

DEPARTMENT OF THE TREASURY**Internal Revenue Service****26 CFR Part 1**

[REG-105847-05]

RIN 1545-BE33

Income Attributable to Domestic Production Activities**AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations concerning the deduction for income attributable to domestic production activities under section 199. Section 199 was enacted as part of the American Jobs Creation Act of 2004, (the Act). The regulations will affect taxpayers engaged in certain domestic production activities. This document also provides a notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by January 3, 2006. Outlines of topics to be discussed at the public hearing scheduled for Wednesday, January 11, 2006, must be received by December 21, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-105847-05), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-105847-05), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS Internet site at <http://www.irs.gov/regs> or via the Federal eRulemaking Portal at <http://www.regulations.gov> (IRS-REG-105847-05). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning §§ 1.199-1, 1.199-3, 1.199-6, and 1.199-8, Paul Handleman or Lauren Ross Taylor, (202) 622-3040; concerning § 1.199-2, Alfred Kelley, (202) 622-6040; concerning § 1.199-4(c) and (d), Richard Chewning, (202) 622-3850; concerning all other provisions of § 1.199-4, Scott Rabinowitz, (202) 622-4970; concerning § 1.199-5, Martin Schaffer, (202) 622-3080; concerning § 1.199-7, Ken Cohen, (202) 622-7790; concerning submission of comments, the hearing, and/or to be placed on the

building access list to attend the hearing, LaNita Van Dyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:**Paperwork Reduction Act**

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by January 3, 2006.

Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collection of information in these proposed regulations is in § 1.199-6(b) involving patrons of agricultural and horticultural cooperatives. This information is required so that patrons of agricultural and horticultural cooperatives may claim the section 199 deduction. The collections of information is mandatory. The likely respondents are business or other for-profit institutions.

Estimated total annual reporting burden: 9,000 hours.

Estimated average annual burden hours per respondent: 3 hours.

Estimated number of respondents: 3,000.

Estimated annual frequency of responses: annually.

An agency may not conduct or sponsor, and a person is not required to

respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed regulations relating to the deduction for income attributable to domestic production activities under section 199 of the Internal Revenue Code (Code). Section 199 was added to the Code by section 102 of the Act (Public Law 108-357, 118 Stat. 1418). On January 19, 2005, the IRS and Treasury Department issued Notice 2005-14 (2005-7 I.R.B. 498) providing interim guidance on section 199 and inviting comments on issues arising under section 199. Written and electronic comments responding to Notice 2005-14 were received. The IRS and Treasury Department have reviewed and considered all the comments in the process of preparing these proposed regulations. This preamble to the proposed regulations describes many of the more significant comments received by the IRS and Treasury Department. Because of the large volume of comments received, however, the IRS and Treasury Department are not able to address all of the comments in this preamble.

General Overview

Section 199(a)(1) allows a deduction equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of: (a) The qualified production activities income (QPAI) of the taxpayer for the taxable year; or (b) taxable income (determined without regard to section 199) for the taxable year (or, in the case of an individual, adjusted gross income (AGI)).

Section 199(b)(1) limits the deduction for a taxable year to 50 percent of the W-2 wages paid by the taxpayer during the calendar year that ends in such taxable year. For this purpose, section 199(b)(2) defines the term *W-2 wages* to mean the sum of the aggregate amounts the taxpayer is required under section 6051(a)(3) and (8) to include on the Forms W-2, "Wage and Tax Statement," of the taxpayer's employees during the calendar year ending during the

taxpayer's taxable year. Section 199(b)(3) provides that the Secretary shall prescribe rules for the application of section 199(b) in the case of an acquisition or disposition of a major portion of either a trade or business or a separate unit of a trade or business during the taxable year.

Qualified Production Activities Income

Under section 199(c)(1), QPAI is the excess of domestic production gross receipts (DPGR) over the sum of: (a) The cost of goods sold (CGS) allocable to such receipts; (b) other deductions, expenses, or losses directly allocable to such receipts; and (c) a ratable portion of deductions, expenses, and losses not directly allocable to such receipts or another class of income.

Section 199(c)(2) provides that the Secretary shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining QPAI.

Section 199(c)(3) provides special rules for determining costs in computing QPAI. Under these special rules, any item or service imported into the United States without an arm's length transfer price shall be treated as acquired by purchase, and its cost shall be treated as not less than its value immediately after it enters the United States. A similar rule applies in determining the adjusted basis of leased or rented property when the lease or rental gives rise to DPGR. If the property has been exported by the taxpayer for further manufacture, the increase in cost or adjusted basis must not exceed the difference between the value of the property when exported and its value when imported back into the United States after further manufacture.

Section 199(c)(4)(A) defines *DPGR* to mean the taxpayer's gross receipts that are derived from: (i) Any lease, rental, license, sale, exchange, or other disposition of (I) qualifying production property (QPP) that was manufactured, produced, grown, or extracted (MPGE) by the taxpayer in whole or in significant part within the United States; (II) any qualified film produced by the taxpayer; or (III) electricity, natural gas, or potable water (collectively, utilities) produced by the taxpayer in the United States; (ii) construction performed in the United States; or (iii) engineering or architectural services performed in the United States for construction projects in the United States.

Section 199(c)(4)(B) excepts from DPGR gross receipts of the taxpayer that are derived from: (i) The sale of food and beverages prepared by the taxpayer at a retail establishment; and (ii) the

transmission or distribution of electricity, natural gas, or potable water.

Section 199(c)(5) defines *QPP* to mean: (A) Tangible personal property; (B) any computer software; and (C) any property described in section 168(f)(4) (certain sound recordings).

Section 199(c)(6) defines a *qualified film* to mean any property described in section 168(f)(3) if not less than 50 percent of the total compensation relating to production of the property is compensation for services performed in the United States by actors, production personnel, directors, and producers. The term does not include property with respect to which records are required to be maintained under 18 U.S.C. 2257 (generally, films, videotapes, or other matter that depict actual sexually explicit conduct and are produced in whole or in part with materials that have been mailed or shipped in interstate or foreign commerce, or are shipped or transported or are intended for shipment or transportation in interstate or foreign commerce).

Section 199(c)(7) provides that DPGR does not include any gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person. A person is treated as related to another person if both persons are treated as a single employer under either section 52(a) or (b) (without regard to section 1563(b)), or section 414(m) or (o).

Pass-Thru Entities

Section 199(d)(1) provides that, in the case of an S corporation, partnership, estate or trust, or other pass-thru entity, section 199 generally is applied at the shareholder, partner, or similar level, except as otherwise provided in rules applicable to patrons of cooperatives. Section 199(d)(1) further provides that the Secretary shall prescribe rules for the application of section 199, including rules relating to: (a) Restrictions on the allocation of the deduction to taxpayers at the partner or similar level; and (b) additional reporting requirements.

The general rule is that section 199 is applied at the shareholder, partner, or similar level. However, section 199(d)(1)(B) limits the amount of W-2 wages from a pass-thru entity that may be used by each shareholder, partner, or similar person to compute the section 199 deduction. Specifically, section 199(d)(1)(B) provides that such person is treated as having been allocated W-2 wages from such entity in an amount equal to the lesser of: (i) Such person's allocable share of such wages (without regard to this rule) from such entity as determined under regulations prescribed by the Secretary; or (ii) 2

times 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the QPAI of that entity allocated to such person for the taxable year.

Individuals

In the case of an individual, section 199(d)(2) provides that the deduction is equal to the applicable percentage of the lesser of the taxpayer's: (a) QPAI for the taxable year; or (b) AGI for the taxable year determined after applying sections 86, 135, 137, 219, 221, 222, and 469, and without regard to section 199.

Patrons of Certain Cooperatives

Section 199(d)(3) provides special rules under which a taxpayer receiving certain patronage dividends or certain qualified per-unit retain allocations from a cooperative (to which subchapter T applies) engaged in the MPGE, in whole or in significant part, or in the marketing of any agricultural or horticultural product is allowed a section 199 deduction with respect to the amount of the patronage dividends or qualified per-unit retain allocations that are: (a) Allocable to the portion of the cooperative's QPAI that would be deductible by the cooperative; and (b) designated as such by the cooperative in a written notice mailed to its patrons during the payment period described in section 1382. Such an amount, however, does not reduce the taxable income of the cooperative under section 1382.

In determining the portion of the cooperative's QPAI that would be deductible by the cooperative, the cooperative's taxable income is computed without taking into account any deduction allowable under section 1382(b) or (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions) and, in the case of a cooperative engaged in marketing agricultural and horticultural products, the cooperative is treated as having MPGE, in whole or in significant part, any agricultural and horticultural products marketed by the cooperative that its patrons have MPGE.

Expanded Affiliated Groups

Section 199(d)(4)(A) provides that all members of an expanded affiliated group (EAG) are treated as a single corporation for purposes of section 199. Taking into account the provisions of the Congressional Letter, as described elsewhere, section 199(d)(4)(B) provides that an EAG is an affiliated group as defined in section 1504(a), determined by substituting "more than 50 percent" for "at least 80 percent" each place it

appears and without regard to section 1504(b)(2) and (4).

Section 199(d)(4)(C) provides that, except as provided in regulations, the section 199 deduction is allocated among the members of the EAG in proportion to each member's respective amount (if any) of QPAI.

Trade or Business Requirement

Section 199(d)(5) provides that section 199 is applied by taking into account only items that are attributable to the actual conduct of a trade or business.

Alternative Minimum Tax

Section 199(d)(6) provides rules to coordinate the deduction allowed under section 199 with the alternative minimum tax (AMT) imposed by section 55. Taking into account the provisions of the Congressional Letter, as described elsewhere, section 199(d)(6) provides that for purposes of determining alternative minimum taxable income (AMTI) under section 55, the section 199 deduction shall be determined without regard to any adjustments under sections 56 through 59, except that in the case of a corporation (including a corporation subject to tax under section 511), the taxable income limitation is the corporation's AMTI.

Authority To Prescribe Regulations

Section 199(d)(7) authorizes the Secretary to prescribe such regulations as are necessary to carry out the purposes of section 199.

Congressional Letter

On July 21, 2005, the Chairman and Ranking Member of the Senate Finance Committee and the Chairman of the House Ways and Means Committee introduced the Tax Technical Corrections Act of 2005, H.R. 3376 and S. 1447, 109th Cong. (2005). In a letter on the same date to the Treasury Department (the Congressional Letter), they provided clarification for several issues so that appropriate regulatory guidance may be issued reflecting their intention. These proposed regulations reflect the intent expressed in the Congressional Letter with respect to section 199.

Summary of Comments

Qualified Production Activities Income

One commentator requested that the proposed regulations clarify the treatment of advance payments, and the costs related to those payments, for purposes of computing QPAI. Section 4.03(3) of Notice 2005-14 provides that, in the case of advance payments (for

goods, services, and use of property) that are recognized under the taxpayer's method of accounting in a taxable year earlier than that in which the property or services are delivered, performed, and provided, the taxpayer must accurately identify, based on a reasonable method, whether the receipts (and the corresponding expenses) qualify as DPGR. If a taxpayer recognizes an advance payment in Year 1, and the CGS in Year 2, the commentator asks whether CGS must be applied to reduce DPGR in Year 2, even though the DPGR and CGS are recognized in different taxable years.

The proposed regulations clarify that, in the example the commentator cites involving advance payments, as well as other circumstances (such as taxpayers that use the cash receipts and disbursements method) where gross receipts and corresponding expenses are recognized in different taxable years, taxpayers must take the receipts and expenses into account for purposes of section 199 in the taxable year such items are recognized under their methods of accounting for Federal income tax purposes. The IRS and Treasury Department believe it would be unduly burdensome and complicated to create a separate set of timing rules for purposes of section 199. Thus, gross receipts and costs are taken into account for purposes of computing QPAI in the taxable year they are recognized for Federal income tax purposes under the taxpayer's methods of accounting, even if the related gross receipts or costs, as applicable, are taken into account in different taxable years. If the gross receipts are recognized in an intercompany transaction within the meaning of § 1.1502-13, see also § 1.199-7(d).

A commentator requested clarification of how the advance payment rules would apply in the following scenario. In Year 1, a taxpayer sells for \$100 a one-year software maintenance agreement that provides for software updates (that the taxpayer would MPGE in whole or in significant part within the United States) and customer support services. At the end of Year 1, the taxpayer uses a reasonable method to allocate 60 percent of the gross receipts (\$60) to the software updates and 40 percent (\$40) to the customer support services. The taxpayer treats the \$60 as DPGR in Year 1. In Year 2, no software updates are provided. The commentator asks whether the taxpayer in this scenario would be required to amend its Year 1 return and reduce its DPGR by \$60, reduce DPGR by \$60 in Year 2, or make no adjustment for Year 1 or Year 2.

Consistent with the application of the rules relating to advance payments, which require that the taxpayer follow its methods of accounting for Federal income tax purposes, the taxpayer should make no adjustment in Year 1 (by amended return) or in Year 2 for the \$60 that was appropriately treated as DPGR in Year 1, even though no software updates were provided in Year 2.

A commentator suggested that the proposed regulations clarify how a taxpayer that uses a long-term contract method determines the portion of the percentage of completion revenue reported for each contract for the taxable year that is allocated to DPGR. The proposed regulations provide that taxpayers using a long-term contract method (for example, under section 460) may use any reasonable method of allocating gross receipts under such a contract between DPGR and non-DPGR.

A number of comments were received regarding the rule in section 4.03(1) of Notice 2005-14 that requires that section 199 be applied on an item-by-item basis. Some commentators stated that applying section 199 on an item-by-item basis is unduly burdensome, and that the proposed regulations should permit taxpayers to determine QPAI on a division or product-line basis instead. The IRS and Treasury Department, however, continue to believe that applying section 199 on a basis other than item-by-item would allow taxpayers to receive the benefits of section 199 with respect to gross receipts that should not qualify as DPGR. Accordingly, the proposed regulations retain the requirement that section 199 be applied on an item-by-item basis.

Many commentators requested clarification of what constitutes an item. Commentators asked whether an item is a final product or whether one or more component parts of the final product may qualify as an item. For example, if a final product does not meet the in whole or in significant part requirement (so that gross receipts from the sale of the final product are non-DPGR), commentators inquired whether they could allocate gross receipts to a component of the product that did meet all of the requirements of section 199(c), and thereby treat that portion of the gross receipts as DPGR.

H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. 272 n. 27 (2004) (the Conference Report) indicates that a component may be treated as qualifying property in the case of food and beverages. Footnote 27 of the Conference Report explains that, in the context of food and beverages prepared

at a retail establishment, although a cup of coffee prepared at a retail establishment does not qualify under section 199(c), a portion of the cup of coffee, that is, the coffee beans (roasted at a facility separate from the retail establishment) that meet the requirements under section 199(c), does qualify under section 199. The Joint Committee on Taxation Staff, *General Explanation of Tax Legislation Enacted in the 108th Congress*, 109th Cong., 1st Sess. 172 (2005) (the Blue Book), indicates Congressional intent that this treatment is not limited to food and beverages, but rather, is permitted with respect to section 199 in general. Accordingly, in the case of QPP, qualified films, and utilities, the proposed regulations define an *item* as the property offered for sale to customers that meets all of the requirements under section 199(c). If the property offered for sale does not meet all of the requirements under section 199(c), a taxpayer must treat as the item any portion of the property offered for sale that meets all of these requirements. However, in no case shall the portion of the property offered for sale that is treated as the item exclude any other portion that meets all of the requirements under section 199(c). For example, assume that the taxpayer MPGE software entirely within the United States, attaches the software to a router that it MPGE entirely outside the United States, and then sells the combined property. Assume further that if the combined property is treated as the item, the gross receipts from the sale will not qualify as DPGR because the combined property does not satisfy the in whole or in significant part requirement. The proposed regulations require the taxpayer to treat the software as an item; separate from the router, because the software meets all of the requirements of section 199(c) (that is, it is computer software that is MPGE by the taxpayer in whole or in significant part within the United States). This is the case even if the software is not offered for sale to customers separately from the router. Accordingly, the gross receipts from the software qualify as DPGR, but the gross receipts from the router do not qualify as DPGR.

Alternatively, assume that the taxpayer MPGE only software but that some of the content is MPGE within the United States and some content is MPGE outside the United States. Assuming that the software does not meet the requirements of section 199(c), that portion of the software that is MPGE within the United States must be treated as the item. Accordingly, gross

receipts from the sale of the software must be allocated (using any reasonable method) between that portion that is MPGE within the United States (which is DPGR if all other requirements of section 199(c) are met) and that portion that is MPGE outside the United States (which is non-DPGR).

In the case of construction and architectural and engineering services, commentators asked that the proposed regulations clarify whether the item is the construction project itself, or whether the item can constitute a task or sub-task that is performed as part of the construction project. The IRS and Treasury Department believe that the determination of what constitutes the item for purposes of construction and architectural or engineering services should be made on a case-by-case basis taking into account all of the facts and circumstances. Taxpayers may use any reasonable method of determining the item for this purpose.

A commentator requested that the proposed regulations clarify how the rules for determining DPGR apply in the case of a taxpayer that repairs or rebuilds property for a customer. The commentator suggested the IRS and Treasury Department distinguish between “repair” activities and “rebuild” activities. In the case of a repair contract where the customer retains the benefits and burdens of the property while it is being repaired, the commentator suggests that the contractor should be permitted to treat as DPGR the gross receipts attributable to parts that the contractor MPGE in whole or in significant part within the United States, as well as the gross receipts attributable to the installation of those parts. Gross receipts attributable to the parts MPGE by the taxpayer in whole or in significant part within the United States are DPGR (assuming all the other requirements of section 199(c) are met). Consistent with the general rule for installation (discussed below), the installation activity will be considered an MPGE activity only if the contractor retains the benefits and burdens of ownership with respect to the parts while the parts are being installed. In addition, the gross receipts attributable to the installation of parts that the contractor MPGE may qualify as DPGR if the exception for embedded installation described in § 1.199–3(h)(4)(ii)(D) of the proposed regulations applies. The contractor is not permitted to treat as DPGR gross receipts attributable to purchased parts, or the installation of purchased parts.

The commentator suggested that the proposed regulations provide a special rule for “rebuild” contracts, which the

commentator suggested be defined as any contract where the value of the rebuild work performed exceeds 25 percent of the value of the preexisting property immediately before the rebuild. The commentator further suggested that if more than 50 percent of the contractor’s costs of performing the rebuild is attributable to the cost of parts that the contractor MPGE, the contractor should not be required to allocate its gross receipts between parts that it MPGE and any parts that it purchased. The commentator’s suggested rule would effectively create for rebuild contracts a separate *de minimis* exception to the general allocation requirement. The IRS and Treasury Department believe that the *de minimis* exceptions provided in the proposed regulations (for example, the 5 percent *de minimis* exception discussed later generally applicable to embedded services and embedded nonqualifying property) are appropriate. Accordingly, the proposed regulations do not adopt this suggestion.

Section 4.03(2) of Notice 2005–14 provides that, if the amount of the taxpayer’s gross receipts that do not qualify as DPGR equals or exceeds 5 percent of the total gross receipts, the taxpayer is required to allocate all gross receipts between DPGR and non-DPGR. For purposes of this 5 percent *de minimis* rule, the proposed regulations in § 1.199–1(d)(2) provide that, in the case of an S corporation, partnership, estate, trust, or other pass-thru entity, the determination of whether less than 5 percent of the pass-thru entity’s total gross receipts are non-DPGR is made at the pass-thru entity level. In the case of an owner of a pass-thru entity, the determination of whether less than 5 percent of the owner’s total gross receipts are non-DPGR is made at the owner level, taking into account the owner’s share of any of the pass-thru entity’s gross receipts as well as all other gross receipts of the owner. In addition, the 5 percent *de minimis* exception in § 1.199–3(h)(4)(ii)(E) applies at the entity level to each item that qualifies.

Commentators also observed that, in determining whether the taxpayer’s method of allocating gross receipts and CGS between DPGR and non-DPGR is reasonable, the list of factors cited in section 4.03(2) of Notice 2005–14 with respect to gross receipts is inconsistent with the list of factors cited in section 4.05(2)(b) of the notice with respect to CGS. The list of factors was intended to be as consistent as possible for both gross receipts and CGS, and appropriate changes to the lists have been

incorporated into the proposed regulations as necessary.

Taxable Income

In the Congressional Letter, the Treasury Department was advised that unrelated business taxable income, rather than taxable income, applies for purposes of section 199(a)(1) in computing the unrelated business income tax under section 511. Accordingly, the proposed regulations in § 1.199-1(b) provide that, for purposes of determining the tax imposed by section 511, section 199(a)(1)(B) is applied using unrelated business taxable income.

The Congressional Letter also indicates that the section 199 deduction is not taken into account for purposes of computing taxable income under the rules relating to the carryover of a net operating loss (NOL). Accordingly, the proposed regulations provide that for purposes of computing the section 199 deduction, the definition of taxable income under section 63 applies, but without regard to section 199. The proposed regulations also provide that the section 199 deduction is not taken into account in computing taxable income when determining the amount of the NOL carryback and carryover under section 172(b)(2). Thus, except as otherwise provided in § 1.199-7(c)(2) of the proposed regulations (concerning the portion of a section 199 deduction allocated to a member of an EAG), the section 199 deduction can neither create an NOL carryback or carryover nor increase the amount of an NOL carryback or carryover.

Wage Limitation

A commentator requested that the IRS and Treasury Department clarify whether self-employment income of self-employed individuals as reported on the individuals' Schedule SE, "Self-Employment Income," of Form 1040 and/or payments for nonemployee compensation reported by the taxpayer on Form 1099-MISC, "Miscellaneous Income," are included in determining the amount of the W-2 wages of the taxpayer. A commentator also requested that the IRS clarify whether guaranteed payments to partners are included in W-2 wages for purposes of section 199.

The statutory language in section 199(b) refers to the amounts a taxpayer is required to report as wages on Form W-2 pursuant to section 6051 with respect to the employment of employees of the taxpayer. Neither self-employment income nor guaranteed payments to partners are required to be reported under section 6051. In addition, section 4.02(1)(a) of Notice

2005-14 and § 1.199-2(a)(1) of the proposed regulations define employees as including only common law employees of the taxpayer and officers of a corporate taxpayer. Consistent with the statutory intent, this definition does not include independent contractors or partners. Thus, payments to independent contractors and self-employment income, including guaranteed payments made to partners, are not included in determining W-2 wages.

The proposed regulations provide for the same three methods of calculating W-2 wages as contained in Notice 2005-14. It is anticipated that when final regulations are issued, these three methods will be published in a notice rather than as part of the final regulations. It is anticipated that this notice will be published at the same time as the final regulations. The methods will be included in a notice rather than the final regulations so that if changes are made to the box numbers on Form W-2, "Wage and Tax Statement," a new notice can be issued reflecting those changes more promptly than an amendment to final regulations.

The non-duplication rule in § 1.199-2(e) continues to provide that amounts that are treated as W-2 wages for any taxable year under any method may not be treated as W-2 wages for any other taxable year. Additional language has been added to the non-duplication rule to clarify that the same W-2 wages cannot be claimed by more than one taxpayer for purposes of section 199.

Domestic Production Gross Receipts

DPGR includes the gross receipts of the taxpayer that are derived from any lease, rental, license, sale, exchange, or other disposition of property described in section 199(c)(4)(A)(i). Commentators specifically asked whether fees such as cotton or real estate broker's fees are DPGR. These fees are non-DPGR because they are not derived from any lease, rental, license, sale, exchange, or other disposition of property under section 199(c)(4)(A)(i).

Commentators asked for clarification of whether DPGR includes gross receipts derived by a taxpayer from the subsequent sale or lease of QPP MPGE within the United States by the taxpayer, sold, and then reacquired by the taxpayer. The proposed regulations in § 1.199-3(h)(2) provide an example to illustrate the rule that gross receipts from the subsequent sale or lease of QPP are DPGR to the taxpayer that originally MPGE the QPP within the United States. Any interest component of the lease payment also qualifies as DPGR because section 199(c)(4)(A)(i) provides that

DPGR means gross receipts derived by the taxpayer from any lease.

Commentators pointed out that the rule for allocating gross receipts for purposes of identifying DPGR under section 3.04(1) of Notice 2005-14 appears to adopt a specific identification standard, whereas section 4.03(2) appears to provide a reasonable basis standard. The proposed regulations provide in § 1.199-1(d)(1) that the taxpayer must allocate its gross receipts from all transactions based on a reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances and that accurately identifies the gross receipts that constitute DPGR. If a taxpayer can, without undue burden or expense, specifically identify where an item was manufactured, or if the taxpayer uses a specific identification method for other purposes, then the taxpayer must use that specific identification method to determine DPGR. If a taxpayer does not use a specific identification method for other purposes and cannot, without undue burden or expense, use a specific identification method, the taxpayer is not required to use a specific identification method to determine DPGR.

Related Persons

Section 199(c)(7) provides that DPGR does not include any gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person. A person is treated as related to another person if both persons are treated as a single employer under either section 52(a) or (b) (without regard to section 1563(b)), or section 414(m) or (o). However, footnote 29 in the Conference Report indicates that this provision is not intended to apply to property leased by the taxpayer to a related person if the property is held for sublease or is subleased to an unrelated person for the ultimate use of such unrelated person, or to a license to a related person for reproduction and sale, exchange, lease, rental or sublicense to an unrelated person for the ultimate use of such unrelated person. Accordingly, the proposed regulations include these exceptions from the general rule of exclusion under section 199(c)(7).

One commentator stated that if a television network licenses programming to an affiliate station, applying section 199(c)(7) to treat the royalty payment received from the affiliate as non-DPGR places these vertically integrated companies at a competitive disadvantage. The commentator therefore suggested that the proposed regulations provide an

exception for networks and affiliate stations. The proposed regulations do not adopt this suggestion, which is not consistent with section 199(c)(7).

Derived From a Lease, Rental, License, Sale, Exchange, or Other Disposition

Commentators asked whether gains and losses associated with hedging transactions are included in DPGR. For example, utilities may hedge to manage the risk of changes in prices of ordinary inputs into the production process. For purposes of section 199 only, the proposed regulations include a rule in § 1.199-3(h)(3) concerning hedges (within the meaning of section 1221(b)(2) and § 1.1221-2(b)) of inventory that is QPP and supplies consumed in activities giving rise to DPGR. The proposed regulations require gain or loss on the hedging transaction to be taken into account in determining DPGR. The proposed rule applies to hedges that manage the risk of currency fluctuations but only to the extent that the hedges are not integrated with an underlying transaction under § 1.988-5(b).

Commentators suggested that the proposed regulations treat gross receipts attributable to the distribution or delivery of QPP as derived from the lease, rental, license, sale, exchange, or other disposition of that property. The commentators stated that section 199(c)(4)(B)(ii), which specifically provides that DPGR does not include gross receipts derived from the transmission and distribution of utilities, indicates (by negative implication) that gross receipts attributable to the distribution or delivery of QPP is intended to be considered DPGR. Moreover, some commentators interpreted language in section 3.04(10)(c) of Notice 2005-14, stating that bottled water is treated as QPP and that DPGR may include gross receipts attributable to distribution of bottled water, as suggesting that gross receipts attributable to distribution and delivery of QPP are considered DPGR.

In general, the IRS and Treasury Department believe that gross receipts attributable to distribution and delivery of QPP are not DPGR because distribution and delivery are properly regarded as services, regardless of whether the taxpayer retains the benefits and burdens of ownership of the property at the time it is delivered. No inference to the contrary in Notice 2005-14 was intended. Thus, the proposed regulations clarify that taxpayers generally must allocate gross receipts between the lease, rental, license, sale, exchange, or other disposition of the property itself and the

delivery component. The IRS and Treasury Department, however, believe that, because distribution and delivery are service components common to QPP, it is appropriate, as a matter of administrative convenience, to treat embedded distribution and delivery services similar to the qualified warranty exception in section 4.04(7)(b) of Notice 2005-14. Thus, the taxpayer must include in DPGR gross receipts attributable to the distribution and delivery of QPP if (1) in the normal course of business, the charge for the delivery or distribution service is included in the price charged for the sale of the QPP, and (2) the charge for the delivery or distribution service is neither separately offered nor separately bargained for with the customer.

For similar reasons, the proposed regulations also treat embedded qualified operating manuals provided in connection with the sale or disposition of QPP, qualified films, and utilities similar to embedded qualified warranties.

The proposed regulations also provide special rules for installation activities. The IRS and Treasury Department believe that, in some circumstances, installation is appropriately viewed as an MPGE activity, and in others it is appropriately viewed as a service. For example, installation is properly viewed as an MPGE activity if the taxpayer MPGE QPP within the United States and installs the QPP while the taxpayer retains the benefits and burdens of ownership of the QPP. In that case, gross receipts attributable to the installation, whether or not embedded, are derived from the lease, rental, license, sale, exchange, or other disposition of the QPP. If, however, the benefits and burdens of ownership pass to the customer prior to the installation of the QPP, the taxpayer is performing a service by installing the customer's property. In that case, gross receipts attributable to installation are not derived from the lease, rental, license, sale, exchange, or other disposition of the property, and the taxpayer generally is required under the proposed regulations to allocate gross receipts between the proceeds of sale or disposition of the property (DPGR) and the installation service (non-DPGR). However, the IRS and Treasury Department believe that, because installation is a service component common to sales or dispositions of QPP, if the benefits and burdens of ownership pass to the customer prior to the installation, it is appropriate to treat embedded installation similar to an embedded qualified warranty, qualified

delivery, and a qualified operating manual.

A number of commentators suggested that the IRS and Treasury Department expand the exception to the allocation requirement for a qualified warranty to include all services (including training, technical and customer support, and regular maintenance of the property), as well as all nonqualifying property (including purchased spare parts), the charge for which is embedded in the contract price of the lease, rental, license, sale, exchange, or other disposition of QPP, qualified films, and utilities. Other commentators stated that the proposed regulations should adopt principles similar to § 1.482-2(b), so that services that are ancillary and incidental to the sale of QPP, qualified films, and utilities would not be treated as embedded services and no allocation of gross receipts to those services would be required. These commentators believe that footnote 27 in the Conference Report supports such a position in stating that the conferees intend that the Secretary provide guidance regarding the allocation of gross receipts that draws on the principles of section 482. Other commentators stated that, elsewhere in the Code and regulations, transactions are given a single characterization based on their predominant nature and that section 199 should be applied in the same manner. For example, if the predominant nature of a transaction is the sale of property, all gross receipts from the transaction should be treated as proceeds from the sale. Finally, some commentators stated that a taxpayer's treatment of a transaction for financial reporting purposes should govern its characterization for section 199 purposes.

The IRS and Treasury Department infer that the commentators are referring to § 1.482-2(b)(8), which provides that, in general, no separate allocation will be made in connection with ancillary and subsidiary services provided with a transfer of property. Services ancillary and subsidiary to another transaction may be referred to, outside the section 199 context, as embedded services. The IRS and Treasury Department do not intend that services defined as embedded services under section 199 will be treated in the same manner provided in § 1.482-2(b)(8) because such treatment would be generally inconsistent with the intent and purpose of section 199.

The IRS and Treasury Department further believe that the reference to section 482 principles in footnote 27 of the Conference Report reflects an intent to apply section 482 principles

consistently with the general intent and purpose of section 199. The IRS and Treasury Department continue to believe that the statutory language and legislative history require that transactions be bifurcated into qualifying and nonqualifying elements and that gross receipts be allocated accordingly for purposes of section 199. The IRS and Treasury Department further believe that the exceptions to this general rule should be limited. Expanding the special exceptions to include all, or ancillary or incidental, embedded services and embedded nonqualifying property would result in the inclusion in DPGR of gross receipts that the IRS and Treasury Department do not believe were intended to be within the scope of section 199. The legislative history also does not support adopting principles applicable to other Code sections under which a single predominant nature character is assigned to a transaction, or characterizing transactions for purposes of section 199 according to their treatment for financial reporting purposes. Accordingly, the proposed regulations do not adopt these suggestions.

One commentator requested that the proposed regulations clarify whether the embedded services rule is intended to require taxpayers to treat certain service-type activities that take place as part of the MPGE process as embedded services. The proposed regulations clarify that embedded services do not include service-type activities that take place as part of the MPGE process (that is, while the taxpayer is engaged in an MPGE activity with respect to the property and retains the benefits and burdens of ownership of the property). For example, with respect to QPP, activities such as non-construction engineering, materials analysis and selection, subcontractor inspections and approval, routine production inspections, product testing and documentation, and assistance with certain regulatory approvals, if undertaken in connection with a qualifying MPGE activity, are considered part of the MPGE of the QPP and are not considered embedded services. No separate allocation of gross receipts to such activities is required.

Services and nonqualifying property are not considered embedded if they are either separately offered or separately bargained for, or a charge for the service or nonqualifying property is separately stated. Thus, for example, if a charge for freight or delivery is separately stated on an invoice for the sale of an item of QPP, the delivery service is not embedded and gross receipts

attributable to that service are non-DPGR, even if the purchaser does not have the option of refusing the service. Further, separately stated or bargained for amounts will not be respected unless they reflect the fair market value of the service or nonqualifying property. For example, if a taxpayer offers contracts to customers that include a cellular phone priced on the invoice at \$595 and three years of cellular telephone service priced on the invoice at \$5, the \$5 stated amount for the service will only be respected if it represents an allocation of gross receipts consistent with the principles of section 482.

Gross receipts attributable to embedded services, embedded nonqualifying property, or any other embedded element (other than a qualified warranty, qualified delivery, qualified installation, and a qualified operating manual) may be considered DPGR under the 5 percent de minimis exception. The proposed regulations clarify that, with respect to the de minimis exception, taxpayers should apply the 5 percent against the total amount of the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the item of QPP, qualified films, or utilities. The total amount of DPGR includes gross receipts attributable to a qualified warranty, qualified delivery, qualified installation, and/or a qualified operating manual that are treated as DPGR with respect to that item. In the case of a lease or an installment sale, the de minimis exception is applied by taking into account the total amount of gross receipts under the lease or installment sale that are attributable to the item of QPP, qualified films, or utilities.

Under the proposed regulations, as under Notice 2005-14, applicable Federal income tax principles apply in determining whether a transaction (or any part of a transaction) is, in substance, a lease, rental, license, sale, exchange, or other disposition, or whether it is a service. For this purpose, section 3.04(7)(a) of Notice 2005-14 cites Rev. Rul. 88-65 (1988-2 C.B. 32), and describes that revenue ruling as treating a short-term rental as a service. Many commentators asked that the proposed regulations clarify that not all short-term rentals will be regarded as services for purposes of section 199. They observed that Rev. Rul. 88-65 involves the lease of automobiles and trucks on a daily basis (normally for not more than one week), and that the taxpayer performs significant services in connection with the vehicle, including maintenance and repairs, and pays all taxes and insurance on the vehicle. The IRS and Treasury Department

acknowledge that the short-term nature of a transaction does not, by itself, render the transaction a service for purposes of section 199 and that many transactions include both service and property rental elements. Therefore, the proposed regulations clarify that, in such cases, taxpayers must allocate gross receipts between the qualifying rental of QPP or qualified films (DPGR) and the non-qualifying services (non-DPGR). The allocation must be based on the facts and circumstances of each transaction. Generally, in the case of short-term transactions, such as those described in Rev. Rul. 88-65, in which significant services are provided in connection with the property, the transaction will consist mostly of services.

Not every transaction in which property is used in connection with providing a service to customers, however, constitutes a mixture of services and rental for which allocation of gross receipts is appropriate. For example, assume that a taxpayer operates a video game arcade that features video game machines that the taxpayer MPGE. The machines remain in the taxpayer's possession during the customers' use. Gross receipts derived from customers' use of the machines at the taxpayer's arcade are not derived from the lease, rental, license, sale, exchange, or other disposition of the machines. Rather, the machines are used to provide a service and, thus, the gross receipts are non-DPGR.

A number of commentators objected to the position taken in section 4.04(7)(d) of Notice 2005-14 that gross receipts from Internet access services, online services, customer support, telephone services, games played through a website, provider-controlled software online access services, and other services are not derived from a lease, rental, license, sale, exchange, or other disposition of the software. Consistent with the notice, the proposed regulations reflect the position that the use of online computer software does not rise to the level of a lease, rental, license, sale, exchange, or other disposition as required under section 199 but is instead a service. This is the case even if the customer must agree to terms and conditions (which may be termed a *license* by the software provider) before using the software online, or receive enabling software to facilitate the customer's use of the primary software on the customer's hardware.

If gross receipts attributable to the use of online software were permitted to qualify as DPGR because the same or similar software also is available to

customers on disk or by download, different items of software available online would be subject to disparate treatment under section 199. In addition, if online software were permitted to qualify as DPGR, it would be difficult to distinguish this online software from software that is used to facilitate a service. The IRS and Treasury Department are requesting comments in the Request for Comments section on this issue.

One commentator suggested that the term lease, rental, license, sale, exchange, or other disposition, especially the term other disposition, was intended to be interpreted broadly to include gross receipts from any means of commercialization of property, whether or not an actual transfer of the property occurs. Another commentator noted that section 3.04(7)(d) of Notice 2005-14 states that gross receipts derived by a taxpayer from software that is merely offered for use to customers online for a fee are non-DPGR, and suggested that if the software is also offered to customers on disk or by download, then gross receipts for online use of otherwise qualifying software would be DPGR. The commentator also noted that the same section provides that a "service provided using computer software that does not involve a transfer of the computer software does not result in [DPGR]," and suggested that this language implies that if the software is not used in providing a service, no transfer is required for purposes of section 199. The IRS and Treasury Department did not intend the results suggested by the commentators and the proposed regulations have been clarified as necessary.

A number of commentators requested clarification and expansion of the rule in Notice 2005-14 that treats advertising receipts attributable to the sale or other disposition of newspapers and magazines as DPGR. Notice 2005-14 explains that advertising receipts in this context are inextricably linked to the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the newspapers and magazines. In response to comments, the proposed regulations clarify that this rule also applies, under the same rationale, to advertising receipts relating to telephone directories and periodicals, whereby a taxpayer's gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the telephone directories or periodicals that are MPGE in whole or in significant part within the United States includes advertising income from advertisements placed in those media, but only to the extent the gross receipts, if any, derived

from the lease, rental, license, sale, exchange, or other disposition of the telephone directories or periodicals are DPGR. The proposed regulations clarify that advertising revenue for advertising in online newspapers and periodicals is non-DPGR, because any underlying receipts from the property itself are non-DPGR, as there is no lease, rental, license, sale, exchange, or other disposition of such property. The proposed regulations provide similar treatment for gross receipts attributable to product placements in a qualified film. The gross receipts attributable to product placements will be treated as DPGR, but (as with newspapers) only if the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the qualified film are DPGR. Thus, for product placement revenue to be derived from a qualified film, there must be a lease, rental, license, sale, exchange, or other disposition of a qualified film.

Section 3.04(9)(a) of Notice 2005-14 provides that revenue from the licensing of film characters is not derived from the lease, rental, license, sale, exchange, or other disposition of a qualified film. One commentator stated that this treatment is inconsistent with the income forecast method, and that revenue from licensing of film-related intangibles is inextricably linked to (and therefore should be treated as derived from) the qualified film. The proposed regulations do not adopt this comment. Section 199(c)(4)(A)(i)(II) clearly requires that receipts must be derived from a lease, rental, license, sale, exchange, or other disposition of a qualified film to be DPGR. Receipts derived from the licensing of related intangibles, including film characters, trademarks, and trade names, do not meet this requirement. Further, the IRS and Treasury Department do not agree that receipts derived from licensing of film-related intangibles are inextricably linked to the gross receipts derived from a qualified film.

Some commentators objected to the rule in section 4.04(7)(a) of Notice 2005-14 that provides that if a taxpayer exchanges QPP MPGE by the taxpayer in whole or in significant part within the United States for other property in a taxable exchange, the value of the property received by the taxpayer is DPGR; whereas any gross receipts derived from a subsequent sale by the taxpayer of the acquired property are non-DPGR because the taxpayer did not MPGE the acquired property. The commentators noted that in their industry, fungible commodities held for sale to customers are exchanged routinely between producers as a

practical means of avoiding logistical problems in meeting customers' needs and reducing transportation and storage costs. The commentators noted that these exchanges typically are not treated as taxable exchanges on the parties' financial records. The commentators requested that the proposed regulations instead provide that if the property relinquished in the exchange is QPP, qualified films, or utilities, then the property received in the exchange should be treated as QPP, qualified films, or utilities and gross receipts derived from the subsequent sale of that property should be treated as DPGR. Another commentator suggested that this treatment be applied only to nontaxable exchanges.

The proposed regulations do not adopt these suggestions. The IRS and Treasury Department believe that the character of property as having been MPGE in whole or in significant part by the taxpayer within the United States is not an attribute of the property, like basis and holding periods, that may be substituted with the transfer of the property. The IRS and Treasury Department believe that the commentators' interpretations are inconsistent with section 199(c)(4)(A)(i)(I).

Commentators requested that the IRS and Treasury Department clarify whether gross receipts from mineral royalties and net profits interests are properly treated as DPGR. Mineral royalties, including net profits interests, are returns on passive interests in mineral properties, the owner of which makes no expenditure for operation or development. The courts and the IRS have long considered these types of income to be in the nature of rent (see, for example, *Kirby Petroleum Co. v. Comm'r*, 326 U.S. 599 (1946)). Accordingly, the proposed regulations in § 1.199-3(h)(9) provide that gross receipts from mineral interests and net profits interests other than operating or working interests are not treated as DPGR.

