FMV immediately after entering the United States. A similar rule is applied to determine the adjusted basis of leased property when the lease "gives rise to domestic production gross receipts."[7] In the case of property previously exported 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 property's value when re-imported into the United States after the additional manufacturing activity.[8]

Note. In Notice 2005-14,[9] the IRS takes the position 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). The final regulations retain this requirement, but limit the item-by-item standard to determining DPGR.[10] The final regulations define an "item" as the property offered for sale to customers in the normal course of business, whether as a retailer or wholesaler. If the property offered for sale does not meet all of the requirements for the deduction, the taxpayer must treat as the "item" any portion of the property offered for sale that meets all of these requirements.

DPGR[11] is defined in terms of 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:[12]

1. The manufacture, production, growth, or extraction (MPGE) in whole or in significant part within the United States of tangible personal property, computer software, or sound recordings
2. Construction of real property performed in the United States
3. Engineering and architectural services performed in the United States for construction projects in the United States
4. Certain types of film production
5. The **production** of electricity, natural gas, or potable water in the United States[13]
6. Gains or losses on hedges, if the hedge involves the purchase of supplies used in the business[14]

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6. IRC §199(c)(1)
7. IRC §199(c)(3)(A)
8. IRC §199(c)(3)(B)
9. IRB 2005-7, 498, Sec. 4.03(1)
10. Treas. Reg. §1.199-3 describes the item-by-item standard with numerous examples.
11. IRC §199(c)(4)
12. The "trade or business" requirement is contained in IRC §199(d)(5).
13. IRC §199(c)(4)(A)(i-iii)
14. Treas. Reg. §1.199-3(h)(3)(i)(C)

DPGR **does not include** gross receipts derived from:

1. The sale of food or beverages, including food and beverages for nonhuman consumption, prepared by the taxpayer at a retail establishment
2. The transmission or distribution of electricity, natural gas, or potable property
3. The lease, rental, license, sale, exchange, or other disposition of land
4. Property that is leased, licensed, or rented by the taxpayer for use by any related person

Note. A person is treated as "related" if both are treated as a single employer under either IRC §52(a) or (b), without regard to IRC §1563(b) or IRC §414(m) or (o).[15] However, the regulations include exceptions for situations in which the property is leased to a related person. This applies if the property is held for sublease or is subleased to an unrelated person for the ultimate use of the unrelated person. It also applies if it is licensed to a related person for reproduction and sale, exchange, lease, or rental, or sublicensed to an unrelated person for the ultimate use of the unrelated person.[16]

What Does "Trade or Business" Mean?

The statute states that "this section shall be applied by only taking into account items which are attributable to the actual conduct of a trade or business."[17] Notice 2005-14 and the proposed regulations mirrored the statute with identical language. The final regulations provide no clarification as to what level of activity constitutes a "trade or business." This is a major issue for taxpayers who are landlords, but are not materially participating under the lease.

Existing Tests for "Trade or Business"[18]

Income averaging for farmers and fishermen is the least demanding trade or business test.[19] Under this provision, share rent lease income is treated as income from a farming business (eligibility for income averaging is dependent upon the taxpayer being engaged in a farming business). Whether the landlord is participating in the operation is immaterial.[20] Therefore, if this test can be used for §199 purposes, a nonmaterially participating share rent landlord (at least in the context of farmers and ranchers) appears to be eligible.

Expense method depreciation is another possible test. This requirement specifies that the taxpayer must "meaningfully participate" in the management or operations of the trade or business.[21] The regulations establish a facts-and-circumstances test for determining whether the test is satisfied.[22]

Material participation that is utilized for **self-employment tax** is a third test possibility.[23] This 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.[24]

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15. Treas. Reg. §1.199-3(b)(1)
16. Treas. Reg. §1.199-3(b)(2)
17. IRC §199(d)(5)
18. This section is drawn largely from Neil E. Harl and Roger A. McEowen, *Farm and Ranch Income, Bureau of National Affairs Tax Management Portfolio,* TM 608-2nd (2006).
19. IRC §1301
20. Treas. Reg. §1.1301-1(b)(2)
21. Treas. Reg. §1.179-2(c)(6)(ii)
22. Ibid
23. The other provisions include the material participation test for purposes of recapture under a special use valuation election or a qualified family-owned business deduction for a decedent's estate.
24. IRC §1402(a)(1)

The **active management** test is another alternative 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.[25]

Material participation for purposes of determining **passive activity under the passive loss rules**[26] is perhaps the most demanding test. It was imposed in 1986. This meaning requires that the taxpayer be involved in the activity on a "regular, continuous, and substantial" basis.[27]

> **Note.** 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 "trade or business" will be imposed is an important one. 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.

Summary. What is currently known is that passive rental income from real estate does not give rise to DPGR. Where the line is drawn between a passive rental situation and the conduct of a trade or business remains in doubt and needs to be clarified by the Treasury. It is believed, however, that **materially participating landlords** should be eligible based upon the fact that they are deriving income from a share of production rather than from land rent. The remaining question is whether nonmaterial participation landlords are eligible for the deduction based on management input under the lease.

MANUFACTURED, PRODUCED, GROWN, OR EXTRACTED (MPGE) (#1 ON PAGE 468)

The statute does not define **manufacturing.** It does not provide guidance about when a taxpayer is considered engaged in activities that "manufacture, produce, grow or extract" property. However, the notice and final regulations state that the phrase "manufactured, produced, grown, or extracted" includes activities related 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
- Cultivating soil, raising livestock, fishing, and mining minerals

> **Note.** Under the final regulations, gross receipts from mineral royalties and net profits interests, other than those derived from operating mineral interests, are treated as returns on passive interests in mineral properties, with the owner making no expenditure for operation or development, and are not treated as DPGR.[28]

- 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

25. IRC §2032A(b)(5)
26. IRC §469(c)(1)
27. IRC §469(h)(1)
28. Treas. Reg. §1.199-3(h)(9)

Example 1. Abe, Bob, and Chuck are unrelated. Abe owns grain storage bins in Kansas. Abe stores Bob's wheat in the bins and charges a storage fee. Bob grew his wheat in Kansas. Bob sells his wheat to Chuck, a processor of wheat who processes Bob's wheat into flour in Kansas. Chuck stores flour in Don's warehouse until it is sold to a local bakery.

The gross receipts from Abe's storage activity, Bob's wheat farming activity, and Chuck's processing activity are DPGR. Don's income from the flour's storage in his warehouse is not DPGR. Don's activity does not involve the rental of a grain production facility.

Example 2. Tex places his hogs in the Swine Place feedlot. The fees Swine Place collects on Tex's pigs are not DPGR. Only income attributable to pigs owned by Swine Place generates DPGR. To constitute DPGR, the taxpayer must bear the burdens and benefits of ownership.

Observation. The taxpayer must have the **benefits and burdens of ownership** of the QPP during the period of the MPGE activity in order for the applicable gross receipts to qualify as DPGR.

Packaging, repackaging, labeling, and minor assembly of QPP does not qualify as MPGE if the taxpayer engages in no other MPGE related to that qualified property.[29] This is also the case for "installing" QPP if the taxpayer engages in no other MPGE related to it.[30] However, if the taxpayer installs QPP that is MPGE by the taxpayer, and (except for government contracts) he has the **benefits and burdens of ownership** of the QPP during the installing activity period, then the portion of the installing activity that relates to the QPP is MPGE.

Example 3. Ike Yoder manufactures furniture in the United States. He sells this furniture to unrelated persons. Ike also purchases pens and pencils from unrelated persons. He engraves customers' names on them and sells them to his customers.

