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Income Attributable to Domestic Production Activities; Final Rule

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

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Income Attributable to Domestic Production Activities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning the deduction for income attributable to domestic production activities under section 199 of the Internal Revenue Code. Section 199 was enacted as part of the American Jobs Creation Act of 2004 (Act). The regulations will affect taxpayers engaged in certain domestic production activities.

DATES: *Effective Date:* These regulations are effective June 1, 2006.

Date of Applicability: For date of applicability see §§ 1.199–8(i) and 1.199–9(k).

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, Jeffery Mitchell, (202) 622–4970; concerning § 1.199–7, Ken Cohen, (202) 622–7790; concerning § 1.199–9, Martin Schaffer, (202) 622–3080 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1966. Responses to this collection of information are mandatory so that patrons of agricultural and horticultural cooperatives may claim the section 199 deduction.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

The estimated annual burden per respondent varies from 15 minutes to 10 hours, depending on individual circumstances, with an estimated average of 3 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP Washington, DC 20224, and 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.

Books or records relating to this 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 amends 26 CFR part 1 to provide rules 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 American Jobs Creation Act of 2004 (Pub. L. 108–357, 118 Stat. 1418) (Act), and amended by section 403(a) of the Gulf Opportunity Zone Act of 2005 (Pub. L. 109–135, 119 Stat. 25) (GOZA) and section 514 of the Tax Increase Prevention and Reconciliation Act of 2005 (Public Law 109–222, 120 Stat. 345) (TIPRA). On January 19, 2005, the IRS and Treasury Department issued Notice 2005–14 (2005–1 C.B. 498) providing interim guidance on section 199. On November 4, 2005, the IRS and Treasury Department published in the **Federal Register** proposed regulations under section 199 (70 FR 67220) (proposed regulations). On January 11, 2006, the IRS and Treasury Department held a public hearing on the proposed regulations. Written and electronic comments responding to the proposed regulations were received. This preamble describes the most 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. After consideration of all of the comments, the proposed regulations are adopted as amended by this Treasury decision. Contemporaneous with the publication of these final regulations, temporary and proposed regulations have been published involving the treatment under section 199 of computer software provided to customers over the Internet.

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, with respect to any person for any taxable year of such person, the sum of the amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. The term *W–2 wages* does not include any amount that is not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for the return. 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.

Section 514(a) of TIPRA amended section 199(b)(2) by excluding from the term *W–2 wages* any amount that is not properly allocable to domestic production gross receipts (DPGR) for purposes of section 199(c)(1). The IRS and Treasury Department plan on issuing regulations on the amendments made to section 199(b)(2) by section 514 of TIPRA.

Qualified Production Activities Income

Section 199(c)(1) defines QPAI for any taxable year as an amount equal to the excess (if any) of (A) the taxpayer's DPGR for such taxable year, over (B) the sum of (i) the cost of goods sold (CGS) that are allocable to such receipts; and (ii) other expenses, losses, or deductions (other than the deduction under section 199) that are properly allocable to such receipts.

Section 199(c)(2) provides that the Secretary shall prescribe rules for the proper allocation of items described in section 199(c)(1) for purposes of determining QPAI. Such rules shall provide for the proper allocation of

items whether or not such items are directly allocable to DPGR.

Section 199(c)(3) provides special rules for determining costs in computing QPAI. Under these special rules, any item or service brought into the United States is treated as acquired by purchase, and its cost is 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 brought 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) in the case of a taxpayer engaged in the active conduct of a construction trade or business, construction of real property performed in the United States by the taxpayer in the ordinary course of such trade or business; or (iii) in the case of a taxpayer engaged in the active conduct of an engineering or architectural services trade or business, engineering or architectural services performed in the United States by the taxpayer in the ordinary course of such trade or business with respect to the construction of real property 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; (ii) the transmission or distribution of utilities; or (iii) the lease, rental, license, sale, exchange, or other disposition of land.

Section 199(c)(4)(C) provides that gross receipts derived from the manufacture or production of any property described in section 199(c)(4)(A)(i)(I) shall be treated as meeting the requirements of section 199(c)(4)(A)(i) if (i) such property is manufactured or produced by the taxpayer pursuant to a contract with the Federal Government, and (ii) the Federal Acquisition Regulation requires that title or risk of loss with respect to such property be transferred to the Federal Government before the manufacture or production of such property is complete.