Definition of Manufactured, Produced, Grown, or Extracted

Section 4.04(3)(b) of Notice 2005-14 provides that a taxpayer that MPGE QPP for the taxable year should treat itself as a producer under section 263A with respect to the QPP for the taxable year unless the taxpayer is not subject to section 263A. In response, commentators questioned whether all taxpayers that are subject to section 263A are considered to have MPGE QPP for purposes of section 199. Taxpayers who do not MPGE QPP may nevertheless be subject to section 263A. For example, a taxpayer that has

property produced for it under a contract is considered a producer of property under section 263A, but may not be considered as having MPGE property for purposes of section 199 if it does not have the benefits and burdens of ownership of the property while it is being produced.

Additionally, in some circumstances a taxpayer that manufactures property for a customer pursuant to a contract may be considered the producer of the property for purposes of section 263A and not to have MPGE the property for purposes of section 199. Accordingly, not all taxpayers that are subject to section 263A are considered to have MPGE QPP for purposes of section 199.

Commentators also have questioned whether a taxpayer that engages in certain production activities that are exempt from section 263A (for example, developing computer software under Rev. Proc. 2000-50 (2000-1 C.B. 601), producing property pursuant to a long-term contract under section 460, or farming exempt under section 263A(d)) must treat itself as a producer under section 263A if the taxpayer wants to be treated as MPGE QPP for purposes of section 199. The proposed regulations in § 1.199-3(d)(4) provide that a taxpayer that has MPGE QPP for the taxable year should treat itself as a producer under section 263A with respect to the QPP for the taxable year unless the taxpayer is not subject to section 263A. A taxpayer whose MPGE activity is exempt from section 263A is not required to change its method of accounting under section 263A to treat itself as engaged in the MPGE of QPP for purposes of section 199.

Commentators requested clarification as to whether a reseller that engages in de minimis production activities or that has property produced for it under contract, which constitutes the MPGE of QPP under section 199, is precluded from using the simplified resale method provided by § 1.263A-3(d). Section 1.263A-3(a)(4)(ii) provides that a reseller with de minimis production activities is permitted to use the simplified resale method. Likewise, § 1.263A-3(a)(4)(iii) provides that a reseller otherwise permitted to use the simplified resale method is permitted to use the method if it has personal property produced for it under a contract if the contract is entered into incident to its resale activities and the property is sold to its customers. The section 263A consistency rule provided in § 1.199-3(d)(4) of the proposed regulations does not affect the rules provided in § 1.263A-3. Accordingly, a reseller with de minimis production or that has property produced for it under

a contract that is considered the MPGE of QPP for purposes of section 199 is not precluded from using the simplified resale method if the taxpayer meets the requirements of § 1.263A-3(a)(4)(ii) or (iii).

Definition of By the Taxpayer

Section 1.199-3(e)(1) of the proposed regulations provides that, with the exception of rules that are applicable to an EAG, certain oil and gas partnerships described in § 1.199-3(h)(7), EAG partnerships described in § 1.199-3(h)(8), and certain government contracts described in § 1.199-3(e)(2), only one taxpayer may claim the section 199 deduction with respect to the MPGE of QPP. If one taxpayer MPGE QPP pursuant to a contract with another person, then only the taxpayer that has the benefits and burdens of ownership of the property under Federal income tax principles during the time the property is MPGE will be considered to have MPGE the QPP. In contrast, § 1.263A-2(a)(1)(ii)(B) provides that property produced for the taxpayer under a contract is considered as produced by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs with respect to the property, even if the taxpayer is not the owner of the property while the property is being produced. Commentators questioned why a similar rule does not apply in the context of section 199. The rule provided by § 1.263A-2(a)(1)(ii)(B) is derived from section 263A(g)(2). That section specifically provides that a taxpayer is treated as producing property produced for it under a contract to the extent that it has made payments or incurred costs with respect to the contract. In contrast, section 199(c)(4)(A)(i) provides that DPGR only includes gross receipts of the taxpayer that are derived from any lease, rental, license, sale, exchange, or other disposition of QPP MPGE by the taxpayer in whole in significant part within the United States. Accordingly, the proposed regulations do not contain a provision that is analogous to § 1.263A-2(a)(1)(ii)(B).

While sections 199, 263A, and 936 all have benefits and burdens standards, the standard under section 199 is not the same as those under sections 263A and 936. Commentators suggested that the proposed regulations adopt the broader standard under § 1.263A-2(a)(1)(ii)(A) that provides that a taxpayer is not considered to be producing property unless the taxpayer is considered the owner of the property produced under Federal income tax principles. The determination of whether a taxpayer is considered an

owner is based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxpayer. Because the standard under the section 263A regulations is broad, it has been interpreted to allow two taxpayers to be considered the producer of the same property. Compare, for example, *Suzy's Zoo v. Comm'r*, 114 T.C. 1 (2000), *aff'd* 273 F.3d 875 (9th Cir. 2001) and *Golden Gate Litho v. Comm'r*, T.C. Memo (1998-184).

The IRS and Treasury Department continue to believe that the requirement of section 199(c)(4)(A)(i) that property be MPGE by the taxpayer means that only one taxpayer may claim the section 199 deduction with respect to the same function performed with respect to the same property. Therefore, it would be inappropriate to adopt the standard under the section 263A regulations. In addition, this interpretation is supported by the Congressional Letter that states the Treasury Department has the authority to prescribe rules to prevent the section 199 deduction from being claimed by more than one taxpayer with respect to the same economic activity described in section 199(c)(4)(A)(i). Thus, consistent with Notice 2005-14, the proposed regulations in § 1.199-3(e)(1) provide that only one taxpayer may claim the section 199 deduction with respect to any MPGE activity.

Commentators also proposed other alternatives to the benefits and burdens standard, such as looking to the person that has the economic risks and benefits, adopting the qualified research rules under § 1.41-2(e)(2), providing safe harbors based on contract terms, treating the person that arranges for the acquisition of the property as the owner, and looking to the person that controls the process by which the property is MPGE. The proposed regulations do not adopt any of these suggestions because the IRS and Treasury Department believe that there is considerable variation in the types of contract manufacturing situations. Therefore, the proposed regulations contain the same benefits and burdens standard used in Notice 2005-14 because it is a standard that the IRS and Treasury Department believe covers all of the varied factual situations.

Commentators requested that the proposed regulations provide examples of how to apply the benefits and burdens standard. The proposed regulations contain examples illustrating contract manufacturing situations in which the taxpayer with the benefits and burdens of ownership

under Federal income tax principles is treated as manufacturing the QPP.

In the Congressional Letter, the Treasury Department was advised that gross receipts derived from certain contracts to manufacture or produce property for the Federal government are derived from the sale of such property and, therefore, are DPGR. The proposed regulations in § 1.199-3(e)(2) provide that a taxpayer will be treated as meeting the by the taxpayer requirement if the QPP, qualified films, or utilities are MPGE or otherwise produced in the United States by the taxpayer pursuant to a contract with the Federal government and the Federal Acquisition Regulation requires that title or risk of loss with respect to the QPP, qualified films, or utilities be transferred to the Federal government before the MPGE or production of the QPP, qualified films, or utilities is complete.

In Whole or In Significant Part

Under section 199(c)(4)(A)(i)(I), QPP must be MPGE in whole or in significant part by the taxpayer within the United States. The proposed regulations in § 1.199-3(f)(1) clarify that the in whole or in significant part requirement applies to both the by the taxpayer requirement and the within the United States requirement.

Section 4.04(5)(b) of Notice 2005-14 provides that QPP will be treated as having been MPGE in significant part by the taxpayer within the United States if the MPGE of the QPP performed within the United States is substantial in nature. Design and development costs do not qualify as substantial in nature for any QPP other than computer software and sound recordings. The proposed regulations in § 1.199-3(f)(2) substitute research and experimental expenditures under section 174 for design and development costs.

Section 4.04(5)(c) of Notice 2005-14 provides that a taxpayer will be treated as having MPGE property in whole or in significant part within the United States if, in connection with the property, conversion costs (direct labor and related factory burden) to MPGE the property are incurred by the taxpayer within the United States and the costs account for 20 percent or more of the total CGS of the property. The proposed regulations in § 1.199-3(f)(3) provide that, in the case of tangible personal property, research and experimental expenditures under section 174 and any other costs of creating intangibles may be excluded from total CGS for purposes of the safe harbor.

A commentator suggested that a taxpayer's activity within the United States that is critical to the functionality

or nature of property should be considered to meet the in significant part requirement under section 199(c)(4)(A)(i)(I) even if the activity is not substantial in nature. The proposed regulations do not adopt this suggestion because the IRS and Treasury Department do not believe that this is an accurate measurement of the degree of activity required to satisfy the in whole or in significant part requirement.

Qualifying Production Property

Commentators requested that the IRS and Treasury Department reconsider the rule under section 4.04(8)(c) and (d) of Notice 2005-14 which provides that, if the medium in which computer software or sound recordings are contained is tangible, then such medium is considered tangible personal property for purposes of section 199. This rule has been removed and the proposed regulations in § 1.199-3(i)(5) provide that if a taxpayer MPGE computer software or sound recordings that the taxpayer fixed on, or added to, tangible personal property (for example, a computer diskette or an appliance), then the tangible medium with the computer software or sound recordings may be treated by the taxpayer as computer software or sound recordings, as applicable. However, the proposed regulations provide that, if a taxpayer treats the tangible medium as computer software or sound recordings, any costs under section 174 attributable to the tangible medium are not considered in determining whether the taxpayer's activity is substantial in nature under § 1.199-3(f)(2) or conversion costs under § 1.199-3(f)(3). In addition, because a taxpayer may MPGE tangible personal property, but not computer software or sound recordings that the taxpayers fixes on, or adds to, the tangible personal property MPGE by the taxpayer, the proposed regulations provide that the computer software or sound recordings may be treated by the taxpayer as tangible personal property.

Commentators requested that the proposed regulations clarify whether the exceptions from computer software under section 168(i)(2)(B)(iv) apply to computer software under section 199. In response to this comment, the proposed regulations provide in § 1.199-3(i)(3)(i) that these exceptions do not apply for purposes of section 199 and computer software also includes the machine-readable code for video games and similar programs, for equipment that is an integral part of other property, and for typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, regardless of whether the

code is designed to operate on a computer (as defined in section 168(i)(2)(B)). Computer programs of all classes, for example, operating systems, executive systems, monitors, compilers and translators, assembly routines, and utility programs as well as application programs, are included.

A commentator requested that the proposed regulations provide that the creation and licensing of copyrighted business information reports constitutes the MPGE of QPP. Formerly distributed in hard copy, this information is now generally distributed electronically. Customers are required to use the information only for their own use, and no copyright is transferred to them. The commentator contends that, while the activity of creating the business information reports provided to customers is not a production activity in the traditional sense, the definition of MPGE is broad enough to encompass this activity. The IRS and Treasury Department do not agree with this comment because creating a database of business information is not MPGE, the database is not QPP, and the business information reports are not QPP MPGE by the taxpayer.

Qualified Films

Similar to the rules for computer software, section 4.04(9)(a) of Notice 2005-14 provides that if a medium on which a qualified film is fixed is tangible (such as a DVD), the property consists of both a qualified film and tangible personal property. The notice contains examples in which taxpayers that either produce a qualified film and purchase the tangible medium, or MPGE the tangible medium and license the qualified film, must allocate gross receipts between the tangible medium and the qualified film. For the reasons stated under the discussion of computer software, the proposed regulations allow certain taxpayers to treat such combined property as either tangible personal property or a qualified film, as applicable.

One commentator requested that the proposed regulations clarify the requirement that 50 percent of the total compensation relating to the production of the film be compensation for services performed in the United States by actors, production personnel, directors, and producers. Specifically, the commentator requested that the phrase "total compensation relating to the production of the film" be interpreted to mean compensation for services performed only by actors, production personnel, directors, and producers. The commentator further requested that the term "compensation" be interpreted to

include all compensation (not just W-2 wages) that is paid to these individuals and that is required to be capitalized by film producers under section 263A and § 1.263A-1(e)(2) and (3). These suggestions have been adopted in the proposed regulations.

Definition of Construction Performed in the United States

Section 4.04(11)(a) of Notice 2005-14 defines the term "construction" to mean the construction or erection of real property by a taxpayer that is in a trade or business that is considered construction for purposes of the North American Industry Classification System (NAICS). Commentators asked how a taxpayer in multiple trades or businesses determines if it is in a construction NAICS code. The proposed regulations clarify that in order for a taxpayer to be considered in a construction NAICS code, it must be engaged in a construction trade or business (but not necessarily its primary trade or business) on a regular and ongoing basis. The determination of whether an entity is in a NAICS code is generally tested on an entity-by-entity basis. Under this rule, a member of an EAG must perform the construction activity in order for its gross receipts to qualify as DPGR from construction. See § 1.199-7(a)(3). In addition, the taxpayer must actually perform the construction activity. For example, if a taxpayer in a construction NAICS code hired an unrelated general contractor to construct a building, the gross receipts derived by the taxpayer from the sale of the building would not be DPGR because the taxpayer did not construct the building. The proposed regulations provide an example to illustrate this rule.

Commentators also asked that the proposed regulations clarify whether eligible construction activities are limited to a specific NAICS code. Section 1.199-3(l)(1)(i) provides that a trade or business that is considered construction for purposes of the NAICS codes means a construction activity under the two-digit NAICS code of 23 and any other construction activity in any other NAICS code relating to the construction of real property. For example, a construction activity relating to the construction of real property that is not under the two-digit NAICS code of 23 but which qualifies as an eligible construction activity would include the construction of oil and gas wells for NAICS code 213111 (drilling oil and gas wells) and 213112 (support activities for oil and gas operations). Commentators also asked that the proposed regulations include a listing of construction

activities relating to oil and gas wells. In response to this request, the proposed regulations provide, as a matter of administrative grace, that qualifying construction activities also include activities relating to drilling an oil well and mining, and include any activities treated by the taxpayer as intangible drilling and development costs under section 263(c) and § 1.612-4 and development expenditures for a mine or natural deposit under section 616.

Commentators contend that gross receipts attributable to the leasing or rental of constructed real property qualify as DPGR because the right to use constructed property represents one right in the bundle of rights derived from the construction of real property. The proposed regulations do not adopt this interpretation because gross receipts derived from the rental of real property that a taxpayer constructs are not derived from construction, but are instead compensation for the use or forbearance of the property. Similarly, gross receipts derived from renting or leasing equipment such as bulldozers and generators to contractors for use in the construction of real property are non-DPGR (assuming the rental companies do not manufacture the equipment).

Section 4.04(11)(a) of Notice 2005-14 contains a safe harbor rule for determining when tangible personal property that is sold as part of a construction project may be considered real property. If more than 95 percent of the total gross receipts derived by a taxpayer from a construction project are derived from real property (as defined in § 1.263A-8(c)), then the total gross receipts derived by the taxpayer from the project are DPGR from construction. Commentators stated that it was unclear what items of tangible personal property are included in this rule (for example, small or major appliances, home theaters, and fixtures installed by a builder) and whether it was intended that land be included for purposes of this safe harbor. Consequently, this rule has been replaced in the proposed regulations with a *de minimis* exception in § 1.199-3(l)(1)(ii). Accordingly, if less than 5 percent of the total gross receipts derived by a taxpayer from a construction project are derived from activities other than the construction of real property in the United States (for example, from non-construction activities, the sale of tangible personal property, or land) then the total gross receipts derived by the taxpayer from the project are DPGR from construction.

Many commentators suggested that the proposed regulations treat gross receipts attributable to the sale or other

disposition of land as DPGR derived from construction of real property. Commentators also suggested that construction begins as soon as production activities begin, that is, when land is acquired and the entitlement process, such as obtaining proper zoning and permits, commences in connection with construction of real property. The proposed regulations do not adopt these suggestions. The IRS and Treasury Department continue to believe that Congress intended the benefit under section 199 only for construction services performed in the United States. Taxpayers do not construct land and thus any gain attributable to the disposition of land (including zoning, planning, entitlement costs and other costs capitalized to the land such as the demolition of structures under section 280B) is not eligible for the section 199 deduction. Commentators also argue that the land exclusion creates an administrative and financial burden because a valuation will be necessary for any sale of real property that includes land. To address the administrative burden in identifying and valuing the gross receipts attributable to land in connection with qualifying construction activities, the proposed regulations provide a safe harbor in § 1.199-3(l)(5)(ii). Under this safe harbor, a taxpayer may allocate gross receipts between the proceeds from the sale, exchange, or other disposition of real property constructed by the taxpayer and the gross receipts attributable to the sale, exchange, or other disposition of land by reducing its costs related to DPGR in § 1.199-4 by costs of the land and any other costs capitalized to the land (collectively, land costs) (including land costs in any common improvements as defined in section 2.01 of Rev. Proc. 92-29 (1992-1 C.B. 748)), and by reducing its DPGR from qualifying construction activities by those land costs plus a specified percentage. The percentage is based on the number of years that elapse between the date the taxpayer acquires the land, including the date the taxpayer enters into the first option to acquire all or a portion of the land, and ends on the date the taxpayer sells each item of real property on the land. The percentage is 5 percent for years zero through 5; 10 percent for years 6 through 10; and 15 percent for years 11 through 15. Land held by a taxpayer for 16 or more years is not eligible for the safe harbor and the taxpayer must allocate gross receipts between the land and the qualifying real property. For example, if a taxpayer acquires land in 2001 and constructs houses that it sells in 2005, 2008, and

2012, the houses sold in 2005 are subject to the 5 percent reduction; the houses sold in 2008 are subject to the 10 percent reduction; and the houses sold in 2012 are subject to the 15 percent reduction.

Commentators suggested that developers of raw land should be entitled to a section 199 deduction for improvements to land such as building roads, sidewalks, and installing utilities. In addition, they suggested that entitlements such as zoning, permits, and surveys that add value to the land should be included in DPGR similar to the treatment of design and development costs for software and sound recordings. The proposed regulations provide that a taxpayer in a construction NAICS code that sells developed land will have DPGR to the extent the receipts are attributable to real property such as infrastructure but not to the land and any entitlements attributable to the land. The proposed regulations provide examples in § 1.199-3(l)(5)(iii) to illustrate this rule.

Commentators suggested that the proposed regulations extend the embedded services exception for qualified warranties in connection with the sale of property to construction warranties. The IRS and Treasury Department agree with this suggestion. Accordingly, § 1.199-3(l)(5)(i) provides DPGR derived from the construction of real property includes gross receipts from any warranty that is provided in connection with the construction of the real property if, in the normal course of the taxpayer's business, the charge for the construction warranty is included in the price for the construction project and the construction warranty is neither separately offered by the taxpayer nor separately bargained for with the customer (that is, the customer cannot purchase the constructed real property without the construction warranty).

Engineering and Architectural Services

Section 4.04(12)(a) of Notice 2005-14 provides that DPGR includes gross receipts derived from engineering or architectural services performed in the United States for real property construction projects in the United States. Commentators stated that the definition of engineering and architectural services should not be limited to real property because this limitation is inconsistent with the rules for engineering and architectural services under the domestic international sales corporation, foreign sales corporation, and extraterritorial income exclusion provisions. The IRS and Treasury Department continue to believe that the statutory language in

section 199(c)(4)(A)(iii) requires that only engineering and architectural services relating to real property qualify for the section 199 deduction and that the same rules relating to construction of real property apply for engineering or architectural services. In addition, the Blue Book at page 172 n. 292, states that DPGR includes gross receipts derived from the engineering or architectural services performed with respect to real property only. Thus, DPGR only includes gross receipts derived from engineering or architectural services performed in the United States for the construction of real property in the United States. In addition, the IRS and Treasury Department believe that, consistent with the rules for construction activities, a taxpayer performing engineering and architectural services must be in a trade or business described in an engineering or architectural NAICS code. Accordingly, the proposed regulations require that, at the time the taxpayer performs the engineering or architectural services, the taxpayer must be in a trade or business on a regular and ongoing basis (but not necessarily its primary trade or business) that is considered engineering or architectural services for purposes of the NAICS codes, for example NAICS codes 541330 (engineering services) or 541310 (architectural services).

A commentator also requested clarification of whether a structure enclosing an electric generation station as described in Rev. Rul. 69-412 (1969-2 C.B. 2) would be considered real property for purposes of section 199(c)(4)(A)(iii). In that revenue ruling, the structure qualified as section 38 property for investment credit purposes. The revenue ruling does not determine whether the property was real or personal property. Under section 4.04(11)(a) of Notice 2005-14, real property includes residential and commercial buildings including items that are structural components of such buildings and inherently permanent structures other than tangible personal property in the nature of machinery. The proposed regulations in § 1.199-3(l)(1)(i) retain this language. Thus, a structure enclosing an electric generation station as described in Rev. Rul. 69-412 is treated as real property for purposes of section 199(c)(4)(A)(iii).

In addition, similar to the rules for construction, the determination of whether an entity is in an engineering or architectural NAICS code is made on an entity-by-entity basis. Under this rule, a member of an EAG must perform the engineering or architectural services in order for its gross receipts to qualify

as DPGR from engineering or architectural services. See § 1.199-7(a)(3). In addition, the taxpayer must actually perform the engineering or architectural services.

One commentator pointed out that the requirement in section 4.04(12)(a) of Notice 2005-14 that a taxpayer must substantiate that the engineering or architectural services relate to a construction project in the United States is unnecessary because taxpayers are already required to identify and allocate gross receipts attributable to DPGR based upon a reasonable method satisfactory to the Secretary for purposes of determining QPAI. Because there was no intention on the part of the IRS and Treasury Department to create an additional substantiation requirement for engineering and architectural services, this additional substantiation requirement is not required under the proposed regulations.

Commentators requested clarification of whether gross receipts attributable to feasibility studies, for example, planning possible road or building configurations for a potential real property development project, is a qualifying activity. The commentators state that engineering and architectural firms are often hired for these studies to determine a project's practicability. Accordingly, the proposed regulations provide in § 1.199-3(m)(1) that DPGR includes gross receipts derived from engineering or architectural services, including feasibility studies for a construction project in the United States, even if the planned construction project is not undertaken or is not completed.

Food and Beverages

Section 199(c)(4)(B)(i) provides that DPGR does not include gross receipts of the taxpayer that are derived from the sale of food and beverages prepared by the taxpayer at a retail establishment. Section 4.04(13) of Notice 2005-14 defines a "retail establishment" as real property leased, occupied, or otherwise used by the taxpayer in its trade or business of selling food or beverages to the public at which retail sales are made. One commentator stated that food carts and portable food stands should not be considered retail establishments because they do not constitute real property. The IRS and Treasury Department believe that the term "retail establishment" is intended to be interpreted broadly to include any facility at which the taxpayer prepares food or beverages and makes retail sales of the food or beverages to the public. See Conference Report at page 272 (footnote 27) (retail establishment not

limited to establishments at which customers dine on premises or to those engaged primarily in the dining trade). Accordingly, the proposed regulations do not adopt this suggestion, and the term "retail establishment" is clarified to include both real and personal property. In addition, a facility at which food and beverages are prepared solely for take out service or delivery is a retail establishment (for example, a caterer).

Consistent with Notice 2005-14, the proposed regulations provide that if a taxpayer's facility is a retail establishment, then, as a matter of administrative grace, a taxpayer is permitted to allocate its gross receipts between gross receipts derived from the wholesale sale of the food and beverages prepared at the retail establishment (which are DPGR, assuming all the other requirements of section 199(c) are met) and the gross receipts derived from the retail sale of the food and beverages prepared and sold at the retail establishment (which are non-DPGR). For this purpose, wholesale sales are defined as sales of food and beverages to be resold by the purchaser.

One commentator requested clarification how the retail establishment exception applies in the case of wineries. While producers of distilled spirits, wines, and beer may conduct retail sales of their products on their premises, such sales do not transform the entire premises of the distilled spirits plant, bonded wine cellar (or bonded winery), or brewery into a retail establishment. Chapter 51 of Title 26 of the United States Code, and the implementing regulations found in 27 CFR parts 19, 24, and 25, create clear distinctions between that portion of a distilled spirits plant, winery, or brewery devoted to production activities and the portion devoted to other activities, such as retail sales. Consistent with the treatment of such facilities for purposes of Chapter 51 of Title 26 of the United States Code and the regulations thereunder, the proposed regulations provide that the portion of a distilled spirits plant, bonded winery, or brewery that is restricted to production activities, including the processing and blending of distilled spirits, wine, and beer products, will not be treated as a retail establishment for purposes of section 199(c)(4)(B)(i). Thus, for example, for purposes of section 199, taxpaid wine sold from the taxpaid premises of a bonded winery is not considered to have been produced at a retail establishment because it is considered to have been produced on the bonded premises of the winery. Accordingly, the sales of such wine will be treated as DPGR for purposes of

section 199 (assuming all the other requirements of section 199(c) are met). A similar result applies to the sale of taxpaid distilled spirits from the general (taxpaid) premises of a distilled spirits plant, and to the sale of taxpaid beer from the tavern portion of a brewery.

A commentator suggested that the proposed regulations interpret the term *food and beverages* to mean only items prepared by the taxpayer in a single serving size for immediate consumption by the purchaser. The commentator believes that the Conference Report in footnote 27 supports this interpretation because these characteristics are common to the examples that the footnote provides (that is, brewed coffee and venison sausage prepared at a restaurant). The commentator further contends that this interpretation eliminates the distinction between food and beverages prepared off-site (gross receipts from the retail sale of which may be DPGR) and those prepared on-site (gross receipts from the retail sale of which are non-DPGR), a distinction that the commentator believes Congress did not intend.

The IRS and Treasury Department do not believe that the statute or Conference Report supports the commentator's interpretation. If the commentator's interpretation was correct, then gross receipts from the retail sale of the roasted coffee beans in footnote 27 would have qualified as DPGR even if the taxpayer had roasted the beans at its retail establishment because the beans are not sold in single servings for immediate consumption. However, footnote 27 makes clear that the gross receipts attributable to the beans only qualify because the beans were roasted at a facility separate from the retail establishment. Thus, the statute and legislative history clearly provide different treatment for gross receipts attributable to the retail sale of food and beverages prepared at a retail establishment and food and beverages prepared elsewhere.

The same commentator requested clarification of how the food and beverages exception applies to in-store bakeries. Footnote 27 of the Conference Report provides an example of a taxpayer that operates a supermarket that includes an in-store bakery, and provides that the taxpayer may allocate its gross receipts between DPGR and non-DPGR. The commentator believes that the example could be interpreted to mean that all gross receipts allocable to sales (both retail and wholesale) of items prepared in the bakery are non-DPGR. Section 4.04(13) of Notice 2005-14 however, as a matter of administrative grace, permits gross

receipts from wholesale sales of food and beverages produced at a retail establishment to qualify as DPGR (if all other requirements of section 199(c) are met), and the proposed regulations retain this rule. Thus, gross receipts from wholesale sales of items produced at the in-store bakery (for example, items sold to restaurants) may qualify as DPGR (if all other requirements of section 199(c) are met). The commentator further stated, consistent with the first comment, that gross receipts from retail sales of bakery products that require further processing by the consumer to be suitable for individual consumption (such as unsliced cakes and unsliced loaves of bread) should not be excluded from DPGR under section 199(c)(4)(B)(i). For the reasons stated above, the IRS and Treasury Department believe that retail sales of these items are subject to that exclusion. Receipts allocable to wholesale sales of these items, however, may qualify as DPGR under the administrative exception, assuming all the other requirements of section 199(c) are met.

Determining Costs

To determine its QPAI for the taxable year, a taxpayer must subtract from its DPGR the amount of CGS allocable to DPGR, the other deductions, expenses, and losses (deductions) directly allocable to DPGR, and a ratable portion of other deductions that are not directly allocable to DPGR or another class of income. A taxpayer's costs must be determined using the taxpayer's methods of accounting for Federal income tax purposes.

Allocation of Cost of Goods Sold

Notice 2005-14 provides that if a taxpayer can identify from its books and records CGS allocable to DPGR, CGS allocable to DPGR is that amount. The Notice also provides that if a taxpayer's books and records do not allow it to identify CGS allocable to DPGR, the taxpayer may use a reasonable allocation method to allocate CGS between DPGR and non-DPGR. The Notice further provides that, if a taxpayer uses a method to allocate gross receipts between DPGR and non-DPGR, then the taxpayer may not use a different method for purposes of allocating CGS.

Commentators suggested that a taxpayer should be permitted to allocate CGS using a reasonable method separate from the method used to allocate gross receipts because using the same allocation method for gross receipts and CGS may not be possible or may distort income. For example, a taxpayer that

can identify from its books and records gross receipts allocable to DPGR may not be able to specifically identify CGS allocable to DPGR. Commentators also questioned whether a taxpayer that can identify from its books and records CGS allocable to DPGR must allocate CGS on such basis when it allocates gross receipts using a different method. The proposed regulations clarify that if a taxpayer does, or can without undue burden or expense, specifically identify from its books and records CGS allocable to DPGR, CGS allocable to DPGR is that amount irrespective of whether the taxpayer uses another allocation method to allocate gross receipts between DPGR and other gross receipts. The proposed regulations also clarify that if a taxpayer cannot, without undue burden or expense, use a specific identification method to determine CGS allocable to DPGR, the taxpayer is not required to use a specific identification method to determine CGS allocable to DPGR, but may use some other reasonable method. A taxpayer's use of a method for purposes of allocating CGS between DPGR and non-DPGR that is different from its method for allocating gross receipts between DPGR and non-DPGR will ordinarily not be considered reasonable unless the method for allocating CGS is demonstrably more accurate than the method used to allocate gross receipts.

Commentators also suggested that CGS allocable to DPGR may not be readily ascertainable when a taxpayer uses the last-in, first-out (LIFO) method to account for its inventory. Therefore, commentators requested that a simplified method be provided to allocate CGS between DPGR and non-DPGR when a taxpayer uses the LIFO method to account for its inventory. The proposed regulations provide that a taxpayer that uses the LIFO method to account for its inventory may use any reasonable method to allocate CGS between DPGR and non-DPGR. In addition, the regulations provide simplified methods that a taxpayer may use to allocate CGS when a taxpayer uses the LIFO method to account for its inventories.

The IRS and Treasury Department also received comments requesting clarification of the types of costs that are required to be allocated as CGS allocable to DPGR. In particular, commentators stated that section 263A only requires taxpayers to capitalize costs with respect to inventory on hand at the end of the taxable year and that as a result taxpayers generally do not include indirect costs in CGS, but instead deduct the amount not allocated to ending inventory. Section 263A

requires a taxpayer that produces inventory to include in inventory costs the direct costs of producing the property and the property's properly allocable share of indirect costs for purposes of determining both ending inventory and CGS. Consistent with Notice 2005-14, the proposed regulations provide that, for purposes of determining CGS allocable to DPGR, CGS includes the costs that would have been included in ending inventory under the principles of sections 263A, 471, and 472 if the goods sold during the taxable year were on hand at the end of the taxable year. However, a taxpayer is permitted to use any reasonable method to allocate indirect costs properly included in CGS between DPGR and non-DPGR if the taxpayer's books and records do not, or cannot without undue burden or expense, specifically identify CGS allocable to DPGR.

Comments also were received concerning whether a taxpayer is permitted to use a reasonable allocation method to allocate CGS if it uses the simplified production method or simplified resale method for additional section 263A costs. The proposed regulations clarify that a taxpayer that uses either the simplified production method or the simplified resale method for additional section 263A costs may use a reasonable allocation method to allocate both section 471 costs and additional section 263A costs included in CGS. The proposed regulations further provide that if a taxpayer uses the simplified production method or the simplified resale method to allocate additional section 263A costs to ending inventory, additional section 263A costs ordinarily should be allocated in the same proportion as section 471 costs are allocated.

Allocation and Apportionment of Deductions

Consistent with Notice 2005-14, the proposed regulations provide three methods for allocating and apportioning deductions. However, as described below, modifications have been made in these proposed regulations to the qualification requirements of the simplified deduction method and the small business simplified overall method.

The first method, the "section 861 method," is required to be used by a taxpayer, unless the taxpayer is eligible and chooses to use either the simplified deduction method or the small business simplified overall method. Under the section 861 method, section 199 is treated as an operative section described in § 1.861-8(f). Accordingly, a taxpayer

determines the deductions allocated and apportioned to DPGR by applying the allocation and apportionment rules provided by §§ 1.861-8 through 1.861-17 and §§ 1.861-8T through 1.861-14T (the section 861 regulations), subject to certain special rules. The IRS and Treasury Department recognize that the allocation and apportionment rules of the section 861 method may be burdensome to certain taxpayers, particularly smaller taxpayers, that otherwise would not be required to use these rules. Accordingly, the proposed regulations provide two alternative methods, the simplified deduction method and the small business simplified overall method, with a goal of minimizing the need for smaller taxpayers to devote additional resources to compliance.

Under the "simplified deduction method," a taxpayer's deductions are apportioned between DPGR and other receipts based on relative gross receipts. The simplified deduction method does not apply to the allocation of CGS. Notice 2005-14 permits only taxpayers with average annual gross receipts of \$25,000,000 or less to use the simplified deduction method. Several commentators requested that the simplified deduction method also be made available to taxpayers with gross receipts in excess of \$25,000,000. Many of these comments were from taxpayers that have not in the past been required to allocate and apportion deductions under the section 861 regulations. Some commentators suggested that the simplified deduction method be used for all costs, except for limited identified costs such as interest, for which the section 861 method would continue to apply. Still other commentators suggested that taxpayers be allowed to use other existing cost allocation methods, such as those under section 263A or under other government regulatory procedures.

In response to these comments, the IRS and Treasury Department have modified the eligibility requirements for the simplified deduction method. Under the proposed regulations, a taxpayer may use the simplified deduction method if it has average annual gross receipts of \$25,000,000 or less, or total assets at the end of the taxable year of \$10,000,000 or less. However, the IRS and Treasury Department still believe that for taxpayers above this threshold the section 861 method is the appropriate method of allocating and apportioning deductions for purposes of determining QPAI. Furthermore, the alternative allocation methods suggested by commentators would each require additional rules and guidance to address

the interaction of the suggested methods with other Federal income tax rules and would result in administrative complexity and inefficiency. The IRS and Treasury Department believe that use of the section 861 method will result in an appropriate cost allocation and apportionment for purposes of section 199 and will be easier administratively for both taxpayers and the IRS than any new, equally comprehensive cost allocation and apportionment rules that might be created.

Section 1.199-4(f) of the proposed regulations provides that a qualifying small taxpayer may use the "small business simplified overall method" to apportion CGS and deductions to DPGR. Under Notice 2005-14, a qualifying small taxpayer is a taxpayer that has average annual gross receipts of \$5,000,000 or less or a taxpayer that is eligible to use the cash method as provided in Rev. Proc. 2002-28 (2002-1 C.B. 815). The IRS and Treasury Department are concerned that the \$5,000,000 average annual gross receipts threshold without further modification could be used by large taxpayers to circumvent the requirements to allocate and apportion deductions using the section 861 method. As a result, a deduction limitation has been added to this method. In addition, commentators requested that the definition of qualifying small taxpayer for purposes of the small business simplified overall method be expanded to include farmers that are not required to use the accrual method under section 447. The proposed regulations incorporate this suggestion. Accordingly, the proposed regulations provide that a qualifying small taxpayer is a taxpayer that: (1) has both average annual gross receipts of \$5,000,000 or less, and CGS and deductions (excluding NOL deductions and deductions not attributable to the conduct of a trade or business) for the current taxable year of \$5,000,000 or less; (2) is engaged in the trade or business of farming that is not required to use the accrual method under section 447; or (3) is eligible to use the cash method as provided in Rev. Proc. 2002-28.

Notice 2005-14 specifically requested comments on whether taxpayers should be able to change between the three cost allocation methods of section 199 on amended returns and whether there should be restrictions on a taxpayer's ability to change from one method to another. Several commentators suggested that a taxpayer should be allowed to change its cost allocation method on an amended return and that a taxpayer should be able to annually

choose to use any of the three methods. The IRS and Treasury Department agree that a taxpayer that qualifies to use a particular allocation and apportionment method should be able to change to that method at any time. Accordingly, the proposed regulations generally provide that a taxpayer eligible to use the simplified deduction method may choose at any time to use the simplified deduction method or the section 861 method for a taxable year. A taxpayer eligible to use the small business simplified overall method may choose at any time to use the small business simplified overall method, the simplified deduction method, or the section 861 method for a taxable year. This rule does not affect, however, any restrictions or limitations that apply within the section 861 method.

Pass-Thru Entities

Section 199 applies at the owner level in a manner consistent with the economic arrangement of the owners of the pass-thru entity. Under the proposed regulations, each owner computes its section 199 deduction by taking into account its distributive or proportionate share of the pass-thru entity's items (including items of income and gain, as well as items of loss and deduction not otherwise disallowed by the Code), CGS allocated to such items of income, and gross receipts included in such items of income. In response to a commentator's inquiry, the proposed regulations make it clear that the owner of a pass-thru entity need not be engaged directly in the entity's trade or business in order to claim a section 199 deduction on the basis of that owner's share of the pass-thru entity's items.

Some commentators recommended that section 199 be applied to partnerships by using an aggregate approach in situations where the qualified production activities are conducted by the partnership, which distributes or sells the QPP, qualified films, or utilities to a partner who then leases, rents, licenses, sells, exchanges, or otherwise disposes of the property, or where the qualified production activities are conducted by a partner which contributes or sells the QPP, qualified films, or utilities to the partnership, which then leases, rents, licenses, sells, exchanges, or otherwise disposes of the property. The commentators maintained that the income derived by the partners and the partnerships from the lease, rental, license, sale, exchange, or other disposition of the property in these situations should be treated as QPAI and qualify for the section 199 deduction. The proposed regulations do

not follow the commentators' recommendation because section 199(c)(4)(A) requires that the gross receipts must be derived from the taxpayer's own qualified production activities to qualify as DPGR. Accordingly, except for: (i) certain qualifying oil and gas partnerships; and (ii) EAG partnerships, discussed below, the proposed regulations provide that the owner of a pass-thru entity is not treated as directly conducting the qualified production activities of the pass-thru entity, and vice versa, with respect to the property transferred between the pass-thru entity and the owner. This rule applies to all partnerships, including partnerships that have elected out of subchapter K under section 761(a). In addition, attribution of activities does not apply for purposes of the construction of real property and the performance of engineering and architectural services.

The proposed regulations, pursuant to the Congressional Letter, provide a limited exception for certain partnerships in which all of the capital and profits interests are owned by members of a single EAG at all times during the taxable year of the partnership (EAG partnership). For purposes of determining the DPGR of a partnership and its partners, an EAG partnership and all members of the EAG in which the partners of the EAG partnership are members are treated as a single taxpayer during the taxable year for purposes of section 199(c)(4). Thus, if an EAG partnership MPGE or produces property and distributes, leases, rents, licenses, sells, exchanges, or otherwise disposes of that property to a member of an EAG in which the partners of the EAG partnership are members, then the MPGE or production activity conducted by the EAG partnership will be treated as having been conducted by the members of the EAG. Similarly, if one or more members of an EAG in which the partners of an EAG partnership are members MPGE or produces property, and contributes, leases, rents, licenses, sells, exchanges, or otherwise disposes of that property to the EAG partnership, then the MPGE or production activity conducted by the EAG member (or members) will be treated as having been conducted by the EAG partnership.

Except as otherwise provided, an EAG partnership is generally treated the same as other partnerships for purposes of section 199. Accordingly, the proposed regulations provide that an EAG partnership is subject to the rules of § 1.199-5 regarding the application of section 199 to pass-thru entities, and the application of the section 199(d)(1)(B)

wage limitation under § 1.199-5(a)(3). Under the proposed regulations, if an EAG partnership distributes property to a partner, then, solely for purposes of section 199(d)(1)(B)(ii), the EAG partnership is treated as having gross receipts in the taxable year of the distribution equal to the fair market value of the property at the time of distribution to the partner and the deemed gross receipts are allocated to that partner, provided the partner derives gross receipts from the distributed property during the taxable year of the partner with or within which the partnership's taxable year (in which the distribution occurs) ends. Costs included in the adjusted basis of the distributed property and any other relevant deductions are taken into account in computing the partner's QPAI. The proposed regulations provide that the small business simplified overall method is not available to EAG partnerships.

Another commentator asked whether the owner of a pass-thru entity might have to perform multiple QPAI calculations, distinguishing between pass-thru and non-pass-thru production activities. The proposed regulations make it clear that, when determining its section 199 deduction, an owner of a pass-thru entity aggregates items of income and expense from the entity (including W-2 wages) with its own items of income and expense (including W-2 wages) for purposes of allocating and apportioning deductions to DPGR. As noted above, the amount of W-2 wages of a pass-thru entity taken into account by an owner in applying the wage limitation of section 199(b) is determined under section 199(d)(1)(B). The proposed regulations provide that in determining an owner's allocable share of wages under section 199(d)(1)(B)(i), W-2 wages are deemed to be allocated in the same way as wage expense is allocated. In the case of a non-grantor trust or estate, the W-2 wages are deemed to be allocated among the trust or estate and the various beneficiaries in the same manner as QPAI, as described below. Although a pass-thru entity's QPAI is computed by deducting wages paid by the entity during its entire taxable year, generally it is the pass-thru entity's W-2 wages (as shown on the Forms W-2 for the calendar year ending within that taxable year) that are used to compute the wage limitation under section 199(b) and an owner's allocable share of wages under section 199(d)(1)(B)(i). If QPAI, computed by taking into account only the items of the pass-thru entity allocated to the owner, is not greater

than zero, the owner may not take into account the W-2 wages of the entity in computing the section 199(b) wage limitation.