Ike's sales of furniture qualifies as DPGR. Ike's status as manufacturer of furniture in the United States does not carry over to his other activities. Consequently, Ike's sales of engraved pens and pencils does not qualify as DPGR because he does not manufacture or produce the pens and pencils.

A taxpayer that manufactures, produces, grows, or extracts QPP for the taxable year should treat itself as a producer under IRC §263A for the QPP unless the taxpayer is not subject to IRC §263A.[31]

"In Whole or Significant Part." Taxpayers wishing to claim a deduction must establish that the property was manufactured, produced, grown, or extracted by the taxpayer "in whole or a significant part within the United States."[32] If a taxpayer imports QPP that is partially manufactured, and he completes the manufacturing process in the United States, and his manufacturing process satisfies the "in significant part" requirement, then the taxpayer's gross receipts from the sale of the QPP qualifies as DPGR.

If the taxpayer manufactures QPP in significant part in the United States and exports the QPP for further manufacture outside the country, the taxpayer's gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of that QPP is considered DPGR, regardless of whether the QPP is imported back into the United States before the lease, rental, license, sale, exchange, or other disposition of the QPP.

The final regulations do not change the two tests described in Notice 2005-14 for determining whether QPP is considered to be MPGE in significant part: a substantial-in-nature test, and a safe-harbor test.[33]

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29. Treas. Reg. §1.199-3(e)(2)
30. Treas. Reg. §1.199-3(e)(3)
31. Treas. Reg. §1.199-3(e)(4)
32. IRC §199(c)(4)(A)(i)(I)
33. Treas. Reg. §1.199-3(g)(2) and (g)(3)

Test 1: "Substantial in Nature"

Based on all the taxpayer's facts and circumstances, if the taxpayer's MPGE activity in the United States is substantial in nature, the first test is satisfied. 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.[34]

> **Note.** The final regulations specifically provide 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 is treated as MPGE that is substantial in nature within the United States.[35]

Test 2: Cost Safe Harbor

Under the cost safe-harbor 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. The requirement is also satisfied when a transaction not involving cost to the taxpayer (e.g., a lease, rental, or license) accounts for **20% or more of the taxpayer's unadjusted depreciable basis of the QPP.**[36]

Example 4. ChewChew Twain, Inc., buys a small engine and various parts and materials for $100. At its factory in Indiana, it incurs $30 in labor costs to fabricate a remote control toy train from the materials and to assemble it. ChewChew also incurs $3 in cost for packaging, and selling and sells the toy train in 2006 for $145. The toy train is considered manufactured by the taxpayer in "significant part" because ChewChew's labor costs are more than 20% of the total cost for the tractor ($30 ÷ ($30 + $100) = 23.1%). ChewChew's deduction is 3% of the $12 ($145 – $133) profit on the train or 36¢.

> **Note.** Two categories of activities or costs generally are 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.

Implications for Packaging Activities. A taxpayer generally cannot qualify for the deduction if his only activities in the United States are packaging and labeling property produced outside of the United States.

Example 5. Soft Hand Co.'s United States activities consist solely of affixing a label to a fancy glass bottle of hand lotion that is otherwise manufactured entirely outside the United States. Soft Hand'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 for the labeling activity. However, a question exists concerning whether the label operation could be taken into account in combination with other activities in determining whether the overall United States operations are substantial in nature.

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34. Treas. Reg. §1.199-3(g)(2)
35. Treas. Reg. §1.199-3(g)(5), Ex. 2
36. Treas. Reg. §1.199-3(g)(3)

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.[37] 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. 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. A manufactured product should be broken down into a tangible component and an intangible component. 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.

What Does "By the Taxpayer" Mean? The §199 deduction requires that the taxpayer be engaged directly in MPGE of the underlying QPP. As such, only one taxpayer may claim the deduction for the same qualifying activity.[38] This has implications for products manufactured under contract because only the taxpayer having the benefits and burdens of ownership of the QPP during the period in which the qualifying activity occurs is treated as engaging in the qualifying activity.[39]

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 to the transaction is entitled to the deduction for its own manufacturing activities depends on whether 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, fee, or manufacturing arrangement), the taxpayer is eligible for the deduction and the third party is not. This is regardless of whether 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. This is usually determined by which party bears the carrying and insurance costs associated with the inventory.

Example 6. Lucille enters into an agreement with Arnie (an unrelated customer) to manufacture 500 widgets for Arnie. Under the statute, either Lucille or Arnie (but not both) are treated as having manufactured the widgets for purposes of manufacturing, producing, growing, or extracting QPP.

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

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37. In Ltr. Rul. 200328002, March 24, 2003, the IRS ruled that taxpayers providing packaging services to unrelated customers were producers within the meaning of IRC §263A.

38. Treas. Reg. §1.199-3(f)(1)

39. Ibid

> **Note.** The rule is applicable to qualifying transactions involving QPP as well as transactions involving: (1) qualified films 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.

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. A question remains as to whether the taxpayer would also be eligible for the deduction to the extent he independently engages in qualifying activities regarding the QPP. It is likely that those qualifying activities would not give rise to a deduction simply because contract manufacturing was undertaken as part of the process.

Example 7. Great Lakes 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 Great Lakes, which completes the process. Since both Great Lakes and U.S. Steel had ownership of the product, each can include their revenue in DPGR.

If Great Lakes 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.

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 the added value in excess of the producer's cost is QPAI.

Example 8. Lyme Mining Co. extracts minerals which it sells to Cooper Steel Co., which renders the minerals into metals. Cooper Steel Co. sells the metals to Ashland Equipment Co., which molds the metal into farm equipment. Ashland Equipment Co. then sells the farm equipment to Wonder Farm Wholesale Co., which sells the farm equipment to the public at retail. Lyme Mining Co., Cooper Steel Co., and Ashland Equipment Co. (but not Wonder Farm Wholesale Co.) are producers that derive QPAI by reason of their presence in the chain of production.

Inconsistency with IRC §263A. Unless provided otherwise in the final regulations, only one taxpayer may claim the §199 deduction for the same qualifying activity (i.e., for the same MPGE of the same QPP) or the same production of a qualified film or utilities.[40] Consequently, if one taxpayer performs a qualifying activity under a contract with another party, then only the taxpayer that bears the benefits and burdens of ownership of the QPP during the period in which the qualifying activity occurs is treated as engaging in the qualifying activity.

> **Note.** The benefits and burdens standard under §199 is not the same as those established for purposes of IRC §§263A and 936. Thus, ownership is not determined by simply examining which party has title to the property, but on a range of factors.

40. Treas. Reg. §1.199-3(f)(1)

Special Exceptions. Gross receipts derived from the MPGE of QPP are treated as DPGR if:

- The QPP is MPGE by the taxpayer under a contract with the federal government and the Federal Acquisition Regulation requires that title or risk of loss for the QPP be transferred to the federal government before the MPGE of the QPP is completed.[41]
- A subcontractor enters into a contract or agreement to MPGE QPP on behalf of a taxpayer to which the special rule for certain government contracts applies, and the Federal Acquisition Regulation requires that title or risk of loss for the receipts derived from the MPGE of QPP is treated as gross receipts derived from the lease, rental, license, sale, exchange or other disposition of QPP MPGE by the subcontractor in whole or in significant part within the United States.[42]

Further Distinctions between IRC §§263A and 199. The regulations under IRC §263A regard one as a producer if the taxpayer is a tax owner of the property being produced. The IRS interpreted those 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.[43] 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. Therefore, it appears that in contract manufacturing settings, only one of the contracting parties is entitled to the §199 deduction.