Section 199(c)(4)(D) provides that for purposes of section 199(c)(4), if all of the interests in the capital and profits of a partnership are owned by members of a single expanded affiliated group (EAG) at all times during the taxable year of such partnership, the partnership and all members of such group shall be treated as a single taxpayer during such period.

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. However, DPGR may include such property if the property is held for sublease, sublicense, or rent, or is subleased, sublicensed, or rented, by the related person to an unrelated person for the ultimate use of the unrelated person. See footnote 29 of H.R. Conf. Rep. No. 755, 108th Cong. 2d Sess. 260 (2004) (Conference Report). 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)(A) provides that, in the case of a partnership or S corporation, (i) section 199 shall be applied at the partner or shareholder level, (ii) each partner or shareholder shall take into account such person's allocable share of each item described in section 199(c)(1)(A) or (B) (determined without regard to whether the items described in section 199(c)(1)(A) exceed the items described in section 199(c)(1)(B)), and (iii) each partner or shareholder shall be treated for purposes of section 199(b) as having W–2 wages for the taxable year in an amount equal to the lesser of (I) such person's allocable share of the W–2 wages of the partnership or S corporation for the taxable year (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 so much of such person's QPAI as is attributable to items allocated under section 199(d)(1)(A)(ii) for the taxable year.

Section 514(b) of TIPRA amended section 199(d)(1)(A)(iii) to provide instead that each partner or shareholder shall be treated for purposes of section 199(b) as having W–2 wages for the taxable year equal to such person's allocable share of the W–2 wages of the partnership or S corporation for the taxable year (as determined under regulations prescribed by the Secretary). The IRS and Treasury Department plan on issuing regulations on the amendments made to section 199(d)(1)(A)(iii) by section 514 of TIPRA.

Section 199(d)(1)(B) provides that, in the case of a trust or estate, (i) the items referred to in section 199(d)(1)(A)(ii) (as determined therein) and the W–2 wages of the trust or estate for the taxable year, shall be apportioned between the beneficiaries and the fiduciary (and among the beneficiaries) under regulations prescribed by the Secretary, and (ii) for purposes of section 199(d)(2), AGI of the trust or estate shall be determined as provided in section 67(e) with the adjustments described in such paragraph.

Section 199(d)(1)(C) provides that the Secretary may prescribe rules requiring or restricting the allocation of items and wages under section 199(d)(1) and may prescribe such reporting requirements as the Secretary determines appropriate.

Individuals

In the case of an individual, section 199(d)(2) provides that the deduction is equal to the applicable percent 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)(A) provides that any person who receives a qualified payment from a specified agricultural or horticultural cooperative shall be allowed for the taxable year in which such payment is received a deduction under section 199(a) equal to the portion of the deduction allowed under section 199(a) to such cooperative which is (i) allowed with respect to the portion of the QPAI to which such payment is attributable, and (ii) identified by such cooperative in a written notice mailed to such person during the payment period described in section 1382(d).

Section 199(d)(3)(B) provides that the taxable income of a specified agricultural or horticultural cooperative shall not be reduced under section 1382 by reason of that portion of any qualified payment as does not exceed the deduction allowable under section 199(d)(3)(A) with respect to such payment.

Section 199(d)(3)(C) provides that, for purposes of section 199, the taxable income of a specified agricultural or horticultural cooperative shall be computed without regard to any deduction allowable under section 1382(b) or (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

Section 199(d)(3)(D) provides that, for purposes of section 199, a specified agricultural or horticultural cooperative described in section 199(d)(3)(F)(ii) shall be treated as having MPGE in whole or in significant part any QPP marketed by the organization that its patrons have so MPGE.

Section 199(d)(3)(E) provides that, for purposes of section 199(d)(3), the term *qualified payment* means, with respect to any person, any amount that (i) is described in section 1385(a)(1) or (3), (ii) is received by such person from a specified agricultural or horticultural cooperative, and (iii) is attributable to QPAI with respect to which a deduction is allowed to such cooperative under section 199(a).

Section 199(d)(3)(F) provides that, for purposes of section 199(d)(3), the term *specified agricultural or horticultural cooperative* means an organization to which part I of subchapter T applies that is engaged (i) in the MPGE in whole or in significant part of any agricultural or horticultural product, or (ii) in the marketing of agricultural or horticultural products.

Expanded Affiliated Group

Section 199(d)(4)(A) provides that all members of an EAG are treated as a single corporation for purposes of section 199. 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 that, for purposes of determining the alternative minimum taxable income under section 55, (A) QPAI shall be determined without regard to any adjustments under sections 56 through 59, and (B) in the case of a corporation, section 199(a)(1)(B) shall be applied by substituting ''alternative minimum taxable income'' for ''taxable income.''