A commentator requested that the proposed regulations clarify and illustrate by example how the section 199(d)(1)(B) wage limitation applies in a tiered partnership structure. In particular, the commentator suggested that the W-2 wages of a lower-tier partnership with positive QPAI are properly allocable to the partner of the upper-tier partnership even if the QPAI allocated to the partner from the upper-tier partnership is less than zero. The proposed regulations do not adopt this suggestion. The proposed regulations provide that the section 199(d)(1)(B) wage limitation must be applied at each level in a tiered structure. Thus, in a tiered structure, the owner of a pass-thru entity (including an owner that itself is a pass-thru entity) calculates the amounts described in section 199(d)(1)(B)(i) (allocable share) and (d)(1)(B)(ii) (twice the applicable percentage of the QPAI from the entity) separately with regard to its interest in that pass-thru entity. The proposed regulations provide rules regarding the treatment of W-2 wages when a pass-thru entity (upper-tier entity) owns an interest in one or more other pass-thru entities (lower-tier entities). An example in the proposed regulations illustrates the application of these rules.

The proposed regulations contain special rules for trusts and estates. To the extent that a grantor or another person is treated as owning all or part of a trust under sections 671 through 679 (grantor trust), the owner will compute its QPAI with respect to the owned portion of the trust as if that QPAI had been generated by activities performed directly by the owner. In the case of a non-grantor trust or estate, the DPGR and expenses needed to compute the QPAI, as well as the W-2 wages relevant to the computation of the wage limitation, must be allocated among the trust or estate and its various beneficiaries. Each beneficiary's share of the trust's or estate's QPAI (which will be less than zero if the CGS and the deductions allocated and apportioned to DPGR exceed the trust's or estate's DPGR) and W-2 wages will be determined based on the proportion of the trust's or estate's distributable net income (DNI), as defined by section 643(a), that is deemed to be distributed to that beneficiary for that taxable year. Similarly, the proportion of the entity's DNI that is not deemed distributed by the trust or estate will determine the entity's share of the QPAI and W-2 wages. In addition, if the trust or estate

has no DNI in a particular taxable year, any QPAI and W-2 wages are allocated to the trust or estate, and not to any beneficiary.

Section 199(d)(1)(A)(i) provides that, in the case of an estate or trust (or other pass-thru entity), section 199 shall apply at the beneficiary (or similar) level. Pursuant to this provision, as clarified by the Congressional Letter, the proposed regulations provide that a trust or estate may claim the section 199 deduction to the extent that QPAI is allocated to it.

Solely for purposes of determining the section 199 deduction for the taxable year, the QPAI of a trust or estate must be computed by allocating the expenses described in section 199(d)(5) under § 1.652(b)-3 with respect to directly attributable expenses. With respect to other expenses described in section 199(d)(5), a trust or estate that qualifies for the simplified deduction method described in § 1.199-4(e) must use that method, and any other trust or estate must use the section 861 method described in § 1.199-4(d). The small business simplified overall method is not available to a trust or estate.

Because the sale of an interest in a pass-thru entity does not reflect the realization of DPGR by that entity, DPGR generally does not include gain or loss recognized on the sale, exchange or other disposition of an interest in the entity. However, consistent with Notice 2005-14, if section 751(a) or (b) applies, then gain or loss attributable to partnership assets giving rise to ordinary income under section 751(a) or (b), the sale, exchange, or other disposition of which would give rise to an item of DPGR, is taken into account in computing the partner's section 199 deduction.

Section 199 applies to taxable years beginning after December 31, 2004. Accordingly, these proposed regulations apply to taxable years of pass-thru entities that begin on or after January 1, 2005. The IRS and Treasury Department recognize that a pass-thru entity will need to provide certain information to its owners to allow those persons to compute the section 199 deduction. No special provision with regard to information reporting is made for electing large partnerships (ELPs) as defined by section 775, which are subject to the same methods for allocating and apportioning deductions as are other partnerships. Thus, ELPs are required to provide the same information to their partners as other partnerships for purposes of computing the section 199 deduction. The IRS and the Treasury Department intend to provide information reporting rules for

pass-thru entities in the relevant forms and instructions.

Agricultural and Horticultural Cooperatives

A commentator suggested that the proposed regulations provide that patrons cannot include patronage dividends and per-unit retain certificates in the computation of the QPAI from the patron's other farming operations to the extent that those amounts were taken into account by a cooperative in determining the cooperative's section 199 deduction. The commentator stated that in many cases, both the cooperative and its patrons will be engaged in qualifying activities. For example, gross receipts from crops raised by a farmer in the United States may be eligible for the section 199 deduction as well as the receipts the cooperative derives from the marketing of the crop. To avoid duplication of section 199 benefits, the proposed regulations clarify that under § 1.199-6(h) patronage dividends and per-unit allocations a patron receives from a cooperative that are taken into account as part of the cooperative's computation of QPAI may not be taken into account in computing the patron's QPAI from its own qualifying activities. In addition, patronage dividends and per-unit retain allocations include any advances on patronage or per-unit retains paid in money made during the taxable year. Examples are provided to illustrate this rule.

A commentator suggested that the proposed regulations clarify the amount of the section 199 deduction a cooperative is required to pass through to its patrons. Accordingly, the proposed regulations clarify in § 1.199-6(d) that the cooperative may, at its discretion, pass through all, some, or none of the allowable section 199 deduction to its patrons.

A commentator suggested that it would be useful if the proposed regulations address whether a cooperative member of a federated cooperative may pass through to its patrons the section 199 deduction it receives as a patron cooperative. Accordingly, the proposed regulations in § 1.199-6(d) provide that a cooperative patron of a federated cooperative may pass through the section 199 deduction it receives to its member patrons.

A commentator requested that the proposed regulations address the form, content, and timing of the patron notification requirements. The commentator stated that the notice should not have to accompany the patronage distribution. For instance, a

cooperative should be permitted to send out a notice passing through an estimated amount of the section 199 deduction at the time patronage dividends are paid and a second notice (when the Federal income tax return is completed and the section 199 deduction is actually determined) covering anything that was not passed through by the first notice, provided the notice is sent during the payment period in section 1382(d). The proposed regulations provide in § 1.199-6(b) that, in order for a patron to qualify for the section 199 deduction, the cooperative must designate the patron's portion of the section 199 deduction in a written notice mailed by the cooperative to its patrons no later than the 15th day of the ninth month following the close of the cooperative's taxable year. The cooperative may use the same written notice, if any, that it uses to notify patrons of their respective allocations of patronage dividends, or may use a separate timely written notice(s) to comply with this section. The cooperative must report the amount of the patron's section 199 deduction on Form 1099-PATR, "Taxable Distributions Received From Cooperative," issued to the patron.

A commentator suggested that the proposed regulations clarify that patrons (whether they use the cash or accrual method of accounting) are entitled to claim the section 199 deduction passed through from the cooperative on the return for the taxable year in which they receive written notification from the cooperative. The proposed regulations provide in § 1.199-6(d) that patrons may claim the section 199 deduction for the taxable year they receive the written notice informing them of the section 199 deduction amount.

A commentator suggested that the proposed regulations clarify that the section 199 deduction of a cooperative is subject to the W-2 wage limitation under section 199(b) at the cooperative level and that it is not subject to a second W-2 wage limitation at the patron level to the extent the section 199 deduction is passed through to its patrons. The proposed regulations provide in § 1.199-6(e) that the W-2 wage limitation shall be applied only at the cooperative level whether or not the cooperative chooses to pass through some or all of the section 199 deduction. In addition, the proposed regulations in § 1.199-6(d) provide that patrons may claim the section 199 deduction without regard to the taxable income limitation.

A commentator suggested that the proposed regulations address what happens when an audit determination results in a decrease in the amount of a

cooperative's section 199 deduction passed through to its patrons. The proposed regulations provide in § 1.199-6(f) that, if an audit determines or an amended return reports that the amount of the section 199 deduction that was passed through to patrons exceeded the amount determined to be allowable by the audit or on the amended return, recapture of the audit adjustment amount or excess amended return amount will occur at the cooperative level.

Expanded Affiliated Groups

Section 199(d)(4)(A) provides that all members of an EAG are treated as a single corporation for purposes of section 199.

The single corporation language in section 199(d)(4)(A) has created confusion among commentators and the proposed regulations clarify the meaning of this language. The proposed regulations provide that except as otherwise provided in the Code and regulations (see, for example, sections 199(c)(7) and 267, §§ 1.199-3(b) and 1.199-7(a)(3), and the consolidated return regulations), 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. For example, if corporations X and Y are members of the same EAG, but are not members of the same consolidated group, and X sells QPP to MPGE within the United States to Y, the transaction is taken into account in determining the EAG's section 199 deduction. If X and Y are members of the same consolidated group, see the section entitled Consolidated Groups, below.

The IRS and Treasury Department believe that Congress intended that an EAG should be eligible for the section 199 deduction if the activities to produce QPP, qualified films, and utilities are done by one or more members of the EAG other than the member who leases, rents, licenses, sells, exchanges, or otherwise disposes of the QPP, qualified films, and utilities. Accordingly, the proposed regulations provide generally that if a member of an EAG (the disposing member) derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of QPP, qualified films, and utilities MPGE or otherwise produced by another member or members of the same EAG, the disposing member is treated as conducting the activities conducted by each other member of the EAG with respect to the QPP, qualified films, and utilities in determining whether its gross receipts are DPGR. However, in general, attribution of

activities does not apply for purposes of the construction of real property under § 1.199-3(l)(1) or the performance of engineering and architectural services under § 1.199-3(m)(1). A member of an EAG must engage in a construction activity under § 1.199-3(l)(2), provide engineering services under § 1.199-3(m)(2), or provide architectural services under § 1.199-3(m)(3) in order for the member's gross receipts to be derived from construction, engineering, or architectural services.

Notwithstanding the above, attribution of activities in the construction of real property and the performance of engineering and architectural services does apply for members of the same consolidated group. For example, if X and Y are members of the same EAG, but are not members of the same consolidated group, and X constructs a commercial building and sells the building to Y, and Y, who performs no construction activities with respect to the building, sells the building to an unrelated person, Y is not attributed the construction activities of X and Y's receipts from the sale of the building will not be DPGR. However, if X and Y are members of the same consolidated group, Y is attributed the construction activities of X and, assuming all the requirements of section 199(c) are met, Y's receipts will be DPGR.

Some commentators suggested that the proposed regulations provide a special rule excluding finance companies from an EAG. Section 199(d)(4)(A) specifically states that all members of an EAG shall be treated as a single corporation. Neither the statute nor the legislative history provide any exceptions that would allow taxpayers to exclude certain types of companies, including finance companies, from the EAG. Accordingly, the commentators' suggestion has not been adopted.

Notwithstanding that a transaction between members of the same EAG (an intragroup transaction) generally is taken into account in determining the section 199 deduction, the IRS and Treasury Department recognize that taxpayers may engage in an intragroup transaction in an attempt to obtain a section 199 deduction when none should be available. Accordingly, the proposed regulations retain the anti-avoidance rule contained in Notice 2005-14. Thus, if a transaction between members of the same EAG is engaged in or structured with a principal purpose of qualifying for, or increasing the amount of, the section 199 deduction of the EAG or the portion of the section 199 deduction allocated to one or more members of the EAG, adjustments must be made to eliminate the effect of the

transaction on the computation of the section 199 deduction.

Some commentators asked whether the \$25,000,000 and \$5,000,000 average annual gross receipts thresholds for using the simplified deduction method and the small business simplified overall method, respectively, are applied at the EAG level, the consolidated group level, or at the member level. If the EAG was a single corporation, the \$25,000,000 and \$5,000,000 average annual gross receipts thresholds would take into account the activities of all the members of the EAG. Accordingly, the \$25,000,000 and \$5,000,000 average annual gross receipts thresholds are applied at the EAG level. Similarly, the new \$10,000,000 total assets threshold for using the simplified deduction method and the new \$5,000,000 current year CGS and deductions threshold for using the small business simplified overall method also are applied at the EAG level. The determination of whether a taxpayer is engaged in the trade or business of farming that is not required to use the accrual method of accounting under section 447 is determined by taking into account the activities of all the members of the EAG. Similarly, the determination of whether a taxpayer is eligible to use the cash method as provided in Rev. Proc. 2002-28, and is thus eligible to use the small business simplified overall method, is determined by taking into account the activities of all the members of the EAG.

Commentators requested that the rule in Notice 2005-14 that requires all members of the same EAG to use the same cost allocation method be changed to allow members to use different cost allocation methods. In response to the comments received, the IRS and Treasury Department agree that if an EAG is eligible to use the simplified deduction method, each member of the EAG may individually determine whether it wants to use the section 861 method or the simplified deduction method, notwithstanding that another member of the EAG uses a different method. Similarly, if the EAG is eligible to use the small business simplified overall method, each member of the EAG may individually determine whether it wants to use the section 861 method, the simplified deduction method, or the small business simplified overall method, notwithstanding that another member of the EAG uses a different method. However, if the EAG is not eligible to use either the simplified deduction method or the small business simplified overall method, then all members of the EAG must use the section 861 method.

Notwithstanding that the members of an EAG generally are not required to use the same cost allocation method, each member of a consolidated group must use the same cost allocation method. Examples are provided to illustrate these provisions.

A commentator also asked at what level the *de minimis* rule described in § 1.199-1(d)(2) is tested. Section 1.199-1(d)(2) treats all of a taxpayer's gross receipts as DPGR if less than 5 percent of the taxpayer's total gross receipts are non-DPGR. The *de minimis* rule is intended to eliminate the burden to a taxpayer of allocating gross receipts between DPGR and non-DPGR when less than 5 percent of its total gross receipts are non-DPGR. When considering the purpose of the *de minimis* rule, the IRS and Treasury Department believe that it is appropriate that the 5 percent threshold be determined at the corporation level, rather than at the EAG or consolidated group level.

Consolidated Groups

The section 199 deduction of a consolidated group (or the section 199 deduction allocated to a consolidated group that is a member of an EAG) is allocated to the members of the consolidated group in proportion to each consolidated group member's QPAI, regardless of whether the consolidated group member has separate taxable income or loss or W-2 wages for the taxable year. Further, if two or more members of a consolidated group engage in an intercompany transaction, as defined in § 1.1502-13(b)(1), the proposed regulations clarify that if an item of income, gain, deduction, or loss is not yet taken into account under § 1.1502-13, the intercompany transaction that gave rise to the item is not taken into account in computing the section 199 deduction until the time and in the same proportion that the item is taken into account under § 1.1502-13. For example, if corporations X and Y file a consolidated Federal income tax return and X sells QPP to MPGE within the United States to Y, the transaction is not taken into account until the time (and in the same proportion) provided in the matching rule of § 1.1502-13(c) or the acceleration rule of § 1.1502-13(d). The proposed regulations provide examples to illustrate these principles.

Some commentators suggested that if X's receipts from an intercompany transaction with consolidated group member Y are non-DPGR (for example, X licenses non-QPP to Y) and Y's CGS and other deductions from the intercompany transaction are taken into

account in determining the consolidated group's QPAI, the consolidated group's QPAI could be different than if X and Y were divisions of a single corporation, contrary to the general intent of § 1.1502-13. The consolidated return regulations already prevent this result. Under § 1.1502-13(c)(1)(i) and (c)(4), X's, Y's, or both X's and Y's separate entity attributes must be redetermined to the extent necessary to treat X and Y as if they were divisions of a single corporation. Thus, X's income may be redetermined to be DPGR (notwithstanding section 199(c)(7) or that the item licensed by X in the intercompany transaction does not otherwise meet the requirements of section 199(c)) or Y's CGS and other deductions from the intercompany transaction may be redetermined to be not allocable to DPGR, whichever produces the effect as though X and Y were divisions of a single corporation. Similarly, if X MPGE QPP within the United States and sells the QPP to Y, but Y does not use the QPP in creating DPGR, in order to produce the effect as though X and Y were divisions of a single corporation, X's gross receipts from the sale of the QPP may be redetermined to be non-DPGR or Y's CGS and other deductions may be redetermined to be allocable to DPGR. In addition, if X MPGE QPP within the United States and sells the QPP to Y, and Y sells the QPP to an unrelated person, X's gross receipts may be redetermined to be non-DPGR (and non-receipts) and Y's CGS and other deductions may be redetermined to be not allocable to DPGR, to the extent necessary to produce the effect as though X and Y were divisions of a single corporation. The proposed regulations provide examples to illustrate the situations described above.

Some commentators asked whether the section 199 deduction results in a downward basis adjustment under § 1.1502-32 if the deduction is allocated to a subsidiary member (S) of a consolidated group. Section 1.1502-32(b)(3)(ii)(B) already addresses this situation. Although the section 199 deduction is taken into account under the general operating rules of § 1.1502-32(b)(3)(i), paragraph (b)(3)(ii)(B) of that section provides that not only is S's income taken into account under the general operating rules of § 1.1502-32(b)(3)(i), but an amount of S's income equivalent to the section 199 deduction is also treated as being tax-exempt income under § 1.1502-32(b)(3)(ii)(A). The net result is that the basis that P (S's parent) has in its S stock is not reduced on account of the section 199 deduction.

For example, if S earns \$100 and is entitled to a \$9 section 199 deduction, P's basis in S increases by \$100 because the \$100 income and the \$9 deduction are taken into account under § 1.1502-32(b)(3)(i) (resulting in \$91 of the increase) and \$9 of the income also is taken into account under § 1.1502-32(b)(3)(ii)(A) as tax-exempt income (resulting in \$9 of the increase).

The proposed regulations treat a consolidated group as a single member of the EAG. For example, if A, B, C, S1, and S2 are members of the same EAG, and A, S1, and S2 are members of the same consolidated group (the A consolidated group), then the A consolidated group is treated as one member of the EAG. Thus, the EAG is considered to have three members, the A consolidated group, B, and C.

Alternative Minimum Tax

Section 199(d)(6), as clarified by the Congressional Letter, provides that for purposes of determining AMTI under section 55, the section 199 deduction must be computed in the same manner as for regular tax, except that in the case of a corporation, the taxable income limitation is the corporation's AMTI. Accordingly, the proposed regulations provide that for purposes of determining AMTI under section 55, a taxpayer that is not a corporation may deduct an amount equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of the taxpayer's QPAI for the taxable year, or the taxpayer's taxable income for the taxable year, determined without regard to the section 199 deduction (or in the case of an individual, AGI). In the case of a corporation (including a corporation subject to tax under section 511(a)), a taxpayer may deduct an amount equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of the taxpayer's QPAI for the taxable year, or the taxpayer's AMTI (as defined in section 55(b)(2)) for the taxable year, determined without regard to the section 199 deduction. For purposes of computing AMTI, QPAI is determined without regard to any adjustments under sections 56 through 59. In the case of an individual or a trust, AGI and taxable income are also determined without regard to any adjustments under sections 56 through 59. The amount of the deduction allowable for purposes of computing AMTI for any taxable year cannot exceed 50 percent of the W-2 wages of the employer for the

taxable year (as determined under § 1.199-2).

Revocation of Election Under Section 631(a)

Section 102(c) of the Act allows a taxpayer to revoke an election under section 631(a) to treat the cutting of timber as a sale or exchange. Any section 631(a) election for a taxable year ending on or before October 22, 2004, may be revoked under section 102(c) of the Act for any taxable year ending after that date. In addition, any election under section 631(a) for a taxable year ending on or before October 22, 2004 (and any revocation of the election under section 102(c) of the Act), is disregarded for purposes of determining whether the taxpayer is eligible to make a subsequent election under section 631(a). A revocation under section 102(c) of the Act will remain in effect until the first taxable year for which the taxpayer makes a new election under section 631(a).

Commentators suggested that, if a taxpayer makes an election under section 631(a), section 199 should apply to any resulting section 1231 gain. A taxpayer that makes an election under section 631(a) reports the difference between the fair market value of the timber cut and its actual cost as section 1231 gain. The proposed regulations do not adopt the suggestion because timber is real property, not tangible personal property, and the cutting of timber does not qualify under section 199(c)(4)(A)(i)(I). In the case of a taxpayer who does not make an election under section 631(a), or a taxpayer who revokes an election under section 631(a) pursuant to section 102(c) of the Act, the cutting and sawing of timber produces lumber which qualifies as tangible personal property. The gross receipts derived by a taxpayer from the sale of lumber it produces qualify as DPGR (assuming all the other requirements of section 199(c) are met).

Proposed Effective Date

The regulations are proposed to be applicable to taxable years beginning after December 31, 2004. Section 199 applies to taxable years of pass-thru entities beginning after December 31, 2004. Accordingly, section 199 does not apply to taxable years of pass-thru entities beginning before January 1, 2005. For example, assume a pass-thru entity has a taxable year beginning July 1, 2004, and ending June 30, 2005, and the owners of the pass-thru entity have calendar taxable years. Because section 199 first applies to the pass-thru entity for its taxable year beginning July 1, 2005, the first taxable year in which an

owner of the pass-thru entity will be eligible to claim a section 199 deduction for the owner's allocable or pro rata share of items allocated or apportioned to the qualified production activities of the pass-thru entity will be the calendar year 2006. Conversely, assume that a pass-thru entity has a calendar taxable year beginning January 1, 2005, and has a short taxable year ending on June 30, 2005, due to the termination of the entity. Assume the owners of that pass-thru entity have taxable years beginning July 1, 2004, and ending June 30, 2005. Because section 199 first applies to the owners for their taxable years beginning July 1, 2005, under § 1.199-8(g), the owners of the pass-thru entity will be ineligible to claim a section 199 deduction for the owners' allocable or pro rata share of items allocated or apportioned to the qualified production activities of the pass-thru entity for their taxable years ending June 30, 2005.

Until the date final regulations are published in the **Federal Register**, the proposed regulations provide that taxpayers may rely on the rules set forth in the interim guidance on section 199 as set forth in Notice 2005-14 (Notice) as well as the proposed regulations under §§ 1.199-1 through 1.199-8 (proposed regulations). For this purpose, if the proposed regulations and the Notice include different rules for the same particular issue, then the taxpayer may rely on either the rule set forth in the proposed regulations or the rule set forth in the Notice. For example, the Notice and the proposed regulations both include the small business simplified overall method, however the eligibility requirements for the method under the Notice have been modified in the proposed regulations. Accordingly, a taxpayer may rely on the eligibility requirements for the method set forth in either the Notice or the proposed regulations. However, if the proposed regulations include a rule that was not included in the Notice, taxpayers are not permitted to rely on the absence of a rule to apply a rule contrary to the proposed regulations. For example, Notice 2005-14 does not include any rules regarding the treatment of hedging transactions whereas the proposed regulations include such rules. Accordingly, taxpayers are not permitted to treat hedging transactions contrary to the treatment provided in the proposed regulations.

Request for Comments

The IRS and Treasury Department invite taxpayers to submit comments on issues relating to section 199. The IRS and Treasury Department intend to finalize the proposed regulations as

soon as possible so taxpayers will have the final regulations as they begin to prepare their 2005 Federal income tax returns. Accordingly, the IRS and Treasury Department encourage taxpayers to submit their comments by January 3, 2006 so they can be given proper consideration. In particular, the IRS and Treasury Department encourage taxpayers to submit comments on the following issues:

1. Questions have arisen as to the applicability under section 199 of a Large and Mid-Size Business (LMSB) directive dated March 14, 2002, "Field Directive on the Use of Estimates from Probability Samples," that authorizes in appropriate circumstances the use of statistical sampling by taxpayers. LMSB taxpayers are not precluded from applying the concepts of the LMSB directive for purposes of section 199. The proposed regulations do not provide specific rules on the use of statistical sampling for 199 purposes, however comments are requested on how taxpayers can apply statistical sampling to section 199, what specific areas of section 199 statistical sampling could be applied to, and whether application of statistical sampling should be limited to specific areas of section 199.

2. Taxpayers are eligible to make certain elections under the section 861 regulations. For example, § 1.861-9T(g)(1)(ii) permits a taxpayer to elect to determine the value of its assets on the basis of either their tax book value or fair market value. Some of the elections under the section 861 regulations require the consent of the Commissioner to revoke or to change to another method. See §§ 1.861-8T(c)(2), 1.861-9T(i)(2), and 1.861-17(e). Because the section 861 method requires certain taxpayers to use the rules of the section 861 regulations in a new context, these taxpayers may want to reconsider previously made elections under those regulations. The IRS and Treasury Department intend to issue a revenue procedure granting taxpayers automatic consent to change certain elections under the section 861 regulations. Comments are requested concerning such an automatic consent procedure, including which elections should be included and the appropriate time period during which the automatic consent should apply.

3. The IRS and Treasury Department note that there are special rules regarding the application of the section 861 method in the case of affiliated groups. See section 864(e)(5) and (6); see also §§ 1.861-11(d)(7), 1.861-11T(d)(6), 1.861-14(d) and 1.861-14T. Comments are requested regarding whether

additional guidance is needed to clarify how the rules under §§ 1.861-11T(c) and (g) and 1.861-14T(c) apply under the section 861 method to allocate and apportion interest and other expenses such as research and experimentation expenses in computing QPAI of the members of such affiliated groups in which otherwise includible corporations are owned indirectly through foreign corporations and partnerships.

4. Comments are requested concerning whether gross receipts derived from the provision of certain types of online software should qualify under section 199 as being derived from a lease, rental, license, sale, exchange, or other disposition of the software and, if so, how to distinguish between such types of online software.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply. It is hereby certified that the collection of information in this regulation will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that, as previously discussed, any burden on cooperatives is minimal. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. Comments are requested on all aspects of the proposed regulations. In addition, the IRS and Treasury Department specifically request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, January 11, 2006, at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington DC. Due to building security procedures, visitors

must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by December 21, 2005. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Paul Handleman and Lauren Ross Taylor, Office of Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *
 Section 1.199–1 also issued under 26 U.S.C. 199(d).
 Section 1.199–2 also issued under 26 U.S.C. 199(d).
 Section 1.199–3 also issued under 26 U.S.C. 199(d).
 Section 1.199–4 also issued under 26 U.S.C. 199(d).
 Section 1.199–5 also issued under 26 U.S.C. 199(d).
 Section 1.199–6 also issued under 26 U.S.C. 199(d).
 Section 1.199–7 also issued under 26 U.S.C. 199(d).
 Section 1.199–8 also issued under 26 U.S.C. 199(d). * * *

Par. 2. Sections 1.199–0 through 1.199–8 are added to read as follows:

§ 1.199–0 Table of contents.

This section lists the headings that appear in §§ 1.199–1 through 1.199–8.

§ 1.199–1 Income attributable to domestic production activities.

- (a) In general.
- (b) Taxable income and adjusted gross income.
 - (1) In general.
 - (2) Examples.
 - (c) Qualified production activities income.
 - (1) In general.
 - (2) Definition of item.
 - (i) In general.
 - (ii) Examples.
 - (d) Allocation of gross receipts.
 - (1) In general.
 - (2) De minimis rule.
 - (3) Examples.
 - (e) Timing rules for determining QPAI.
 - (1) Gross receipts and costs recognized in different taxable years.
 - (2) Percentage of completion method.
 - (3) Example.

§ 1.199–2 Wage limitation.

- (a) Rules of application.
 - (1) In general.
 - (2) Wages paid by entity other than common law employer.
 - (b) No application in determining whether amounts are wages for employment tax purposes.
 - (c) Application in case of taxpayer with short taxable year.
 - (d) Acquisition or disposition of a trade or business (or major portion).
 - (e) Non-duplication rule.
 - (f) Definition of W–2 wages.
 - (1) In general.
 - (2) Methods for calculating W–2 wages.
 - (i) Unmodified box method.
 - (ii) Modified Box 1 method.
 - (iii) Tracking wages method.

§ 1.199–3 Domestic production gross receipts.

- (a) In general.
- (b) Related persons.
 - (1) In general.
 - (2) Exceptions.
 - (c) Definition of gross receipts.
 - (d) Definition of manufactured, produced, grown, or extracted.
 - (1) In general.
 - (2) Packaging, repackaging, labeling, or minor assembly.
 - (3) Installing.
 - (4) Consistency with section 263A.
 - (5) Examples.
 - (e) Definition of by the taxpayer.
 - (1) In general.
 - (2) Special rule for certain government contracts.
 - (3) Examples.
 - (f) Definition of in whole or in significant part.
 - (1) In general.
 - (2) Substantial in nature.
 - (3) Safe harbor.
 - (4) Examples.

- (g) Definition of United States.
- (h) Definition of derived from the lease, rental, license, sale, exchange, or other disposition.
 - (1) In general.
 - (2) Examples.
 - (3) Hedging transactions.
 - (i) In general.
 - (ii) Currency fluctuations.
 - (iii) Other rules.
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 - (1) Determination at partner level.
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- (a) In general.
- (b) Written notice to patrons.
- (c) Determining cooperative's qualified production activities income.
- (d) Additional rules relating to pass-through of section 199 deduction.
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- (a) In general.
 - (1) Definition of expanded affiliated group.
 - (2) Identification of members of an expanded affiliated group.
 - (i) In general.
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 - (3) Attribution of activities.
 - (4) Examples.
 - (5) Anti-avoidance rule.
 - (b) Computation of expanded affiliated group's section 199 deduction.
 - (1) In general.
 - (2) Net operating loss carryovers.
 - (c) Allocation of an expanded affiliated group's section 199 deduction among members of the expanded affiliated group.
 - (1) In general.
 - (2) Use of section 199 deduction to create or increase a net operating loss.
 - (d) Special rules for members of the same consolidated group.

(1) Intercompany transactions.

(2) Attribution of activities in the construction of real property and the performance of engineering and architectural services.

(3) Application of the simplified deduction method and the small business simplified overall method.

(4) Determining the section 199 deduction.

(i) Expanded affiliated group consists of consolidated group and non-consolidated group members.

(ii) Expanded affiliated group consists only of members of a single consolidated group.

(5) Allocation of the section 199 deduction of a consolidated group among its members.

(e) Examples.

(f) Allocation of income and loss by a corporation that is a member of the expanded affiliated group for only a portion of the year.

(1) In general.

(i) Pro rata allocation method.

(ii) Section 199 closing of the books method.

(iii) Making the section 199 closing of the books election.

(2) Coordination with rules relating to the allocation of income under § 1.1502-76(b).

(g) Total section 199 deduction for a corporation that is a member of an expanded affiliated group for some or all of its taxable year.

(1) Member of the same expanded affiliated group for the entire taxable year.

(2) Member of the expanded affiliated group for a portion of the taxable year.

(3) Example.

(h) Computation of section 199 deduction for members of an expanded affiliated group with different taxable years.

(1) In general.

(2) Example.

§ 1.199-8 Other rules.

- (a) Individuals.
- (b) Trade or business requirement.
- (c) Coordination with alternative minimum tax.
- (d) Nonrecognition transactions.
 - (1) In general.
 - (2) Section 1031 exchanges.
 - (3) Section 381 transactions.
 - (e) Taxpayers with a 52-53 week taxable year.
 - (f) Section 481(a) adjustments.
 - (g) Effective date.

§ 1.199-1 Income attributable to domestic production activities.

(a) *In general.* A taxpayer may deduct an amount equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of the taxpayer's qualified production activities income (QPAI) (as defined in paragraph (c) of this section) for the taxable year, or the taxpayer's taxable income for the taxable year (or, in the case of an individual, adjusted gross income). The amount of the deduction allowable under this paragraph (a) for any taxable year cannot exceed 50

percent of the W-2 wages of the employer for the taxable year (as determined under § 1.199-2).

(b) *Taxable income and adjusted gross income*—(1) *In general.* For purposes of paragraph (a) of this section, the definition of taxable income under section 63 applies and taxable income is determined without regard to section 199. In the case of individuals, adjusted gross income for the taxable year is determined after applying sections 86, 135, 137, 219, 221, 222, and 469, and without regard to section 199. For purposes of determining the tax imposed by section 511, paragraph (a) of this section is applied using unrelated business taxable income. For purposes of determining the amount of a net operating loss (NOL) carryback or carryover under section 172(b)(2), taxable income is determined without regard to the deduction allowed under section 199.

(2) *Examples.* The following examples illustrate the application of this paragraph (b):

Example 1. (i) *Facts.* X, a United States corporation that is not part of an expanded affiliated group (EAG) (as defined in § 1.199-7), engages in production activities that generate QPAI and taxable income (without taking into account the deduction under this section) of \$600 in 2010. During 2010, X incurs W-2 wages of \$300. X has an NOL carryover to 2010 of \$500. X's deduction under this section for 2010 is \$9 (.09 × (lesser of QPAI of \$600 and taxable income of \$100) subject to the wage limitation of \$150 (50% × \$300)).

Example 2. (i) *Facts.* X, a United States corporation that is not part of an EAG, engages in production activities that generate QPAI and taxable income (without taking into account the deduction under this section and an NOL deduction) of \$100 in 2010. X has an NOL carryover to 2010 of \$500. X's deduction under this section for 2010 is \$0 (.09 × (lesser of QPAI of \$100 and taxable income of \$0)).

(ii) *Carryover to 2011.* X's taxable income for purposes of determining its NOL carryover to 2011 is \$100. Accordingly, X's NOL carryover to 2011 is \$400 (\$500 NOL carryover to 2010—\$100 NOL used in 2010).

(c) *Qualified production activities income*—(1) *In general.* QPAI for any taxable year is an amount equal to the excess (if any) of the taxpayer's domestic production gross receipts (DPGR) over the sum of the cost of goods sold (CGS) that is allocable to such receipts, other deductions, expenses, or losses (collectively, deductions) directly allocable to such receipts, and a ratable portion of deductions that are not directly allocable to such receipts or another class of income. See §§ 1.199-3 and 1.199-4. For purposes of this paragraph (c), QPAI is determined on an item-by-

item basis (and not, for example, on a division-by-division, product line-by-product line, or transaction-by-transaction basis) and is the sum of QPAI derived by the taxpayer from each item (as defined in paragraph (c)(2) of this section). For purposes of this determination, QPAI from each item may be positive or negative. DPGR and its related CGS and deductions must be included in the QPAI computation regardless of whether, when viewed in isolation, the DPGR exceeds the CGS and deductions allocated and apportioned thereto. For example, if a taxpayer has \$3 of QPAI from the sale of a shirt and derives (\$1) of QPAI from the sale of a hat, the taxpayer's QPAI is \$2.

(2) *Definition of item*—(i) *In general.* Except as otherwise provided in this paragraph, the term *item* means, for purposes of §§ 1.199-1 through 1.199-8, the property offered for sale to customers that meets all of the requirements under this section and § 1.199-3. If the property offered for sale does not meet these requirements, a taxpayer must treat as the item any portion of the property offered for sale that meets these requirements. However, in no case shall the portion of the property offered for sale that is treated as the item exclude any other portion that meets these requirements. In no event may an item consist of two or more properties offered for sale that are not packaged and sold together as one item. In addition, in the case of property customarily sold by weight or by volume, the item is determined using the custom of the industry (for example, barrels of oil). In the case of construction (as defined in § 1.199-3(l)(1)) or engineering and architectural services (as defined in § 1.199-3(m)(1)), a taxpayer may use any reasonable method, taking into account all of the facts and circumstances, to determine what construction activities and engineering or architectural services constitute an item.

(ii) *Examples.* The following examples illustrate the application of paragraph (c)(2)(i) of this section:

Example 1. X manufactures leather and rubber shoe soles in the United States. X imports shoe uppers, which are the parts of the shoe above the sole. X manufactures shoes for sale by sewing or otherwise attaching the soles to the imported uppers. If the shoes do not meet the requirements under this section and § 1.199-3, then under paragraph (c)(2)(i) of this section, X must treat the sole as the item if the sole meets the requirements under this section and § 1.199-3.

Example 2. The facts are the same as in *Example 1* except that X also buys some finished shoes from unrelated parties and

resells them to retail shoe stores. X sells shoes in individual pairs. X ships the shoes in boxes, each box containing 50 pairs of shoes, some of which X manufactured, and some of which X purchased. X cannot treat a box of 50 pairs of shoes as an item, because the box of shoes is not sold at retail.

Example 3. Y manufactures toy cars in the United States. Y also purchases cars that were manufactured by unrelated parties. In addition to packaging some cars individually, Y also packages some cars in sets of three. Some of the cars in the sets may have been manufactured by Y and some may have been purchased. The three-car packages are sold by toy stores at retail. Y must treat each three-car package as the item. However, if the three-car package does not meet the requirements under this section and § 1.199-3, Y must treat a toy car in the three-car package as the item, provided the toy car meets the requirements under this section and § 1.199-3.

Example 4. The facts are the same as *Example 3* except that the toy store follows Y's recommended pricing arrangement for the individual toy cars for sale to customers at three for \$10. Frequently, this results in retail customers purchasing three individual cars in one transaction. Y must treat each toy car as an item and cannot treat three individual toy cars as one item, because the individual toy cars are not packaged together for retail sale.

Example 5. Z produces in bulk form in the United States the active ingredient for a pharmaceutical product. Z sells the active ingredient in bulk form to FX, a foreign corporation. This sale qualifies as DPGR assuming all the other requirements of this section and § 1.199-3 are met. FX uses the active ingredient to produce the finished dosage form drug. FX sells the drug in finished dosage to Z, which sells the drug to customers. Under paragraph (c)(2)(i) of this section, if the finished dosage does not meet the requirements under this section and § 1.199-3, Z must treat the active ingredient portion as the item if the ingredient meets the requirements under this section and § 1.199-3.

(d) *Allocation of gross receipts*—(1) *In general.* A taxpayer must determine the portion of its gross receipts that is DPGR and the portion of its gross receipts that is non-DPGR. Applicable Federal income tax 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 (or some combination thereof). For example, if a taxpayer leases, rents, licenses, sells, exchanges, or otherwise disposes of qualifying production property (QPP) (as defined in § 1.199-3(i)(1)), the gross receipts of which constitute DPGR, and engages in transactions with respect to similar property, the gross receipts of which do not constitute DPGR, the taxpayer must allocate its gross receipts from all the transactions based on a reasonable method that is satisfactory to the Secretary based on all of the facts

and circumstances and that accurately identifies the gross receipts that constitute DPGR. Factors taken into consideration in determining whether the method is reasonable include whether the taxpayer uses the most accurate information available; the relationship between the gross receipts and the method chosen; the accuracy of the method chosen 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 or state income tax purposes; the time, burden, and cost of using various methods; and whether the taxpayer applies the method consistently from year to year. Thus, if a taxpayer can, without undue burden or expense, specifically identify where an item was manufactured, or if the taxpayer uses a specific identification method for other purposes, then the taxpayer must use that specific identification method to determine DPGR. If a taxpayer does not use a specific identification method for other purposes and cannot, without undue burden or expense, use a specific identification method, then the taxpayer is not required to use a specific identification method to determine DPGR.

(2) *De minimis rule.* All of a taxpayer's gross receipts may be treated as DPGR if less than 5 percent of the taxpayer's total gross receipts are non-DPGR (after application of exceptions provided in § 1.199-3(h)(4), (k)(4)(iv), (l)(1)(ii), (m)(4), and (n)(1) that result in gross receipts being treated as DPGR). If the amount of the taxpayer's gross receipts that do not qualify as DPGR equals or exceeds 5 percent of the taxpayer's total gross receipts, the taxpayer is required to allocate all gross receipts between DPGR and non-DPGR in accordance with paragraph (d)(1) of this section. If a corporation is a member of an EAG or a consolidated group, the determination of whether less than 5 percent of the taxpayer's total gross receipts are non-DPGR is made at the corporation level rather than at the EAG or consolidated group level, as applicable. In the case of an S corporation, partnership, estate or trust, or other pass-thru entity, the determination of whether less than 5 percent of the pass-thru entity's total gross receipts are non-DPGR is made at the pass-thru entity level. In the case of an owner of a pass-thru entity, the determination of whether less than 5 percent of the owner's total gross receipts are non-DPGR is made at the owner level, taking into account all

gross receipts earned by the owner from its activities as well as the owner's share of any pass-thru entity's gross receipts.

(3) *Examples.* The following examples illustrate the application of this paragraph (d):

Example 1. X derives its gross receipts from the sale of gasoline refined by X within the United States and the sale of refined gasoline that X acquired (either by purchase or in a taxable exchange for gasoline refined by X in the United States) from an unrelated party. X does not commingle the gasoline. X must allocate its gross receipts between the gross receipts attributable to the gasoline refined by X in the United States (that qualify as DPGR if all the other requirements of § 1.199-3 are met) and X's gross receipts derived from the resale of the acquired gasoline (that do not qualify as DPGR) if 5 percent or more of X's total gross receipts are not from the sale of gasoline refined by X within the United States.

Example 2. X manufactures the same type of QPP at facilities within the United States and outside the United States which are sold separately. X must allocate its gross receipts between the receipts from the QPP manufactured within the United States and receipts from the QPP not manufactured within the United States if 5 percent or more of X's total gross receipts are not from the sale of QPP manufactured by X within the United States.