However, the Statement of Managers that accompanied the AJCA describes in a footnote:

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 the property is 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.

IRC §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.

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

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41. IRC §199(c)(4)(C), added on a retroactive basis by the Gulf Opportunity Zone Act of 2005

42. Treas. Reg. §1.199-3(f)(3)

43. IRC §263A(g)(2) provides that a taxpayer is to be 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, for example, *Suzy's Zoo v. Commr.*, 273 F3d 875 (9th Cir. 2001), November 21, 2001.

What Does "In the United States" Mean? While the statute does not define "United States," the final regulations define 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. "United States" does not include possessions and territories of the United States, or the airspace over the United States and its possessions.[44]

TANGIBLE PERSONAL PROPERTY

Definition

The final regulations define "tangible personal property" as any tangible property other than land, real property,[45] computer software,[46] sound recordings,[47] qualified films,[48] and utilities.[49] In addition, the final regulations include any gas (other than natural gas), chemicals, and similar property (e.g., steam oxygen, hydrogen, and nitrogen) in the definition of tangible personal property.

Conversely, the final regulations define "real property" as buildings (including structural components), inherently permanent structures other than machinery, inherently permanent land improvements, oil and gas wells, and infrastructure. Structural components of buildings and inherently permanent structures include property such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property. In addition, an entire utility plant including both the shell and the interior constitutes an inherently permanent structure.

Property that is not real property in the hands of the taxpayer, but that may be incorporated into real property by another taxpayer is **not** treated as real property by the producing taxpayer (e.g., bricks, nails, paint, and windowpanes).

TANGIBLE PERSONAL PROPERTY 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 (i.e., video cassettes, computer diskettes, or other similar tangible items). Books, magazines, newspapers, and similar intellectual or creative property embodied on any tangible medium and mass distributed may also meet the definition of tangible personal property.

> **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 QPP as long as the property is MPGE 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 QPA.

44. Treas. Reg. §1.199-3(h)
45. As described in the construction rules in Treas. Reg. §1.199-3(m)(1)
46. As described in Treas. Reg. §1.199-3(j)(3)
47. As described in Treas. Reg. §1.199-3(j)(4)
48. As described in Treas. Reg. §1.199-3(k)(1)
49. As described in Treas. Reg. §1.199-3(l)

For qualified films, computer software, and sound recordings, the means by which the property is distributed may control whether the taxpayer qualifies for the §199 deduction. For example, gross receipts derived from the sale of magazine subscriptions and related advertising qualifies as DPGR if the words are embodied on a tangible medium. However, income from online subscriptions and advertising to the very same publication fails to qualify because the intellectual or creative property is not affixed to a tangible medium.

Computer Software. Computer software refers to any program, routine, or 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.[50] 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."[51]

> **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.

Example 9. Steve Duti 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. 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.[52] 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.

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.

50. Treas. Reg. §1.199-3(j)(3)(i). Thus, an electronic book that is available online or for download is not computer software.

51. As the term is defined in IRC §168 (i)(2)(B)

52. Treas. Reg. §1.199-3(j)(3)(iii)

Sound Recordings. The final regulations do not change the definition specified in Notice 2005-14. Sound recordings refer to work that results from the fixation of a series of musical, spoken, or other sounds under IRC §168(f)(4).[53] The definition is limited to the master copy of the recordings and, if the medium in which the sounds are embodied is tangible (such as compact discs, tapes or other phonorecordings), then the medium is considered tangible personal property.

Example 10. Flutist Eric 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, it is likely that digital music, audio and other sound recordings are qualified property.

Film Production. The final regulations do not change the definition specified in Notice 2005-14. A qualified film is any motion picture film or 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 paid by the taxpayer for services performed in the United States by actors, production personnel, directors, and producers.[54] Production personnel include writers, choreographers, and composers providing services during the production of a film, casting agents, camera operators, set designers, lighting technicians, makeup artists, and others whose activities are directly related to the film's production.

Under the proposed regulations (applicable for tax years before June 1, 2006), individuals not included as production personnel for purposes of determining compensation for services in the United States are those 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.

Note. The final regulations clarify that the list of production personnel is not exclusive, and that compensation for services includes all direct and indirect compensation costs required to be capitalized under Treas. Reg. §1.263A-1(e)(2)-(3).

The 50% requirement is determined by reference to all compensation paid in the production of the film and is calculated by using a fraction. The numerator of the fraction is compensation paid for production services performed in the U.S., and the denominator is the sum of the total compensation paid by the taxpayer to all such individuals regardless of where the production services are performed and the total compensation paid by others to all such individuals regardless of where the production services are performed.[55]

53. Treas. Reg. §199-3(j)(4)

54. IRC §199(c)(6)

55. Treas. Reg. §1.199-3(k)(5)

Example 11. Xavier creates a television program in the United States that includes scenes from films licensed by Xavier from unrelated persons, Myra and Zach. Myra and Zach produced the films licensed by Xavier.

The not-less-than-50%-of-total-compensation requirement is determined by reference to all compensation paid in the production of the television program, including the films licensed by Xavier from Myra and Zach. It is calculated using a fraction. The numerator of the fraction is the compensation paid by Xavier to actors, production personnel, directors, and producers for production services performed in the United States, and the denominator is the sum of the total compensation paid by Xavier to such individuals regardless of where the production services are performed and the total compensation paid by Myra and Zach to actors, production personnel, directors, and producers relating to the production of the films licensed by Xavier (regardless of where the services are performed).

However, for purposes of calculating the denominator, in determining the total compensation paid by Myra and Zach, Xavier need only include the total compensation paid by Myra and Zach to actors, production personnel, directors, and producers for the production of the scenes used by Xavier in creating its television program.

Electricity, Natural Gas, or Potable Water

The statute defines DPGR to include activities related to the production of electricity, natural gas, and potable water by the taxpayer in the United States.[56] Specifically, DPGR includes the taxpayer's gross receipts 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 income related to the **transmission or distribution** of electricity, natural gas, and potable water is **not** included in DPGR.

Income Segregation Required. 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.

Like Notice 2005-14, the final regulations contain 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.[57]

Example 12. Appalachian 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.

Appalachian Water 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.

The final regulations clarify that gross receipts attributable to the **transmission of electricity** from the generating facility to a point of local distribution and gross receipts attributable to the distribution of electricity to customers are nonDPGR.

56. IRC §199(c)(4)(A)(i)(III)

57. Treas. Reg. §1.199-3(l)(4)(iv)

Example 13. Samantha owns a wind turbine in the United States that generates electricity. Pricey Power Co. owns a high voltage transmission line that passes near Samantha's wind turbine and ends near the system of local distribution lines of Voltage Co. Samantha sells the electricity produced at the wind turbine to Voltage Co. She contracts with Pricey Power Co. to transmit the electricity produced at the wind turbine to Voltage Co., who sells the electricity to customers using Voltage Co.'s distribution network. The gross receipts received by Samantha from the sale of electricity produced at the wind turbine are DPGR, but the gross receipts of Pricey Power Co. derived from transporting Voltage Co.'s electricity are non-DPGR.

The notice and final regulations define **natural gas** in a manner consistent with IRC §613A(e)(2), and include only natural gas extracted from a natural deposit. They do 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, there is not a specific 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 producers of the property for purposes of §263A. A determination of whether, under the same facts, those utilities are producers requires a benefits-and-burdens-of-ownership analysis.