Unrelated Business Taxable Income

Section 199(d)(7) provides that, for purposes of determining the tax imposed by section 511, section 199(a)(1)(B) shall be applied by substituting ''unrelated business taxable income'' for ''taxable income.''

Authority To Prescribe Regulations

Section 199(d)(8) authorizes the Secretary to prescribe such regulations as are necessary to carry out the purposes of section 199, including regulations that prevent more than one taxpayer from being allowed a deduction under section 199 with respect to any activity described in section 199(c)(4)(A)(i).

Effective Date

The effective date of section 199 in section 102(e) of the Act was amended by section 403(a)(19) of the GOZA. Section 102(e)(1) of the Act provides that the amendments made by section 102 of the Act shall apply to taxable years beginning after December 31, 2004. Section 102(e)(2) of the Act provides that, in determining the deduction under section 199, items arising from a taxable year of a partnership, S corporation, estate, or trust beginning before January 1, 2005, shall not be taken into account for purposes of section 199(d)(1). Section 514(c) of TIPRA provides that the amendments made by section 514 apply to taxable years beginning after May 17, 2006, the enactment date of TIPRA.

Summary of Comments and Explanation of Provisions

Taxable Income

The section 199 deduction is not taken into account in computing any net operating loss (NOL) or the amount of any NOL carryback or carryover. Thus, except as otherwise provided in § 1.199–7(c)(2) of the final regulations (concerning the portion of a section 199 deduction allocated to a member of an EAG), the section 199 deduction cannot create, or increase, the amount of an NOL deduction.

For purposes of section 199(a)(1)(B), taxable income is determined without regard to section 199 and without regard to any amount excluded from gross income pursuant to section 114 of the Code or pursuant to section 101(d) of the Act. Thus, any extraterritorial income exclusion or amount excluded from gross income pursuant to section 101(d) of the Act does not reduce taxable income for purposes of section 199(a)(1)(B), even though such excluded amounts are taken into account in determining QPAI.

Wage Limitation

The final regulations give the Secretary authority to provide for methods of calculating W–2 wages. Contemporaneous with the publication of these final regulations, Rev. Proc. 2006–22 (2006–22 I.R.B.) has been published and provides for taxable years beginning on or before May 17, 2006, the enactment date of TIPRA, the same three methods of calculating W–2 wages as were contained in Notice 2005–14 and the proposed regulations. It is expected that any new revenue procedure applicable for taxable years beginning after May 17, 2006, will contain methods for calculating W–2 wages similar to the three methods in Rev. Proc. 2006–22. The methods are included in a revenue procedure rather than the final regulations so that if changes are made to Form W–2, ''Wage and Tax Statement,'' a new revenue procedure can be issued reflecting those changes more promptly than an amendment to the final regulations.

Taxpayers have inquired whether remuneration paid to employees for domestic services in a private home of the employer, which remuneration may be reported on Schedule H (Form 1040), ''Household Employment Taxes,'' or, under certain conditions, on Form 941, ''Employer's Quarterly Federal Tax

Return,'' are included in W–2 wages. Such remuneration is generally excepted from wages for income tax withholding purposes by section 3401(a)(3) of the Code. Section 199(b)(5) provides that section 199 shall be applied by only taking into account items that are attributable to the actual conduct of a trade or business. Payments to employees of a taxpayer for domestic services in a private home of the taxpayer are not attributable to the actual conduct of a trade or business of the taxpayer. Accordingly, such payments are not included in W–2 wages for purposes of section 199(b)(2).

The IRS and Treasury Department have also received numerous inquiries concerning whether amounts paid to workers who receive Forms W–2 from professional employer organizations (PEOs), or employee leasing firms, may be included in the W–2 wages of the clients of the PEOs or employee leasing firms. In order for wages reported on a Form W–2 to be included in the determination of W–2 wages of a taxpayer, the Form W–2 must be for employment by the taxpayer. Employees of the taxpayer are defined in § 1.199–2(a)(1) of the final regulations as including only common law employees of the taxpayer and officers of a corporate taxpayer. Thus, the issue of whether the payments to the employees are included in W–2 wages depends on an application of the common law rules in determining whether the PEO, the employee leasing firm, or the client is the employer of the worker. As noted in § 1.199–2(a)(2) of the final regulations, taxpayers may take into account wages reported on Forms W–2 issued by other parties provided that the wages reported on the Forms W–2 were paid to employees of the taxpayer for employment by the taxpayer. However, with respect to individuals who taxpayers assert are their common law employees for purposes of section 199, taxpayers are reminded of their duty to file returns and apply the tax law on a consistent basis.