(e) *Timing rules for determining QPAI*—(1) *Gross receipts and costs recognized in different taxable years.* If a taxpayer recognizes and reports on a Federal income tax return gross receipts that the taxpayer identifies as DPGR, then the taxpayer must treat the CGS and deductions related to such receipts as relating to DPGR, regardless of whether such receipts ultimately qualify as DPGR. Similarly, if a taxpayer pays or incurs and reports on a Federal income tax return CGS or deductions and identifies such CGS or deductions as relating to DPGR, then the taxpayer must treat the gross receipts related to such CGS or deductions as DPGR, regardless of whether such receipts ultimately qualify as DPGR. Similar rules apply if the taxpayer recognizes and reports on a Federal income tax return gross receipts that the taxpayer identifies as non-DPGR, or pays or incurs and reports on a Federal income tax return CGS or deductions that the taxpayer identifies as relating to non-DPGR. The determination of whether gross receipts qualify as DPGR or non-DPGR, and whether CGS or deductions relate to DPGR or non-DPGR, must be made in accordance with the rules provided in §§ 1.199-1 through 1.199-8, as applicable. If the gross receipts are recognized in an intercompany transaction within the meaning of § 1.1502-13, see also § 1.199-7(d). See

§ 1.199-4 for allocation and apportionment of CGS and deductions.

(2) *Percentage of completion method.* A taxpayer using the percentage of completion method under section 460 must determine the ratio of DPGR and non-DPGR using a reasonable method that accurately identifies the gross receipts that constitute DPGR. See paragraph (d)(1) of this section for the factors taken into consideration in determining whether the taxpayer's method is reasonable.

(3) *Example.* The following example illustrates the application of paragraph (e)(1) of this section:

Example. X, a calendar year accrual method taxpayer, enters into a contract with Y, an unrelated person, in 2005 for the sale of QPP. In 2005, X receives an advance payment from Y for the QPP. In 2006, X manufactures the QPP within the United States and delivers the QPP to Y. X's method of accounting requires X to include the entire advance payment in its gross income for Federal income tax purposes in 2005. Assuming X can determine, using any reasonable method, that all the requirements of this section and § 1.199-3 will be met, the advance payment qualifies as DPGR in 2005. The CGS and deductions relating to the QPP under the contract are taken into account under § 1.199-4 in determining X's QPAI in 2006, the taxable year the CGS and deductions are otherwise deductible for Federal income tax purposes and must be treated as relating to DPGR in that taxable year.

§ 1.199-2 Wage limitation.

(a) *Rules of application*—(1) *In general.* The amount of the deduction allowable under § 1.199-1(a) (section 199 deduction) to a taxpayer for any taxable year shall not exceed 50 percent of the W-2 wages of the taxpayer. For this purpose, except as provided in paragraph (c) of this section, the Forms W-2, "Wage and Tax Statement," used in determining the amount of W-2 wages are those issued for the calendar year ending during the taxpayer's taxable year for wages paid to employees (or former employees) of the taxpayer for employment by the taxpayer. For purposes of this section, employees of the taxpayer are limited to employees of the taxpayer as defined in section 3121(d)(1) and (2) (that is, officers of a corporate taxpayer and employees of the taxpayer under the common law rules). For purposes of section 199(b)(2) and this section, the term *taxpayer* means employer.

(2) *Wages paid by entity other than common law employer.* In determining W-2 wages, a taxpayer may take into account any wages paid by another entity and reported by the other entity on Forms W-2 with the other entity as

the employer listed in Box c of the Forms W-2, provided that the wages were paid to employees of the taxpayer for employment by the taxpayer. If the taxpayer is treated as an employer described in section 3401(d)(1) because of control of the payment of wages (that is, the taxpayer is not the common law employer of the payee of the wages), the payment of wages may not be included in determining W-2 wages of the taxpayer. 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.

(b) *No application in determining whether amounts are wages for employment tax purposes.* The discussion of wages in this section is for purposes of section 199 only and has no application in determining whether amounts are wages under section 3121(a) for purposes of the Federal Insurance Contributions Act (FICA), under section 3306(b) for purposes of the Federal Unemployment Tax Act (FUTA), under section 3401(a) for purposes of the Collection of Income Tax at Source on Wages (Federal income tax withholding), or any other wage related determination.

(c) *Application in case of taxpayer with short taxable year.* In the case of a taxpayer with a short taxable year, subject to the rules of paragraph (a) of this section, the W-2 wages of the taxpayer for the short taxable year shall include those wages paid during the short taxable year to employees of the taxpayer as determined under the tracking wages method described in paragraph (f)(2)(iii) of this section. In applying the tracking wages method in the case of a short taxable year, the taxpayer must apply the method as follows—

(1) In paragraph (f)(2)(iii)(A) of this section, the total amount of wages subject to Federal income tax withholding and reported on Form W-2 must include only those wages subject to Federal income tax withholding that are actually paid to employees during the short taxable year and reported on Form W-2 for the calendar year ending within that short taxable year;

(2) In paragraph (f)(2)(iii)(B) of this section, only the supplemental unemployment benefits paid during the short taxable year that were included in the total in paragraph (f)(2)(iii)(A) of this section as modified by paragraph (c)(1) of this section are required to be deducted; and

(3) In paragraph (f)(2)(iii)(C) of this section, only the portion of the amounts reported in Box 12, Codes D, E, F, G,

and S, on Forms W-2, that are actually deferred or contributed during the short taxable year may be included in W-2 wages.

(d) *Acquisition or disposition of a trade or business (or major portion).* If a taxpayer (a successor) acquires a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business from another taxpayer (a predecessor), then, for purposes of computing the respective section 199 deduction of the successor and of the predecessor, the W-2 wages paid for that calendar year shall be allocated between the successor and the predecessor based on whether the wages are for employment by the successor or for employment by the predecessor. Thus, in this situation, the W-2 wages are allocated based on whether the wages are for employment for a period during which the employee was employed by the predecessor or for employment for a period during which the employee was employed by the successor, regardless of which permissible method for Form W-2 reporting is used.

(e) *Non-duplication rule.* Amounts that are treated as W-2 wages for a taxable year under any method may not be treated as W-2 wages of any other taxable year. Also, an amount may not be treated as W-2 wages by more than one taxpayer.

(f) *Definition of W-2 wages—*(1) *In general.* Section 199(b)(2) defines W-2 wages for purposes of section 199(b)(1) as the sum of the amounts required to be included on statements under section 6051(a)(3) and (8) with respect to employment of employees of the taxpayer for the calendar year. Thus, the term W-2 wages includes the total amount of wages as defined in section 3401(a); the total amount of elective deferrals (within the meaning of section 402(g)(3)); the compensation deferred under section 457; and for taxable years beginning after December 31, 2005, the amount of designated Roth contributions (as defined in section 402A). Under the 2004 and 2005 Form W-2, the elective deferrals under section 402(g)(3) and the amounts deferred under section 457 directly correlate to coded items reported in Box 12 on Form W-2. Box 12, Code D, is for elective deferrals to a section 401(k) cash or deferred arrangement; Box 12, Code E, is for elective deferrals under a section 403(b) salary reduction agreement; Box 12, Code F, is for elective deferrals under a section 408(k)(6) salary reduction Simplified Employee Pension (SEP); Box 12, Code G, is for elective deferrals under a section 457(b) plan; and Box 12, Code

S, is for employee salary reduction contributions under a section 408(p) SIMPLE (simple retirement account).

(2) *Methods for calculating W-2 wages.* For any taxable year, taxpayers may use one of three methods in calculating W-2 wages. These three methods are subject to the non-duplication rule provided in paragraph (e) of this section, and the tracking wages method is subject to the rule provided in paragraph (c) of this section, if applicable.

(i) *Unmodified box method.* Under the Unmodified box method, W-2 wages are calculated by taking, without modification, the lesser of—

(A) The total entries in Box 1 of all Forms W-2 filed with the Social Security Administration (SSA) by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer; or

(B) The total entries in Box 5 of all Forms W-2 filed with the SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer.

(ii) *Modified Box 1 method.* Under the Modified Box 1 method, the taxpayer makes modifications to the total entries in Box 1 of Forms W-2 filed with respect to employees of the taxpayer. W-2 wages under this method are calculated as follows—

(A) Total the amounts in Box 1 of all Forms W-2 filed with the SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer;

(B) Subtract from the total in paragraph (f)(2)(ii)(A) of this section amounts 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 section 3402(o) (for example, supplemental unemployment benefits); and

(C) Add to the amount obtained after paragraph (f)(2)(ii)(B) of this section amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, or S.

(iii) *Tracking wages method.* Under the Tracking wages method, the taxpayer actually tracks total wages subject to Federal income tax withholding and makes appropriate modifications. W-2 wages under this method are calculated as follows—

(A) Total the amounts of wages subject to Federal income tax withholding that are paid to employees of the taxpayer for employment by the taxpayer and that are reported on Forms

W-2 filed with the SSA by the taxpayer for the calendar year;

(B) Subtract from the total in paragraph (f)(2)(iii)(A) of this section the supplemental unemployment compensation benefits (as defined in section 3402(o)(2)(A)) that were included in the total in paragraph (f)(2)(iii)(A) of this section; and

(C) Add to the amount obtained after paragraph (f)(2)(iii)(B) of this section amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, or S.

§ 1.199-3 Domestic production gross receipts.

(a) *In general.* Domestic production gross receipts (DPGR) are the gross receipts (as defined in paragraph (c) of this section) of the taxpayer that are derived from (as defined in paragraph (h) of this section)—

(1) Any lease, rental, license, sale, exchange, or other disposition of—

(i) Qualifying production property (QPP) (as defined in paragraph (i)(1) of this section) that is manufactured, produced, grown, or extracted (MPGE) (as defined in paragraph (d) of this section) by the taxpayer (as defined in paragraph (e) of this section) in whole or in significant part (as defined in paragraph (f) of this section) within the United States (as defined in paragraph (g) of this section);

(ii) Any qualified film (as defined in paragraph (j) of this section) produced by the taxpayer (in accordance with paragraph (j) of this section); or

(iii) Electricity, natural gas, or potable water (as defined in paragraph (k) of this section) (collectively, utilities) produced by the taxpayer in the United States (in accordance with paragraph (k) of this section);

(2) Construction (as defined in paragraph (l) of this section) performed in the United States (in accordance with paragraph (l) of this section); or

(3) Engineering or architectural services (as defined in paragraph (m) of this section) performed in the United States for construction projects in the United States (in accordance with paragraph (m) of this section).

(b) *Related persons*—(1) *In general.* DPGR does not include any gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person. A person is treated as related to another person if both persons are treated as a single employer under either section 52(a) or (b) (without regard to section 1563(b)), or section 414(m) or (o).

(2) *Exceptions.* Paragraph (b)(1) of this section does not apply to any QPP or qualified films leased or rented by the taxpayer to a related person if the QPP or qualified films are held for sublease or rent, or are subleased or rented, by the related person to an unrelated person for the ultimate use of the unrelated person. Similarly, paragraph (b)(1) of this section does not apply to the license of QPP or qualified films to a related person for reproduction and sale, exchange, lease, rental or sublicense to an unrelated person for the ultimate use of the unrelated person.

(c) *Definition of gross receipts.* The term *gross receipts* means the taxpayer's receipts for the taxable year that are recognized under the taxpayer's methods of accounting used for Federal income tax purposes for the taxable year. If the gross receipts are recognized in an intercompany transaction within the meaning of § 1.1502-13, see also § 1.199-7(d). For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of section 103), dividends, rents, royalties, and annuities, regardless of whether the amounts are derived in the ordinary course of the taxpayer's trade of business. Gross receipts are not reduced by cost of goods sold (CGS) or by the cost of property sold if such property is described in section 1221(a)(1), (2), (3), (4), or (5). Gross receipts do not include the amounts received in repayment of a loan or similar instrument (for example, a repayment of the principal amount of a loan held by a commercial lender) and, except to the extent of gain recognized, do not include gross receipts derived from a non-recognition transaction, such as a section 1031 exchange. Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts include the amounts received that are allocable to the payment of such tax.

(d) *Definition of manufactured, produced, grown, or extracted*—(1) *In general.* Except as provided in paragraphs (d)(2) and (3) of this section,

the term *MPGE* includes manufacturing, producing, growing, extracting, installing, developing, improving, and creating 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. The term *MPGE* also includes 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. The taxpayer must have the benefits and burdens of ownership of the QPP under Federal income tax principles during the period the MPGE activity occurs, pursuant to paragraph (e)(1) of this section, in order for gross receipts derived from the MPGE of QPP to qualify as DPGR.

(2) *Packaging, repackaging, labeling, or minor assembly.* If a taxpayer packages, repackages, labels, or performs minor assembly of QPP and the taxpayer engages in no other MPGE activity with respect to that QPP, the taxpayer's packaging, repackaging, labeling, or minor assembly do not qualify as MPGE.

(3) *Installing.* If a taxpayer installs an item of QPP and engages in no other MPGE with respect to the QPP, the taxpayer's installing activity does not qualify as MPGE. However, if the taxpayer installs an item of QPP MPGE by the taxpayer, and the taxpayer has the benefits and burdens of ownership of the item of QPP under Federal income tax principles during the period the installing activity occurs, the portion of the installing activity that relates to the item of QPP is MPGE.

(4) *Consistency with section 263A.* A taxpayer that has MPGE QPP for the taxable year should treat itself as a producer under section 263A with respect to the QPP for the taxable year unless the taxpayer is not subject to section 263A. A taxpayer that currently is not properly accounting for its production activities under section 263A, and wishes to change its method of accounting to comply with the producer requirements of section 263A, must follow the applicable administrative procedures issued under § 1.446-1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 97-27 (1997-1 C.B. 680), or Rev. Proc.

2002–9 (2002–1 C.B. 327), whichever applies (see § 601.601(d)(2) of this chapter)).

(5) *Examples.* The following examples illustrate the application of this paragraph (d):

Example 1. A, B, and C are unrelated taxpayers and are not cooperatives to which Part I of subchapter T of the Internal Revenue Code applies. A owns grain storage bins in the United States in which it stores for a fee B's agricultural products that were grown in the United States. B sells its agricultural products to C. C processes B's agricultural products into refined agricultural products in the United States. The gross receipts from A's, B's, and C's activities are DPGR from the MPGE of QPP.

Example 2. The facts are the same as in *Example 1* except that B grows the agricultural products outside the United States and C processes B's agricultural products into refined agricultural products outside the United States. Pursuant to paragraph (d)(1) of this section, the gross receipts derived by A are DPGR from the MPGE of QPP within the United States. B's and C's respective activities occur outside the United States and, therefore, their respective gross receipts are non-DPGR.

Example 3. Y is hired to reconstruct and refurbish unrelated customers' tangible personal property. As part of the reconstruction and refurbishment, Y installs purchased replacement parts in the customers' property. Y's installation of purchased replacement parts does not qualify as MPGE pursuant to paragraph (d)(3) of this section because Y did not MPGE the replacement parts.

Example 4. The facts are the same as in *Example 3* except that Y manufactures the replacement parts it uses for the reconstruction and refurbishment of customers' tangible personal property. Y has the benefits and burdens of ownership of the replacement parts during the reconstruction and refurbishment activity and while installing the parts. Y's gross receipts from the MPGE of the replacement parts and Y's gross receipts from the installation of the replacement parts, which is an MPGE activity pursuant to paragraph (d)(3) of this section, are DPGR.

Example 5. Z MPGE QPP within the United States. The following activities are performed by Z as part of the MPGE of the QPP while Z has the benefits and burdens of ownership under Federal income tax principles: materials analysis and selection, subcontractor inspections and qualifications, testing of component parts, assisting customers in their review and approval of the QPP, routine production inspections, product documentation, diagnosis and correction of system failure, and packaging for shipment to customers. Because Z MPGE the QPP, these activities performed by Z are part of the MPGE of the QPP.

Example 6. X purchases automobiles from unrelated parties and customizes them by adding ground effects, spoilers, custom wheels, specialized paint and decals, sunroofs, roof racks, and similar accessories. X does not manufacture any of the

accessories. X's activity is minor assembly under paragraph (d)(2) of this section which is not an MPGE activity.

Example 7. The facts are the same as in *Example 6* except that X manufactures some of the accessories it adds to the automobiles. Pursuant to § 1.199–1(c)(2), if an automobile with accessories does not meet the requirements for being an item, X must treat each accessory that it manufactures as an item for purposes of determining whether X MPGE the item in whole or in significant part within the United States under paragraph (f)(1) of this section and whether the installation of the item is MPGE under paragraph (d)(3) of this section.

Example 8. Y manufactures furniture in the United States that it sells to unrelated persons. Y also engraves customers' names on pens and pencils purchased from unrelated persons and sells the pens and pencils to such customers. Although Y's sales of furniture qualify as DPGR if all the other requirements of this section are met, Y's sales of the engraved pens and pencils do not qualify as DPGR because Y does not MPGE the pens and pencils.

(e) *Definition of by the taxpayer*—(1) *In general.* With the exception of the rules applicable to an expanded affiliated group (EAG) under § 1.199–7, certain oil and gas partnerships under paragraph (h)(7) of this section, EAG partnerships under paragraph (h)(8) of this section, and government contracts in paragraph (e)(2) of this section, only one taxpayer may claim the deduction under § 1.199–1(a) with respect to any qualifying activity under paragraph (d)(1) of this section performed in connection with the same QPP, or the production of qualified films or utilities. If one taxpayer performs a qualifying activity under paragraph (d)(1), (j)(1), or (k)(1) of this section pursuant to a contract with another party, then only the taxpayer that has the benefits and burdens of ownership of the property under Federal income tax principles during the period the qualifying activity occurs is treated as engaging in the qualifying activity.

(2) *Special rule for certain government contracts.* QPP, qualified films, or utilities will be treated as MPGE or otherwise produced by the taxpayer notwithstanding the requirements of paragraph (e)(1) of this section if—

(i) The QPP, qualified films, or utilities are MPGE or otherwise produced by the taxpayer pursuant to a contract with the Federal government; and

(ii) The Federal Acquisition Regulation (48 CFR) requires that title or risk of loss with respect to the QPP, qualified films, or utilities be transferred to the Federal government before the MPGE of the QPP, or the production of

the qualified films or utilities, is complete.

(3) *Examples.* The following examples illustrate the application of this paragraph (e):

Example 1. X designs machines that it uses in its trade or business. X contracts with Y, an unrelated taxpayer, for the manufacture of the machines. The contract between X and Y is a fixed-price contract. The contract specifies that the machines will be manufactured in the United States using X's design. X owns the intellectual property attributable to the design and provides it to Y with a restriction that Y may only use it during the manufacturing process and has no right to exploit the intellectual property. The contract specifies that Y controls the details of the manufacturing process while the machines are being produced; Y bears the risk of loss or damage during manufacturing of the machines; and Y has the economic loss or gain upon the sale of the machines based on the difference between Y's costs and the fixed price. Y has legal title during the manufacturing process and legal title to the machines is not transferred to X until final manufacturing of the machines has been completed. Based on all of the facts and circumstances, pursuant to paragraph (e)(1) of this section Y has the benefits and burdens of ownership of the machines under Federal income tax principles during the period the manufacturing occurs and, as a result, Y is treated as the manufacturer of the machines.

Example 2. X designs and engineers machines that it sells to customers. X contracts with Y, an unrelated taxpayer, for the manufacture of the machines. The contract between X and Y is a cost-reimbursable type contract. X has the benefits and burdens of ownership of the machines under Federal income tax principles during the period the manufacturing occurs except that legal title to the machines is not transferred to X until final manufacturing of the machines is completed. Based on all of the facts and circumstances, X is treated as the manufacturer of the machines under paragraph (e)(1) of this section.

(f) *Definition of in whole or in significant part*—(1) *In general.* QPP must be MPGE in whole or in significant part by the taxpayer and in whole or in significant part within the United States to qualify under section

199(c)(4)(A)(i)(I). If a taxpayer enters into a contract pursuant to paragraph (e)(1) of this section with an unrelated party for the unrelated party to MPGE QPP for the taxpayer and the taxpayer has the benefits and burdens of ownership of the QPP under applicable Federal income tax principles during the period the MPGE activity occurs, then the taxpayer is considered to MPGE the QPP under this section. The unrelated party must perform the MPGE activity on behalf of the taxpayer in whole or in significant part within the United States in order for the taxpayer to satisfy the requirements of this paragraph (f)(1).

(2) *Substantial in nature.* QPP will be treated as MPGE in significant part by the taxpayer within the United States for purposes of paragraph (f)(1) of this section if the MPGE of the QPP by the taxpayer within the United States is substantial in nature taking into account all of the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer's MPGE activity within the United States, the nature of the property, and the nature of the MPGE activity that the taxpayer performs within the United States. Research and experimental activities under section 174 and the creation of intangibles do not qualify as substantial in nature for any QPP other than computer software (as defined in paragraph (i)(3) of this section) and sound recordings (as defined in paragraph (i)(4) of this section). In the case of an EAG member, an EAG partnership (as defined in paragraph (h)(8) of this section), or members of an EAG in which the partners of the EAG partnership are members, in determining whether the substantial in nature requirement is met with respect to an item of QPP, all of the previous activities of the members of the EAG, the EAG partnership, and all members of the EAG in which the partners of the EAG partnership are members, as applicable, are taken into account.

(3) *Safe harbor.* A taxpayer will be treated as having MPGE QPP in whole or in significant part within the United States for purposes of paragraph (f)(1) of this section if, in connection with the QPP, conversion costs (direct labor and related factory burden) of such taxpayer to MPGE the QPP within the United States account for 20 percent or more of the taxpayer's CGS of the QPP. For purposes of the safe harbor under this paragraph (f)(3), research and experimental expenditures under section 174 and the costs of creating intangibles do not qualify as conversion costs for any QPP other than computer software and sound recordings. In the case of tangible personal property (as defined in paragraph (i)(2) of this section), research and experimental expenditures under section 174 and any other costs incurred in the creation of intangibles may be excluded from CGS for purposes of determining whether the taxpayer meets the safe harbor under this paragraph (f)(3). For purposes of this safe harbor, research and experimental expenditures under section 174 and any other costs of creating intangibles for computer software and sound recordings must be allocated to the computer software and sound recordings to which the

expenditures and costs relate under § 1.199-4(b). In the case of an EAG member, an EAG partnership, or members of an EAG in which the partners of the EAG partnership are members, in determining whether the requirements of the safe harbor under this paragraph (f)(3) are met with respect to an item of QPP, all of the previous conversion costs of the members of the EAG, the EAG partnership, and all members of the EAG in which the partners of the EAG partnership are members, as applicable, to MPGE the QPP are taken into account. If a taxpayer enters into a contract with an unrelated party for the unrelated party to MPGE QPP for the taxpayer, and the taxpayer is considered pursuant to paragraph (e)(1) of this section to MPGE the QPP, then for purposes of this safe harbor the taxpayer's conversion costs shall include both the taxpayer's conversion costs as well as the conversion costs of the unrelated party to MPGE the QPP under the contract.

(4) *Examples.* The following examples illustrate the application of this paragraph (f):

Example 1. X purchases from Y unrefined oil extracted outside the United States and X refines the oil in the United States. The refining of the oil by X is an MPGE activity that is substantial in nature.

Example 2. X purchases gemstones and precious metal from outside the United States and then uses these materials to produce jewelry within the United States by cutting and polishing the gemstones, melting and shaping the metal, and combining the finished materials. X's activity is substantial in nature under paragraph (f)(2) of this section. Therefore, X has MPGE the jewelry in significant part within the United States.

Example 3. (i) X operates an automobile assembly plant in the United States. In connection with such activity, X purchases assembled engines, transmissions, and certain other components from Y, an unrelated taxpayer, and X assembles all of the component parts into an automobile. X also conducts stamping, machining, and subassembly operations, and X uses tools, jigs, welding equipment, and other machinery and equipment in the assembly of automobiles. On a per-unit basis, X's selling price and costs of such automobiles are as follows:

Selling price: \$2,500

Cost of goods sold:

Material—Acquired from Y: \$1,475

Conversion costs (direct labor and factory burden): \$325

Total cost of goods sold: \$1,800

Gross profit: \$700

Administrative and selling expenses: \$300

Taxable income: \$400

(ii) Although X's conversion costs are less than 20 percent of total CGS (\$325/

\$1,800, or 18 percent), the operations conducted by X in connection with the property purchased and sold are substantial in nature under paragraph (f)(2) of this section because of the nature of X's activity and the relative value of X's activity. Therefore, X's automobiles will be treated as MPGE in significant part by X within the United States for purposes of paragraph (f)(1) of this section.

Example 4. X produces a qualified film (as defined in paragraph (j)(1) of this section) and licenses the film to Y, an unrelated taxpayer, for duplication of the film onto DVDs. Y purchases the DVDs from an unrelated person. Unless Y satisfies the safe harbor under paragraph (f)(3) of this section, Y's income for duplicating X's qualified film onto the DVDs is non-DPGR because the duplication is not substantial in nature relative to the DVD with the film.

Example 5. X imports into the United States QPP that is partially manufactured. X completes the manufacture of the QPP within the United States and X's completion of the manufacturing of the QPP within the United States satisfies the in whole or in significant part requirement under paragraph (f)(1) of this section. Therefore, X's gross receipts from the lease, rental, license, sale, exchange, or other disposition of the QPP qualify as DPGR if all other applicable requirements under this section are met.

Example 6. X manufactures QPP in significant part within the United States and exports the QPP for further manufacture outside the United States. Assuming X meets all the requirements under this section for the QPP after the further manufacturing, X's gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the QPP will be considered DPGR, regardless of whether the QPP is imported back into the United States prior to the lease, rental, license, sale, exchange, or other disposition of the QPP.

Example 7. X is a retailer that sells cigars and pipe tobacco that X purchases from an unrelated person. While being displayed and offered for sale by X, the cigars and pipe tobacco age on X's shelves in a room with controlled temperature and humidity. Although X's cigars and pipe tobacco may become more valuable as they age, the gross receipts derived by X from the sale of the cigars and pipe tobacco are non-DPGR because the aging of the cigars and pipe tobacco while being displayed and offered for sale by X does not qualify as an MPGE activity that occurs in whole or in significant part within the United States.

(g) *Definition of United States.* For purposes of this section, the term *United States* includes 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, with respect to the exploration and

exploitation of natural resources. The term *United States* does not include possessions and territories of the United States or the airspace or space over the United States and these areas.

(h) *Definition of derived from the lease, rental, license, sale, exchange, or other disposition*—(1) *In general.* The term *derived from the lease, rental, license, sale, exchange, or other disposition* is defined as, and limited to, the gross receipts directly derived from the lease, rental, license, sale, exchange, or other disposition, even if the taxpayer has already recognized gross receipts from a previous lease, rental, license, sale, exchange, or other disposition of the same property. Applicable Federal income tax 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 (or some combination thereof). For example, gross receipts derived from the sale of QPP includes gross receipts derived from the sale of QPP MPGE in whole or in significant part within the United States by a taxpayer for sale, as well as gross receipts derived from the sale of QPP MPGE in whole or in significant part within the United States by a taxpayer and used in the taxpayer's trade or business before being sold. The entire amount of lease income including any interest that is not separately stated is considered derived from the lease of QPP or a qualified film. In addition, the proceeds from business interruption insurance, governmental subsidies, and governmental payments not to produce are treated as gross receipts derived from the lease, rental, license, sale, exchange, or other disposition to the extent that they are substitutes for gross receipts that would qualify as DPGR. The value of property received by a taxpayer in a taxable exchange of QPP MPGE in whole or in significant part within the United States, qualified films, or utilities for an unrelated person's property is DPGR for the taxpayer (assuming all the other requirements of this section are met). However, unless the taxpayer further MPGE the QPP or further produces the qualified films or utilities received in the exchange, any gross receipts from the subsequent sale by the taxpayer of the property received in the exchange are non-DPGR because the taxpayer did not MPGE or otherwise produce such property, even if the property was QPP, qualified films, or utilities in the hands of the other person.

(2) *Examples.* The following examples illustrate the application of paragraph (h)(1) of this section:

Example 1. X MPGE QPP within the United States and sells the QPP to Y, an unrelated person. Y leases the QPP for 3 years to Z, a taxpayer unrelated to both X and Y, and shortly thereafter, X repurchases the QPP from Y subject to the lease. At the end of the lease term, Z purchases the QPP from X. X's proceeds derived from the sale of the QPP to Y, from the lease to Z, and from the sale of the QPP to Z all qualify as DPGR (assuming all the other requirements of this section are met).

Example 2. X MPGE QPP within the United States and sells the QPP to Y, an unrelated taxpayer, for \$25,000. X finances Y's purchase of the QPP and receives total payments of \$35,000, of which \$10,000 relates to interest and finance charges. The \$25,000 qualifies as DPGR but the \$10,000 in interest and finance charges do not qualify as DPGR because the \$10,000 is not derived from the MPGE of QPP within the United States but rather from X's lending activity.

Example 3. Cable company X charges subscribers \$15 a month for its basic cable television. Y, an unrelated taxpayer, produces in the United States all of the programs on its cable channel which it licenses to X for \$.10 per subscriber per month. The programs are qualified films within the meaning of paragraph (j)(1) of this section. The gross receipts derived by Y are derived from a license of a qualified film produced by Y and are DPGR (assuming all the other requirements of this section are met).

(3) *Hedging transactions*—(i) *In general.* For purposes of this section, provided that the risk being hedged relates to QPP described in section 1221(a)(1) or property described in section 1221(a)(8) consumed in the activity giving rise to DPGR, and provided that the transaction is a hedging transaction within the meaning of section 1221(b)(2) and § 1.1221-2(b), then—

(A) In the case of a hedge of purchases of property described in section 1221(a)(1), gain or loss on the hedging transaction must be taken into account in determining CGS;

(B) In the case of a hedge of sales of property described in section 1221(a)(1), gain or loss on the hedging transaction must be taken into account in determining DPGR; and

(C) In the case of a hedge of purchases of property described in section 1221(a)(8), gain or loss on the hedging transaction must be taken into account in determining DPGR.

(ii) *Currency fluctuations.* For purposes of this section, in the case of a transaction that manages the risk of currency fluctuations, the determination of whether the transaction is a hedging transaction within the meaning of § 1.1221-2(b) is made without regard to whether the transaction is a section 988 transaction. See § 1.1221-2(a)(4). The

preceding sentence applies only to the extent that § 1.988-5(b) does not apply.

(iii) *Other rules.* See § 1.1221-2(e) for rules applicable to hedging by members of a consolidated group and § 1.446-4 for rules regarding the timing of income, deductions, gain, or loss with respect to hedging transactions.

(4) *Allocation of gross receipts—embedded services and non-qualified property*—(i) *In general.* Except as otherwise provided in paragraph (h)(4)(ii), paragraph (l) (relating to construction), and paragraph (m) (relating to architectural and engineering services) of this section, gross receipts derived from the performance of services do not qualify as DPGR. In the case of an embedded service, that is, a service the price of which is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of QPP, qualified films, or utilities, DPGR includes only the receipts from the lease, rental, license, sale, exchange, or other disposition of the item (if all the other requirements of this section are met) and not any receipts attributable to the embedded service by the taxpayer. In addition, DPGR does not include the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of property that does not meet all of the requirements under this section (non-qualified property). For example, gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of a replacement part that is non-qualified property does not qualify as DPGR.

(ii) *Exceptions.* There are five exceptions to the rules under paragraph (h)(4)(i) of this section regarding embedded services and non-qualified property. A taxpayer may include in DPGR, if all the other requirements of this section are met with respect to the underlying item of property to which the embedded services or non-qualified property relate, gross receipts derived from—

(A) A qualified warranty, that is, a warranty that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of QPP, qualified films or utilities if—

(1) In the normal course of the taxpayer's business, the price for the warranty is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the property; and

(2) The warranty is neither separately offered by the taxpayer nor separately bargained for with the customer (that is, a customer cannot purchase the property without the warranty);

(B) A qualified delivery, that is, a delivery or distribution service that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of QPP if—

(1) In the normal course of the taxpayer's business, the price for the delivery or distribution service is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the property; and

(2) The delivery or distribution service is neither separately offered by the taxpayer nor separately bargained for with the customer (that is, a customer cannot purchase the property without delivery or distribution service);

(C) A qualified operating manual, that is, a manual of instructions (including electronic instructions) that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of QPP, qualified films or utilities if—

(1) In the normal course of the taxpayer's business, the price for the manual is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the property;

(2) The manual is neither separately offered by the taxpayer nor separately bargained for with the customer (that is, a customer cannot purchase the property without the manual); and

(3) The manual is not provided in connection with a training course for the customer;

(D) A qualified installation, that is, an installation service (including minor assembly) for QPP that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of the QPP if—

(1) In the normal course of the taxpayer's business, the price for the installation service is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the property; and

(2) The installation is neither separately offered by the taxpayer nor separately bargained for with the customer (that is, a customer cannot purchase the property without the installation service); and

(E) A *de minimis* amount of gross receipts from embedded services and non-qualified property for each item of QPP, qualified films, or utilities. For purposes of the preceding sentence, a *de minimis* amount of gross receipts from embedded services and non-qualified property is less than 5 percent of the total gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of each item of QPP,

qualified films, or utilities (including the gross receipts for the embedded services and property described in paragraphs (h)(4)(ii)(A), (B), (C), (D) and (k)(4)(iv) of this section). The allocation of the gross receipts attributable to the embedded services or non-qualified property will be deemed to be reasonable if the allocation reflects the fair market value of the embedded services or property. In the case of gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP, qualified films, and utilities that are received over a period of time (for example, a multi-year lease or installment sale), this *de minimis* exception is applied by taking into account the total gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the item of QPP, qualified films, or utilities. For purposes of applying this *de minimis* exception, the gross receipts described in paragraphs (h)(4)(ii)(A), (B), (C), (D) and (k)(4)(iv) of this section are treated as DPGR. This *de minimis* exception does not apply if the prices of the services or non-qualified property are separately stated by the taxpayer, or if the services or non-qualified property are separately offered or separately bargained for with the customer (that is, the customer can purchase the property without the services or non-qualified property).

(iii) *Examples.* The following examples illustrate the application of this paragraph (h)(4):

Example 1. X MPGE QPP within the United States. As part of the sale of the QPP to Z, X trains Z's employees on how to use and operate the QPP. No other services or property are provided to Z in connection with the sale of the QPP to Z. The QPP and training services are separately stated in the sales contract. Because the training services are separately stated, the training services are not treated as embedded services under the *de minimis* exception in paragraph (h)(4)(ii)(E) of this section.

Example 2. The facts are the same as in *Example 1* except that the training services are not separately stated in the sales contract and the customer cannot purchase the QPP without the training services. If the gross receipts for the embedded training services are less than 5 percent of the gross receipts derived from the sale of X's QPP to Z, including the gross receipts for the training services, then the gross receipts may be included in DPGR under the *de minimis* exception in paragraph (h)(4)(ii)(E) of this section.

Example 3. X MPGE QPP within the United States. As part of the sale of the QPP to retailers, X charges a fee for delivering the QPP. The price of the QPP and the delivery fee are separately stated in the sales contract. The retailer's customers cannot purchase the QPP without paying for the delivery fee.

Because the delivery fee is separately stated, the delivery fee does not qualify as DPGR under the qualified delivery exception in paragraph (h)(4)(ii)(B) of this section or the *de minimis* exception under paragraph (h)(4)(ii)(E) of this section.

Example 4. X enters into a single, lump-sum priced contract with Y, an unrelated taxpayer, and the contract has the following terms: X will produce QPP within the United States for Y; X will deliver the QPP to Y; X will provide a one-year warranty on the QPP; X will provide operating and maintenance manuals with the QPP; X will provide 100 hours of training and training manuals to Y's employees on the use and maintenance of the QPP; X will provide purchased spare parts for the QPP; and X will provide a 3-year service agreement for the QPP. None of the services or property was separately offered or separately bargained for. The receipts for the production of the QPP are DPGR under paragraphs (d)(1) and (f) of this section (assuming all the other requirements of this section are met). X may include in DPGR the gross receipts for delivering the QPP, which is a qualified delivery under paragraph (h)(4)(ii)(B) of this section; the gross receipts for the one-year warranty, which is a qualified warranty under paragraph (h)(4)(ii)(A) of this section; and the gross receipts for the operating and maintenance manuals, each of which is a qualified operating manual under paragraph (h)(4)(ii)(C) of this section. If the gross receipts for the embedded services consisting of the employee training and 3-year service agreement, and for the non-qualified property consisting of the purchased spare parts and the employee training manuals, which are not qualified operating manuals, are in total less than 5 percent of the gross receipts derived from the sale of X's QPP to Y (including the gross receipts for the embedded services and non-qualified property), those gross receipts may be included in DPGR (assuming there are no other embedded services or non-qualified property under the contract) under the *de minimis* exception in paragraph (h)(4)(ii)(E) of this section. If, however, the gross receipts for the embedded services and non-qualified property consisting of employee training, the 3-year service agreement, purchased spare parts, and employee training manuals equal or exceed 5 percent of the gross receipts derived from the sale of X's QPP to Y (including the gross receipts for the embedded services and non-qualified property), those gross receipts do not qualify as DPGR under the *de minimis* exception in paragraph (h)(4)(ii)(E) of this section.

(5) *Advertising income*—(i) *Tangible personal property.* A taxpayer's gross receipts that are derived from the lease, rental, license, sale, exchange, or other disposition of newspapers, magazines, telephone directories, or periodicals that are MPGE in whole or in significant part within the United States include advertising income from advertisements placed in those media, but only to the extent the gross receipts, if any, derived from the lease, rental, license, sale,

exchange, or other disposition of the newspapers, magazines, telephone directories, or periodicals are DPGR (without regard to this paragraph (h)(5)(i)).

(ii) *Qualified films.* A taxpayer's gross receipts that are derived from the lease, rental, license, sale, exchange, or other disposition of a qualified film include product-placement income with respect to that qualified film, that is, compensation for placing or integrating a product into the qualified film, but only to the extent the gross receipts derived from the qualified film (if any) are DPGR (without regard to this paragraph (h)(5)(ii)).

(iii) *Examples.* The following examples illustrate the application of this paragraph (h)(5):

Example 1. X MPGE and sells newspapers within the United States. X's gross receipts from the newspapers include gross receipts derived from the sale of newspapers to customers and payments from advertisers to publish display advertising or classified advertisements in X's newspapers. X's gross receipts described above are DPGR derived from the sale of X's newspapers.

Example 2. The facts are the same as in *Example 1* except that X also distributes with its newspapers advertising flyers that are MPGE by the advertiser. The fees X receives for distributing the advertising flyers are not derived from the sale of X's newspapers because X did not MPGE the advertising flyers that it distributes. As a result, the distribution fee is for the provision of a distribution service and is non-DPGR under paragraph (h)(5)(i) of this section.

Example 3. X produces two television programs that are qualified films (as defined in paragraph (j)(1) of this section). X licenses the first television program to Y's television station and X licenses the second television program to Z's television station. Both television programs contain product placements for which X received compensation. Z, but not Y, is a related person to X within the meaning of paragraph (b)(1) of this section. The gross receipts derived by X from licensing the qualified film to Y are DPGR. As a result, pursuant to paragraph (h)(5)(ii) of this section, all of X's product placement income for the first television program is treated as gross receipts that are derived from the license of the qualified film. The gross receipts derived by X from licensing the qualified film to Z are non-DPGR under paragraph (b)(1) of this section. As a result, pursuant to paragraph (h)(5)(ii) of this section, none of X's product placement income for the second television program is treated as gross receipts derived from the qualified film under paragraph (h)(5)(ii) of this section.

(6) *Computer software—(i) In general.* Gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of computer software (as defined in paragraph (i)(3) of this section) do not include gross receipts

derived from Internet access services, online services, customer and technical support, telephone services, online electronic books and journals, games played through a Web site, provider-controlled software online access services, and other similar services that do not constitute the lease, rental, license, sale, exchange, or other disposition of computer software that was developed by the taxpayer.

(ii) *Examples.* The following examples illustrate the application of this paragraph (h)(6):

Example 1. X produces and prints a newspaper in the United States which it sells to customers. X also has an online version of the newspaper which is available only to subscribers. The gross receipts derived from the sale of the newspaper X produces and prints qualify as DPGR. However, because X's gross receipts from the online newspaper subscription are not derived from the lease, rental, license, sale, exchange, or disposition of computer software under paragraph (h)(6)(i) of this section, the gross receipts attributable to the online newspaper subscription fees are non-DPGR under paragraph (h)(6)(i) of this section.

Example 2. The facts are the same as in *Example 1* except that X's gross receipts attributable to the online version of its newspaper are derived from fees from customers to view the newspaper online and payments from advertisers to display advertising online. X's gross receipts derived from allowing customers online access to X's newspaper are non-DPGR because, pursuant to paragraph (h)(6)(i) of this section, the gross receipts relating to online newspapers are not derived from the lease, rental, license, sale, exchange, or other disposition of QPP, but rather is the provision of an online access service. As a result, because X's gross receipts from the online access services are non-DPGR, the related online advertising receipts are similarly non-DPGR under paragraph (h)(5)(i) of this section.