Potable water refers to unbottled drinking water. Qualified production activities include the:

- Acquisition, collection, and storage of raw water (untreated water)
- Transportation of raw water to a treatment facility
- Treatment of the raw water at the facility[58]

However, after the water is treated, storage and delivery of the water are not considered qualified production activities.[59]

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

Note. More information about the exclusion of tangible personal property can be found in the *2005 University of Illinois Federal Tax Workbook,* Chapter 15.

58. Treas. Reg. §1.199-3(l)(3)

59. Treas. Reg. §1.199-3(l)(4)

CONSTRUCTION PERFORMED IN THE UNITED STATES (#2 ON PAGE 468)

DPGR includes receipts derived from the taxpayer's construction of real property in the United States in the ordinary course of the taxpayer's construction trade or business.[60] Construction refers to the construction or erection of real property — residential and commercial buildings, including structural components and inherently permanent land improvements and structural components. **The construction of oil and gas wells involves the construction of real property.**

Four requirements must be satisfied to qualify for the §199 deduction 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.

Real Property

Construction refers to the construction or erection of real property. Real property is defined as:

- Residential and commercial buildings (including the structural components of such buildings)[61]
- Inherently permanent structures other than tangible personal property in the nature of machinery (e.g., walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators)
- Inherently permanent land improvements (e.g., swimming pools, roads, bridges, tunnels, paved parking areas and other pavements, special foundations, wharves and docks, fences, advertising displays, outdoor lighting facilities, railroad tracks and signals, telephone poles, power generation and transmission facilities, installed telecommunications cables, broadcasting towers, oil and gas pipelines, derricks and storage equipment, grain storage bins and silos) made in connection with the erection or substantial renovation of real property
- Infrastructure (e.g., roads, power lines, water systems, railroad spurs, communication facilities, sewers, sidewalks, cable, wiring, and inherently permanent oil and gas platforms)[62]

DPGR derived from the construction of real property **does not include** gross receipts attributable to the **sale or other disposition of land.**

Observation. Taxpayers should perform valuations of land before construction activities begin to substantiate DPGR derived from construction.

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60. IRC §199(c)(4)(A)(ii), as amended by the 2005 Gulf Opportunity Zone Act, P.L. 109-135, §403(a)(5).

61. 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.

62. Treas. Reg. §1.199-3(m)(4)

De Minimis Rule for Construction Industry. Although tangible personal property (e.g., appliances, furniture, and fixtures) is not considered real property, the regulations establish 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,[63] the taxpayer's total gross receipts derived from the construction project can be treated as DPGR from construction. This 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 14.** Tom is a home builder and sells homes containing appliances and carpeting. Tom completes construction on a home that he sells for $250,000. Tom may treat the entire sales proceeds as DPGR as long as less than 5% of the gross receipts are derived from the appliances, carpeting, and any other tangible personal property.

> **Note.** Tangible personal property that is sold as part of a construction project is not considered real property. Property may not be real property even though it is considered real property under local law. Conversely, property may be real property even though it is not considered real property under local law.[64]

Construction Trade or Business

At the time of the construction activity, the taxpayer must be engaged in a trade or business that is considered construction for purposes of the North American Industry Classification System (NAICS) codes. Only construction activity by a taxpayer in a trade or business that is considered construction is eligible for the QPAD.[65] That includes activities under NAICS Code 23 and any other construction activity in any other NAICS code relating to the construction of real property.[66]

Under the NAICS definitions, the construction sector includes businesses that are primarily engaged in a variety of activities, including land development, land subdivision, general contracting, infrastructure construction, and many specialty subcontracting trades.

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 regulations clarify that a taxpayer is classified within a construction NAICS code only if the taxpayer is engaged in a construction trade or business on a regular and ongoing basis. However, such trade or business need not be the taxpayer's primary, or only, business. This is an important issue for taxpayers engaged in multiple activities. Such taxpayers must determine their primary business activity.

> **Note.** The IRS could utilize a "principal business activity" test as described in Rev. Proc. 2002-28.[67] 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 3-year-average test.

63. Treas. Reg. §1.199-3(m)(1)(iii)(A)
64. Treas. Reg. §1.199-3(m)(1)(i)
65. The NAICS codes are available at **www.census.gov/epcd/www/naics.html.**
66. Treas. Reg. §1.199-(m)(1)(i)
67. Rev. Proc. 2002-28, April 12, 2002

> **Observation.** The NAICS code designation is not limited to NAICS Code 23, but includes "any other construction activity in any other NAICS code provided the construction activity relates to the construction of real property." However, distinctions between a primary trade or business in the context of an expanded affiliated group (EAG) could be significant. Because all members of an EAG are treated as a single corporation under IRC §199, and because the production activities of one member of an EAG are attributed to all other members of the EAG, gross receipts derived from the construction activities of any member of an EAG might qualify as DPGR if one member is in the trade or business of construction and that trade or business is not the primary trade or business of the EAG.

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 15. Grace, who is not in the trade or business of construction, owns a building. She hires general contractor Lenny to oversee a substantial renovation of the building. Lenny retains subcontractor Greg to install a new electrical system in the building, as part of the substantial renovation.

The amount that Lenny receives from Grace, and the amount that Greg receives from Lenny qualify as DPGR. However, the proceeds that Grace receives from the subsequent sale of the building do not qualify as DPGR since she did not engage in activity constituting construction.

Example 16. Albert is in the trade or business of construction under NAICS Code 23 on a regular basis. He purchases a building in the United States and retains Barbara, an unrelated person, to oversee a substantial renovation of the building. Barbara performs general contractor work and activities relating to management and oversight of the construction process. Barbara retains Clyde (a general contractor) to oversee day-to-day operations and hire subcontractors. Clyde hires Dale (a subcontractor) to install a new electrical system in the building as part of the substantial renovation.

The amounts that Barbara receives from Albert for construction services, the amounts that Clyde receives from Barbara for construction services, and the amounts that Dale receives from Clyde for construction services qualify as DPGR. However, the gross receipts that Albert receives from the subsequent sale of the building are not DPGR. Albert did not engage in construction activity in this instance, even though he is in the trade or business of construction.

> **Observation.** In **Example 16,** Albert likely reports the sale of the building on Schedule D, *Capital Gains and Losses.*

Example 17. Use the same facts as **Example 16,** except Barbara is in the business of building new homes as a general contractor. She hires various subcontractors to do plumbing, electrical, drywall installation, HVAC, landscaping, and concrete work. Each of these subs generates their own share of DPGR. Barbara also generates DPGR based on her gross profits from sales, excluding any profit attributable to land.

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> **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. Gross receipts derived from the sale or other disposition of land, including zoning, planning and other entitlement costs, are not DPGR derived from construction of real property.[68] Likewise, DPGR derived from the construction of real property in the United States does not include gross receipts derived from the sale, exchange, or other disposition of real property acquired by the taxpayer, even if he originally constructed the property.[69] The same is true when land is simply held for investment. Furthermore, it does not matter if the land is held as inventory for use in a trade or business, or for investment purposes.

Example 18. New-Line Development Co. is engaged in business on a regular and ongoing basis that is considered construction under NAICS Code 23. New-Line buys unimproved land in the United States. New-Line gets the land zoned for residential housing through an entitlement process. New-Line grades the land and sells the land to home builders who construct houses on the land.

The gross receipts that are attributable to the grading **qualify as DPGR** because those services are undertaken in connection with a construction project in the United States. New-Line's gross receipts derived from the land, including capitalized costs of entitlements (including zoning), do not qualify as DPGR because the gross receipts are not derived from the construction of real property.

Example 19. The facts are the same as **Example 18**, except New-Line constructs roads, sewers, and sidewalks, and installs power and water lines on the land. New-Line conveys the roads, sewers, sidewalks, and power and water lines to the local government and utilities.

The gross receipts that are attributable to grading, and the construction of the roads, sewers, sidewalks, and power and water lines (that qualify as infrastructure) **are DPGR.** New-Line's gross receipts derived from the land, including capitalized costs of entitlements (including zoning), do not qualify as DPGR because the gross receipts are not derived from the construction of real property.

Land Safe Harbor

Taxpayers must segregate gross receipts attributable to land (in connection with qualifying construction activities) from gross receipts associated with the sale or other disposition of land. The final regulations provide a safe harbor. The taxpayer may allocate gross receipts between the proceeds from the disposition of real property constructed by the taxpayer, and the gross receipts attributable to the disposition of land. This is done by reducing costs allocable to DPGR by the costs of the land and any other costs capitalized to the land.

This allocation is accomplished by reducing the property's DPGR by land costs plus a specified percentage based on the number of months between the date the taxpayer acquires the land (not including options to acquire the land) and the date the taxpayer sells each item of real property on the land.[70] The percentage is 5% for years zero through five; 10% for years six through 10; and 15% for years 11 through 15. Land that a taxpayer holds for 16 or more years is not eligible for the safe harbor, and the taxpayer must allocate gross receipts between land and qualifying real property.[71]

Note. If a taxpayer applies the land safe harbor, then the gross receipts (if any) excluded (in the safe harbor) are also excluded in determining total gross receipts under the de minimis exception. If a taxpayer does not apply the land safe harbor and uses any reasonable method to allocate gross receipts attributable to the land to non-DPGR, then the taxpayer applies the de minimis exception by excluding gross receipts derived from the sale, exchange, or other disposition of the land from total gross receipts.[72]

68. Treas. Reg. §1.199-3(m)(6)(iii)

69. Treas. Reg. §1.199-3(m)(6)(iii)

70. Treas. Reg. §1.199-3(m)(6)(iv)(A)

71. In the regulations, the allocations are described in months. For simplification purposes, months are converted to years in the text.

72. Treas. Reg. §1.199-3(m)(1)(iii) (A)

Qualifying Construction Activities

Activities performed in connection with a project to erect or substantially renovate real property qualify as construction. A construction project means the construction activities and services treated as an item.[73] 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 (i.e., 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 DPGR.

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.[74] 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.

Substantial renovation includes structural improvements. This does not include mere cosmetic changes, such as painting. The standard applied under IRC §263(a) is used to determine whether substantial renovation of real property is made. The criteria examines whether the cost of the activities must be capitalized. Substantial renovation means 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.

Miscellaneous Activities. Various scenarios can give rise to the question of what constitutes a construction activity. The final regulations make the following points:

1. Construction includes activities related to drilling oil or gas wells and mining, and any activity for which the taxpayer could deduct intangible drilling and development costs or development expenditures for a mine or natural deposit.[75]
2. Construction includes certain administrative support services such as billing and secretarial services performed by the taxpayer.[76]
3. Construction **does not include** the lease, license, or rental of equipment to contractors for use in the construction of real property.
4. To the extent that a particular activity is included in the definition of "engineering and architectural services," the activity **does not qualify** as construction.[77]
5. Gross receipts derived from the lease or rental of real property the taxpayer constructs are **not DPGR.**

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73. Treas. Reg. §1.199-3(m)(1)(i)
74. Treas. Reg. §1.199-3(m)(2)(iii)
75. Ibid
76. Treas. Reg. §1.199-3(m)(2)(iv)
77. Treas. Reg. §1.199-3(m)(2)(v)

Example 20. John Jones leases heavy machinery to Jones Backhoe and Excavating, Inc. John is the sole shareholder of the corporation.

Question 20A. Does the equipment lease income that John receives qualify as DPGR?

Answer 20A. Whether the equipment is being leased to a related party is not relevant in this situation. Instead, whether the lessor was the actual manufacturer or producer of the goods being leased is important. Lessors of real property **do not qualify** for the §199 deduction.

However, if tangible personal property is involved, then the lessor must meet the MPGE test. In this instance, John, the lessor, simply purchased the equipment from the manufacturer and then proceeded to lease it. As a result, the test is not met and the gross receipts (i.e., rent) do not qualify as DPGR.

Gross Receipts Derived from Construction

DPGR derived from the construction of real property in the United States includes the proceeds from either of the following:

- Sale, exchange, or other disposition of the property constructed
- The performance of construction services

Lease or rental income related to property constructed by the taxpayer is not "derived from construction." However, a sale, exchange, or other disposition of property need not occur immediately on completion of construction. Therefore, a taxpayer that constructs a building, and leases it for several years before selling it, may qualify for a §199 deduction 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 exclusion of lease and rental income is consistent with the objectives of the statute.

Example 21. 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.

DPGR derived from construction of real property also includes gross receipts derived from materials and supplies consumed in the construction project, or that become part of the constructed real property.[78] Similarly, DPGR includes gross receipts from any warranty that is provided in connection with the construction of real property if:

1. The price for the construction warranty is not separately stated from the amount charged for the constructed property, and
2. The construction warranty is neither separately offered by the taxpayer, nor separately bargained for with customers (i.e., the customer cannot purchase the constructed real property without the construction warranty).[79]

78. Treas. Reg. §1.199-3(m)(6)(v)

79. Treas. Reg. §1.199-3(m)(6)(ii)

ENGINEERING AND ARCHITECTURAL SERVICES (#3 ON PAGE 468)

DPGR includes the taxpayer's gross receipts derived from engineering or architectural services performed in the United States for construction projects in the United States.[80] The definitions of the terms "engineering services" and "architectural services" generally follow the definitions in regulations associated with IRC §924. To qualify, engineering or architectural services must meet all of the following requirements:

1. The services must relate to real property.
2. The services must be performed in the United States.
3. The services must be performed by the taxpayer.
4. The taxpayer must be engaged in an engineering or architectural services trade or business as defined by the NAICS.[81]

Engineering services in connection with any construction project include professional services requiring engineering education, training, and experience. Also included are professional services that require application of special knowledge of the mathematical, physical, or engineering sciences, such as consultation, investigation, evaluation, planning, and design. Professional services such as responsible supervision of construction for the purpose of ensuring compliance with plans, specifications, and design are also included. Engineering or architectural services can also include feasibility studies for a construction project, even if the planned construction project is not undertaken or completed.[82]

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

The final regulations also specify that engineering and architectural services also include administrative support services (e.g., billing and secretarial services) incidental and necessary to engineering or architectural services, which are performed by the same taxpayer that provides the incidental administrative support services.[83] Engineering or architectural services **do not include** post-construction services such as annual audits and inspections.[84]

Limitation to Services Real Property Construction Projects

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

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80. IRC §199(c)(4)(A)(iii). The engineering or architectural services must be for a construction project described in Treas. Reg. §1.199-3(m)(1)(i).

81. IRC §199(c)(4)(A)(iii), *as amended retroactively by the Gulf Opportunity Zone Act of 2005,* P.L. 109-35, §403(a)(5). The determination of whether an entity is in an engineering or architectural NAICS code is made on an entity-by-entity basis. The trade or business of engineering or architecture need not be the taxpayer's primary trade or business, but it must be regular and on-going. For a taxpayer that is a newly formed trade or business, or is in the taxpayer's first taxable year, the taxpayer is considered to be engaged in a trade or business on a regular and ongoing basis if the taxpayer reasonably expects that it will engage in a trade or business on a regular and ongoing basis. Treas. Reg. §1.199-3(n)(1).