(7) *Exception for certain oil and gas partnerships—(i) In general.* If a partnership is engaged solely in the extraction, refining, or processing of oil or natural gas, and distributes the oil or natural gas or products derived from the oil or natural gas (products) to one or more partners, then each partner is treated as extracting, refining, or processing any oil or natural gas or products extracted, refined, or processed by the partnership and distributed to that partner. Thus, to the extent that the extracting, refining, or processing of the distributed oil or natural gas or products occurs in whole or in significant part within the United States, gross receipts derived by each partner from the sale, exchange, or other disposition of the distributed oil or natural gas or products are treated as DPGR (provided all requirements of this section are met). Solely for purposes of

section 199(d)(1)(B)(ii), the partnership is treated as having gross receipts in the taxable year of the distribution equal to the fair market value of the distributed oil or natural gas or products at the time of distribution to the partner and the deemed gross receipts are allocated to that partner, provided the partner derives gross receipts from the distributed property during the taxable year of the partner with or within which the partnership's taxable year (in which the distribution occurs) ends. Costs included in the adjusted basis of the distributed oil or natural gas or products and any other relevant deductions are taken into account in computing the partner's QPAI. See § 1.199-5 for the application of section 199 to pass-thru entities.

(ii) *Example.* The following example illustrates the application of this paragraph (h)(7). Assume that PRS and X are calendar year taxpayers. The example reads as follows:

Example. X is a partner in PRS, a partnership which engages solely in the extraction of oil within the United States. In 2010, PRS distributes oil to X that PRS derived from its oil extraction. PRS incurred \$600 of CGS, including \$500 of W-2 wages (as defined in § 1.199-2(f)), extracting the oil distributed to X, and X's adjusted basis in the distributed oil is \$600. The fair market value of the oil at the time of the distribution to X is \$1,000. X incurs \$200 of CGS, including \$100 of W-2 wages, in refining the oil within the United States. In 2010, X sells the oil for \$1,500 to a customer. Under paragraph (h)(7)(i) of this section, X is treated as having extracted the oil. The extraction and refining of the oil qualify as an MPGE activity under paragraph (d)(1) of this section. Therefore, X's \$1,500 of gross receipts qualify as DPGR. X subtracts from the \$1,500 of DPGR the \$600 of CGS incurred by PRS and the \$200 of refining costs incurred by X. Thus, X's QPAI is \$700 for 2010. In addition, PRS is treated as having \$1,000 of DPGR solely for purposes of applying the wage limitation of section 199(d)(1)(B)(ii). Accordingly, X's share of PRS's W-2 wages determined under section 199(d)(1)(B) is \$72, the lesser of \$500 (X's allocable share of PRS's W-2 wages included in CGS) and \$72 ($2 \times (\$400 (\$1,000 \text{ deemed DPGR less } \$600 \text{ of CGS}) \times .09)$). X adds the \$72 of PRS W-2 wages to its \$100 of W-2 wages incurred in refining the oil for purposes of section 199(b).

(8) *Partnerships owned by members of a single expanded affiliated group—(i) In general.* For purposes of this section, if all of the interests in the capital and profits of a partnership are owned by members of a single EAG at all times during the taxable year of the partnership (EAG partnership), then the EAG partnership and all members of that EAG are treated as a single taxpayer for purposes of section 199(c)(4) during that taxable year. Thus, if an EAG

partnership MPGE or produces property and distributes, leases, rents, licenses, sells, exchanges, or otherwise disposes of that property to a member of an EAG in which the partners of the EAG partnership are members, then the MPGE or production activity conducted by the EAG partnership will be treated as having been conducted by the members of the EAG. Similarly, if one or more members of an EAG in which the partners of an EAG partnership are members MPGE or produces property and contributes, leases, rents, licenses, sells, exchanges, or otherwise disposes of that property to the EAG partnership, then the MPGE or production activity conducted by the EAG member (or members) will be treated as having been conducted by the EAG partnership. Attribution of activities does not apply for purposes of the construction of real property under § 1.199–3(l)(1) and the performance of engineering and architectural services under § 1.199–3(m)(2) and (3), respectively. An EAG partnership may not use the small business simplified overall method described in § 1.199–4(f). Except as provided in this paragraph (h)(8), an EAG partnership is treated the same as other partnerships for purposes of section 199. Accordingly, an EAG partnership is subject to the rules of § 1.199–5 regarding the application of section 199 to pass-thru entities, including application of the section 199(d)(1)(B) wage limitation under § 1.199–5(a)(3). See paragraphs (f)(2) and (3) of this section for the aggregation of activities and conversion costs among EAG partnerships and all members of the EAG in which the partners of the EAG partnership are members.

(ii) *Special rules for distributions from EAG partnerships.* If an EAG partnership distributes property to a partner, then, solely for purposes of section 199(d)(1)(B)(ii), the EAG partnership is treated as having gross receipts in the taxable year of the distribution equal to the fair market value of the property at the time of distribution to the partner and the deemed gross receipts are allocated to that partner, provided the partner derives gross receipts from the distributed property during the taxable year of the partner with or within which the partnership's taxable year (in which the distribution occurs) ends. Costs included in the adjusted basis of the distributed property and any other relevant deductions are taken into account in computing the partner's QPAI.

(iii) *Examples.* The following examples illustrate the rules of this

paragraph (h)(8). Assume that PRS, X, Y, and Z all are calendar year taxpayers. The examples read as follows:

Example 1. Contribution. X and Y, both members of a single EAG, are the only partners in PRS, a partnership, for PRS's entire 2010 taxable year. In 2010, X MPGE QPP within the United States and contributes the property to PRS. In 2010, PRS sells the QPP for \$1,000. PRS's \$1,000 gross receipts constitute DPGR. PRS, X, and Y must apply the rules of § 1.199–5 regarding the application of section 199 to pass-thru entities with respect to the activity of PRS, including application of the section 199(d)(1)(B) wage limitation under § 1.199–5(a)(3).

Example 2. Sale. X, Y, and Z are the only members of a single EAG. X and Y each own 50% of the capital and profits interests in PRS, a partnership, for PRS's entire 2010 taxable year. In 2010, PRS MPGE QPP within the United States and then sells the property to X for \$6,000, its fair market value at the time of the sale. PRS's gross receipts of \$6,000 qualify as DPGR. In 2010, X sells the QPP to customers for \$10,000, incurring selling expenses of \$2,000. Under this paragraph (h)(8), X is treated as having MPGE the QPP within the United States, and X's \$10,000 of gross receipts qualify as DPGR (\$6,000 of CGS and \$2,000 of other selling expenses are subtracted from DPGR in determining X's QPAI). The results would be the same if PRS sold the property to Z rather than to X.

Example 3. Distribution. X and Y, both members of a single EAG, are the only partners in PRS, a partnership, for PRS's entire 2010 taxable year. In 2010, PRS MPGE QPP within the United States, incurring \$600 of CGS, including \$500 of W–2 wages (as defined in § 1.199–2(f)), and then distributes the QPP to X. X's adjusted basis in the QPP is \$600. At the time of the distribution the fair market value of the QPP is \$1,000. X incurs \$200 of directly allocable costs, including \$100 of W–2 wages, to further MPGE the QPP within the United States. In 2010, X sells the QPP for \$1,500 to a customer. Under paragraph (h)(8)(i) of this section, X is treated as having MPGE the QPP within the United States, and X's \$1,500 of gross receipts qualify as DPGR. X subtracts from the \$1,500 of DPGR the \$600 of CGS incurred by PRS and the \$200 of direct costs incurred by X. Thus, X's QPAI is \$700 for 2010. In addition, PRS is treated as having DPGR of \$1,000 solely for purposes of applying the wage limitation of section 199(d)(1)(B)(ii). Accordingly, X's share of PRS's W–2 wages determined under section 199(d)(1)(B) is \$72, the lesser of \$500 (X's allocable share of PRS's W–2 wages included in CGS) and \$72 ($2 \times (\$400 (\$1,000 \text{ deemed DPGR less } \$600 \text{ of CGS}) \times .09)$). X adds the \$72 of PRS W–2 wages to its \$100 of W–2 wages incurred in MPGE the QPP for purposes of section 199(b).

Example 4. Multiple sales. X and Y, both non-consolidated members of a single EAG, are the only partners in PRS, a partnership, for PRS's entire 2010 taxable year. PRS produces in bulk form in the United States the active ingredient for a pharmaceutical

product. Assume that PRS's own MPGE activity with respect to the active ingredient is not substantial in nature, taking into account all of the facts and circumstances, and PRS's conversion costs to MPGE the active ingredient within the United States are \$15 and account for 15 percent of PRS's \$100 CGS of the active ingredient. PRS sells the active ingredient in bulk form to X. X uses the active ingredient to produce the finished dosage form drug. Assume that X's own MPGE activity with respect to the drug is not substantial in nature, taking into account all of the facts and circumstances, and X's conversion costs to MPGE the drug within the United States are \$12 and account for 10 percent of X's \$120 CGS of the drug. X sells the drug in finished dosage to Y and Y sells the drug to customers. Y incurs \$2 of conversion costs and Y's CGS in selling the drug to customers is \$130. PRS's gross receipts from the sale of the active ingredient to X are non-DPGR because PRS's MPGE activity is not substantial in nature and PRS does not satisfy the safe harbor described in paragraph (f)(3) of this section because PRS's conversion costs account for less than 20 percent of PRS's CGS of the active ingredient. X's gross receipts from the sale of the drug to Y are DPGR because X is considered to have MPGE the drug in significant part in the United States pursuant to the safe harbor described in paragraph (f)(3) of this section because the \$27 (\$15 + \$12) of conversion costs incurred by PRS and X equals or exceeds 20 percent of X's total CGS (\$120) of the drug at the time the drug is sold to Y. Similarly, Y's gross receipts from the sale of the drug to customers are DPGR because Y is considered to have MPGE the drug in significant part in the United States pursuant to the safe harbor described in paragraph (f)(3) of this section because the \$29 (\$15 + \$12 + \$2) of conversion costs incurred by PRS, X, and Y equals or exceeds 20 percent of Y's total CGS (\$130) of the drug at the time the drug is sold to customers.

(9) *Non-operating mineral interests.* DPGR does not include gross receipts derived from mineral interests other than operating mineral interests within the meaning of § 1.614–2(b).

(i) *Definition of qualifying production property—(1) In general.* QPP means—

(i) Tangible personal property (as defined in paragraph (i)(2) of this section);

(ii) Computer software (as defined in paragraph (i)(3) of this section); and

(iii) Sound recordings (as defined in paragraph (i)(4) of this section).

(2) *Tangible personal property—(i) In general.* The term *tangible personal property* is any tangible property other than land, buildings (including items that are structural components of such buildings), and any property described in paragraph (i)(3), (i)(4), (j)(1), or (k) of this section. Property such as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves,

and neon and other signs that are contained in or attached to a building constitutes tangible personal property for purposes of this paragraph (i)(2)(i). Except as provided in paragraphs (i)(5)(ii) and (j)(2)(i) of this section, computer software, sound recordings, and qualified films are not treated as tangible personal property regardless of whether they are fixed on a tangible medium. However, the tangible medium on which such property may be fixed (for example, a videocassette, a computer diskette, or other similar tangible item) is tangible personal property.

(ii) *Local law.* In determining whether property is tangible personal property, local law is not controlling.

(iii) *Machinery.* Property that is in the nature of machinery (other than structural components of a building) is tangible personal property even if such property is located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, is considered tangible personal property. A structure that is property in the nature of machinery or is essentially an item of machinery or equipment is not an inherently permanent structure and is tangible personal property. In the case, however, of a building or inherently permanent structure that includes property in the nature of machinery as a structural component, the property in the nature of machinery is real property.

(iv) *Intangible property.* The term *tangible personal property* does not include property in a form other than in a tangible medium. For example, mass-produced books are tangible personal property, but neither the rights to the underlying manuscript nor an online version of the book is tangible personal property.

(3) *Computer software*—(i) *In general.* The term *computer software* means any program or routine or any sequence of machine-readable code that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine. For purposes of this paragraph (i)(3), computer software also includes the machine-readable code for video games and similar programs, for equipment that is an integral part of other property, and for typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, regardless of whether the code is designed to operate on a computer (as defined in section 168(i)(2)(B)). Computer programs of all classes, for example, operating systems,

executive systems, monitors, compilers and translators, assembly routines, and utility programs, as well as application programs, are included. Except as provided in paragraph (i)(5) of this section, if the medium in which the software is contained, whether written, magnetic, or otherwise, is tangible, then such medium is considered tangible personal property for purposes of this section.

(ii) *Incidental and ancillary rights.* Computer software also includes any incidental and ancillary rights that are necessary to effect 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. Such incidental and ancillary rights are not included in the definition of trademark or trade name under § 1.197-2(b)(10)(i). For example, a trademark or trade name that is ancillary to the ownership or use of a specific computer software program in the taxpayer's trade or business and is not acquired for the purpose of marketing the computer software is included in the definition of computer software and is not included in the definition of trademark or trade name.

(iii) *Exceptions.* Computer software does not include any data or information base unless the data or information base is in the public domain and is incidental to a computer program. For this purpose, a copyrighted or proprietary data or information base is treated as in the public domain if its availability through the computer program does not contribute significantly to the cost of the program. For example, if a word-processing program includes a dictionary feature that may be used to spell-check a document or any portion thereof, the entire program (including the dictionary feature) is computer software regardless of the form in which the dictionary feature is maintained or stored.

(4) *Sound recordings*—(i) *In general.* The term *sound recordings* means any works that result from the fixation of a series of musical, spoken, or other sounds under section 168(f)(4). The definition of sound recordings is limited to the master copy of the recordings (or other copy from which the holder is licensed to make and produce copies), and, except as provided in paragraph (i)(5) of this section, if the medium (such as compact discs, tapes, or other phonorecordings) in which the sounds may be embodied is tangible, the medium is considered tangible personal property for purposes of paragraph (i)(2) of this section.

(ii) *Exception.* The term *sound recordings* does not include the creation of copyrighted material in a form other than a sound recording, such as lyrics or music composition.

(5) *Tangible personal property with computer software or sound recordings*—(i) *Computer software and sound recordings.* If a taxpayer MPGE computer software or sound recordings that is fixed on, or added to, tangible personal property by the taxpayer (for example, a computer diskette, or an appliance), then for purposes of this section—

(A) The computer software and the tangible personal property may be treated by the taxpayer as computer software. If the taxpayer treats the tangible personal property as computer software under this paragraph (i)(5)(i)(A), any costs under section 174 attributable to the tangible personal property are not considered in determining whether the taxpayer's activity is substantial in nature under paragraph (f)(2) of this section and are not conversion costs under paragraph (f)(3) of this section; and

(B) The sound recordings and the tangible personal property with the sound recordings may be treated by the taxpayer as sound recordings. If the taxpayer treats the tangible personal property as sound recordings under this paragraph (i)(5)(i)(B), any costs under section 174 attributable to the tangible personal property are not considered in determining whether the taxpayer's activity is substantial in nature under paragraph (f)(2) of this section and are not conversion costs under paragraph (f)(3) of this section.

(ii) *Tangible personal property.* If a taxpayer MPGE tangible personal property but not the computer software or sound recordings that the taxpayer fixes on, or adds to, the tangible personal property MPGE by the taxpayer (for example, a computer diskette or an appliance), then for purposes of this section the tangible personal property with the computer software or sound recordings may be treated by the taxpayer as tangible personal property under paragraph (i)(2) of this section. For purposes of paragraph (f)(3) of this section, the taxpayer's CGS for each item includes the taxpayer's cost of licensing the computer software or sound recordings.

(j) *Definition of qualified film*—(1) *In general.* The term *qualified film* means any motion picture film or video tape under section 168(f)(3), or live or delayed television programming if not less than 50 percent of the total compensation paid to all actors, production personnel, directors, and

producers relating to the production of the motion picture film, video tape, or television programming is compensation for services performed in the United States by those individuals. The term *production personnel* includes writers, choreographers and composers providing services during the production of a film, casting agents, camera operators, set designers, lighting technicians, make-up artists, and others whose activities are directly related to the production of the film. The term *production personnel* does not include, however, individuals whose activities are ancillary to the production, such as advertisers and promoters, distributors, studio administrators and managers, studio security personnel, and personal assistants to actors. The term *production personnel* also does not include individuals whose activities relate to fixing the film on tangible personal property. The definition of *qualified film* is limited to the master copy of the film (or other copy from which the holder is licensed to make and produce copies), and, except as provided in paragraph (j)(2) of this section, does not include tangible personal property embodying the qualified film, such as DVDs or videocassettes.

(2) *Tangible personal property with a film*—(i) *Film licensed to a taxpayer*. If a taxpayer MPGE tangible personal property (such as a DVD) in whole or in significant part in the United States and fixes to the tangible personal property a film that the taxpayer licenses from the producer of the film, then the taxpayer may treat the tangible personal property with the affixed film as QPP, regardless of whether the film is a qualified film. The determination of whether gross receipts of such a taxpayer from the lease, rental, license, sale, exchange, or other disposition of the tangible personal property with the affixed film are DPGR is made under the rules of paragraphs (d), (e), and (f) of this section. For purposes of paragraph (f)(3) of this section, the taxpayer's CGS for each item includes the taxpayer's cost of licensing the film from the producer of the film.

(ii) *Film produced by a taxpayer*. If a taxpayer produces a film and also fixes the film on tangible personal property (for example, a DVD), then for purposes of this section—

(A) *Qualified films*. If the film is a qualified film, the taxpayer may treat the tangible personal property on which the qualified film is fixed as part of the qualified film, in which case the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the tangible personal property with the affixed qualified film

will be DPGR (assuming all the other requirements of this section are met), regardless of whether the taxpayer MPGE the tangible personal property in whole or in significant part within the United States; and

(B) *Nonqualified films*. If the film is not a qualified film (nonqualified film), any gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the tangible personal property with the nonqualified film that are allocable to the nonqualified film are non-DPGR. The taxpayer, however, may treat the tangible personal property (without the nonqualified film) as an item of QPP. Thus, the determination of whether gross receipts of such a taxpayer derived from the lease, rental, license, sale, exchange, or other disposition of the tangible personal property with the affixed nonqualified film, that are allocable to the tangible personal property, are DPGR is made under the rules of paragraphs (d), (e), and (f) of this section.

(3) *Derived from a qualified film*. DPGR includes the gross receipts of the taxpayer which are derived from any lease, rental, license, sale, exchange, or other disposition of any qualified film produced by the taxpayer. Showing a qualified film on a television station is not a lease, rental, license, sale, exchange, or other disposition of the qualified film. Ticket sales for viewing qualified films do not constitute DPGR because the gross receipts are not derived from the lease, rental, license, sale, exchange, or other disposition of a qualified film. Because a taxpayer that merely writes a screenplay or other similar material is not considered to have produced a qualified film under paragraph (j)(1) of this section, the amounts that the taxpayer receives from the sale of the script or screenplay, even if the script is developed into a qualified film, are not gross receipts derived from a qualified film. In addition, revenue from the sale of film-themed merchandise is revenue from the sale of tangible personal property and not gross receipts derived from a qualified film. Gross receipts derived from a license of the right to use the film characters are not gross receipts derived from a qualified film.

(4) *Examples*. The following examples illustrate the application of paragraphs (j)(2) and (3) of this section:

Example 1. X produces a qualified film in the United States and duplicates the film onto purchased DVDs. X sells the DVDs with the qualified film to customers. Under paragraph (j)(2)(ii)(A) of this section, X may treat the DVD with the qualified film as a qualified film. Accordingly, X's gross receipts

derived from the sale of the qualified film to customers are DPGR (assuming all the other requirements of this section are met).

Example 2. The facts are the same as in *Example 1* except that the film is a nonqualified film because the film does not satisfy the 50 percent requirement under (j)(1) of this section and X manufactures the DVDs in the United States. Under paragraph (j)(2)(ii)(B) of this section, X may treat the DVD without the nonqualified film as tangible personal property. X's gross receipts (not including the gross receipts attributable to the nonqualified film) derived from the sale of the tangible personal property are DPGR (assuming all the other requirements of this section are met).

Example 3. X produces television programs that are qualified films. X shows the programs on its own television station. X sells advertising time slots to advertisers for the television programs. Because showing qualified films on a television station is not a lease, rental, license, sale, exchange, or other disposition, pursuant to paragraph (j)(3) of this section, the advertising income X receives from advertisers is not derived from the lease, rental, license, sale, exchange, or other disposition of qualified films.

Example 4. X produces a qualified film and contracts with Y, an unrelated taxpayer, to duplicate the film onto DVDs. Y manufactures blank DVDs within the United States, duplicates X's film onto the DVDs in the United States, and sells the DVDs with the qualified film to X who then sells them to customers. Y has all of the benefits and burdens of ownership under Federal income tax principles of the DVDs during the MPGE and duplication process. Assume Y's activities relating to manufacture of the blank DVDs and duplicating the film onto the DVDs collectively satisfy the safe harbor under paragraph (f)(3) of this section. Y's gross receipts from manufacturing the DVDs and duplicating the film onto the DVDs are DPGR. X's gross receipts from the sale of the DVDs to customers are DPGR.

(5) *Compensation for services*. The term *compensation for services* means all payments for services performed by actors, production personnel, directors, and producers, including participations and residuals. In the case of a taxpayer that uses the income forecast method of section 167(g) and capitalizes participations and residuals into the adjusted basis of the qualified film, the taxpayer must use the same estimate of participations and residuals for services performed by actors, production personnel, directors, and producers for purposes of this section. In the case of a taxpayer that excludes participations and residuals from the adjusted basis of the qualified film under section 167(g)(7)(D)(i), the taxpayer must determine the compensation expected to be paid for services performed by actors, production personnel, directors, and producers as participations and residuals based on the total forecasted income used in determining income

forecast depreciation. Compensation for services includes all direct and indirect compensation costs required to be capitalized under section 263A for film producers under § 1.263A-1(e)(2) and (3). Compensation for services is not limited to W-2 wages and includes compensation paid to independent contractors.

(6) *Determination of 50 percent.* A taxpayer may use any reasonable method of determining the compensation for services performed in the United States by actors, production personnel, directors, and producers, and the total compensation paid to those individuals for services relating to the production of the property. Among the factors to be considered in determining whether a taxpayer's method of allocating compensation is reasonable is whether the taxpayer uses that method consistently.

(7) *Exception.* A qualified film does not include property with respect to which records are required to be maintained under 18 U.S.C. 2257. Section 2257 of Title 18 requires maintenance of certain records with respect to any book, magazine, periodical, film, videotape, or other matter that—

(i) Contains one or more visual depictions made after November 1, 1990, of actual sexually explicit conduct; and

(ii) Is produced in whole or in part with materials that have been mailed or shipped in interstate or foreign commerce, or is shipped or transported or is intended for shipment or transportation in interstate or foreign commerce.

(k) *Electricity, natural gas, or potable water—(1) In general.* DPGR includes gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of utilities produced by the taxpayer in the United States if all other requirements of this section are met. In the case of an integrated producer that both produces and delivers utilities, see paragraph (k)(4) of this section that describes certain gross receipts that do not qualify as DPGR, therefore requiring a taxpayer to allocate its gross receipts between DPGR and non-DPGR.

(2) *Natural gas.* The term *natural gas* includes only natural gas extracted from a natural deposit and does not include, for example, methane gas extracted from a landfill. In the case of natural gas, production activities include all activities involved in extracting natural gas from the ground and processing the gas into pipeline quality gas.

(3) *Potable water.* The term *potable water* means unbottled drinking water. In the case of potable water, production

activities include the acquisition, collection, and storage of raw water (untreated water), transportation of raw water to a water treatment facility, and treatment of raw water at such a facility. Gross receipts attributable to any of these activities are included in DPGR if all other requirements of this section are met.

(4) *Exceptions—(i) Electricity.* 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 final customers are non-DPGR.

(ii) *Natural gas.* Gross receipts attributable to the transmission of pipeline quality gas from a natural gas field (or, if treatment at a natural gas processing plant is necessary to produce pipeline quality gas, from a natural gas processing plant) to a local distribution company's citygate (or to another customer) are non-DPGR. Likewise, gross receipts of a local gas distribution company attributable to distribution from the citygate to the local customers are non-DPGR.

(iii) *Potable water.* Gross receipts attributable to the storage of potable water after completion of treatment of the potable water, as well as gross receipts attributable to the transmission and distribution of potable water, are non-DPGR.

(iv) *De minimis exception.* Notwithstanding paragraphs (k)(4)(i), (ii), and (iii) of this section, if less than 5 percent of a taxpayer's gross receipts derived from a sale, exchange, or other disposition of utilities are attributable to the transmission or distribution of the utilities, then the gross receipts derived from that lease, rental, license, sale, exchange, or other disposition that are attributable to the transmission and distribution of the utilities must be treated for purposes of section 199 as being DPGR if all other requirements of this section are met.

(5) *Example.* The following example illustrates the application of this paragraph (k):

Example. X owns a wind turbine in the United States that generates electricity and Y owns a high voltage transmission line that passes near X's wind turbine and ends near the system of local distribution lines of Z. X sells the electricity produced at the wind turbine to Z who sells the electricity to customers using Z's distribution network. The gross receipts received by X for the sale of electricity produced at the wind turbine are DPGR. The gross receipts of Y from transporting X's electricity to Z are non-DPGR under paragraph (k)(4)(i) of this section. Likewise, the gross receipts of Z from

distributing the electricity are non-DPGR under paragraph (k)(4)(i) of this section. If X made direct sales of electricity to customers in Z's service area and Z receives remuneration for the distribution of electricity, the gross receipts of Z are non-DPGR under paragraph (k)(4)(i) of this section. If X, Y, and Z are related persons (as defined in paragraph (b) of this section), then X, Y, and Z must allocate gross receipts to production activities, transmission activities, and distribution activities.

(l) *Definition of construction performed in the United States—(1) Construction of real property—(i) In general.* The term *construction* means the construction or erection of real property (that is, residential and commercial buildings (including items that are structural components of such buildings), inherently permanent structures other than tangible personal property in the nature of machinery (see paragraph (i)(2)(iii) of this section), inherently permanent land improvements, oil and gas wells, and infrastructure) in the United States by a taxpayer that, at the time the taxpayer constructs the real property, is engaged in a trade or business (but not necessarily its primary, or only, trade or business) that is considered construction for purposes of the North American Industry Classification System (NAICS) on a regular and ongoing basis. A trade or business that is considered construction under the NAICS means a construction activity under the two-digit NAICS code of 23 and any other construction activity in any other NAICS code provided the construction activity relates to the construction of real property such as NAICS code 213111 (drilling oil and gas wells) and 213112 (support activities for oil and gas operations). Tangible personal property (for example, appliances, furniture, and fixtures) that is sold as part of a construction project is not considered real property for purposes of this paragraph (l)(1)(i). In determining whether property is real property, the fact that property is real property under local law is not controlling. Conversely, property may be real property for purposes of this paragraph (l)(1)(i) even though under local law the property is considered tangible personal property.

(ii) *De minimis exception.* For purposes of paragraph (l)(1)(i) of this section, if less than 5 percent of the total gross receipts derived by a taxpayer from a construction project (as described in paragraph (l)(1)(i) of this section) are derived from activities other than the construction of real property in the United States (for example, from non-construction activities or the sale of

tangible personal property or land) then the total gross receipts derived by the taxpayer from the project are DPGR from construction.

(2) *Activities constituting construction.* Activities constituting construction include activities performed in connection with a project to erect or substantially renovate real property, but do not include tangential services such as hauling trash and debris, and delivering materials, even if the tangential services are essential for construction. However, if the taxpayer performing construction also, in connection with the construction project, 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. Improvements to land that are not capitalizable to the land (for example, landscaping) and painting are activities constituting construction only if these 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 and provided the taxpayer meets the requirements under paragraph (1)(1) of this section. The taxpayer engaged in these activities must make a reasonable inquiry to determine whether the activity relates to the erection or substantial renovation of real property in the United States. Construction activities also include activities relating to drilling an oil well and mining and include any activities pursuant to which the taxpayer could deduct intangible drilling and development costs under section 263(c) and § 1.612-4 and development expenditures for a mine or natural deposit under section 616. The lease, license, or rental of equipment, for example, bulldozers, generators, or computers, to contractors for use by the contractors in the construction of real property is not a construction activity under this paragraph (1)(2). The term *construction* does not include any activity that is within the definition of engineering and architectural services under paragraph (m) of this section.

(3) *Definition of infrastructure.* The term *infrastructure* includes roads, power lines, water systems, railroad spurs, communications facilities, sewers, sidewalks, cable, and wiring. The term also includes inherently permanent oil and gas platforms.

(4) *Definition of substantial renovation.* The term *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.

(5) *Derived from construction—(i) In general.* Assuming all the requirements of this section are met, DPGR derived from the construction of real property performed in the United States includes the proceeds from the sale, exchange, or other disposition of real property constructed by the taxpayer in the United States (whether or not the property is sold immediately after construction is completed and whether or not the construction project is complete). DPGR derived from the construction of real property includes compensation for the performance of construction services by the taxpayer in the United States. However, DPGR derived from the construction of real property does not include gross receipts from the lease or rental of real property constructed by the taxpayer or, except as provided in paragraph (1)(5)(ii) of this section, gross receipts attributable to the sale or other disposition of land (including zoning, planning, entitlement costs, and other costs capitalized to the land such as the demolition of structures under section 280B). In addition, DPGR derived from the construction of real property includes gross receipts from any qualified construction warranty, that is, a warranty that is provided in connection with the constructed real property if—

(A) In the normal course of the taxpayer's business, the price for the construction warranty is not separately stated from the amount charged for the constructed real property; and

(B) The construction warranty is neither separately offered by the taxpayer nor separately bargained for with the customer (that is, the customer cannot purchase the constructed real property without the construction warranty).

(ii) *Land safe harbor.* For purposes of paragraph (1)(5)(i) of this section, a taxpayer may allocate gross receipts between the proceeds from the sale, exchange, or other disposition of real property constructed by the taxpayer and the gross receipts attributable to the sale, exchange, or other disposition of land by reducing its costs related to DPGR under § 1.199-4 by costs of the land and any other costs capitalized to the land (collectively, land costs) (including zoning, planning, entitlement costs, and other costs capitalized to the land such as the demolition of structures under section 280B and land costs in any common improvements as defined in section 2.01 of Rev. Proc. 92-29 (1992-1 C.B. 748) (see § 601.601(d)(2) of this chapter)) and by reducing its

DPGR by those land costs plus a percentage. The percentage is based on the number of years that elapse between the date the taxpayer acquires the land, including the date the taxpayer enters into the first option to acquire all or a portion of the land, and ends on the date the taxpayer sells each item of real property on the land. The percentage is 5 percent for years zero through 5; 10 percent for years 6 through 10; and 15 percent for years 11 through 15. Land held by a taxpayer for 16 or more years is not eligible for the safe harbor under this paragraph (1)(5)(ii) and the taxpayer must allocate gross receipts between land and qualifying real property.

(iii) *Examples.* The following examples illustrate the application of this paragraph (1)(5):

Example 1. X, who is in the trade or business of construction under NAICS code 23 on a regular and ongoing basis, purchases a building in the United States and retains Y, an unrelated taxpayer (a general contractor), to oversee a substantial renovation of the building (within the meaning of paragraph (1)(4) of this section). Y retains Z (a subcontractor) to install a new electrical system in the building as part of that substantial renovation. The amounts that Y receives from X for construction services, and amounts that Z receives from Y for construction services, qualify as DPGR under paragraph (1)(5)(i) of this section provided Y and Z meet all of the requirements of paragraph (1)(1) of this section. The gross receipts that X receives from the subsequent sale of the building do not qualify as DPGR because X did not engage in any activity constituting construction under paragraph (1)(2) of this section even though X is in the trade or business of construction. The results would be the same if X and Y were members of the same EAG under § 1.199-7(a). However, if X and Y were members of the same consolidated group, see § 1.199-7(d)(2).

Example 2. X is engaged as an electrical contractor under NAICS code 238210 on a regular and ongoing basis. X purchases the wires, conduits, and other electrical materials that it installs in construction projects in the United States. In a particular construction project, all of the wires, conduits, and other electrical materials installed by X for the operation of that building are considered structural components of the building. X's gross receipts derived from installing that property are derived from the construction of real property under paragraph (1)(1) of this section. However, X's gross receipts derived from the purchased materials do not qualify as DPGR.

Example 3. X is in a trade or business that is considered construction under the two-digit NAICS code of 23. X buys unimproved land. X gets the land zoned for residential housing through an entitlement process. X grades the land and sells the land to home builders. The gross receipts that X receives from the sale of the land do not qualify as DPGR under paragraph (1)(5)(i) of this section because the gross receipts are not derived from the construction of real property.

Example 4. The facts are the same as in *Example 3* except that X builds roads, sewers, sidewalks, and installs power and water lines on the land. The gross receipts that X receives that are attributable to the sale of the roads, sewers, sidewalks, and power and water lines, which qualify as infrastructure under paragraph (l)(3) of this section, are DPGR. X's gross receipts from the land including capitalized costs of entitlements do not qualify as DPGR under paragraph (l)(5)(i) of this section because the gross receipts are not derived from the construction of real property.

Example 5. (i) X is engaged in the business activities of constructing housing within the meaning of paragraph (l)(1) of this section. On June 1, 2005, X pays \$50,000,000 for 1,000 acres of land that X will develop as a new housing development. In 2008, after the expenditure of \$10,000,000 for entitlement costs, X receives permits to begin construction. After this expenditure, X's land costs total \$60,000,000. The development consists of 1,000 houses to be built on half-acre lots over 5 years. On January 31, 2010, the first house is sold for \$300,000. Construction costs for each house are \$170,000. Common improvements consisting of streets, sidewalks, sewer lines, playgrounds, clubhouses, tennis courts, and swimming pools that X is contractually obligated or required by law to provide cost \$55,000 per lot. The common improvements include \$30,000 in land costs underlying the common improvements.

(ii) Pursuant to the land safe harbor under paragraph (l)(5)(ii) of this section, X calculates the total costs under § 1.199-4 for each house sold in 2010 as \$195,000 (total costs of \$255,000 (\$170,000 in construction costs plus \$55,000 in common improvements (including \$30,000 in land costs) plus \$30,000 in land costs for the lot), which are reduced by land costs of \$60,000). X calculates the DPGR for each house sold by May 31, 2010, by taking the gross receipts of \$300,000 and reducing that amount by land costs of \$60,000 plus a percentage of \$60,000. As X acquired the land on June 1, 2005, and sold the houses on the land between January 31, 2010, and May 31, 2010, the percentage reduction for X is 5 percent because X has held the land for not more than 5 years from the anniversary of the date of acquisition. Thus, the DPGR for each house is \$237,000 (\$300,000 – \$60,000 – \$3,000) with costs for each house of \$195,000 for a calculation of QPAI for each house of \$42,000.

Example 6. The facts are the same as in *Example 5* except some of the houses are sold between June 1, 2010, and December 31, 2010. X calculates the DPGR for each house sold between June 1, 2010, and December 31, 2010, by taking the gross receipts of \$300,000 and reducing that amount by land costs of \$60,000 plus a percentage of \$60,000. As X acquired the land on June 1, 2005, and sold the houses on the land between June 1, 2010,

and December 31, 2010, the percentage reduction for X is 10 percent because X has held the land for more than 5 years but not more than 10 years from the anniversary of the date of acquisition. Thus, the DPGR for each house is \$234,000 (\$300,000 – \$60,000 – \$6,000) with costs for each house of \$195,000 for a calculation of QPAI for each house of \$39,000.

(m) *Definition of engineering and architectural services*—(1) *In general.* DPGR includes gross receipts derived from engineering or architectural services performed in the United States for a construction project described in paragraph (l) of this section. At the time the taxpayer performs the engineering or architectural services, the taxpayer must be engaged in a trade or business (but not necessarily its primary, or only, trade or business) that is considered engineering or architectural services for purposes of the NAICS, for example NAICS codes 541330 (engineering services) or 541310 (architectural services), on a regular and ongoing basis. DPGR includes gross receipts derived from engineering or architectural services, including feasibility studies for a construction project in the United States, even if the planned construction project is not undertaken or is not completed.

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

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

(4) *De minimis exception for performance of services in the United States.* If less than 5 percent of the total gross receipts derived by a taxpayer from engineering or architectural services performed in the United States for a construction project (described in paragraph (l) of this section) are derived from services not relating to a

construction project described in paragraph (l) of this section (for example, the services are performed outside the United States or in connection with property other than real property) then the total gross receipts derived by the taxpayer are DPGR from engineering or architectural services performed in the United States for a construction project.

(n) *Exception for sales of certain food and beverages*—(1) *In general.* DPGR does not include gross receipts of the taxpayer that are derived from the sale of food or beverages prepared by the taxpayer at a retail establishment. A *retail establishment* is defined as tangible property (both real and personal) 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. In addition, a facility that prepares food and beverages solely for take out service or delivery is a retail establishment (for example, a caterer). A facility at which food or beverages are prepared will not be treated as a retail establishment if less than 5 percent of the gross receipts from the sale of food or beverages at that facility during the taxable year are attributable to retail sales. If a taxpayer's facility is a retail establishment in the United States, then, for purposes of this section, the taxpayer may 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 sales of food and beverages to be resold by the purchaser. The exception for sales of certain food and beverages also applies to food and beverages for non-human consumption. 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). See Chapter 51 of Title 26 of the United States Code and the implementing regulations thereunder.

(2) *Examples.* The following examples illustrate the application of this paragraph (n):

Example 1. X buys coffee beans and roasts those beans at a facility in the United States, the only activity of which is the roasting and packaging of roasted coffee beans. X sells the roasted coffee beans through a variety of unrelated third-party vendors and also sells roasted coffee beans at X's retail establishments. At X's retail establishments, X prepares brewed coffee and other foods. To the extent that the gross receipts of X's retail

establishments represent receipts from the sale of coffee beans roasted at the facility, the receipts are DPGR. To the extent the gross receipts of X's retail establishments represent receipts from the retail sale of brewed coffee or food prepared at the retail establishments, the receipts are non-DPGR. However, pursuant to § 1.199-1(c)(2), X must allocate part of the receipts from the retail sale of the brewed coffee as DPGR to the extent of the value of the coffee beans that were roasted at the facility and that were used to brew coffee.

Example 2. Y operates a bonded winery in California. Bottles of wine produced by Y at the bonded winery are sold to consumers at the taxpaid premises. Pursuant to paragraph (n)(1) of this section, the bonded premises is not considered a retail establishment and is treated as separate and apart from the taxpaid premises, which is considered a retail establishment for purposes of paragraph (n)(1) of this section. Accordingly, the wine produced by Y in the bonded premises and sold by Y from the taxpaid premises is not considered to have been produced at a retail establishment, and the sales of the wine are DPGR (assuming all the other requirements of this section are met).

§ 1.199-4 Costs allocable to domestic production gross receipts.

(a) *In general.* To determine its qualified production activities income (QPAI) (as defined in § 1.199-1(c)) for a taxable year, a taxpayer must subtract from its domestic production gross receipts (DPGR) (as defined in § 1.199-3(a)) the cost of goods sold (CGS) allocable to DPGR, the amount of expenses or losses (deductions) directly allocable to DPGR, and a ratable portion of other deductions not directly allocable to DPGR or to another class of income. Paragraph (b) of this section provides rules for determining CGS allocable to DPGR. Paragraph (c) of this section provides rules for determining the deductions allocated and apportioned to DPGR and a ratable portion of deductions that are not directly allocable to DPGR or to another class of income. Paragraph (d) of this section provides that a taxpayer generally must determine deductions allocated and apportioned to DPGR using the rules of the regulations at §§ 1.861-8 through 1.861-17 and §§ 1.861-8T through 1.861-14T (the section 861 regulations), subject to the rules in paragraph (d) of this section (the section 861 method). Paragraph (e) of this section provides that certain taxpayers may apportion deductions to DPGR using the simplified deduction method. Paragraph (f) of this section provides a small business simplified overall method that a qualifying small taxpayer may use to apportion CGS and deductions to DPGR.

(b) *Cost of goods sold allocable to domestic production gross receipts—(1) In general.* When determining its QPAI, a taxpayer must reduce DPGR by the CGS allocable to DPGR. A taxpayer determines its CGS allocable to DPGR in accordance with this paragraph (b) or, if applicable, paragraph (f) of this section. In the case of a sale, exchange, or other disposition of inventory, CGS is equal to beginning inventory plus purchases and production costs incurred during the taxable year and included in inventory costs, less ending inventory. CGS is determined under the methods of accounting that the taxpayer uses to compute taxable income. See sections 263A, 471, and 472. Additional section 263A costs, as defined in § 1.263A-1(d)(3), must be included in determining CGS. In the case of a sale, exchange, or other disposition (including, for example, theft, casualty, or abandonment) of non-inventory property, CGS for purposes of this section includes the adjusted basis of the property. CGS allocable to DPGR for a taxable year may include the inventory cost and adjusted basis of qualifying production property (QPP) (as defined in § 1.199-3(i)(1)), a qualified film (as defined in § 1.199-3(j)(1)), or electricity, natural gas, and potable water (as defined in § 1.199-3(k)) (collectively, utilities) that will, or have, generated DPGR notwithstanding that the gross receipts attributable to the sale of the QPP, qualified films, or utilities will, or have been, included in the computation of gross income for a different taxable year. For example, advance payments related to DPGR may be included in gross income under § 1.451-5(b)(1)(i) in a different taxable year than the related CGS allocable to that DPGR. CGS allocable to DPGR includes inventory valuation adjustments such as writedowns under the lower of cost or market method. If non-DPGR is treated as DPGR pursuant to §§ 1.199-1(d)(2) and 1.199-3(h)(4), (k)(4)(iv), (l)(1)(ii), (m)(4), or (n)(1), CGS related to such gross receipts that are treated as DPGR must be allocated or apportioned to DPGR.

(2) *Allocating cost of goods sold.* A taxpayer must use a reasonable method that is satisfactory to the Secretary to allocate CGS between DPGR and non-DPGR. Whether an allocation method is reasonable is based on all of the facts and circumstances including whether the taxpayer uses the most accurate information available; the relationship between CGS and the method used; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the

taxpayer for internal management and other business purposes; whether the method is used for other Federal or state income tax purposes; the availability of costing information; the time, burden, and cost of using various methods; and whether the taxpayer applies the method consistently from year to year. If a taxpayer does, or can, without undue burden or expense, specifically identify from its books and records CGS allocable to DPGR, the CGS allocable to DPGR is that amount irrespective of whether the taxpayer uses another allocation method to allocate gross receipts between DPGR and non-DPGR. A taxpayer that cannot, without undue burden or expense, use a specific identification method to determine CGS allocable to DPGR is not required to use a specific identification method to determine CGS allocable to DPGR. Ordinarily, if a taxpayer uses a method to allocate gross receipts between DPGR and non-DPGR, the use of a different method to allocate CGS that is not demonstrably more accurate than the method used to allocate gross receipts will not be considered reasonable. Depending on the facts and circumstances, reasonable methods may include methods based on gross receipts, number of units sold, number of units produced, or total production costs.

(3) *Special rules for imported items or services.* The cost of any item or service brought into the United States (as defined in § 1.199-3(g)) without an arm's length transfer price may not be treated as less than its value immediately after it entered the United States for purposes of determining the CGS to be used in the computation of QPAI. When an item or service is imported into the United States that had been exported by the taxpayer for further manufacture, the increase in cost may not exceed the difference between the value of the property when exported and the value of the property when imported back into the United States after further manufacture. For this purpose, the value of property is its customs value as defined in section 1059A(b)(1).

(4) *Rules for inventories valued at market or bona fide selling prices.* If part of CGS is attributable to inventory valuation adjustments, CGS allocable to DPGR includes inventory adjustments to QPP that is MPGE in whole or in significant part within the United States, qualified films produced in the United States, or utilities produced in the United States. Accordingly, taxpayers that value inventory under § 1.471-4 (inventories at cost or market, whichever is lower) or § 1.471-2(c)

(subnormal goods at bona fide selling prices) must allocate a proper share of such adjustments (for example, writedowns) to DPGR based on a reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances. Factors taken into account in determining whether the method is reasonable include whether the taxpayer uses the most accurate information available; the relationship between the adjustment and the allocation base chosen; the accuracy of the method chosen 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 or state income tax purposes; the time, burden, and cost of using various methods; and whether the taxpayer applies the method consistently from year to year. If a taxpayer does, or can, without undue burden or expense, specifically identify from its books and records the proper amount of inventory valuation adjustments allocable to DPGR, then the taxpayer must allocate that amount to DPGR. A taxpayer that cannot, without undue burden or expense, use a specific identification method to determine the proper amount of inventory valuation adjustments allocable to DPGR is not required to use a specific identification method to allocate adjustments to DPGR.

(5) *Rules applicable to inventories accounted for under the last-in, first-out (LIFO) inventory method*—(i) *In general.* This paragraph applies to inventories accounted for using the specific goods last-in, first-out (LIFO) method or the dollar-value LIFO method. Whenever a specific goods grouping or a dollar-value pool contains QPP, qualified films, or utilities that produces DPGR and goods that do not, the taxpayer must allocate CGS attributable to that grouping or pool between DPGR and non-DPGR using a reasonable method. Whether a method of allocating CGS between DPGR and non-DPGR is reasonable must be determined in accordance with paragraph (b)(2) of this section. In addition, this paragraph (b)(5) provides methods that a taxpayer may use to allocate CGS for inventories accounted for using the LIFO method. If a taxpayer uses the LIFO/FIFO ratio method provided in paragraph (b)(5)(ii) of this section or the change in relative base-year cost method provided in paragraph (b)(5)(iii) of this section, the taxpayer must use that method for all inventory accounted for under the LIFO method.

(ii) *LIFO/FIFO ratio method.* A taxpayer using the specific goods LIFO

method or the dollar-value LIFO method may use the LIFO/FIFO ratio method. The LIFO/FIFO ratio method is applied with respect to all LIFO inventory of a taxpayer on a grouping-by-grouping or pool-by-pool basis. Under the LIFO/FIFO ratio method, a taxpayer computes the CGS of a grouping or pool allocable to DPGR by multiplying the CGS of QPP, qualified films, or utilities in the grouping or pool that produced DPGR computed using the first-in, first-out (FIFO) method by the LIFO/FIFO ratio of a grouping or pool is equal to the total CGS of the grouping or pool computed using the LIFO method over the total CGS of the grouping or pool computed using the FIFO method.

(iii) *Change in relative base-year cost method.* A taxpayer using the dollar-value LIFO method may use the change in relative base-year cost method. The change in relative base-year cost method is applied with respect to all LIFO inventory of a taxpayer on a pool-by-pool basis. The change in relative base-year cost method determines the CGS allocable to DPGR by increasing or decreasing the total production costs (section 471 costs and additional section 263A costs) of QPP, qualified films, and utilities that generate DPGR by a portion of any increment or liquidation of the dollar-value pool. The portion of an increment or liquidation allocable to DPGR is determined by multiplying the LIFO value of the increment or liquidation (expressed as a positive number) by the ratio of the change in total base-year cost (expressed as a positive number) of the QPP, qualifying films, and utilities that will generate DPGR in ending inventory to the change in total base-year cost (expressed as a positive number) of all goods in the ending inventory. The portion of an increment or liquidation allocable to DPGR may be zero but cannot exceed the amount of the increment or liquidation. Thus, a ratio in excess of 1.0 must be treated as 1.0.

(6) *Taxpayers using the simplified production method or simplified resale method for additional section 263A costs.* A taxpayer that uses the simplified production method or simplified resale method to allocate additional section 263A costs, as defined in § 1.263A-1(d)(3), to ending inventory must follow the rules in paragraph (b)(2) of this section to determine the amount of additional section 263A costs allocable to DPGR. Allocable additional section 263A costs include additional section 263A costs included in beginning inventory as well as additional section 263A costs incurred during the taxable year.

Ordinarily, if a taxpayer uses the simplified production method or the simplified resale method, then additional section 263A costs should be allocated in the same proportion as section 471 costs are allocated.

(7) *Examples.* The following examples illustrate the application of this paragraph (b):

Example 1. Advance payments. T, a calendar year taxpayer, is a manufacturer of furniture in the United States. Under its method of accounting, T includes advance payments in gross income when the payments are received. In December 2005, T receives an advance payment of \$5,000 from X with respect to an order of furniture to be manufactured for a total price of \$20,000. In 2006, T produces and ships the furniture to X. In 2006, T incurs \$14,000 of section 471 and additional section 263A costs to produce the furniture ordered by X. T receives the remaining \$15,000 of the contract price from X in 2006. T must include the \$5,000 advance payment in income and DPGR in 2005. The remaining \$15,000 of the contract price must be included in income and DPGR when received by T in 2006. T must include the \$14,000 it incurred to produce the furniture in CGS and CGS allocable to DPGR in 2006. See § 1.199-1(e)(1) for rules regarding gross receipts and costs recognized in different taxable years.

Example 2. Use of standard cost method. X, a calendar year taxpayer, manufactures item A in a factory located in the United States and item B in a factory located in Country Y. Item A is produced by X in significant part within the United States and the sale of A generates DPGR. X uses the FIFO inventory method to account for its inventory and determines the cost of item A using a standard cost method. At the beginning of its taxable year, X's inventory contains 2,000 units of item A at a standard cost of \$5 per unit. X did not incur significant cost variances in previous taxable years. During the 2005 taxable year, X produces 8,000 units of item A at a standard cost of \$6 per unit. X determines that with regard to its production of item A it has incurred a significant cost variance. When X reallocates the cost variance to the units of item A that it has produced, the production cost of item A is \$7 per unit. X sells 7,000 units of item A during the taxable year. X can identify from its books and records that CGS related to sale of item A is \$45,000 $((2,000 \times \$5) + (5,000 \times \$7))$. Accordingly, X has CGS allocable to DPGR of \$45,000.

Example 3. Change in relative base-year cost method. (i) Y elects, beginning with the calendar year 2005, to compute its inventories using the dollar-value, LIFO method under section 472. Y establishes a pool for items A and B. Y produces item A in significant part within the United States and the sales of item A generate DPGR. Y does not produce item B in significant part within the United States and the sale of item B does not generate DPGR. The composition of the inventory for the pool at the base date, January 1, 2005, is as follows:

Item	Unit	Unit cost	Total cost
A	2,000	\$5.00	\$10,000
B	1,250	4.00	5,000
Total .....	.....	.....	15,000

(ii) Y uses a standard cost method to allocate all direct and indirect costs (section 471 and additional section 263A costs) to the units of item A and item B that it produces. During 2005, Y incurs \$52,500 of section 471 costs and additional section 263A costs to

produce 10,000 units of item A and \$114,000 of section 471 costs and additional section 263A costs to produce 20,000 units of item B.

(iii) The closing inventory of the pools at December 31, 2005, contains 3,000 units of

item A and 2,500 units of item B. The closing inventory of the pool at December 31, 2005, shown at base-year and current-year cost is as follows:

Item	Quantity	Base-year cost	Amount	Current-year cost	Amount
A	3,000	\$5.00	\$15,000	\$5.25	\$15,750
B	2,500	4.00	10,000	5.70	14,250
Totals .....	.....	.....	25,000	.....	30,000

(iv) The base-year cost of the closing LIFO inventory at December 31, 2005, amounts to \$25,000, and exceeds the \$15,000 base-year cost of the opening inventory for the taxable year by \$10,000 (the increment stated at base-year cost). The increment valued at current-year cost is computed by multiplying the increment stated at base-year cost by the ratio

of the current-year cost of the pool to total base-year cost of the pool (that is, \$30,000/\$25,000, or 120 percent). The increment stated at current-year cost is \$12,000 (\$10,000 × 120%).

(v) The change in relative base-year cost of item A is \$5,000 (\$15,000 – \$10,000). The change in relative base-year cost (the

increment stated at base-year cost) of the total inventory is \$10,000 (\$25,000 – \$15,000). The ratio of the change in base-year cost of item A to the change in base-year cost of the total inventory is 50% (\$5,000/\$10,000).

(vi) CGS allocable to DPGR is \$46,500, computed as follows:

Current-year production costs related to DPGR .....	.....	\$52,500
Less:		
Increment stated at current-year cost	\$12,000	.....
Ratio	50%	.....
Total .....	.....	(6,000)
Total .....	.....	46,500

Example 4. Change in relative base-year cost method. (i) The facts are the same as in Example 3 except that, during the calendar year 2006, Y experiences an inventory decrement. During 2006, Y incurs \$66,000 of section 471 costs and additional section

263A costs to produce 12,000 units of item A and \$150,000 of section 471 costs and additional section 263A costs to produce 25,000 units of item B.

(ii) The closing inventory of the pool at December 31, 2006, contains 2,000 units of

item A and 2,500 units of item B. The closing inventory of the pool at December 31, 2006, shown at base-year and current-year cost is as follows:

Item	Quantity	Base-year cost	Amount	Current-year cost	Amount
A	2,000	\$5.00	\$10,000	\$5.50	\$11,000
B	2,500	4.00	10,000	6.00	15,000
Totals .....	.....	.....	20,000	.....	26,000

(iii) The base-year cost of the closing LIFO inventory at December 31, 2006, amounts to \$20,000, and is less than the \$25,000 base-

year cost of the opening inventory for that year by \$5,000 (the decrement stated at base-year cost). This liquidation is reflected by

reducing the most recent layer of increment. The LIFO value of the inventory at December 31, 2006 is:

	Base cost	Index	LIFO value
January 1, 2005, base cost	\$15,000	1.00	\$15,000
December 31, 2005, increment	5,000	1.20	6,000
Total .....	.....	.....	21,000

(iv) The change in relative base-year cost of item A is \$5,000 (\$15,000 – \$10,000). The change in relative base-year cost of the total

inventory is \$5,000 (\$25,000 – \$20,000). The ratio of the change in base-year cost of item

A to the change in base-year cost of the total inventory is 100% (\$5,000/\$5,000).

(v) CGS allocable to DPGR is \$72,000, computed as follows:

Current-year production costs related to DPGR	\$66,000
Plus:	
LIFO value of decrement	\$6,000
Ratio	100%
Total	6,000
Total	72,000

Example 5. LIFO/FIFO ratio method. (i) The facts are the same as in *Example 3* except that Y uses the LIFO/FIFO ratio method to determine its CGS allocable to DPGR.

(ii) Y's CGS related to item A on a FIFO basis is \$46,750 ((2,000 units at \$5) + (7,000 units at \$5.25)).

(iii) Y's total CGS computed on a LIFO basis is \$154,500 (beginning inventory of \$15,000 plus total production costs of \$166,500 less ending inventory of \$27,000).

(iv) Y's total CGS computed on a FIFO basis is \$151,500 (beginning inventory of \$15,000 plus total production costs of \$166,500 less ending inventory of \$30,000).

(v) The ratio of Y's CGS computed using the LIFO method to its CGS computed using the FIFO method is 102% (\$154,500/\$151,500). Y's CGS related to DPGR computed using the LIFO/FIFO ratio method is \$47,685 (\$46,750 × 102%).

Example 6. LIFO/FIFO ratio method. (i) The facts are the same as in *Example 4* except that Y uses the LIFO/FIFO ratio method to compute CGS allocable to DPGR.

(ii) Y's CGS related to item A on a FIFO basis is \$70,750 ((3,000 units at \$5.25) + (10,000 units at \$5.50)).

(iii) Y's total CGS computed on a LIFO basis is \$222,000 (beginning inventory of \$27,000 plus total production costs of \$216,000 less ending inventory of \$21,000).

(iv) Y's total CGS computed on a FIFO basis is \$220,000 (beginning inventory of \$30,000 plus total production costs of \$216,000 less ending inventory of \$26,000).

(v) The ratio of Y's CGS computed using the LIFO method to its CGS computed using the FIFO method is 101% (\$222,000/\$220,000). Y's CGS related to DPGR computed using the LIFO/FIFO ratio method is \$71,457 (\$70,750 × 101%).

(c) **Other deductions allocable or apportioned to domestic production gross receipts or gross income attributable to domestic production gross receipts—**(1) *In general.* In determining its QPAI, a taxpayer must subtract from its DPGR, in addition to its CGS allocable to DPGR, the deductions that are directly allocable to DPGR, and a ratable portion of deductions that are not directly allocable to DPGR or to another class of income. A taxpayer generally must allocate and apportion these deductions using the rules of the section 861 method. In lieu of the section 861 method, certain taxpayers may apportion these deductions using the

simplified deduction method provided in paragraph (e) of this section.

Paragraph (f) of this section provides a small business simplified overall method that may be used by a qualified small taxpayer, as defined in that paragraph. A taxpayer using the simplified deduction method or the small business simplified overall method must use that method for all deductions. A taxpayer eligible to use the small business simplified overall method may choose at any time to use the small business simplified overall method, the simplified deduction method, or the section 861 method for a taxable year. A taxpayer eligible to use the simplified deduction method may choose at any time to use the simplified deduction method or the section 861 method for a taxable year.

(2) **Treatment of certain deductions—**(i) *In general.* The rules provided in this paragraph (c)(2) apply to net operating losses and certain other deductions for purposes of allocating and apportioning deductions to DPGR or gross income attributable to DPGR for all of the methods provided by this section.

(ii) *Net operating losses.* A deduction under section 172 for a net operating loss is not allocated or apportioned to DPGR or gross income attributable to DPGR.

(iii) *Deductions not attributable to the conduct of a trade or business.* Deductions not attributable to the conduct of a trade or business are not allocated or apportioned to DPGR or gross income attributable to DPGR. For example, the standard deduction provided by section 63(c) and the deduction for personal exemptions provided by section 151 are not allocated or apportioned to DPGR or gross income attributable to DPGR.

(d) **Section 861 method—**(1) *In general.* A taxpayer must allocate and apportion its deductions using the allocation and apportionment rules provided by the section 861 method under which section 199 is treated as an operative section described in § 1.861–8(f). Accordingly, the taxpayer applies the rules of the section 861 regulations to allocate and apportion deductions (including its distributive share of

deductions from pass-thru entities) to gross income attributable to DPGR. If the taxpayer applies the allocation and apportionment rules of the section 861 regulations for an operative section other than section 199, the taxpayer must use the same method of allocation and the same principles of apportionment for purposes of all operative sections (subject to the rules provided in paragraphs (c)(2) and (d)(2) and (3) of this section). See § 1.861–8(f)(2)(i).

(2) **Deductions for charitable contributions.** Deductions for charitable contributions (as allowed under sections 170, 873(b)(2), and 882(c)(1)(B)) must be ratably apportioned between gross income attributable to DPGR and other gross income based on the relative amounts of gross income. For individuals, this provision applies solely to deductions for charitable contributions that are attributable to the actual conduct of a trade or business.

(3) **Research and experimental expenditures.** Research and experimental expenditures must be allocated and apportioned in accordance with § 1.861–17 without taking into account the exclusive apportionment rule of § 1.861–17(b).

(4) **Deductions related to gross receipts deemed to be domestic production gross receipts.** If non-DPGR is treated as DPGR pursuant to §§ 1.199–1(d)(2) and 1.199–3(h)(4), (k)(4)(iv), (l)(1)(ii), (m)(4), or (n)(1), deductions related to such gross receipts that are treated as DPGR must be allocated or apportioned to gross income attributable to DPGR.

(5) **Examples.** The following examples illustrate the operation of the section 861 method. Assume that with respect to the allocation and apportionment of interest expense, § 1.861–10T does not apply in the following examples. The examples read as follows:

Example 1. General section 861 method. (i) X, a United States corporation that is not a member of an expanded affiliated group (EAG) (as defined in § 1.199–7), engages in activities that generate both DPGR and non-DPGR. All of X's production activities that generate DPGR are within Standard Industrial Classification (SIC) Industry Group AAA (SIC AAA). All of X's production

activities that generate non-DPGR are within SIC Industry Group BBB (SIC BBB). X is able to identify from its books and records CGS allocable to DPGR and to non-DPGR. X incurs \$900 of research and experimentation expenses (R&E) that are deductible under section 174, \$300 of which are performed

with respect to SIC AAA and \$600 of which are performed with respect to SIC BBB. None of the R&E is legally mandated R&E as described in § 1.861-17(a)(4) and none of the R&E is included in CGS. X incurs section 162 selling expenses (that include W-2 wages as defined in § 1.199-2(f)) that are not

includible in CGS and not directly allocable to any gross income. For 2010, the adjusted basis of X's assets that generate gross income attributable to DPGR and to non-DPGR is, respectively, \$4,000 and \$1,000. For 2010, X's taxable income is \$1,380 based on the following Federal income tax items:

DPGR (all from sales of products within SIC AAA)	\$3,000
Non-DPGR (all from sales of products within SIC BBB)	3,000
CGS allocable to DPGR (includes \$100 of W-2 wages)	(600)
CGS allocable to non-DPGR (includes \$100 of W-2 wages)	(1,800)
Section 162 selling expenses (includes \$100 of W-2 wages)	(840)
Section 174 R&E-SIC AAA	(300)
Section 174 R&E-SIC BBB	(600)
Interest expense (not included in CGS)	(300)
Charitable contributions	(180)
X's taxable income	1,380

(ii) *X's QPAI.* X chooses to allocate and apportion its deductions to gross income attributable to DPGR under the section 861 method of this paragraph (d). In this case, the section 162 selling expenses (including W-2 wages) are definitely related to all of X's gross income. Based on the facts and

circumstances of this specific case, apportionment of those expenses between DPGR and non-DPGR on the basis of X's gross receipts is appropriate. For purposes of apportioning R&E, X elects to use the sales method as described in § 1.861-17(c). X elects to apportion interest expense under the

tax book value method of § 1.861-9T(g). X has \$2,400 of gross income attributable to DPGR (DPGR of \$3,000—CGS of \$600 (includes \$100 of W-2 wages) allocated based on X's books and records). X's QPAI for 2010 is \$1,320, as shown below:

DPGR (all from sales of products within SIC AAA)	\$3,000
CGS allocable to DPGR (includes \$100 of W-2 wages)	(600)
Section 162 selling expenses (includes \$100 of W-2 wages) (\$840 × (\$3,000 DPGR/\$6,000 total gross receipts))	(420)
Interest expense (not included in CGS) (\$300 × (\$4,000 (X's DPGR assets)/\$5,000 (X's total assets)))	(240)
Charitable contributions (not included in CGS) (\$180 × (\$2,400 gross income attributable to DPGR/\$3,600 total gross income)) ...	(120)
Section 174 R&E-SIC AAA	(300)
X's QPAI	1,320

(iii) *Section 199 deduction determination.* X's tentative deduction under § 1.199-1(a) (section 199 deduction) is \$119 (.09 × (lesser of QPAI of \$1,320 and taxable income of \$1,380)) subject to the wage limitation of \$150 (50% × \$300). Accordingly, X's section 199 deduction for 2010 is \$119.

Example 2. Section 861 method and EAG.

(i) *Facts.* The facts are the same as in Example 1 except that X owns stock in Y, a United States corporation, equal to 75 percent of the total voting power of stock of Y and 80 percent of the total value of stock

of Y. X and Y are not members of an affiliated group as defined in section 1504(a). Accordingly, the rules of § 1.861-14T do not apply to X's and Y's selling expenses, R&E, and charitable contributions. X and Y are, however, members of an affiliated group for purposes of allocating and apportioning interest expense (see § 1.861-11T(d)(6)) and are also members of an EAG. For 2010, the adjusted basis of Y's assets that generate gross income attributable to DPGR and to non-DPGR is, respectively, \$21,000 and \$24,000. All of Y's activities that generate

DPGR are within SIC Industry Group AAA (SIC AAA). All of Y's activities that generate non-DPGR are within SIC Industry Group BBB (SIC BBB). None of X's and Y's sales are to each other. Y is not able to identify from its books and records CGS allocable to DPGR and non-DPGR. In this case, because CGS is definitely related under the facts and circumstances to all of Y's gross receipts, apportionment of CGS between DPGR and non-DPGR based on gross receipts is appropriate. For 2010, Y's taxable income is \$1,910 based on the following tax items:

DPGR (all from sales of products within SIC AAA)	\$3,000
Non-DPGR (all from sales of products within SIC BBB)	3,000
CGS allocated to DPGR (includes \$300 of W-2 wages)	(1,200)
CGS allocated to non-DPGR (includes \$300 of W-2 wages)	(1,200)
Section 162 selling expenses (includes \$300 of W-2 wages)	(840)
Section 174 R&E-SIC AAA	(100)
Section 174 R&E-SIC BBB	(200)
Interest expense (not included in CGS and not subject to § 1.861-10T)	(500)
Charitable contributions	(50)
Y's taxable income	1,910

(ii) *QPAI.* (A) *X's QPAI.* Determination of X's QPAI is the same as in *Example 1* except that interest is apportioned to gross income

attributable to DPGR based on the combined adjusted bases of X's and Y's assets. See

§ 1.861-11T(c). Accordingly, X's QPAI for 2010 is \$1,410, as shown below:

DPGR (all from sales of products within SIC AAA)	\$3,000
CGS allocated to DPGR (includes \$300 of W-2 wages)	(600)
Section 162 selling expenses (includes \$100 of W-2 wages) (\$840 × (\$3,000 DPGR/\$6,000 total gross receipts))	(420)

Interest expense (not included in CGS and not subject to § 1.861-10T) (\$300 × (\$25,000 (tax book value of X's and Y's DPGR assets)/\$50,000 (tax book value of X's and Y's total assets)))	(150)
Charitable contributions (not included in CGS) (\$180 × (\$2,400 gross income attributable to DPGR/\$3,600 total gross income)) ...	(120)
Section 174 R&E-SIC AAA	(300)
X's QPAI	1,410

(B) *Y's QPAI.* Y makes the same elections under the section 861 method as does X. Y has \$1,800 of gross income attributable to DPGR (DPGR of \$3,000—CGS of \$1,200 allocated based on Y's gross receipts). Y's QPAI for 2010 is \$1,005, as shown below:

DPGR (all from sales of products within SIC AAA)	\$3,000
CGS allocated to DPGR (includes \$300 of W-2 wages)	(1,200)
Section 162 selling expenses (includes \$300 of W-2 wages) (\$840 × (\$3,000 DPGR/\$6,000 total gross receipts))	(420)
Interest expense (not included in CGS and not subject to § 1.861-10T) (\$500 × (\$25,000 (tax book value of X's and Y's DPGR assets)/\$50,000 (tax book value of X's and Y's total assets)))	(250)
Charitable contributions (not included in CGS) (\$50 × (\$1,800 gross income attributable to DPGR/\$3,600 total gross income))	(25)
Section 174 R&E-SIC AAA	(100)
Y's QPAI	1,005

(iii) *Section 199 deduction determination.* The section 199 deduction of the X and Y EAG is determined by aggregating the separately determined QPAI, taxable income, and W-2 wages of X and Y. See § 1.199-7(b). Accordingly, the X and Y EAG's tentative section 199 deduction is \$217 (.09 × (lesser of combined taxable incomes of X and Y of \$3,290 (X's taxable income of \$1,380 plus Y's taxable income of \$1,910) and combined QPAI of \$2,415 (X's QPAI of \$1,410 plus Y's QPAI of \$1,005)) subject to the wage limitation of \$600 (50% × (\$300 (X's W-2 wages) + \$900 (Y's W-2 wages))). Accordingly, the X and Y EAG's section 199 deduction for 2010 is \$217. The \$217 is allocated to X and Y in proportion to their QPAI. See § 1.199-7(c).

(e) *Simplified deduction method—(1) In general.* A taxpayer with average annual gross receipts (as defined in paragraph (g) of this section) of \$25,000,000 or less, or total assets at the end of the taxable year (as defined in paragraph (h) of this section) of \$10,000,000 or less, may use the simplified deduction method to apportion deductions between DPGR and non-DPGR. This paragraph does not apply to CGS. Under the simplified deduction method, a taxpayer's deductions (except the net operating loss deduction as provided in paragraph (c)(2)(ii) of this section and deductions not attributable to the actual conduct of a trade or business as provided in paragraph (c)(2)(iii) of this section) are ratably apportioned between DPGR and non-DPGR based on relative gross receipts. Accordingly, the amount of deductions apportioned to DPGR is equal to the same proportion of the total deductions that the amount of DPGR bears to total gross receipts. Whether an owner of a pass-thru entity may use the simplified deduction method is determined at the level of the owner of the pass-thru entity. Whether a trust or an estate may use the simplified

deduction method is determined at the trust or estate level. In the case of a trust or estate, the simplified deduction method is applied at the trust or estate level, taking into account the trust's or estate's DPGR, non-DPGR, and other items from all sources, including its distributive or allocable share of those items of any lower-tier entity, prior to any charitable or distribution deduction. In the case of an owner of any other pass-thru entity, the simplified deduction method is applied at the level of the owner of the pass-thru entity taking into account the owner's DPGR, non-DPGR, and other items from all sources including its distributive or allocable share of those items of the pass-thru entity.

(2) *Members of an expanded affiliated group—(i) In general.* Whether the members of an EAG may use the simplified deduction method is determined by reference to the average annual gross receipts and total assets of the EAG. If the average annual gross receipts of the EAG are less than or equal to \$25,000,000 or the total assets of the EAG at the end of its taxable year are less than or equal to \$10,000,000, each member of the EAG may individually determine whether to use the simplified deduction method, regardless of the cost allocation method used by the other members.

(ii) *Exception.* Notwithstanding paragraph (e)(2)(i) of this section, all members of the same consolidated group must use the same cost allocation method.

(iii) *Examples.* The following examples illustrate the application of paragraph (e)(2) of this section:

Example 1. Corporations X, Y, and Z are the only three members of an EAG. Neither X, Y, nor Z is a member of a consolidated group. X, Y, and Z have average annual gross receipts of \$2,000,000, \$7,000,000, and

\$13,000,000, respectively. X, Y, and Z each have total assets at the end of the taxable year of \$5,000,000. Because the average annual gross receipts of the EAG are less than or equal to \$25,000,000, each of X, Y, and Z may use either the simplified deduction method or the section 861 method.

Example 2. The facts are the same as in *Example 1* except that X and Y are members of the same consolidated group. X, Y, and Z may use either the simplified deduction method or the section 861 method. However, X and Y must use the same cost allocation method.

Example 3. The facts are the same as in *Example 1* except that Z's average annual gross receipts are \$17,000,000. Because the average annual gross receipts of the EAG are greater than \$25,000,000 and the total assets of the EAG at the end of the taxable year are greater than \$10,000,000, X, Y, and Z must each use the section 861 method.

(f) *Small business simplified overall method—(1) In general.* A qualifying small taxpayer may use the small business simplified overall method to apportion CGS and deductions between DPGR and non-DPGR. Under the small business simplified overall method, a taxpayer's total costs for the current taxable year (as defined in paragraph (i) of this section) are apportioned between DPGR and other receipts based on relative gross receipts. Accordingly, the amount of total costs for the current taxable year apportioned to DPGR is equal to the same proportion of total costs for the current taxable year that the amount of DPGR bears to total gross receipts. In the case of a pass-thru entity, whether the small business simplified overall method may be used by such entity is determined at the pass-thru entity level and, if such entity is eligible, the small business simplified overall method is applied at the pass-thru entity level.

(2) *Qualifying small taxpayer.* For purposes of this paragraph (f), a *qualifying small taxpayer* is—

(i) A taxpayer that has both average annual gross receipts (as defined in paragraph (g) of this section) of \$5,000,000 or less and total costs for the current taxable year of \$5,000,000 or less;

(ii) A taxpayer that is engaged in the trade or business of farming that is not required to use the accrual method of accounting under section 447; or

(iii) A taxpayer that is eligible to use the cash method as provided in Rev. Proc. 2002-28 (2002-1 C.B. 815) (that is, certain taxpayers with average annual gross receipts of \$10,000,000 or less that are not prohibited from using the cash method under section 448, including partnerships, S corporations, C corporations, or individuals). See § 601.601(d)(2) of this chapter.

(3) *Members of an expanded affiliated group*—(i) *In general.* Whether the members of an EAG may use the small business simplified overall method is determined by reference to all the members of the EAG. If both the average annual gross receipts and the total costs for the current taxable year of the EAG are less than or equal to \$5,000,000; the EAG, viewed as a single corporation, is engaged in the trade or business of farming that is not required to use the accrual method of accounting under section 447; or the EAG, viewed as a single corporation, is eligible to use the cash method as provided in Rev. Proc. 2002-28, then each member of the EAG may individually determine whether to use the small business simplified overall method, regardless of the cost allocation method used by the other members.

(ii) *Exception.* Notwithstanding paragraph (f)(3)(i) of this section, all members of the same consolidated group must use the same cost allocation method.

(iii) *Examples.* The following examples illustrate the application of paragraph (f)(3) of this section:

Example 1. Corporations L, M, and N are the only three members of an EAG. Neither L, M, nor N is a member of a consolidated group. L, M, and N have average annual gross receipts and total costs for the current taxable year of \$1,000,000, \$1,500,000, and \$2,000,000, respectively. Because both the average annual gross receipts and total costs for the current taxable year of the EAG are less than or equal to \$5,000,000, each of L, M, and N may use the small business simplified overall method, the simplified deduction method, or the section 861 method.

Example 2. The facts are the same as in *Example 1* except that M and N are members of the same consolidated group. L, M, and N

may use the small business simplified overall method, the simplified deduction method, or the section 861 method. However, M and N must use the same cost allocation method.

Example 3. The facts are the same as in *Example 1* except that N has average annual gross receipts of \$4,000,000. Unless the EAG, viewed as a single corporation, is engaged in the trade or business of farming that is not required to use the accrual method of accounting under section 447, or the EAG, viewed as a single corporation, is eligible to use the cash method as provided in Rev. Proc. 2002-28, because the average annual gross receipts of the EAG are greater than \$5,000,000, L, M, and N are all ineligible to use the small business simplified overall method.

(4) *Ineligible pass-thru entities.* Qualifying oil and gas partnerships under § 1.199-3(h)(7), EAG partnerships under § 1.199-3(h)(8), and trusts and estates under § 1.199-5(d) may not use the small business simplified overall method.

(g) *Average annual gross receipts*—(1) *In general.* For purposes of the simplified deduction method and the small business simplified overall method, average annual gross receipts means the average annual gross receipts of the taxpayer for the 3 taxable years (or, if fewer, the taxable years during which the taxpayer was in existence) preceding the current taxable year, even if one or more of such taxable years began before the effective date of section 199. In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts shall be annualized by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in the short period.

(2) *Members of an EAG.* To compute the average annual gross receipts of an EAG, the gross receipts, for the entire taxable year, of each corporation that is a member of the EAG at the end of its taxable year that ends with or within the taxable year of the computing member (as described in § 1.199-7(h)) are aggregated.

(h) *Total assets*—(1) *In general.* For purposes of the simplified deduction method provided by paragraph (e) of this section, total assets means the total assets the taxpayer has at the end of the taxable year that are attributable to the taxpayer's trade or business. In the case of a C corporation, the corporation's total assets at the end of the taxable year is the amount required to be reported on Schedule L of the Form 1120, "United States Corporation Income Tax Return," in accordance with the Form 1120 instructions.

(2) *Members of an EAG.* To compute the total assets at the end of the taxable year of an EAG, the total assets, at the

end of its taxable year, of each corporation that is a member of the EAG at the end of its taxable year that ends with or within the taxable year of the computing member are aggregated.

(i) *Total costs for the current taxable year*—(1) *In general.* For purposes of the small business simplified overall method, total costs for the current taxable year means the total CGS and deductions (excluding the net operating loss deduction as provided in paragraph (c)(2)(ii) of this section and deductions not attributable to the conduct of a trade or business as provided in paragraph (c)(2)(iii) of this section) for the current taxable year.

(2) *Members of an EAG.* To compute the total costs for the current taxable year of an EAG, the total costs for the entire taxable year of each corporation that is a member of the EAG at the end of the taxable year that ends with or within the taxable year of the computing member are aggregated.

§ 1.199-5 Application of section 199 to pass-thru entities.

(a) *Partnerships*—(1) *Determination at partner level.* The deduction allowable under § 1.199-1(a) (section 199 deduction) is determined at the partner level. As a result, each partner must compute its deduction separately. For purposes of this section, each partner is allocated, in accordance with sections 702 and 704, its share of partnership items (including items of income, gain, loss, and deduction), cost of goods sold (CGS) allocated to such items of income, and gross receipts that are included in such items of income, even if the partner's share of CGS and other deductions and losses exceeds domestic production gross receipts (DPGR) (as defined in § 1.199-3(a)). A partnership may specially allocate items of income, gain, loss, or deduction to its partners, subject to the rules of section 704(b) and the supporting regulations. To determine its section 199 deduction for the taxable year, a partner generally aggregates its distributive share of such items, to the extent they are not otherwise disallowed by the Internal Revenue Code, with those items it incurs outside the partnership (whether directly or indirectly) for purposes of allocating and apportioning deductions to DPGR and computing its qualified production activities income (QPAI) (as defined in § 1.199-1(c)). However, if a partnership uses the small business simplified overall method described in § 1.199-4(f), then each partner is allocated its share of QPAI and W-2 wages (as defined in § 1.199-2(f)), which (subject to the limitation under section 199(d)(1)(B)) are combined with

the partner's QPAI and W-2 wages from other sources. Under this method, a partner's distributive share of QPAI from a partnership may be less than zero.

(2) *Disallowed deductions.*

Deductions of a partnership that otherwise would be taken into account in computing the partner's section 199 deduction are taken into account only if and to the extent the partner's distributive share of those deductions from all of the partnership's activities is not disallowed by section 465, 469, 704(d), or any other provision of the Internal Revenue Code. If only a portion of the partner's distributive share of the losses or deductions is allowed for a taxable year, a proportionate share of those allowable losses or deductions that are allocated to the partnership's qualified production activities, determined in a manner consistent with sections 465, 469, 704(d), and any other applicable provision of the Internal Revenue Code, is taken into account in computing the section 199 deduction for that taxable year. To the extent that any of the disallowed losses or deductions are allowed in a later taxable year, the partner takes into account a proportionate share of those losses or deductions in computing its QPAI for that later taxable year.

(3) *Partner's share of W-2 wages.*

Under section 199(d)(1)(B), a partner's share of W-2 wages of a partnership for purposes of determining the partner's

section 199(b) limitation is the lesser of the partner's allocable share of those wages (without regard to section 199(d)(1)(B)), or 2 times 9 percent (3 percent for taxable years beginning in 2005 or 2006, and 6 percent for taxable years beginning in 2007, 2008, or 2009) of the QPAI computed by taking into account only the items of the partnership allocated to the partner for the taxable year of the partnership. In general, this QPAI calculation is performed by the partner using the same cost allocation method that the partner uses in calculating the partner's section 199 deduction. However, if a partnership uses the small business simplified overall method described in § 1.199-4(f), the QPAI used by each partner to determine the wage limitation under section 199(d)(1)(B) is the same as the share of QPAI allocated to the partner. Each partner must compute its share of W-2 wages from the partnership in accordance with section 199(d)(1)(B) (with W-2 wages being allocated to the partner in the same manner as is wage expense), and then add that share to its W-2 wages from other sources, if any. The application of section 199(d)(1)(B) therefore means that if QPAI, computed by taking into account only the items of the partnership allocated to the partner for the taxable year, is not greater than zero, the partner may not take into account any W-2 wages of the partnership in computing the partner's section 199

deduction. See § 1.199-2 for the computation of W-2 wages, and paragraph (f) of this section for rules regarding pass-thru entities in a tiered structure.