82. Treas. Reg. §1.199-3(n)(1)

83. Treas. Reg. §1.199-3(n)(4)

84. Treas. Reg. §1.199-3(n)(5)

The final regulations provide 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 total less than 5% of the taxpayer's total gross receipts derived from engineering or architectural services performed by the taxpayer regarding the same construction project, the receipts are treated as DPGR.[85]

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.[86] A "retail establishment" is real property that is 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.[87]

If a taxpayer's facility is a retail establishment, 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). Wholesale sales are defined as food and beverages held for resale by the purchaser.

Example 22. Mario buys coffee beans and roasts the beans at his facility. He roasts and packages roasted coffee. Mario sells the roasted coffee through a variety of unrelated third-party vendors, and also sells the roasted coffee at his own retail establishments. His retail establishments also sell other foods in addition to the brewed coffee.

To the extent that Mario'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. Mario may be able to include the value of the beans which are used to produce the brewed coffee in DPGR.

Note. Legislative history provides that "retail establishment" includes carry-out restaurants as well as in-store bakeries at grocery stores. The final regulations specify that a "retail establishment" does not include the bonded premises of a distilled spirits plant or wine cellar, or the premises of a brewery (other than a tavern on the brewery premises).

Five Percent (5%) De Minimis Rule

A facility is not treated as a retail establishment if less than 5% of the gross receipts derived from the sale of food or beverages sold at that facility during the year are retail sales.[88]

Example 23. Doughie Shop bakes bread to sell at wholesale and also operates a "day-old" shop on the plant premises. Doughie 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. Doughie needs to maintain records to qualify for this exception.

If more than 5% of the bread is sold through the day-old shop, Doughie is regarded as a retail establishment. Thus, it must allocate its gross receipts between gross receipts derived from wholesale activities (DPGR) and retail activities (non-DPGR) to calculate QPAI.

85. Treas. Reg. §1.199-3(n)(6)(i)
86. IRC §199(c)(4)(B)(i)
87. Treas. Reg. §1.199-3(o)(1)
88. Treas. Reg. §1.199-3(o)(2)

Allocation of Gross Receipts

If a taxpayer's facility is a retail establishment, then he must allocate gross receipts between gross receipts derived from the retail sale of food and beverages prepared and sold at the retail establishment (which are nonDPGR), and gross receipts derived from the wholesale sale of food and beverages prepared at the retail establishment (which are DPGR, assuming all the other requirements of the QPAD are met).[89] The general cost allocation rules apply.

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 separate qualifying activities into individual separate business lines or individual product lines. However, Notice 2005-14 denotes the deduction is applied on an item-by-item basis.

The regulations retain this requirement, but limit the item-by-item standard to determining DPGR.[90] The regulations define an "item" as the property offered for sale to customers in the normal course of business that meets the requirements under IRC §199(c), whether as a retailer or wholesaler. If the property offered for sale does not meet all of the requirements, a taxpayer must treat any portion of the property offered for sale meeting all requirements as the item.[91]

Therefore, 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.

Note. 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

Gross receipts are the taxpayer's receipts for the taxable year that are recognized under the taxpayer's method of accounting for the tax year. Gross receipts:

- Include total sales (net of returns and allowances), and all amounts received for services[92]
- Include income from investments, and incidental and outside sources
- Are not reduced by cost of goods sold or by cost of property sold (if the property includes inventory, depreciable property used in a trade or business, copyrights and similar property, accounts or notes receivable in the ordinary course of a trade or business, or a publication of the federal government)[93]

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89. Treas. Reg. §1.199-3(o)(1)
90. Treas. Reg. §1.199-3
91. Ibid
92. Treas. Reg. §1.199-3(c)
93. IRC §1221(a)(1)-(5)

- Do not include loan repayments or nonrecognized gain from nonrecognition transactions (such as a tax-free exchange)
- Do not include amounts received by the taxpayer for sales tax or other similar state and local taxes, if the tax is legally imposed on the buyer of the goods or services and all the taxpayer does is remit the tax.[94]

> **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.

Segregation. A taxpayer must 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.[95]

Allocation. When a taxpayer engages in transactions that create both DPGR and nonDPGR, 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 describes the following factors to use in determining whether the taxpayer's allocation method is reasonable (the final regulations don't list the factors, but provide numerous examples):

- 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

De Minimis Rule. Notice 2005-14 originally provided a de minimis safe harbor applicable when small amounts of nonDPGR were present. Under that de minimis rule, if the taxpayer's nonDPGR was less than 5% of its total gross receipts, the taxpayer could treat all gross receipts as DPGR.

However, the final regulations now provide that in the case of an S corporation, partnership, estate, trust, or other pass-through entity, the determination of whether less than 5% of the pass-through entity's total gross receipts are non-DPGR is made at the pass-through entity level.[96] For an owner of a pass-through entity, the determination of whether less than 5% of the owner's total gross receipts are non-DPGR is made at the owner level, taking into account all of the owner's gross receipts.[97]

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. This rule requires that the taxpayer accurately identify whether the receipts (and corresponding expenses) qualify as DPGR. Guidance on the reasonable method can be found in Rev. Proc. 2004-34.

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94. Ibid
95. Treas. Reg. §1.199-3(d)(1)
96. Treas. Reg. §1.199-1(d)(2)
97. Notice 2005-14, January 19, 2005

> **Observation.** Many taxpayers must deal with the fact that different types of ordinary business income receive 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 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 in which a third party is the primary obligor.

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

> **Example 24.** Hooch, Inc., produced its most popular brand, White Lightning, from 1990 to 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. If inventory produced domestically before 2005 are moved to a location outside of the United States and then sold, they may qualify for the §199 deduction.[98]

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.[99] However, the statute does not provide a definition or method for determining what constitutes gross receipts "derived from" those types of transactions.

Qualifying gross receipts are limited to direct proceeds from the lease, rental, license, sale, exchange, or other disposition of QPP. Likewise, 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.

The notice and final regulations further explain 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.[100]

98. However, items arising from a taxable year of a pass-through entity beginning before January 1, 2005, are not taken into account in computing the IRC §199 deduction.

99. IRC §199(c)(4)(A)(i)

100. Treas. Reg. §1.199-3(i)(1)(i). For taxpayers relying on the former proposed regulations for tax years beginning before June 1, 2006, the proposed regulations add that this includes gross receipts from the sale of QPP manufactured in whole or in significant part in the U.S. by a taxpayer for sale, as well as gross receipts from the sale of self-constructed QPP manufactured in whole or in significant part in the U.S. and used in the taxpayer's trade or business before being sold. Prop. Treas. Reg. §1.199-3(h)(1).

> **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 and final regulations explain 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 **six exceptions:**[101]

1. Qualified warranties
2. Qualified deliveries
3. Qualified operating manuals
4. Qualified installations
5. Embedded computer software maintenance contracts
6. De minimis

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 25. The Daily Rag 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.

OTHER QUALIFYING PRODUCTION PROPERTY (#4, #5, AND #6 ON PAGE 468)

The statute indicates that computer software, sound recordings, certain types of film production, and the production of electricity, natural gas, or potable water qualifies as QPP. The notice and the final regulations include detailed guidance for each type of property in determining DPGR and the definition of qualifying property. Taxpayers producing these types of properties should review the notice and final regulations for specific guidance.