(4) *Examples.* The following examples illustrate the application of this paragraph (a). Assume that each partner has sufficient adjusted gross income or taxable income so that the section 199 deduction is not limited under section 199(a)(1)(B); that the partnership and each of its partners (whether individual or corporate) are calendar year taxpayers; and that the amount of the partnership's W-2 wages equals wage expense for each taxable year. The examples read as follows:

Example 1. Section 861 method with interest expense. (i) *Partnership Federal income tax items.* X and Y, unrelated United States corporations, are each 50% partners in PRS, a partnership that engages in production activities that generate both DPGR and non-DPGR. X and Y share all items of income, gain, loss, deduction, and credit 50% each. PRS is not able to identify from its books and records CGS allocable to DPGR and non-DPGR. In this case, because CGS is definitely related under the facts and circumstances to all of PRS's gross income, apportionment of CGS between DPGR and non-DPGR based on gross receipts is appropriate. For 2010, the adjusted basis of PRS business assets is \$5,000, \$4,000 of which generate gross income attributable to DPGR and \$1,000 of which generate gross income attributable to non-DPGR. For 2010, PRS has the following Federal income tax items:

DPGR	\$3,000
Non-DPGR	3,000
CGS (includes \$200 of W-2 wages)	3,240
Section 162 selling expenses (includes \$300 of W-2 wages)	1,200
Interest expense (not included in CGS)	300

(ii) *Allocation of PRS's items of income, gain, loss, deduction, or credit.* X and Y each receive the following distributive share of PRS's items of income, gain, loss, deduction or credit, as determined under the principles of § 1.704-1(b)(1)(vii):

Gross income attributable to DPGR (\$1,500 (DPGR) – \$810 (allocable CGS, includes \$50 of W-2 wages)) ..	\$690
Gross income attributable to non-DPGR (\$1,500 (non-DPGR) – \$810 (allocable CGS, includes \$50 of W-2 wages))	690
Section 162 selling expenses (includes \$150 of W-2 wages)	600
Interest expense (not included in CGS)	150

(iii) *Determination of QPAI.* (A) *X's QPAI.* Because the section 199 deduction is

determined at the partner level, X determines its QPAI by aggregating, to the extent necessary, its distributive share of PRS's Federal income tax items with all other such items from all other, non-PRS-related activities. For 2010, X does not have any other such items. For 2010, the adjusted basis of X's non-PRS assets, all of which are investment assets, is \$10,000. X's only gross receipts for 2010 are those attributable to the allocation of gross income from PRS. X allocates and apportions its deductible items to gross income attributable to DPGR under the section 861 method of § 1.199-4(d). In this case, the section 162 selling expenses (including W-2 wages) are definitely related to all of PRS's gross receipts. Based on the facts and circumstances of this specific case, apportionment of those expenses between DPGR and non-DPGR on the basis of PRS's gross receipts is appropriate. X elects to apportion its distributive share of interest expense under the tax book value method of § 1.861-9T(g). X's QPAI for 2010 is \$366, as shown below:

DPGR	\$1,500
CGS allocable to DPGR (includes \$50 of W-2 wages) ...	(810)
Section 162 selling expenses (includes \$75 of W-2 wages) (\$600 × \$1,500/\$3,000)	(300)
Interest expense (not included in CGS) (\$150 × \$2,000 (X's share of PRS's DPGR assets)/ \$12,500 (X's non-PRS assets and X's share of PRS assets))	(24)
X's QPAI	366

(B) *Y's QPAI.* (1) For 2010, in addition to the activities of PRS, Y engages in production activities that generate both DPGR and non-DPGR. Y is able to identify from its books and records CGS allocable to DPGR and to non-DPGR. For 2010, the adjusted basis of Y's non-PRS assets attributable to its production activities that generate DPGR is \$8,000 and to other production activities that

generate non-DPGR is \$2,000. Y has no other assets. Y has the following Federal income tax items relating to its non-PRS activities:

Gross income attributable to DPGR (\$1,500 (DPGR) – \$900 (allocable CGS, includes \$70 of W–2 wages))	\$600
Gross income attributable to non-DPGR (\$3,000 (other gross receipts) – \$1,620 (allocable CGS, includes \$150 of W–2 wages))	1,380
Section 162 selling expenses (includes \$30 of W–2 wages)	540
Interest expense (not included in CGS)	90

(2) Y determines its QPAI in the same general manner as X. However, because Y has activities outside of PRS, Y must aggregate its distributive share of PRS's Federal income tax items with its own such items. Y allocates and apportions its deductible items to gross income attributable to DPGR under the section 861 method of § 1.199–4(d). In this case, Y's distributive share of PRS's section 162 selling expenses (including W–2 wages), as well as those selling expenses from Y's non-PRS activities, are definitely related to all of its gross income. Based on the facts and circumstances of this specific case, apportionment of those expenses between DPGR and non-DPGR on the basis of Y's gross receipts is appropriate. Y elects to apportion its distributive share of interest expense under the tax book value method of § 1.861–9T(g). Y has \$1,290 of gross income attributable to DPGR (\$3,000 DPGR (\$1,500 from PRS and \$1,500 from non-PRS activities) – \$1,710 CGS (\$810 from PRS and \$900 from non-PRS activities)). Y's QPAI for 2010 is \$642, as shown below:

DPGR (\$1,500 from PRS and \$1,500 from non-PRS activities)	\$3,000
CGS allocable to DPGR (\$810 from PRS and \$900 from non-PRS activities) (includes \$120 of W–2 wages)	(1,710)
Section 162 selling expenses (includes \$180 of W–2 wages) (\$1,140 (\$600 from PRS and \$540 from non-PRS activities) × (\$1,500 PRS DPGR + \$1,500 non-PRS DPGR)/(\$3,000 PRS total gross receipts + \$4,500 non-PRS total gross receipts))	(456)
Interest expense (not included in CGS) (\$240 (\$150 from PRS and \$90 from non-PRS activities) × \$10,000 (Y's non-PRS DPGR assets and Y's share of PRS DPGR assets)/\$12,500 (Y's non-PRS assets and Y's share of PRS assets))	(192)
Y's QPAI	642

(iv) PRS W–2 wages allocated to X and Y under section 199(d)(1)(B). Solely for

purposes of calculating the PRS W–2 wages that are allocated to them under section 199(d)(1)(B) for purposes of the wage limitation of section 199(b), X and Y must separately determine QPAI taking into account only the items of PRS allocated to them. X and Y must use the same methods of allocation and apportionment that they use to determine their QPAI in paragraphs (iii)(A) and (B) of this *Example 1*, respectively. Accordingly, X and Y must apportion deductible section 162 selling expenses which includes W–2 wage expense on the basis of gross receipts, and apportion interest expense according to the tax book value method of § 1.861–9T(g).

(A) QPAI of X and Y, solely for this purpose, is determined by allocating and apportioning each partner's share of PRS expenses to each partner's share of PRS gross income of \$690 attributable to DPGR (\$1,500 DPGR – \$810 CGS, apportioned based on gross receipts). Thus, QPAI of X and Y solely for this purpose is \$270, as shown below:

DPGR	\$1,500
CGS allocable to DPGR	(810)
Section 162 selling expenses (including W–2 wages) (\$600 × (\$1,500/\$3,000))	(300)
Interest expense (not included in CGS) (\$150 × \$2,000 (partner's share of adjusted basis of PRS's DPGR assets)/\$2,500 (partner's share of adjusted basis of total PRS assets))	(120)
QPAI	270

(B) X's and Y's shares of PRS's W–2 wages determined under section 199(d)(1)(B) for purposes of the wage limitation of section 199(b) are \$49, the lesser of \$250 (partner's allocable share of PRS's W–2 wages (\$100 included in CGS, and \$150 included in selling expenses) and \$49 (2 × (\$270 × .09)).

(v) *Section 199 deduction determination.* (A) X's tentative section 199 deduction is \$33 (.09 × \$366 (that is, QPAI determined at partner level)) subject to the wage limitation of \$25 (50% × \$49). Accordingly, X's section 199 deduction for 2010 is \$25.

(B) Y's tentative section 199 deduction is \$58 (.09 × \$642 (that is, QPAI determined at the partner level) subject to the wage limitation of \$150 (50% × (\$49 (from PRS)) and \$250 (from non-PRS activities)). Accordingly, Y's section 199 deduction for 2010 is \$58.

Example 2. Section 861 method with R&E expense. (i) *Partnership items of income, gain, loss, deduction or credit.* X and Y, unrelated United States corporations, are partners in PRS, a partnership that engages in production activities that generate both DPGR and non-DPGR. Neither X nor Y is a member of an affiliated group. X and Y share all items of income, gain, loss, deduction, and credit 50% each. All of PRS's domestic production activities that generate DPGR are within Standard Industrial Classification (SIC) Industry Group AAA (SIC AAA). All of PRS's production activities that generate non-DPGR are within SIC Industry Group BBB (SIC BBB). PRS is not able to identify from

its books and records CGS allocable to DPGR and to non-DPGR and, therefore, apportions CGS to DPGR and non-DPGR based on its gross receipts. PRS incurs \$900 of research and experimentation expenses (R&E) that are deductible under section 174, \$300 of which are performed with respect to SIC AAA and \$600 of which are performed with respect to SIC BBB. None of the R&E is legally mandated R&E as described in § 1.861–17(a)(4) and none is included in CGS. PRS incurs section 162 selling expenses (that include W–2 wage expense) that are not includible in CGS and not directly allocable to any gross income. For 2010, PRS has the following Federal income tax items:

DPGR (all from sales of products within SIC AAA)	\$3,000
Non-DPGR (all from sales of products within SIC BBB)	3,000
CGS (includes \$200 of W–2 wages)	2,400
Section 162 selling expenses (includes \$100 of W–2 wages)	840
Section 174 R&E–SIC AAA	300
Section 174 R&E–SIC BBB	600

(ii) *Allocation of PRS's items of income, gain, loss, deduction, or credit.* X and Y each receive the following distributive share of PRS's items of income, gain, loss, deduction, or credit, as determined under the principles of § 1.704–1(b)(1)(vii):

Gross income attributable to DPGR (\$1,500 (DPGR) – \$600 (CGS, includes \$50 of W–2 wages))	\$900
Gross income attributable to non-DPGR (\$1,500 (other gross receipts) – \$600 (CGS, includes \$50 of W–2 wages))	900
Section 162 selling expenses (includes \$50 of W–2 wages)	420
Section 174 R&E–SIC AAA	150
Section 174 R&E–SIC BBB	300

(iii) *Determination of QPAI.* (A) *X's QPAI.*

Because the section 199 deduction is determined at the partner level, X determines its QPAI by aggregating, to the extent necessary, its distributive shares of PRS's Federal income tax items with all other such items from all other, non-PRS-related activities. For 2010, X does not have any other such tax items. X's only gross receipts for 2010 are those attributable to the allocation of gross income from PRS. As stated, all of PRS's domestic production activities that generate DPGR are within SIC AAA. X allocates and apportions its deductible items to gross income attributable to DPGR under the section 861 method of § 1.199–4(d). In this case, the section 162 selling expenses (including W–2 wages) are definitely related to all of PRS's gross income. Based on the facts and circumstances of this specific case, apportionment of those expenses between DPGR and non-DPGR on the basis of PRS's gross receipts is appropriate. For purposes of apportioning R&E, X elects to use the sales method as described in § 1.861–17(c). Because X has no direct sales of products,

and because all of PRS's SIC AAA sales attributable to X's share of PRS's gross income generate DPGR, all of X's share of PRS's section 174 R&E attributable to SIC AAA is taken into account for purposes of determining X's QPAI. Thus, X's total QPAI for 2010 is \$540, as shown below:

DPGR (all from sales of products within SIC AAA)	\$1,500
CGS (includes \$50 of W-2 wages)	(600)
Section 162 selling expenses (including W-2 wages) (\$420 × (\$1,500 DPGR/\$3,000 total gross receipts))	(210)
Section 174 R&E-SIC AAA	(150)
X's QPAI	540

(B) *Y's QPAI.* (1) For 2010, in addition to the activities of PRS, Y engages in domestic production activities that generate both DPGR and non-DPGR. With respect to those non-PRS activities, Y is not able to identify from its books and records CGS allocable to DPGR and to non-DPGR. In this case, because CGS is definitely related under the facts and circumstances to all of Y's non-PRS gross receipts, apportionment of CGS between DPGR and non-DPGR based on Y's non-PRS gross receipts is appropriate. For 2010, Y has the following non-PRS Federal income tax items:

DPGR (from sales of products within SIC AAA)	\$1,500
DPGR (from sales of products within SIC BBB)	1,500
Non-DPGR (from sales of products within SIC BBB)	3,000
CGS (allocated to DPGR within SIC AAA) (includes \$56 of W-2 wages)	750
CGS (allocated to DPGR within SIC BBB) (includes \$56 of W-2 wages)	750
CGS (allocated to non-DPGR within SIC BBB) (includes \$113 of W-2 wages)	1,500
Section 162 selling expenses (includes \$30 of W-2 wages)	540
Section 174 R&E-SIC AAA	300
Section 174 R&E-SIC BBB	450

(2) Because Y has DPGR as a result of activities outside PRS, Y must aggregate its distributive share of PRS's Federal income tax items with such items from all its other, non-PRS-related activities. Y allocates and apportions its deductible items to gross income attributable to DPGR under the section 861 method of § 1.199-4(d). In this case, the section 162 selling expenses (including W-2 wages) are definitely related to all of Y's gross income. Based on the facts and circumstances of the specific case, apportionment of such expenses between DPGR and non-DPGR on the basis of Y's gross receipts is appropriate. For purposes of apportioning R&E, Y elects to use the sales method as described in § 1.861-17(c).

(3) With respect to sales that generate DPGR, Y has gross income of \$2,400 (\$4,500 DPGR (\$1,500 from PRS and \$3,000 from non-PRS activities) - \$2,100 CGS (\$600 from

sales of products by PRS and \$1,500 from non-PRS activities)). Because all of the sales in SIC AAA generate DPGR, all of Y's share of PRS's section 174 R&E attributable to SIC AAA and the section 174 R&E attributable to SIC AAA that Y incurs in its non-PRS activities are taken into account for purposes of determining Y's QPAI. Because only a portion of the sales within SIC BBB generate DPGR, only a portion of the section 174 R&E attributable to SIC BBB is taken into account in determining Y's QPAI. Thus, Y's QPAI for 2010 is \$1,282, as shown below:

DPGR (\$4,500 DPGR (\$1,500 from PRS and \$3,000 from non-PRS activities)	\$4,500
CGS (\$600 from sales of products by PRS and \$1,500 from non-PRS activities)	(2,100)
Section 162 selling expenses (including W-2 wages) (\$420 from PRS + \$540 from non-PRS activities) × (\$4,500 DPGR/\$9,000 total gross receipts)	(480)
Section 174 R&E-SIC AAA (\$150 from PRS and \$300 from non-PRS activities)	(450)
Section 174 R&E-SIC BBB (\$300 from PRS + \$450 from non-PRS activities) × (\$1,500 DPGR/\$6,000 total gross receipts allocated to SIC BBB)	(188)
Y's QPAI	1,282

(iv) *PRS W-2 wages allocated to X and Y under section 199(d)(1)(B).* Solely for purposes of calculating the PRS W-2 wages that are allocated to X and Y under section 199(d)(1)(B) for purposes of the wage limitation of section 199(b), X and Y must separately determine QPAI taking into account only the items of PRS allocated to them. X and Y must use the same methods of allocation and apportionment that they use to determine their QPAI in paragraphs (iii)(A) and (B) of this *Example 2*, respectively. Accordingly, X and Y must apportion section 162 selling expense which includes W-2 wage expense on the basis of gross receipts, and apportion section 174 R&E expense under the sales method as described in § 1.861-17(c).

(A) QPAI of X and Y, solely for this purpose, is determined by allocating and apportioning each partner's share of PRS expenses to each partner's share of PRS gross income of \$900 attributable to DPGR (\$1,500 DPGR - \$600 CGS, allocated based on PRS's gross receipts). Because all of PRS's SIC AAA sales generate DPGR, all of X's and Y's shares of PRS's section 174 R&E attributable to SIC AAA is taken into account for purposes of determining X's and Y's QPAI. None of PRS's section 174 R&E attributable to SIC BBB is taken into account because PRS has no DPGR within SIC BBB. Thus, X and Y each has QPAI, solely for this purpose, of \$540, as shown below:

DPGR (all from sales of products within SIC AAA)	\$1,500
CGS (includes \$50 of W-2 wages)	(600)

Section 162 selling expenses (including W-2 wages) (\$420 × \$1,500/\$3,000)	(210)
Section 174 R&E-SIC AAA	(150)
QPAI	540

(B) X's and Y's shares of PRS's W-2 wages determined under section 199(d)(1)(B) for purposes of the wage limitation of section 199(b) are \$97, the lesser of \$150 (partner's allocable share of PRS's W-2 wages (\$100 included in CGS, and \$50 included in selling expenses)) and \$97 (2 × (\$540 × .09)).

(v) *Section 199 deduction determination.* (A) X's tentative section 199 deduction is \$49 (.09 × \$540 (QPAI determined at partner level)) subject to the wage limitation of \$49 (50% × \$97). Accordingly, X's section 199 deduction for 2010 is \$49.

(B) Y's tentative section 199 deduction is \$115 (.09 × \$1,282 (QPAI determined at partner level)) subject to the wage limitation of \$176 (50% × \$352 (\$97 from PRS + \$255 from non-PRS activities)). Accordingly, Y's section 199 deduction for 2010 is \$115.

Example 3. Simplified deduction method with special allocations. (i) *In general.* X and Y are unrelated corporate partners in PRS. PRS engages in a domestic production activity and other activities. In general, X and Y share all partnership items of income, gain, loss, deduction, and credit equally, except that 80% of the wage expense of PRS and 20% of PRS's other expenses are specially allocated to X (substantial economic effect under section 704(b) is presumed). In the 2010 taxable year, PRS's only wage expense is \$2,000 for marketing, which is not included in CGS. PRS has \$8,000 of gross receipts (\$6,000 of which is DPGR), \$4,000 of CGS (\$3,500 of which is allocable to DPGR), and \$3,000 of deductions (comprised of \$2,000 of wages for marketing and \$1,000 of other expenses). X qualifies for and uses the simplified deduction method under § 1.199-4(e). Y does not qualify to use that method and therefore, must use the section 861 method under § 1.199-4(d). In the 2010 taxable year, X has gross receipts attributable to non-partnership activities of \$1,000 and wages of \$200. None of X's non-PRS gross receipts is DPGR.

(ii) *Allocation and apportionment of costs.* Under the partnership agreement, X's distributive share of the items of the partnership is \$1,250 of gross income attributable to DPGR (\$3,000 DPGR - \$1,750 allocable CGS), \$750 of gross income attributable to non-DPGR (\$1,000 non-DPGR - \$250 allocable CGS), and \$1,800 of deductions (comprised of X's special allocations of \$1,600 of wage expense for marketing and \$200 of other expenses). Under the simplified deduction method, X apportions \$1,200 of other deductions to DPGR (\$2,000 (\$1,800 from the partnership and \$200 from non-partnership activities) × (\$3,000 DPGR/\$5,000 total gross receipts)). Accordingly, X's QPAI is \$50 (\$3,000 DPGR - \$1,750 CGS - \$1,200 of deductions). However, in determining the section 199(d)(1)(B) wage limitation, QPAI is computed taking into account only the items of the partnership allocated to the partner for the taxable year of the partnership. Thus, X

apportions \$1,350 of deductions to DPGR (\$1,800 \times (\$3,000 DPGR/\$4,000 total gross receipts from PRS)). Accordingly, X's QPAI for purposes of the section 199(d)(1)(B) wage limitation is \$0 (\$3,000 DPGR $-$ \$1,750 CGS $-$ \$1,350 of deductions). X's share of PRS's W-2 wages is \$0, the lesser of \$1,600 (X's 80% allocable share of \$2,000 of wage expense for marketing) or \$0 ($2 \times (\$0 \text{ QPAI} \times .09)$). X's tentative deduction is \$5 ($\$50 \text{ QPAI} \times .09$), subject to the section 199(b)(1) wage limitation of \$100 ($50\% \times \200 (\$0 of PRS-related W-2 wages $+$ \$200 of non-PRS W-2 wages)). Accordingly, X's total section 199 deduction for the 2010 taxable year is \$5.

Example 4. Small business simplified overall method. A, an individual, and X, a corporation, are partners in PRS. PRS engages in manufacturing activities that generate both DPGR and non-DPGR. A and X share all items of income, gain, loss, deduction, and credit equally. In the 2010 taxable year, PRS has total gross receipts of \$2,000 (\$1,000 of which is DPGR), CGS of \$800 (including \$400 of W-2 wages), and deductions of \$800. A and PRS use the small business simplified overall method under § 1.199-4(f). X uses the section 861 method. Under the small business simplified overall method, PRS's CGS and deductions apportioned to DPGR equal \$800 ($(\$800 \text{ CGS plus } \$800 \text{ of other deductions}) \times (\$1,000 \text{ DPGR}/\$2,000 \text{ total gross receipts})$). Accordingly, PRS's QPAI is \$200 ($\$1,000 \text{ DPGR} - \$800 \text{ CGS and other deductions}$). Under the partnership agreement, PRS's QPAI is allocated \$100 to A and \$100 to X. A's share of partnership W-2 wages for purposes of the section 199(d)(1)(B) limitation is \$18, the lesser of \$200 (A's 50% allocable share of PRS's \$400 of W-2 wages) or \$18 ($2 \times (\$100 \text{ QPAI} \times .09)$). A's tentative deduction is \$9 ($\$100 \text{ QPAI} \times .09$), subject to the section 199(b)(1) wage limitation of \$9 ($50\% \times \18). Assuming that A engages in no other activities generating DPGR, A's total section 199 deduction for the 2010 taxable year is \$9. X must use \$100 of QPAI and \$18 of W-2 wages to determine its section 199 deduction using the section 861 method.

(b) S corporations—(1) Determination at shareholder level. The section 199 deduction is determined at the shareholder level. As a result, each shareholder must compute its deduction separately. For purposes of this section, each shareholder is allocated, in accordance with section 1366, its pro rata share of S corporation items (including items of income, gain, loss, and deduction), CGS allocated to such items of income, and gross receipts included in such items of income, even if the shareholder's share of CGS and other deductions and losses exceeds DPGR. To determine its section 199 deduction for the taxable year, the shareholder generally aggregates its pro rata share of such items, to the extent they are not otherwise disallowed by the Internal Revenue Code, with those items it incurs outside the S corporation (whether directly or indirectly) for

purposes of allocating and apportioning deductions to DPGR and computing its QPAI. However, if an S corporation uses the small business simplified overall method described in § 1.199-4(f), then each shareholder is allocated its share of QPAI and W-2 wages, which (subject to the limitation under section 199(d)(1)(B)) are combined with the shareholder's QPAI and W-2 wages from other sources. Under this method, a shareholder's share of QPAI from an S corporation may be less than zero.

(2) Disallowed deductions. Deductions of the S corporation that otherwise would be taken into account in computing the shareholder's section 199 deduction are taken into account only if and to the extent the shareholder's pro rata share of the losses or deductions from all of the S corporation's activities are not disallowed by section 465, 469, 1366(d), or any other provision of the Internal Revenue Code. If only a portion of the shareholder's pro rata share of the losses or deductions is allowed for a taxable year, a proportionate share of the losses or deductions allocated to the S corporation's qualified production activities, determined in a manner consistent with sections 465, 469, 1366(d), and any other applicable provision of the Internal Revenue Code, is taken into account in computing the section 199 deduction for that taxable year. To the extent that any of the disallowed losses or deductions is allowed in a later taxable year, the shareholder takes into account a proportionate share of those losses or deductions in computing its QPAI for that later taxable year.

(3) Shareholder's share of W-2 wages. Under section 199(d)(1)(B), an S corporation shareholder's share of the W-2 wages of the S corporation for purposes of determining the shareholder's section 199(b) limitation is the lesser of the shareholder's allocable share of those wages (without regard to section 199(d)(1)(B)), or 2 times 9 percent (3 percent for taxable years beginning in 2005 or 2006, and 6 percent for taxable years beginning in 2007, 2008, or 2009) of the QPAI computed by taking into account only the items of the S corporation allocated to the shareholder for the taxable year. In general, this QPAI calculation is performed by the shareholder using the same cost allocation method that the shareholder uses in calculating the shareholder's section 199 deduction. However, if an S corporation uses the small business simplified overall method described in § 1.199-4(f), the QPAI used by each shareholder to determine the wage limitation under

section 199(d)(1)(B) is the same as the share of QPAI allocated to the shareholder. Each shareholder must compute its share of W-2 wages from an S corporation in accordance with section 199(d)(1)(B) (with W-2 wages being allocated to the shareholder in the same manner as is wage expense), and then add that share to the shareholder's W-2 wages from other sources, if any. The application of section 199(d)(1)(B) therefore means that if QPAI, computed by taking into account only the items of the S corporation allocated to the shareholder for the taxable year, is not greater than zero, the shareholder may not take into account any W-2 wages of the S corporation in computing the shareholder's section 199 deduction. See § 1.199-2 for the computation of W-2 wages, and paragraph (f) of this section for rules regarding pass-thru entities in a tiered structure.

(c) Grantor trusts. To the extent that the grantor or another person is treated as owning all or part (the owned portion) of a trust under sections 671 through 679, the owner computes its QPAI with respect to the owned portion of the trust as if that QPAI had been generated by activities performed directly by the owner. Similarly, for purposes of the section 199(b) wage limitation, the owner of the trust takes into account the owner's share of the W-2 wages of the trust that are attributable to the owned portion of the trust. The section 199(d)(1)(B) wage limitation is not applicable to the owned portion of the trust.

(d) Non-grantor trusts and estates—(1) Computation of section 199 deduction. Except as provided in paragraph (c) of this section, solely for purposes of determining the section 199 deduction for the taxable year, the QPAI of a trust or estate must be computed by allocating expenses described in section 199(d)(5) under § 1.652(b)-3 with respect to directly attributable expenses, and under the simplified deduction method of § 1.199-4(e) with respect to other expenses described in section 199(d)(5) (unless the trust or estate does not qualify to use the simplified deduction method, in which case it must use the section 861 method of § 1.199-4(d) with respect to such other expenses). For this purpose, the trust's or estate's share of other expenses from a lower-tier pass-thru entity is not directly attributable to any class of income (whether or not those other expenses are directly attributable to the aggregate pass-thru gross income as a class for purposes other than section 199). A trust or estate may not use the small business simplified overall method for computing its QPAI. See

§ 1.199-4(f)(4). The QPAI (which will be less than zero if the CGS and deductions allocated and apportioned to DPGR exceed the trust's or estate's DPGR) and W-2 wages of the trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust's or estate's distributable net income (DNI), as defined by section 643(a), for the taxable year that is distributed or required to be distributed to the beneficiary or is retained by the trust or estate. To the extent that the trust or estate has no DNI for the taxable year, any QPAI and W-2 wages are allocated entirely to the trust or estate. A trust or estate may claim the section 199 deduction in computing its taxable income to the extent that QPAI and W-2 wages are

allocated to the trust or estate. A beneficiary of a trust or estate is allowed the section 199 deduction in computing its taxable income based on its share of QPAI and W-2 wages from the trust or estate, which (subject to the wage limitation of section 199(d)(1)(B)) are aggregated with the beneficiary's QPAI and W-2 wages from other sources. Each beneficiary must compute its share of W-2 wages from a trust or estate in accordance with section 199(d)(1)(B). The application of section 199(d)(1)(B) therefore means that if QPAI, computed by taking into account only the items of the trust or estate allocated to the beneficiary for the taxable year, is not greater than zero, the beneficiary may not take into account any W-2 wages of the trust or estate in computing the

beneficiary's section 199 deduction. See paragraph (f) of this section for rules applicable to pass-thru entities in a tiered structure.

(2) *Example.* The following example illustrates the application of this paragraph (d). Assume that the partnership, trust, and trust beneficiary all are calendar year taxpayers. The example is as follows:

Example. (i) *Computation of DNI and inclusion and deduction amounts.* (A) *Trust's distributive share of partnership items.* Trust, a complex trust, is a partner in PRS, a partnership that engages in activities that generate DPGR and non-DPGR. In 2010, PRS distributes \$10,000 to Trust. Trust's distributive share of PRS items, which are properly included in Trust's DNI, is as follows:

Gross income attributable to DPGR (\$15,000 DPGR – \$5,000 CGS (including W-2 wages of 1,000))	\$10,000
Gross income attributable to other gross receipts (\$5,000 other gross receipts – \$0 CGS)	5,000
Selling expenses (includes W-2 wages of \$2,000)	3,000
Other expenses (includes W-2 wages of \$1,000)	2,000

(B) *Trust's direct activities.* In addition to receiving in 2010 the distribution from PRS,

Trust also directly has the following items which are properly included in Trust's DNI:

Dividends	\$10,000
Tax-exempt interest	10,000
Rents from commercial real property that is subject to a section 6166 election	10,000
Real estate taxes	1,000
Trustee commissions	3,000
State income and personal property taxes	5,000
W-2 wages	2,000
Other business expenses	1,000

(C) *Allocation of deductions under § 1.652(b)-3.* (1) *Directly attributable expenses.* In computing Trust's DNI for the taxable year, the distributive share of expenses of PRS are directly attributable under § 1.652(b)-3(a) to the distributive share of income of PRS. Accordingly, the \$20,000 of gross receipts from PRS is reduced by \$5,000 of CGS, \$3,000 of selling expenses, and \$2,000 of other expenses, resulting in net income from PRS of \$10,000. With respect to the Trust's direct expenses, \$1,000 of the trustee commissions, the \$1,000 of real estate taxes, and the \$2,000 of W-2 wages are directly attributable under § 1.652(b)-3(a) to the rental income.

(2) *Non-directly attributable expenses.* Under § 1.652(b)-3(b), the trustee must allocate a portion of the sum of the balance of the trustee commissions (\$2,000), state income and personal property taxes (\$5,000), and the other business expenses (\$1,000) to the \$10,000 of tax-exempt interest. The portion to be attributed to tax-exempt interest is \$2,222 (\$8,000 × (\$10,000 tax exempt interest/\$36,000 gross receipts net of direct expenses)), resulting in \$7,778 (\$10,000 – \$2,222) of net tax-exempt interest. Pursuant to its authority recognized under § 1.652(b)-3(b), the trustee allocates the entire amount of the remaining \$5,778 of trustee commissions, state income and

personal property taxes, and other business expenses to the \$6,000 of net rental income, resulting in \$222 (\$6,000 – \$5,778) of net rental income.

(D) *Amounts included in taxable income.* For 2010, Trust has DNI of \$28,000 (net dividend income of \$10,000 + net PRS income of \$10,000 + net rental income of \$222 + net tax-exempt income of \$7,778). Pursuant to Trust's governing instrument, Trustee distributes 50%, or \$14,000, of that DNI to B, an individual who is a discretionary beneficiary of Trust. Assume that there are no separate shares under Trust, and no distributions are made to any other beneficiary that year. Consequently, with respect to the \$14,000 distribution, B properly includes in B's gross income \$5,000 of income from PRS, \$111 of rents, and \$5,000 of dividends, and properly excludes from B's gross income \$3,889 of tax-exempt interest. Trust includes \$20,222 in its adjusted total income and deducts \$10,111 under section 661(a) in computing its taxable income.

(ii) *Section 199 deduction.* (A) *Simplified deduction method.* For purposes of computing the section 199 deduction for the taxable year, assume Trust qualifies for the simplified deduction method under § 1.199-4(e). Determining Trust's QPAI under the simplified deduction method requires a

multi-step approach to allocating costs. In step 1, the Trust's DPGR is first reduced by the Trust's expenses directly attributable to DPGR under § 1.652(b)-3(a). In this step, the \$15,000 of DPGR from PRS is reduced by the directly attributable \$5,000 of CGS and selling expenses of \$3,000. In step 2, Trust allocates its other business expenses on the basis of its total gross receipts. In this example, the portion of the trustee commissions not directly attributable to the rental operation, as well as the portion of the state income and personal property taxes not directly attributable to either the PRS interests or the rental operation, are not trade or business expenses and, thus, are ignored in computing QPAI. The portion of the state income and personal property taxes that is treated as other trade or business expenses is \$3,000 (\$5,000 × \$30,000 total trade or business gross receipts/\$50,000 total gross receipts). Trust then combines its non-directly attributable (other) expenses (\$2,000 from PRS + \$4,000 (\$1,000 + \$3,000) from its own activities) and then apportions this total between DPGR and other receipts on the basis of Trust's total gross receipts (\$6,000 × \$15,000 DPGR/\$50,000 total gross receipts = \$1,800). Thus, for purposes of computing Trust's and B's section 199 deduction, Trust's QPAI is \$5,200 (\$7,000 – \$1,800). Because the distribution of Trust's DNI to B equals

one-half of Trust's DNI, Trust and B each has QPAI from PRS for purposes of the section 199 deduction of \$2,600.

(B) *Section 199(d)(1)(B) wage limitation.* The wage limitation under section 199(d)(1)(B) must be applied both at the Trust level and at B's level. After applying this limitation to the Trust's share of PRS's W-2 wages, Trust is allocated \$990 of W-2 wages from PRS (the lesser of Trust's allocable share of PRS's W-2 wages (\$4,000) or $2 \times 9\%$ of PRS's QPAI (\$5,500)). PRS's QPAI for purposes of the section 199(d)(1)(B) limitation is determined by taking into account only the items of PRS allocated to Trust (\$15,000 DPGR—(\$5,000 of CGS + \$3,000 selling expenses + \$1,500 of other expenses). For this purpose, the \$1,500 of other expenses is determined by multiplying \$2,000 of other expenses from PRS by \$15,000 of DPGR from PRS, divided by \$20,000 of total gross receipts from PRS. Trust adds this \$990 of W-2 wages to Trust's own \$2,000 of W-2 wages (thus, \$2,990). Because the \$14,000 distribution to B equals one-half of Trust's DNI, Trust and B each has W-2 wages of \$1,495. After applying the section 199(d)(1)(B) wage limitation to B's share of the W-2 wages allocated from Trust, B has W-2 wages of \$468 from Trust (lesser of \$1,495 (allocable share of W-2 wages) or $2 \times .09 \times \$2,600$ (Trust's QPAI)). B has W-2 wages of \$100 from non-Trust activities for a total of \$568 of W-2 wages.

(C) *Section 199 deduction computation.* (1) *B's computation.* B is eligible to use the small business simplified overall method. Assume that B has sufficient adjusted gross income so that the section 199 deduction is not limited under section 199(a)(1)(B). B has \$1,000 of QPAI from non-Trust activities which is added to the \$2,600 QPAI from Trust for a total of \$3,600 of QPAI. B's tentative deduction is \$324 ($.09 \times \$3,600$) which is limited under section 199(b) to \$284 ($50\% \times \568 W-2 wages). Accordingly, B's section 199 deduction for 2010 is \$284.

(2) *Trust's computation.* Trust has sufficient taxable income so that the section 199 deduction is not limited under section 199(a)(1)(B). Trust's tentative deduction is \$234 ($.09 \times \$2,600$ QPAI) which is limited under section 199(b) to \$748 ($50\% \times \$1,495$ W-2 wages). Accordingly, Trust's section 199 deduction for 2010 is \$234.

(e) *Gain or loss from the disposition of an interest in a pass-thru entity.* DPGR generally does not include gain or loss recognized on the sale, exchange, or other disposition of an interest in a pass-thru entity. However, with respect to partnerships, if section 751(a) or (b) applies, gain or loss attributable to assets of the partnership giving rise to ordinary income under section 751(a) or (b), the sale, exchange, or other disposition of which would give rise to DPGR, is taken into account in computing the partner's section 199 deduction. Accordingly, to the extent that money or property received by a partner in a sale or exchange for all or part of its partnership interest is attributable to unrealized receivables or

inventory items within the meaning of section 751(c) or (d), respectively, and the sale or exchange of the unrealized receivable or inventory items would give rise to DPGR if sold or exchanged or otherwise disposed of by the partnership, the money or property received is taken into account by the partner in determining its DPGR for the taxable year. Likewise, to the extent that a distribution of property to a partner is treated under section 751(b) as a sale or exchange of property between the partnership and the distributee partner, and any property deemed sold or exchanged would give rise to DPGR if sold or exchanged by the partnership, the deemed sale or exchange of the property must be taken into account in determining the partnership's and distributee partner's DPGR. See § 1.751-1(b).

(f) *Section 199(d)(1)(B) wage limitation and tiered structures—(1) In general.* If a pass-thru entity owns an interest, directly or indirectly, in one or more pass-thru entities, the wage limitation of section 199(d)(1)(B) must be applied at each tier (that is, separately for each entity). Thus, at each tier, the owner of a pass-thru entity calculates the amounts described in sections 199(d)(1)(B)(i) (allocable share) and 199(d)(1)(B)(ii) (twice the applicable percentage of QPAI from that entity) separately with regard to its interest in that pass-thru entity.

(2) *Share of W-2 wages.* For purposes of section 199(d)(1)(B)(i) and section 199(b), the W-2 wages of the owner of an interest in a pass-thru entity (upper-tier entity) that owns an interest in one or more pass-thru entities (lower-tier entities) are equal to the sum of the owner's allocable share of W-2 wages of the upper-tier entity, as limited in accordance with section 199(d)(1)(B), and the owner's own W-2 wages. The upper-tier entity's W-2 wages are equal to the sum of the upper-tier entity's allocable share of W-2 wages of the next lower-tier entity, as limited in accordance with section 199(d)(1)(B), and the upper-tier entity's own W-2 wages. The W-2 wages of each lower-tier entity in a tiered structure, in turn, is computed as described in the preceding sentence. Although all wages paid during that taxable year are taken into account in computing QPAI, only the W-2 wages as described in § 1.199-2 are taken into account in computing the W-2 wage limitation.

(3) *Example.* The following example illustrates the application of this paragraph (f). Assume that each partnership and each partner (whether or not an individual) is a calendar year taxpayer. The example is as follows:

Example. (i) In 2010, A, an individual, owns a 50% interest in a partnership, UTP, which in turn owns a 50% interest in another partnership, LTP. All partnership items are allocated in proportion to these ownership percentages. Both partnerships are eligible for and use the small business simplified overall method under § 1.199-4(f). LTP has QPAI of \$400 (\$900 DPGR—\$450 CGS (which includes W-2 wages of \$100)—\$50 other deductions). Before taking into account its distributive share from LTP, UTP has QPAI of (\$500) (\$500 DPGR—\$500 CGS (which includes W-2 wages of \$200)—\$500 other deductions). UTP's distributive share of LTP's QPAI is \$200.

(ii) UTP's share of LTP's W-2 wages for purposes of the section 199(d)(1)(B) limitation is \$36, the lesser of \$50 (UTP's allocable share of LTP's W-2 wages paid) or \$36 ($2 \times (\$200 \text{ QPAI} \times .09)$). After taking into account its distributive share from LTP, UTP has QPAI of (\$300) and W-2 wages of \$236. A's distributive share of UTP's QPAI is (\$150). A's limitation under section 199(d)(1)(B) with respect to A's interest in UTP is \$0, the lesser of \$118 (A's allocable share of UTP's W-2 wages paid) or \$0 (because A's share of QPAI, (\$150), is less than zero).

(g) *No attribution of qualified activities.* Except as provided in § 1.199-3(h)(7) regarding certain qualifying oil and gas partnerships and § 1.199-3(h)(8) regarding EAG partnerships, for purposes of section 199, an owner of a pass-thru entity is not treated as conducting the qualified production activities of the pass-thru entity, and vice versa. This rule applies to all partnerships, including partnerships that have elected out of subchapter K under section 761(a). Accordingly, if a partnership MPGE QPP within the United States, or otherwise produces a qualified film or utilities in the United States, and distributes or leases, rents, licenses, sells, exchanges, or otherwise disposes of the property to a partner who then leases, rents, licenses, sells, exchanges, or otherwise disposes of the property, the partner's gross receipts from this latter lease, rental, license, sale, exchange, or other disposition are not treated as DPGR under § 1.199-3. In addition, if a partner MPGE QPP within the United States, or otherwise produces a qualified film or utilities in the United States, and contributes or leases, rents, licenses, sells, exchanges, or otherwise disposes of the property to a partnership which then leases, rents, licenses, sells, exchanges, or otherwise disposes of the property, the partnership's gross receipts from this latter disposition are not treated as DPGR under § 1.199-3.

§ 1.199-6 Agricultural and horticultural cooperatives.

(a) *In general.* This section applies to a cooperative to which Part I of

subchapter T of the Internal Revenue Code applies and its patrons if the cooperative has manufactured, produced, grown, or extracted (MPGE) (as defined in § 1.199-3(d)) in whole or significant part (as defined in § 1.199-3(f)) within the United States (as defined in § 1.199-3(g)) any agricultural or horticultural product, or has marketed agricultural or horticultural products. For this purpose, agricultural or horticultural products also include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production. If any amount of a patronage dividend or per-unit retain allocation received by a patron is allocable to the qualified production activities income (QPAI) (as defined in § 1.199-1(c)) of the cooperative, would be allowable as a deduction under § 1.199-1(a) (section 199 deduction) by the cooperative, and is designated as such in a written notice to the patron during the payment period defined under section 1382(d), then such amount is deductible by the patron as a section 199 deduction. For this purpose, patronage dividends and per-unit retain allocations include any advances on patronage or per-unit retains paid in money during the taxable year.

(b) *Written notice to patrons.* In order for a patron to qualify for the section 199 deduction, paragraph (a) of this section requires that the cooperative designate in a written notice the amount of the patron's patronage dividend or per-unit retain allocation that is allocable to QPAI and deductible by the cooperative. This written notice designating the patron's portion of the section 199 deduction must be mailed by the cooperative to its patrons no later than the 15th day of the ninth month following the close of the taxable year. The cooperative may use the same written notice, if any, that it uses to notify patrons of their respective allocations of patronage dividends, or may use a separate timely written notice(s) to comply with this section. The cooperative must report the amount of the patron's section 199 deduction on Form 1099-PATR, "Taxable Distributions Received from Cooperative," issued to the patron.

(c) *Determining cooperative's qualified production activities income.* In determining the portion of the cooperative's QPAI that would be allowable as a section 199 deduction by the cooperative, the cooperative's taxable income is computed without taking into account any deduction allowable under section 1382(b) or (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions) and, in the

case of a cooperative engaged in the marketing of agricultural and/or horticultural products, the cooperative is treated as having MPGE in whole or in significant part within the United States any agricultural or horticultural products marketed by the cooperative that its patrons have MPGE.

(d) *Additional rules relating to pass-through of section 199 deduction.* The cooperative may, at its discretion, pass through all, some, or none of the section 199 deduction to its patrons. A cooperative member of a federated cooperative may pass through the section 199 deduction it receives from the federated cooperative to its member patrons. Patrons may claim the section 199 deduction for the taxable year in which they receive the written notice from the cooperative informing them of the section 199 amount without regard to the taxable income limitation under § 1.199-1(a) and (b).

(e) *W-2 wages.* The W-2 wage limitation described in § 1.199-2 shall be applied at the cooperative level whether or not the cooperative chooses to pass through some or all of the section 199 deduction. Any section 199 deduction that has been passed through by a cooperative to its patrons is not subject to the W-2 wage limitation a second time at the patron level.

(f) *Recapture of section 199 deduction.* If the amount of the section 199 deduction that was passed through to patrons exceeds the amount allowable as a section 199 deduction as determined on audit or reported on the amended return, recapture of the excess will occur at the cooperative level.

(g) *Section is exclusive.* This section is the exclusive method for cooperatives and their patrons to compute the amount of the section 199 deduction. Thus, a patron may not deduct any amount with respect to a patronage dividend or a per-unit retain allocation unless the requirements of this section are satisfied.

(h) *No double counting.* A patronage dividend or per-unit retain allocation received by a patron of a cooperative is not QPAI in the hands of the patron.

(i) *Examples.* The following examples illustrate the application of this section:

Example 1. (i) Cooperative X markets corn grown by its members within the United States for sale to retail grocers. For its calendar year ended December 31, 2005, Cooperative X has gross receipts of \$1,500,000, all derived from the sale of corn grown by its members. Cooperative X's W-2 wages for 2005 total \$500,000. Cooperative X has no other costs. Patron A is a member of Cooperative X. Patron A is a cash basis taxpayer and files Federal income tax returns on a calendar year basis. All corn grown by

Patron A in 2005 is sold through Cooperative X and Patron A is eligible to share in patronage dividends paid by Cooperative X for that year.

(ii) Cooperative X is an agricultural cooperative described in paragraph (a) of this section. Accordingly, this section applies to Cooperative X and its patrons and all of Cooperative X's gross receipts from the sale of its patrons' corn qualify as domestic production gross receipts (as defined § 1.199-3(a)). Cooperative X's QPAI under paragraph (c) of this section is \$1,000,000. Cooperative X's section 199 deduction for its taxable year 2005 is \$30,000 ($.03 \times \$1,000,000$). Since this amount is less than 50% of Cooperative X's W-2 wages, the entire amount is deductible.

Example 2. (i) The facts are the same as in *Example 1* except that Cooperative X decides to pass its entire section 199 deduction through to its members. Cooperative X declares a patronage dividend for its 2005 taxable year of \$1,000,000, which it pays on March 15, 2006. Pursuant to paragraph (b) of this section, Cooperative X notifies members in written notices which accompany the patronage dividend notification that it is allocating to them the section 199 deduction it is entitled to claim in the taxable year 2005. On March 15, 2006, Patron A receives a \$10,000 patronage dividend from Cooperative X. In the notice that accompanies the patronage dividend, Patron A is designated a \$300 section 199 deduction. Under paragraph (d) of this section, Patron A may claim a \$300 section 199 deduction for the taxable year ending December 31, 2006, without regard to the taxable income limitation under § 1.199-1(a) and (b). Cooperative X must report the amount of Patron A's section 199 deduction on Form 1099-PATR, "Taxable Distributions Received from Cooperative," issued to the Patron A for the calendar year 2006.

(ii) Under section 199(d)(3)(A), Cooperative X is required to reduce its patronage dividend deduction of \$1,000,000 by the \$30,000 section 199 deduction passed through to members (whether or not Cooperative X pays patronage on book or tax net earnings). As a consequence, Cooperative X is entitled to a patronage dividend deduction for the taxable year ending December 31, 2005, in the amount of \$970,000 ($\$1,000,000 - \$30,000$) and to a section 199 deduction in the amount of \$30,000 ($\$1,000,000 \times .03$). Its taxable income for 2005 is \$0.

Example 3. (i) The facts are the same as in *Example 1* except that Cooperative X paid out \$500,000 to its patrons as advances on expected patronage net earnings. In 2005, Cooperative X pays its patrons a \$500,000 ($\$1,000,000 - \$500,000$ already paid) patronage dividend in cash or a combination of cash and qualified written notices of allocation. Under sections 199(d)(3)(A) and 1382, Cooperative X is allowed a patronage dividend deduction of \$470,000 ($\$500,000 - \$30,000$ section 199 deduction), whether patronage net earnings are distributed on book or tax net earnings.

(ii) The patrons will have received a gross amount of \$1,000,000 from Cooperative X (\$500,000 paid during the taxable year as advances and the additional \$500,000 paid as

qualified patronage dividends). If Cooperative X passes through its entire section 199 deduction to its members by providing the notice required by paragraph (b) of this section, the patrons will be allowed a \$30,000 section 199 deduction, resulting in a net \$970,000 taxable distribution from Cooperative X. Pursuant to paragraph (h) of this section, the \$1,000,000 received by the patrons from Cooperative X is not QPAI in the hands of the patrons.

§ 1.199-7 Expanded affiliated groups.

(a) *In general.* All members of an expanded affiliated group (EAG) are treated as a single corporation for purposes of section 199. Notwithstanding the preceding sentence, except as otherwise provided in the Internal Revenue Code and regulations (see, for example, sections 199(c)(7) and 267, § 1.199-3(b), paragraph (a)(3) of this section, and the consolidated return regulations), each member of an EAG is a separate taxpayer that computes its own taxable income or loss, qualified production activities income (QPAI) (as defined in § 1.199-1(c)), and W-2 wages (as defined in § 1.199-2(f)). If members of an EAG are also members of a consolidated group, see paragraph (d) of this section.

(1) *Definition of expanded affiliated group.* An EAG is an affiliated group as defined in section 1504(a), determined by substituting “more than 50 percent” for “at least 80 percent” each place it appears and without regard to section 1504(b)(2) and (4).

(2) *Identification of members of an expanded affiliated group—(i) In general.* A corporation must determine if it is a member of an EAG on a daily basis.

(ii) *Becoming or ceasing to be a member of an expanded affiliated group.* If a corporation becomes or ceases to be a member of an EAG, the corporation is treated as becoming or ceasing to be a member of the EAG at the end of the day on which its status as a member changes.

(3) *Attribution of activities.* In general, if a member of an EAG (the disposing member) derives gross receipts (as defined in § 1.199-3(c)) from the lease, rental, license, sale, exchange, or other disposition (as defined in § 1.199-3(h)) of qualifying production property (QPP) (as defined in § 1.199-3(i)) that was manufactured, produced, grown or extracted (MPGE) (as defined in § 1.199-3(d)), in whole or in significant part (as defined in § 1.199-3(f)), in the United States (as defined in § 1.199-3(g)), a qualified film (as defined in § 1.199-3(j)) that was produced in the United States, or electricity, natural gas, or potable water (as defined in § 1.199-3(k))

(collectively, utilities) that was produced in the United States by another member or members of the same EAG, the disposing member is treated as conducting the activities conducted by each other member of the EAG with respect to the QPP, qualified film, or utilities in determining whether its gross receipts are domestic production gross receipts (DPGR) (as defined in § 1.199-3(a)). However, attribution of activities does not apply for purposes of the construction of real property under § 1.199-3(l) or the performance of engineering and architectural services under § 1.199-3(m). A member of an EAG must engage in a construction activity under § 1.199-3(l)(2), provide engineering services under § 1.199-3(m)(2), or provide architectural services under § 1.199-3(m)(3) in order for the member's gross receipts to be derived from construction, engineering, or architectural services.

(4) *Examples.* The following examples illustrate the application of paragraph (a)(3) of this section:

Example 1. Corporations M and N are members of the same EAG. M is engaged solely in the trade or business of manufacturing furniture in the United States that it sells to unrelated persons. N is engaged solely in the trade or business of engraving companies' names on pens and pencils purchased from unrelated persons and then selling the pens and pencils to such companies. If N was not a member of an EAG, its activities would not qualify as MPGE. Accordingly, although M's sales of the furniture qualify as DPGR (assuming all the other requirements of § 1.199-3 are met), N's sales of the engraved pens and pencils do not qualify as DPGR because neither N nor another member of the EAG MPGE the pens and pencils.

Example 2. For the entire 2006 taxable year, Corporations A and B are members of the same EAG. A is engaged solely in the trade or business of manufacturing QPP in the United States. A and B each own 45 percent of partnership C and unrelated persons own the remaining 10 percent. C is engaged solely in the trade or business of manufacturing the same type of QPP in the United States as A. In 2006, B purchases and then resells the QPP manufactured in 2006 by A and C. B also resells QPP it purchases from unrelated persons. If only B's activities were considered, B would not qualify for the deduction under § 1.199-1(a) (section 199 deduction). However, because B is a member of the EAG that includes A, B is treated as conducting A's manufacturing activities in determining whether B's gross receipts are DPGR. C is not a member of the EAG and thus C's MPGE activities are not attributed to B in determining whether B's gross receipts are DPGR. Accordingly, B's gross receipts attributable to its sale of the QPP it purchases from A are DPGR (assuming all the other requirements of § 1.199-3 are met). B's gross receipts attributable to its sale of the QPP it purchases from C and from the unrelated

persons are non-DPGR because no member of the EAG MPGE the QPP. If rather than reselling the QPP, B rented the QPP it acquired from A to unrelated persons, B's gross receipts attributable to the rental of the QPP would also be DPGR (assuming all the other requirements of § 1.199-3 are met).

(5) *Anti-avoidance rule.* If a transaction between members of an EAG is engaged in or structured with a principal purpose of qualifying for, or increasing the amount of, the section 199 deduction of the EAG or the portion of the section 199 deduction allocated to one or more members of the EAG, adjustments must be made to eliminate the effect of the transaction on the computation of the section 199 deduction.

(b) *Computation of expanded affiliated group's section 199 deduction—(1) In general.* The section 199 deduction for an EAG is determined by aggregating each member's taxable income or loss, QPAI, and W-2 wages. For this purpose, a member's QPAI is determined under § 1.199-1. For purposes of this determination, a member's QPAI may be positive or negative. A member's taxable income or loss and QPAI shall be determined by reference to the member's methods of accounting.

(2) *Net operating loss carryovers.* In determining the taxable income of an EAG, if a member of an EAG has a net operating loss (NOL) carryback or carryover to the taxable year, then the amount of the NOL used to offset taxable income cannot exceed the taxable income of that member.

(c) *Allocation of an expanded affiliated group's section 199 deduction among members of the expanded affiliated group—(1) In general.* An EAG's section 199 deduction is allocated among the members of the EAG in proportion to each member's QPAI regardless of whether the EAG member has taxable income or loss or W-2 wages for the taxable year. For this purpose, if a member has negative QPAI, the QPAI of the member shall be treated as zero.

(2) *Use of section 199 deduction to create or increase a net operating loss.* Notwithstanding § 1.199-1(b), which generally prevents the section 199 deduction from creating or increasing an NOL, if a member of an EAG has some or all of the EAG's section 199 deduction allocated to it under paragraph (c)(1) of this section and the amount allocated exceeds the member's taxable income (determined prior to allocation of the section 199 deduction), the section 199 deduction will create an NOL for the member. Similarly, if a member of an EAG, prior to the

allocation of some or all of the EAG's section 199 deduction to the member, has an NOL for the taxable year, the portion of the EAG's section 199 deduction allocated to the member will increase the member's NOL.

(d) *Special rules for members of the same consolidated group—(1) Intercompany transactions.* In the case of an intercompany transaction between consolidated group members S and B (intercompany transaction, S, and B as defined in § 1.1502–13(b)(1)), S takes an intercompany transaction into account in computing the section 199 deduction at the same time and in the same proportion as S takes into account the income, gain, deduction, or loss from the intercompany transaction under § 1.1502–13.

(2) *Attribution of activities in the construction of real property and the performance of engineering and architectural services.* Notwithstanding paragraph (a)(3) of this section, a disposing member (as described in such paragraph) is treated as conducting the activities conducted by each other member of the consolidated group with respect to the construction of real property under § 1.199–3(l) and the performance of engineering and architectural services under § 1.199–3(m).

(3) *Application of the simplified deduction method and the small business simplified overall method.* For purposes of applying the simplified deduction method under § 1.199–4(e) and the small business simplified overall method under § 1.199–4(f), a consolidated group determines its QPAI by reference to its members' DPGR, non-DPGR, cost of goods sold (CGS), and all other deductions, expenses, or losses (deductions), determined on a consolidated basis.

(4) *Determining the section 199 deduction—(i) Expanded affiliated group consists of consolidated group and non-consolidated group members.* If an EAG includes corporations that are members of the same consolidated group and corporations that are not members of the same consolidated group, in computing the taxable income of the EAG, the consolidated taxable income or loss, QPAI, and W–2 wages of the consolidated group, not the separate taxable income or loss, QPAI, and W–2 wages of the members of the consolidated group, are aggregated with the taxable income or loss, QPAI, and W–2 wages of the non-consolidated group members. For example, if A, B, C, S1, and S2 are members of the same EAG, and A, S1, and S2 are members of the same consolidated group (the A consolidated group), the A consolidated

group is treated as one member of the EAG. Accordingly, the EAG is considered to have three members, the A consolidated group, B, and C. The consolidated taxable income or loss, QPAI, and W–2 wages of the A consolidated group are aggregated with the taxable income or loss, QPAI, and W–2 wages of B and C in determining the EAG's section 199 deduction.

(ii) *Expanded affiliated group consists only of members of a single consolidated group.* If all the members of an EAG are members of the same consolidated group, the consolidated group's section 199 deduction is determined by reference to the consolidated group's consolidated taxable income or loss, QPAI, and W–2 wages, not the separate taxable income or loss, QPAI, and W–2 wages of its members.

(5) *Allocation of the section 199 deduction of a consolidated group among its members.* The section 199 deduction of a consolidated group (or the section 199 deduction allocated to a consolidated group that is a member of an EAG) must be allocated to the members of the consolidated group in proportion to each consolidated group member's QPAI, regardless of whether the consolidated group member has separate taxable income or loss or W–2 wages for the taxable year. For purposes of allocating the section 199 deduction of a consolidated group among its members, any redetermination of a corporation's receipts from an intercompany transaction as DPGR or non-DPGR or as non-receipts, and any redetermination of a corporation's CGS or other deductions from an intercompany transaction as either allocable to or not allocable to DPGR under § 1.1502–13(c)(1)(i) or (c)(4) is not taken into account. Also, for purposes of this allocation, if a consolidated group member has negative QPAI, the QPAI of the member shall be treated as zero.

(e) *Examples.* The following examples illustrate the application of paragraphs (b), (c), and (d) of this section:

Example 1. Corporations X and Y are members of the same EAG but are not members of a consolidated group. X and Y each use the section 861 method described in § 1.199–4(d) for allocating and apportioning their deductions. X incurs \$5,000 in costs in manufacturing a machine, all of which are capitalized. X is entitled to a \$1,000 depreciation deduction for the machine in the current taxable year. X rents the machine to Y for \$1,500. Y uses the machine in manufacturing QPP within the United States. Y incurs \$1,400 of CGS in manufacturing the QPP. Y sells the QPP to unrelated persons for \$7,500. Pursuant to section 199(c)(7) and § 1.199–3(b), X's rental income is non-DPGR (and its related costs are not attributable to

DPGR). Accordingly, Y has \$4,600 of QPAI (Y's \$7,500 DPGR received from unrelated persons – Y's \$1,400 CGS allocable to such receipts – Y's \$1,500 of rental expense), X has \$0 of QPAI, and the EAG has \$4,600 of QPAI.

Example 2. The facts are the same as in *Example 1* except that X and Y are members of the same consolidated group. Pursuant to section 199(c)(7) and § 1.199–3(b), X's rental income ordinarily would not be DPGR (and its related costs would not be allocable to DPGR). However, because X and Y are members of the same consolidated group, § 1.1502–13(c)(1)(i) provides that the separate entity attributes of X's income or Y's expenses, or both X's income and Y's expenses, may be redetermined in order to produce the same effect as if X and Y were divisions of a single corporation. If X and Y were divisions of a single corporation, X and Y would have QPAI of \$5,100 (\$7,500 DPGR received from unrelated persons – \$1,400 CGS allocable to such receipts – \$1,000 depreciation deduction). To obtain this same result for the consolidated group, X's rental income is recharacterized as DPGR, which results in the consolidated group having \$9,000 of DPGR (the sum of Y's DPGR of \$7,500 + X's DPGR of \$1,500) and \$3,900 of costs allocable to DPGR (the sum of Y's \$1,400 CGS + Y's \$1,500 rental expense + X's \$1,000 depreciation expense). For purposes of determining how much of the consolidated group's section 199 deduction is allocated to X and Y, pursuant to paragraph (d)(5) of this section, the redetermination of X's rental income as DPGR under § 1.1502–13(c)(1)(i) is not taken into account (X's costs are considered to be allocable to DPGR because they are allocable to the consolidated group deriving DPGR). Accordingly, for this purpose, X is deemed to have (\$1,000) of QPAI (X's \$0 DPGR – X's \$1,000 depreciation deduction). Because X is deemed to have negative QPAI, also pursuant to paragraph (d)(5) of this section, X's QPAI is treated as zero. Y has \$4,600 of QPAI (Y's \$7,500 DPGR – Y's \$1,400 CGS allocable to such receipts – Y's \$1,500 of rental expense). Accordingly, X is allocated \$0/(\$0 + \$4,600) of the consolidated group's section 199 deduction and Y is allocated \$4,600/(\$0 + \$4,600) of the consolidated group's section 199 deduction.

Example 3. (i) Facts. Corporations A and B are the only two members of an EAG but are not members of a consolidated group. A and B each file Federal income tax returns on a calendar year basis. The average annual gross receipts of the EAG are less than or equal to \$25,000,000 and A and B each use the simplified deduction method under § 1.199–4(e). In 2006, A MPGE televisions within the United States. A has \$10,000,000 of DPGR from sales of televisions to unrelated persons and \$2,000,000 of DPGR from sales of televisions to B. In addition, A has gross receipts from computer consulting services with unrelated persons of \$3,000,000. A has CGS of \$6,000,000. A is able to determine from its books and records that \$4,500,000 of its CGS are attributable to televisions sold to unrelated persons and \$1,500,000 are attributable to televisions sold to B (see § 1.199–4(b)(2)). A has other deductions of

\$4,000,000. A has no other items of income, gain, or deductions. In 2006, B sells the televisions it purchased from A to unrelated persons for \$4,100,000 and pays \$100,000 for administrative services performed in 2006. B has no other items of income, gain, or deductions.

(ii) *QPAI. (A) A's QPAI.* In order to determine A's QPAI, A subtracts its \$6,000,000 CGS from its \$12,000,000 DPGR. Under the simplified deduction method, A then apportions its remaining \$4,000,000 of deductions to DPGR in proportion to the ratio of its DPGR to total gross receipts. Thus, of A's \$4,000,000 of deductions, \$3,200,000 is apportioned to DPGR ($\$4,000,000 \times \$12,000,000 / \$15,000,000$). Accordingly, A's QPAI is \$2,800,000 (\$12,000,000 DPGR – \$6,000,000 CGS – \$3,200,000 deductions apportioned to its DPGR).

(B) *B's QPAI.* Although B did not MPGE the televisions it sold, pursuant to paragraph (a)(3) of this section, B is treated as conducting A's MPGE of the televisions in determining whether B's gross receipts are DPGR. Thus, B has \$4,100,000 of DPGR. In order to determine B's QPAI, B subtracts its \$2,000,000 CGS from its \$4,100,000 DPGR. Under the simplified deduction method, B then apportions its remaining \$100,000 of deductions to DPGR in proportion to the ratio of its DPGR to total gross receipts. Thus, because B has no other gross receipts, all of B's \$100,000 of deductions is apportioned to DPGR ($\$100,000 \times \$4,100,000 / \$4,100,000$). Accordingly, B's QPAI is \$2,000,000 (\$4,100,000 DPGR – \$2,000,000 CGS – \$100,000 deductions apportioned to its DPGR).

Example 4. (i) Facts. The facts are the same as in *Example 3* except that A and B are members of the same consolidated group, B does not sell the televisions purchased from A until 2007, and B's \$100,000 paid for administrative services are paid in 2007 for services performed in 2007. In addition, in 2007, A has \$3,000,000 in gross receipts from computer consulting services with unrelated persons and \$1,000,000 in related deductions.

(ii) *Consolidated group's 2006 QPAI.* The consolidated group's DPGR and total gross receipts in 2006 are \$10,000,000 and \$13,000,000, respectively, because, pursuant to paragraph (d)(1) of this section and § 1.1502–13, the sale of the televisions from A to B is not taken into account in 2006. In order to determine the consolidated group's QPAI, the consolidated group subtracts its \$4,500,000 CGS from the televisions sold to unrelated persons from its \$10,000,000 DPGR. Under the simplified deduction method, the consolidated group apportions its remaining \$4,000,000 of deductions to DPGR in proportion to the ratio of its DPGR to total gross receipts. Thus, \$3,076,923 ($\$4,000,000 \times \$10,000,000 / \$13,000,000$) is allocated to DPGR. Accordingly, the consolidated group's QPAI for 2006 is \$2,423,077 (\$10,000,000 DPGR – \$4,500,000 CGS – \$3,076,923 deductions apportioned to its DPGR).

(iii) *Allocation of consolidated group's 2006 section 199 deduction to its members.* Because B's only activity during 2006 is the purchase of televisions from A, B has no

DPGR or deductions and thus, no QPAI, in 2006. Accordingly, the entire section 199 deduction in 2006 for the consolidated group will be allocated to A.

(iv) *Consolidated group's 2007 QPAI.* Pursuant to paragraph (d)(1) of this section and § 1.1502–13(c), A's sale of televisions to B in 2006 is taken into account in 2007 when B sells the televisions to unrelated persons. However, because A and B are members of a consolidated group, § 1.1502–13(c)(1)(i) provides that the separate entity attributes of A's income or B's expenses, or both A's income and B's expenses, may be redetermined in order to produce the same effect as if A and B were divisions of a single corporation. Accordingly, A's \$2,000,000 of gross receipts are redetermined to be non-DPGR and non-receipts and B's \$2,000,000 CGS are redetermined to be not allocable to DPGR. Notwithstanding that A's receipts are redetermined to be non-DPGR and non-receipts, A's CGS are still considered to be allocable to DPGR because they are allocable to the consolidated group deriving DPGR. Accordingly, the consolidated group's DPGR in 2007 is \$4,100,000 from B's sales of televisions, and its total receipts are \$7,100,000 (\$4,100,000 DPGR plus \$3,000,000 non-DPGR from A's computer consulting services). To determine the consolidated group's QPAI, the consolidated group subtracts A's \$1,500,000 CGS from the televisions sold to B from its \$4,100,000 DPGR. Under the simplified deduction method, the consolidated group apportions its remaining \$1,100,000 of deductions (\$1,000,000 from A and \$100,000 from B) to DPGR in proportion to the consolidated group's ratio of its DPGR to total gross receipts. Thus, \$635,211 ($\$1,100,000 \times \$4,100,000 / \$7,100,000$) is allocated to DPGR. Accordingly, the consolidated group's QPAI for 2007 is \$1,964,789 (\$4,100,000 DPGR – \$1,500,000 CGS – \$635,211 deductions apportioned to its DPGR), the same QPAI that would result if A and B were divisions of a single corporation.

(v) *Allocation of consolidated group's 2007 section 199 deduction to its members. (A) A's QPAI.* For purposes of allocating the consolidated group's section 199 deduction to its members, pursuant to paragraph (d)(5) of this section, the redetermination of A's \$2,000,000 in receipts as non-DPGR and non-receipts is disregarded. Accordingly, for this purpose, A's DPGR is \$2,000,000 (receipts from the sale of televisions to B taken into account in 2007) and its total receipts are \$5,000,000 (\$2,000,000 DPGR + \$3,000,000 non-DPGR from its computer consulting services). In determining A's QPAI, A subtracts its \$1,500,000 CGS from the televisions sold to B from its \$2,000,000 DPGR. Under the simplified deduction method, A apportions its remaining \$1,000,000 of deductions in proportion to the ratio of its DPGR to total receipts. Thus, \$400,000 ($\$1,000,000 \times \$2,000,000 / \$5,000,000$) is allocated to DPGR. Thus, A's QPAI is \$100,000 (\$2,000,000 DPGR – \$1,500,000 CGS – \$400,000 deductions allocated to its DPGR).

(B) *B's QPAI.* B's DPGR and its total gross receipts are each \$4,100,000. For purposes of allocating the consolidated group's section

199 deduction to its members, pursuant to paragraph (d)(5) of this section, the redetermination of B's \$2,000,000 CGS as not allocable to DPGR is disregarded. In determining B's QPAI, B subtracts its \$2,000,000 CGS from the televisions purchased from A from its \$4,100,000 DPGR. Under the simplified deduction method, B apportions its remaining \$100,000 deductions in proportion to the ratio of its DPGR to total receipts. Thus, all \$100,000 ($\$100,000 \times \$4,100,000 / \$4,100,000$) is allocated to DPGR. Thus, B's QPAI is \$2,000,000 (\$4,100,000 DPGR – \$2,000,000 CGS – \$100,000 deductions allocated to its DPGR).

(C) *Allocation to A and B.* Pursuant to paragraph (d)(5) of this section, the consolidated group's section 199 deduction for 2007 is allocated \$100,000/(\$100,000 + \$2,000,000) to A and \$2,000,000/(\$100,000 + \$2,000,000) to B.

Example 5. Corporations S and B are members of the same consolidated group. In 2006, S manufactures office furniture for B to use in B's corporate headquarters and S sells the office furniture to B. S and B have no other activities in the taxable year. If S and B were not members of a consolidated group, S's gross receipts from the sale of the office furniture to B would be DPGR (assuming all the other requirements of § 1.199–3 are met) and S's CGS or other deductions, expenses, or losses from the sale to B would be allocable to S's DPGR. However, because S and B are members of a consolidated group, the separate entity attributes of S's income or B's expenses, or both S's income and B's expenses, may be redetermined under § 1.1502–13(c)(1)(i) or (c)(4) in order to produce the same effect as if S and B were divisions of a single corporation. If S and B were divisions of a single corporation, there would be no DPGR with respect to the office furniture because there would be no lease, rental, license, sale, exchange, or other disposition of the furniture by the single corporation (and no CGS or other deductions allocable to DPGR). Thus, in order to produce the same effect as if S and B were divisions of a single corporation, S's gross receipts are redetermined as non-DPGR. Accordingly, the consolidated group has no DPGR (and no CGS or other deductions allocated or apportioned to DPGR) and receives no section 199 deduction in 2006.

Example 6. Corporations X, Y, and Z are members of the same EAG but are not members of a consolidated group. X, Y, and Z each files Federal income tax returns on a calendar year basis. Assume that the EAG has W–2 wages in excess of the section 199(b) wage limitation. Prior to 2006, X had no taxable income or loss. In 2006, X has \$0 of taxable income and \$2,000 of QPAI, Y has \$4,000 of taxable income and \$3,000 of QPAI, and Z has \$4,000 of taxable income and \$5,000 of QPAI. Accordingly, the EAG has taxable income of \$8,000, the sum of X's taxable income of \$0, Y's taxable income of \$4,000, and Z's taxable income of \$4,000. The EAG has QPAI of \$10,000, the sum of X's QPAI of \$2,000, Y's QPAI of \$3,000, and Z's QPAI of \$5,000. Because X's, Y's, and Z's taxable years all began in 2006, the transition percentage under section 199(a)(2) is 3

percent. Thus, the EAG's section 199 deduction for 2006 is \$240 (3% of the lesser of the EAG's taxable income of \$8,000 or the EAG's QPAI of \$10,000). Pursuant to paragraph (c)(1) of this section, the \$240 section 199 deduction is allocated to X, Y, and Z in proportion to their respective amounts of QPAI, that is \$48 to X ($\$240 \times \$2,000/\$10,000$), \$72 to Y ($\$240 \times \$3,000/\$10,000$), and \$120 to Z ($\$240 \times \$5,000/\$10,000$). Although X's taxable income for 2006 determined prior to allocation of a portion of the EAG's section 199 deduction to it was \$0, pursuant to paragraph (c)(2) of this section X will have an NOL for 2006 equal to \$48. Because X's NOL for 2006 cannot be carried back to a previous taxable year, X's NOL carryover to 2007 will be \$48.

(f) *Allocation of income and loss by a corporation that is a member of the expanded affiliated group for only a portion of the year*—(1) *In general.* A corporation that becomes or ceases to be a member of an EAG during its taxable year must allocate its taxable income or loss, QPAI, and W–2 wages between the portion of the taxable year that it is a member of the EAG and the portion of the taxable year that it is not a member of the EAG. In general, this allocation of items must be made by using the pro rata allocation method described in paragraph (f)(1)(i) of this section. However, a corporation may elect to use the section 199 closing of the books method described in paragraph (f)(1)(ii) of this section. Neither the pro rata allocation method nor the section 199 closing of the books method is a method of accounting.

(i) *Pro rata allocation method.* Under the pro rata allocation method, an equal portion of a corporation's taxable income or loss, QPAI, and W–2 wages for the taxable year is assigned to each day of the corporation's taxable year. Those items assigned to those days that the corporation was a member of the EAG are then aggregated.

(ii) *Section 199 closing of the books method.* Under the section 199 closing of the books method, a corporation's taxable income or loss, QPAI, and W–2 wages for the period during which the corporation was a member of an EAG are computed by treating the corporation's taxable year as two separate taxable years, the first of which ends at the close of the day on which the corporation's status as a member of the EAG changes and the second of which begins at the beginning of the day after the corporation's status as a member of the EAG changes.

(iii) *Making the section 199 closing of the books election.* A corporation makes the section 199 closing of the books election by making the following statement: "The section 199 closing of the books election is hereby made with

respect to [insert name of corporation and its employer identification number] with respect to the following periods [insert dates of the two periods between which items are allocated pursuant to the closing of the books method]." The statement must be filed with the corporation's timely filed (including extensions) Federal income tax return for the taxable year that includes the periods that are subject to the election. Once made, a section 199 closing of the books election is irrevocable.

(2) *Coordination with rules relating to the allocation of income under § 1.1502–76(b).* If § 1.1502–76(b) (relating to items included in a consolidated return) applies to a corporation that is a member of an EAG, any allocation of items required under this paragraph (f) is made only after the allocation of the corporation's items pursuant to § 1.1502–76(b).

(g) *Total section 199 deduction for a corporation that is a member of an expanded affiliated group for some or all of its taxable year*—(1) *Member of the same expanded affiliated group for the entire taxable year.* If a corporation is a member of the same EAG for its entire taxable year, the corporation's section 199 deduction for the taxable year is the amount of the section 199 deduction allocated to the corporation by the EAG under paragraph (c)(1) of this section.

(2) *Member of the expanded affiliated group for a portion of the taxable year.* If a corporation is a member of an EAG only for a portion of its taxable year and is either not a member of any EAG or is a member of another EAG, or both, for another portion of the taxable year, the corporation's section 199 deduction for the taxable year is the sum of its section 199 deductions for each portion of the taxable year.

(3) *Example.* The following example illustrates the application of paragraphs (f) and (g) of this section:

Example. Corporations X and Y, calendar year corporations, are members of the same EAG for the entire 2005 taxable year. Corporation Z, also a calendar year corporation, is a member of the EAG of which X and Y are members for the first half of 2005 and not a member of any EAG for the second half of 2005. During the 2005 taxable year, Z does not join in the filing of a consolidated return. Z makes a section 199 closing of the books election. As a result, Z has \$80 of taxable income and \$100 of QPAI that is allocated to the first half of the taxable year and a \$150 taxable loss and (\$200) of QPAI that is allocated to the second half of the taxable year. Taking into account Z's taxable income, QPAI, and W–2 wages allocated to the first half of the taxable year pursuant to the section 199 closing of the books election, the EAG has positive taxable

income and QPAI for the taxable year and W–2 wages in excess of the section 199(b) wage limitation. Because the EAG has both positive taxable income and QPAI and sufficient W–2 wages, and because Z has positive QPAI for the first half of the year, a portion of the EAG's section 199 deduction is allocated to Z. Because Z has negative QPAI for the second half of the year, Z is allowed no section 199 deduction for the second half of the taxable year. Thus, despite the fact that Z has a \$70 taxable loss and (\$100) of QPAI for the entire 2005 taxable year, Z is entitled to a section 199 deduction for the taxable year equal to the section 199 deduction allocated to Z as a member of the EAG.

(h) *Computation of section 199 deduction for members of an expanded affiliated group with different taxable years*—(1) *In general.* If members of an EAG have different taxable years, in determining the section 199 deduction of a member (the computing member), the computing member is required to take into account the taxable income or loss, QPAI, and W–2 wages of each group member that are both—

(i) Attributable to the period that the member of the EAG and the computing member are both members of the EAG; and

(ii) Taken into account in a taxable year that begins after the effective date of section 199 and ends with or within the taxable year of the computing member with respect to which the section 199 deduction is computed.

(2) *Example.* The following example illustrates the application of this paragraph (h):

Example. (i) Corporations X, Y, and Z are members of the same EAG. Neither X, Y, nor Z is a member of a consolidated group. X and Y are calendar year taxpayers and Z is a June 30 fiscal year taxpayer. Each corporation has taxable income that exceeds its QPAI and has sufficient W–2 wages to avoid the limitation under section 199(b). For its taxable year ending June 30, 2005, Z's QPAI is \$4,000. For the taxable year ending December 31, 2005, X's QPAI is \$8,000 and Y's QPAI is (\$6,000). For its taxable year ending June 30, 2006, Z's QPAI is \$2,000.

(ii) Because Z's taxable year ending June 30, 2005, began on July 1, 2004, prior to the effective date of section 199, Z is not allowed a section 199 deduction for its taxable year ending June 30, 2005.

(iii) In computing X's and Y's respective section 199 deductions for their taxable years ending December 31, 2005, Z's items from its taxable year ending June 30, 2005, are not taken into account because Z's taxable year began before the effective date of section 199. Instead, only X's and Y's taxable income, QPAI, and W–2 wages from their respective taxable years ending December 31, 2005, are aggregated. The EAG's QPAI for this purpose is \$2,000 (X's QPAI of \$8,000 + Y's QPAI of (\$6,000)). Because the taxable years of the computing members, X and Y, began in 2005, the transition percentage under section

199(a)(2) is 3 percent. Accordingly, the EAG's section 199 deduction is \$60 ($\$2,000 \times .03$). The \$60 deduction is allocated to each of X and Y in proportion to their respective QPAI as a percentage of the QPAI of each member of the EAG that was taken into account in computing the EAG's section 199 deduction. Pursuant to paragraph (c)(1) of this section, in allocating the section 199 deduction between X and Y, because Y's QPAI is negative, Y's QPAI is treated as being \$0. Accordingly, X's section 199 deduction for its taxable year ending December 31, 2005, is \$60 ($\$60 \times \$8,000/(\$8,000 + \$0)$). Y's section 199 deduction for its taxable year ending December 31, 2005, is \$0 ($\$60 \times \$0/(\$8,000 + \$0)$).

(iv) In computing Z's section 199 deduction for its taxable year ending June 30, 2006, X's and Y's items from their respective taxable years ending December 31, 2005, are taken into account. Therefore, X's and Y's taxable income or loss, QPAI, and W-2 wages from their taxable years ending December 31, 2005, are aggregated with Z's taxable income or loss, QPAI, and W-2 wages from its taxable year ending June 30, 2006. The EAG's QPAI is \$4,000 (X's QPAI of \$8,000 + Y's QPAI of (\$6,000) + Z's QPAI of \$2,000). Because the taxable year of the computing member, Z, began in 2005, the transition percentage under section 199(a)(2) is 3 percent. Accordingly, the EAG's section 199 deduction is \$120 ($\$4,000 \times .03$). A portion of the \$120 deduction is allocated to Z in proportion to its QPAI as a percentage of the QPAI of each member of the EAG that was taken into account in computing the EAG's section 199 deduction. Pursuant to paragraph (c)(1) of this section, in allocating a portion of the \$120 deduction to Z, because Y's QPAI is negative, Y's QPAI is treated as being \$0. Z's section 199 deduction for its taxable year ending June 30, 2006, is \$24 ($\$120 \times \$2,000/(\$8,000 + \$0 + \$2,000)$).

§ 1.199-8 Other rules.

(a) *Individuals.* In the case of an individual, the deduction under § 1.199-1(a) (section 199 deduction) is equal to the applicable percentage of the lesser of the taxpayer's qualified production activities income (QPAI) (as defined in § 1.199-1(c)) for the taxable year, or adjusted gross income (AGI) for the taxable year determined after applying sections 86, 135, 137, 219, 221, 222, and 469, and without regard to section 199.

(b) *Trade or business requirement.* Section 1.199-3 is applied by taking into account only items that are attributable to the actual conduct of a trade or business.

(c) *Coordination with alternative minimum tax.* For purposes of determining alternative minimum taxable income (AMTI) under section 55, a taxpayer that is not a corporation may deduct an amount equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years

beginning in 2007, 2008, or 2009) of the lesser of the taxpayer's QPAI for the taxable year, or the taxpayer's taxable income for the taxable year, determined without regard to the section 199 deduction (or in the case of an individual, AGI). For purposes of determining AMTI in the case of a corporation (including a corporation subject to tax under section 511(a)), a taxpayer may deduct an amount equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of the taxpayer's QPAI for the taxable year, or the taxpayer's AMTI for the taxable year, determined without regard to the section 199 deduction. For purposes of computing AMTI, QPAI is determined without regard to any adjustments under sections 56 through 59. In the case of an individual or a trust, AGI and taxable income are also determined without regard to any adjustments under sections 56 through 59. The amount of the deduction allowable under this paragraph (c) for any taxable year cannot exceed 50 percent of the W-2 wages of the employer for the taxable year (as determined under § 1.199-2).

(d) *Nonrecognition transactions—(1) In general.* Except as provided for an expanded affiliated group (EAG) (as defined in § 1.199-7) and EAG partnerships (as defined in § 1.199-3(h)(8)), if property is transferred by the taxpayer to an entity in a transaction to which section 351 or 721 applies, then whether the gross receipts derived by the entity are domestic production gross receipts (DPGR) (as defined in § 1.199-3) shall be determined based on the activities performed by the entity without regard to the activities performed by the taxpayer prior to the contribution of the property to the entity. Except as provided in § 1.199-3(h)(7) and (8) (exceptions for certain oil and gas partnerships and EAG partnerships), if property is transferred by a partnership to a partner in a transaction to which section 731 applies, then whether gross receipts derived by the partner are DPGR shall be determined based on the activities performed by the partner without regard to the activities performed by the partnership before the distribution of the property to the partner.

(2) *Section 1031 exchanges.* If a taxpayer exchanges property for replacement property in a transaction to which section 1031 applies, then whether the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the replacement property are DPGR shall be determined

based solely on the activities performed by the taxpayer with respect to the replacement property.

(3) *Section 381 transactions.* If a corporation (the acquiring corporation) acquires the assets of another corporation (the target corporation) in a transaction to which section 381(a) applies, the acquiring corporation shall be treated as performing those activities of the target corporation with respect to the acquired assets of the target corporation. Therefore, to the extent that the acquired assets of the target corporation would have given rise to DPGR if leased, rented, licensed, sold, exchanged, or otherwise disposed of by the target corporation, then the assets will give rise to DPGR if leased, rented, licensed, sold, exchanged, or otherwise disposed of by the acquiring corporation.

(e) *Taxpayers with a 52-53 week taxable year.* For purposes of applying § 1.441-2(c)(1) in the case of a taxpayer using a 52-53 week taxable year, any reference in section 199(a)(2) (the phase-in rule), §§ 1.199-1 through 1.199-7, and this section to a taxable year beginning after a particular calendar year means a taxable year beginning after December 31st of that year. Similarly, any reference to a taxable year beginning in a particular calendar year means a taxable year beginning after December 31st of the preceding calendar year. For example, a 52-53 week taxable year that begins on December 26, 2004, is deemed to begin on January 1, 2005, and the transition percentage for that taxable year is 3 percent.

(f) *Section 481(a) adjustments.* For purposes of determining QPAI, a section 481(a) adjustment, whether positive or negative, taken into account during the taxable year that is solely attributable to either gross receipts, cost of goods sold (CGS), or deductions, expenses, or losses (deductions) must be allocated or apportioned in the same manner as the gross receipts, CGS, or deductions to which it is attributable. See §§ 1.199-1(d), 1.199-4(b), and 1.199-4(c) for rules related to the allocation and apportionment of gross receipts, CGS, and deductions. For example, if a taxpayer changes its method of accounting for inventories from the last-in, first-out (LIFO) method to the first-in, first-out (FIFO) method, the taxpayer is required to allocate the resulting section 481(a) adjustment, whether positive or negative, in the same manner as the CGS computed for the taxable year with respect to those inventories. If a section 481(a) adjustment is not solely attributable to either gross receipts, CGS, or deductions (for example, the

taxpayer changes its overall method of accounting from an accrual method to the cash method and the section 481(a) adjustment cannot be specifically identified with either gross receipts, CGS, or deductions), the section 481(a) adjustment, whether positive or negative, must be attributed to, or among, gross receipts, CGS, or deductions using any reasonable method that is satisfactory to the Secretary and allocated or apportioned in the same manner as the gross receipts, CGS, or deductions to which it is attributable. Factors taken into consideration in determining whether the method is reasonable include whether the taxpayer uses the most accurate information available; the relationship between the section 481(a) adjustment and the apportionment base chosen; the accuracy of the method chosen as compared with other possible methods; and the time, burden, and cost of using various methods. If a section

481(a) adjustment is spread over more than one taxable year, a taxpayer must attribute the section 481(a) adjustment among gross receipts, CGS, or deductions, as applicable, in the same manner for each taxable year within the spread period. For example, if a taxpayer, using a reasonable method, determines that a section 481(a) adjustment that is required to be spread over four taxable years should be attributed entirely to gross receipts, then the taxpayer must attribute the section 481(a) adjustment entirely to gross receipts in each of the four taxable years of the spread period.

(g) *Effective date.* The final regulations will be applicable to taxable years beginning after December 31, 2004. In the case of pass-thru entities described in § 1.199-5, the final regulations will be applicable to taxable years of pass-thru entities beginning after December 31, 2004. Until the date final regulations are published in the

Federal Register, taxpayers may rely on the interim guidance on section 199 as set forth in Notice 2005-14 (2005-7 I.R.B. 498) (see § 601.601(d)(2) of this chapter), as well as the proposed regulations under §§ 1.199-1 through 1.199-7, and this section. For this purpose, if the proposed regulations and Notice 2005-14 include different rules for the same particular issue, then the taxpayer may rely on either the rule set forth in the proposed regulations or the rule set forth in Notice 2005-14. However, if the proposed regulations include a rule that was not included in Notice 2005-14, taxpayers are not permitted to rely on the absence of a rule to apply a rule contrary to the proposed regulations.

Kevin M. Brown,

Acting Deputy Commissioner for Services and Enforcement.

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