> **Note.** Descriptions of these types of QPP can be found in the 2005 *University of Illinois Federal Tax Workbook*, pages 627–630.

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101. Thus, there must be an allocation of gross receipts attributable to the embedded services or nonqualified property. The allocation will be deemed reasonable if the allocation reflects the fair market value of the embedded services or nonqualified property. Treas. Reg. §1.199-3(i)(4)(i).

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 (however, 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 federal 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 several methods within each step.

COST OF GOODS SOLD

In order to determine its QPAI for the taxable year, a taxpayer must subtract from its DPGR the cost of goods sold which is allocable to DPGR, other expenses and deductions directly allocable to DPGR and a ratable portion of other deductions not directly allocable to DPGR or another class of income.[102] A taxpayer's costs must be determined using the taxpayer's method of accounting for federal income tax purposes.[103] The final regulations specify that, for purposes of determining the cost of goods sold allocable to DPGR, "cost of goods sold" includes the costs that would have been included in ending inventory if the goods sold during the year were on hand at the end of the year.[104]

Note. Notice 2005-14 explains 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 taxpayer 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
4. Sells it in connection with more-than-de-minimis services

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, Notice 2005-14 explains that for purposes of the deduction, CGS also refers to the adjusted basis of noninventory QPP.

102. IRC §199(c)(1)
103. Treas. Reg. §1.199-4(b)(1)
104. Ibid

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Methods for Allocation and Apportionment of Deductions

Consistent with both the proposed regulations and Notice 2005-14, the final regulations provide for the same three methods for allocating and apportioning deductions, except the **final regulations modify the qualification requirements for the "simplified method."**

> **Observation.** These methods are presumably 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). Under this method, the taxpayer applies the rules of the IRC §861 regulations to allocate and apportion deductions to gross income attributable to DPGR.[105]

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.** 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 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, or total assets at the end of the taxable year of $10 million or less.[106] It provides a simplified formula that allocates deductions based on the ratio of the taxpayer's gross receipts derived from QPAs as compared to the taxpayer's gross receipts 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. In other words, a taxpayer's expenses, losses, or deductions are apportioned between DPGR and non-DPGR based on relative gross receipts. 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).

> **Note.** The proposed regulations provided for a land safe harbor under which a taxpayer may allocate gross receipts between the proceeds from the sale, exchange, or other disposition of real property that the taxpayer constructs and land by reducing its costs related to DPGR by the cost of land and other costs capitalized into the land and reducing its DPGR by those land costs plus a percentage. The final regulations clarify that a **taxpayer that uses the land safe harbor to allocate gross receipts between real property the taxpayer constructs and land does not take into account under the simplified deduction method the costs that have already been taken into account for purposes of the DPAD pursuant to the land safe harbor.**

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105. 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.

106. Treas. Reg. §1.199-4(e)(1)

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 nonDPGR 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

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 below include wages paid to employees or former employees of the taxpayer for employment. Employees would include corporate officers and common-law employees, but not independent contractors or guaranteed payments made to partners in a partnership.

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. 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. However, wages of all common-law employees count 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.

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W-2 WAGES

IRC §514(a) of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA)[107] amended IRC §199(b)(2) by excluding from W-2 wages any amount that is not properly allocable to DPGR for purposes of IRC §199(c)(1). Taxpayers can only include amounts properly allocable to DPGR. The provision is applicable for tax years beginning after May 17, 2006. For 2006 calendar year taxpayers, the old law is used.

107. Pub. L. No. 109-222, signed into law May 17, 2006

The §199 deduction for any tax year is limited to 50% of the W-2 wages paid by the taxpayer during the calendar year that ends in that tax year that are attributable to the actual conduct of the taxpayer's trade or business.[108] Fiscal year taxpayers use 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). This includes:

- 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
- The amounts described in IRC §6051(a)(3) and (8) paid by the taxpayer for employment of employees by the taxpayer during the calendar year ending during the taxable year

Amounts paid to workers who receive Forms W-2 from professional employer organizations (PEOs), or employee leasing firms may possibly be included in the W-2 wages of the clients of the PEOs or employee leasing firms (the "taxpayer" for purposes of the §199 deduction). The final regulations clarify that the resolution of the matter depends on whether the PEO, employee leasing firm or the client is the employer of the worker as determined under the application of common law rules.

Treas. Reg. §1.199-2(a)(2) notes that taxpayers may take into account wages reported on Forms W-2 issued by other parties provided that the wages reported on the Forms W-2 were paid to employees of the taxpayer for employment by the taxpayer. W-2 wages do not include any amount that is not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for the return. Thus, an individual filing a joint return may take into account wages paid to employees of the individual's spouse in determining the amount of W-2 wages provided they are paid in the spouse's trade or business.

Under the final regulations, payments to employees of a taxpayer for domestic services in the taxpayer's private home are not attributable to the actual conduct of the taxpayer's business and do not qualify as W-2 wages for purposes of the QPAD.

Observation. The wage limitation may encourage married persons to file a joint return. That is particularly true when one spouse reports Schedule C income with QPAI, but no W-2 wages, and the other spouse has W-2 wages in a second trade or business reported on Schedule C, but with no QPAI. The final regulations[109] provide that married persons filing jointly are treated as one taxpayer for purposes of determining W-2 wages. Thus, wages paid to an employee for domestic services performed in the taxpayer's private home are not included in the taxpayer's W-2 wages.[110]

108. IRC §199(b)(1)

109. Treas. Reg. §1.199-2(a)(4)

110. Treas. Reg. §1.199-8(c)(1)

Calculation Methods

Determining W-2 wages under §199 cannot be satisfied by a box on Form W-2. As a result, Notice 2005-14, the proposed regulations, and Rev. Proc. 2006-22[111] provide three alternative methods for making the required calculations. The final regulations state that it is expected that any new revenue procedure, applicable for tax years after May 17, 2006, will contain methods for calculating W-2 wages similar to the three methods. The three alternative methods for calculating W-2 wages are:

1. **Unmodified Box Method.** The taxpayer can treat as "wages" the lesser of the aggregate amount reported as
   - Wages, Tips, and Other Compensation (box 1), or
   - 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 1: Total the amounts in box 1 of Forms W-2 for all the taxpayer's employees.

   Step 2: 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).

   Step 3: Add to the result of Step 2 any amounts that are reported in box 12 of Forms W-2 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 1. Add the amounts of wages subject to federal income tax withholding that are paid to the taxpayer's employees and that are reported on Forms W-2 for the calendar year.

   Step 2. Subtract from the result of Step 1 the supplemental unemployment compensation benefits that were included in the Step 1 calculation.

   Step 3. Add to the result of Step 2 amounts that are reported in box 12 of Forms W-2 for the taxpayer's employees that are properly coded as D, E, F, G, or S.

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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.

111. Rev. Proc. 2006-22, May 24, 2006

> **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 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.

CORPORATE ACQUISITIONS

When a taxpayer purchases another business, if it (the successor) acquires a major portion of a trade or business, or a major portion of a separate unit of a trade or business (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.

The new rules apply for tax years beginning after 2006. Consequently, only wages attributable to DPGR qualify.

SPECIAL RULES

EXPANDED AFFILIATED GROUPS

Corporations and expanded affiliate groups (EAGs) are eligible for the §199 deduction. In general, all members of an 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 without regard to IRC §1504(b)(2) and (4)), and includes insurance companies and corporations that have made an election under the possessions tax credit rules. **S corporations are not included in this group.**

The regulations clarify that each member of an EAG is a separate taxpayer that computes its own taxable income or loss, QPAI, and W-2 wages, which are then aggregated at the EAG level.[112] A corporation determines whether it is a member of an EAG on a daily basis. If the corporation becomes or ceases to be a member of an EAG, the corporation is treated as becoming or ceasing to be a member at the end of the day on which its status as a member changes.[113] A change in stock ownership may change a corporation's inclusion in the EAG.

The QPAD for an EAG is determined by aggregating each member's taxable income or loss, QPAI, and W-2 wages. The deduction must be allocated to group members in proportion to each member's respective amount (if any) of QPAI.

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. The corporation may use one of two allocation methods: pro rata allocation or closing-of-the books allocation.

112. Treas. Reg. §1.199-7(b)(1)

113. Treas. Reg. §1.199-7(a)(2). If a corporation is a member of an EAG for its entire taxable year, the corporation's QPAD for the tax year is the amount of the deduction that the EAG allocates to the corporation. If the corporation is a member of an EAG for part of the tax year, and is either not a member of any EAG or a member of another EAG, or both, for another portion of the taxable year, the corporation's QPAD for the tax year is the sum of its QPAD for each portion of the tax year. Treas. Reg. §1.199-7(g).

Application to Pass-Through Entities

In the case of a partnership, S corporation, estate, trust, or other pass-through entity, the QPAD is determined at the partner, shareholder, or similar level. The statute is applied in a manner consistent with the economic arrangement of the owners of a pass-through entity. Therefore, in the case of a partnership or S corporation, the deduction is applied at the partner or shareholder level.[114] In the case of an estate or nongrantor trust, DPGR, CGS, deductions, and W-2 wages are apportioned between the beneficiaries and the fiduciary and among the beneficiaries.[115] For grantor trusts, the deemed owner computes QPAI of the owned portion of the trust as if the owner had conducted the activities, and takes into account the owner's W-2 wages attributable to the owned portion of the trust.[116]

Observation. While it is not clear whether the character of a production item passes through to the partner or shareholder, it seems logical that the character should pass through to the partner or shareholder. Also, it is not entirely clear how to determine when a partnership's activities are qualifying activities. However, 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. Also, an owner of a pass-through entity need not be engaged directly in the entity's trade or business to claim the QPAD based on the owner's share of the pass-through entity's items.[117]

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.[118]

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.

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114. Treas. Reg. §1.199-9(b)(1)
115. Treas. Reg. §1.199-9(e)
116. Treas. Reg. §1.199-9(d)
117. Treas. Reg. §1.199-9
118. IRC §199(d)(1)(B)

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.

TIPRA modified the W-2 wage provisions regarding pass-through entities.

Note. For tax years beginning after May 17, 2006, a shareholder or partner who is allocated QPAI from a pass-through entity is treated as having W-2 wages from the entity in an amount equal to his allocable share of the entity's wages, even if that amount is more than twice the QPAI allocated to him for the tax year.[119] The person then includes in his wage limitation only the wages that are deducted in calculating QPAI.

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. When IRC §751 applies, the notice is not clear on how to determine when items of QPAI are generated.

Effective Date. The QPAD applies only to tax years of pass-through entities that begin on or after January 1, 2005, and only those items arising from taxable years of a pass-through entity beginning on or after January 1, 2005, are taken into account in determining the QPAD.[120]

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 his QPAD. While a January 1, 2005, effective date is easier to administer, it is not consistent with the aggregate approach.

Additional K-1 Reporting Requirements. It is anticipated that the IRS will 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

Application to Cooperatives

Note. For information on agricultural or horticultural cooperatives, see Chapter 12, "Agricultural Issues and Rural Investments," Issue 1.

119. IRC §199(d)(1)(A)

120. AJCA, §102(e), as amended by 2005 Gulf Opportunity Zone Act, P.L. 109-135, §403(a)(19); Treas. Reg. §1.199-8(i)(2).

671106

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

Schedule K-1 (Form 1120S) **2006**
Department of the Treasury
Internal Revenue Service

For calendar year 2006, or tax year beginning ____________, 2006 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
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) 2006**

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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:

	Report 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%)	See the Shareholder's Instructions
B	Cash contributions (30%)	See the Shareholder's Instructions
C	Noncash contributions (50%)	See the Shareholder's Instructions
D	Noncash contributions (30%)	See the Shareholder's Instructions
E	Capital gain property to a 50% organization (30%)	See the Shareholder's Instructions
F	Capital gain property (20%)	See the Shareholder's Instructions
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	Preproductive period expenses	See the Shareholder's Instructions
M	Commercial revitalization deduction from rental real estate activities	See Form 8582 Instructions
N	Reforestation expense deduction	See the Shareholder's 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

A	Low-income housing credit (section 42(j)(5))	See the Shareholder's Instructions
B	Low-income housing credit (other)	See the Shareholder's Instructions
C	Qualified rehabilitation expenditures (rental real estate)	See the Shareholder's Instructions
D	Other rental real estate credits	See the Shareholder's Instructions
E	Other rental credits	See the Shareholder's Instructions
F	Undistributed capital gains credit	Form 1040, line 70, check box a
G	Credit for alcohol used as fuel	See the Shareholder's Instructions
H	Work opportunity credit	See the Shareholder's Instructions
I	Welfare-to-work credit	See the Shareholder's Instructions
J	Disabled access credit	See the Shareholder's Instructions
K	Empowerment zone and renewal community employment credit	Form 8844, line 3
L	Credit for increasing research activities	See the Shareholder's Instructions
M	New markets credit	See the Shareholder's Instructions
N	Credit for employer social security and Medicare taxes	See the Shareholder's Instructions
O	Backup withholding	Form 1040, line 64
P	Other credits	See the Shareholder's Instructions

14. Foreign transactions

Code		*Report on*
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	See the Shareholder's Instructions and the Instructions for Form 6251
C	Depletion (other than oil & gas)	See the Shareholder's Instructions and the Instructions for Form 6251
D	Oil, gas, & geothermal—gross income	See the Shareholder's Instructions and the Instructions for Form 6251
E	Oil, gas, & geothermal—deductions	See the Shareholder's Instructions and the Instructions for Form 6251
F	Other AMT items	See the Shareholder's Instructions and the Instructions for Form 6251

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	Qualified rehabilitation expenditures (other than rental real estate)	See the Shareholder's Instructions
D	Basis of energy property	See the Shareholder's Instructions
E	Recapture of low-income housing credit (section 42(j)(5))	Form 8611, line 8
F	Recapture of low-income housing credit (other)	Form 8611, line 8
G	Recapture of investment credit	See Form 4255
H	Recapture of other credits	See the Shareholder's Instructions
I	Look-back interest—completed long-term contracts	See Form 8697
J	Look-back interest—income forecast method	See Form 8866
K	Dispositions of property with section 179 deductions	See the Shareholder's Instructions
L	Recapture of section 179 deduction	See the Shareholder's Instructions
M	Section 453(l)(3) information	See the Shareholder's Instructions
N	Section 453A(c) information	See the Shareholder's Instructions
O	Section 1260(b) information	See the Shareholder's Instructions
P	Interest allocable to production expenditures	See the Shareholder's Instructions
Q	CCF nonqualified withdrawals	See the Shareholder's Instructions
R	Information needed to figure depletion—oil and gas	See the Shareholder's Instructions
S	Amortization of reforestation costs	See the Shareholder's Instructions
T	Other information	See the Shareholder's Instructions

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