Commentators also raised the issue of whether an individual filing as part of a joint return may include wages paid by his or her spouse to employees of his or her spouse in determining the amount of the individual's W–2 wages for purposes of the section 199 deduction. The example given was an individual who had a trade or business reported on Schedule C (Form 1040) with QPAI but no W–2 wages, and the individual's spouse had W–2 wages in a second trade or business reported on Schedule C (Form 1040) but no QPAI. Section 1.199–2(a)(4) of the final regulations provides that married individuals who file a joint return are treated as one taxpayer for purposes of determining W–2 wages. Therefore, an individual filing as part of a joint return may take into account wages paid to employees of his or her spouse in determining the amount of W–2 wages provided the wages are paid in a trade or business of the spouse and the other requirements of the final regulations are met. In contrast, if the taxpayer and the taxpayer's spouse file separate returns, the taxpayer may not use the spouse's wages in determining the taxpayer's W–2 wages for purposes of the taxpayer's section 199 deduction because they are not considered one taxpayer.

Domestic Production Gross Receipts

Commentators suggested that rules similar to the de minimis rules provided in §§ 1.199–1(d)(2) (gross receipts allocation), 1.199–3(h)(4) (embedded services), 1.199–3(l)(1)(ii) (construction services), and 1.199–3(m)(4) (engineering or architectural services) of the proposed regulations, under which taxpayers may treat de minimis amounts of non-DPGR as DPGR, should be available in the opposite situation. Thus, for example, if a taxpayer's gross receipts that are allocable to DPGR are less than 5 percent of its overall gross receipts for the taxable year, the commentators suggested that the final regulations allow the taxpayer to treat those gross receipts as non-DPGR. The IRS and Treasury Department agree with this suggestion, and the final regulations provide such rules for the provisions discussed above as well as under § 1.199–3(l)(4)(iv)(B) for utilities.

Several comments were received regarding the burden imposed by the requirement in the proposed regulations that QPAI be computed on an item-by-item basis (rather than on a division-by-division, or product line-by-product line basis). Several commentators urged the IRS and Treasury Department to limit the item-by-item standard to the requirements of § 1.199–3 in determining DPGR (that is, the lease, rental, license, sale, exchange, or other disposition requirement, the in-whole-or-in-significant-part requirement, etc.). Specifically, the commentators argued that the item-by-item standard is inconsistent with the cost allocation methods provided in § 1.199–4. The IRS and Treasury Department agree with this comment. Therefore, the final regulations clarify that the item-by-item standard applies solely for purposes of the requirements of § 1.199–3 noted above in determining whether the gross receipts derived from an item are DPGR. The final regulations also provide that a taxpayer must determine, using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, whether gross receipts qualify as DPGR on an item-by-item basis.

The proposed regulations provide that an item is defined as the property offered for lease, rental, license, sale, exchange or other disposition to customers that meets the requirements of section 199. The proposed regulations also provide several examples to illustrate this rule. Some commentators observed that the examples involving a manufacturer of toy cars that sold the cars to toy stores appear to imply that, in the case of property offered for lease, rental, license, sale, exchange or other disposition by a wholesaler, the item is defined with reference to the property offered for sale to retail consumers by the wholesaler's customer. The rules for defining an item, and the related examples, have been clarified in the final regulations to provide that an item is defined with reference to the property offered by the taxpayer for lease, rental, license, sale, exchange or other disposition to the taxpayer's customers in the normal course of the taxpayer's business, whether the taxpayer is a wholesaler or a retailer.

The proposed regulations provide that, if the property offered for lease, rental, license, sale, exchange or other disposition by the taxpayer does not meet the requirements of section 199, then the taxpayer must treat as the item any portion of that property that does meet those requirements. In a case where two or more portions of the property meet the requirements of section 199, commentators inquired whether the two or more portions are properly treated as a single item or as two or more items. The final regulations generally are consistent with the rules of the proposed regulations, and provide that if the gross receipts derived from the lease, rental, license, sale, exchange or other disposition of the property offered in the normal course of a taxpayer's business do not qualify as DPGR, then any component of such property is treated as the item, provided the gross receipts attributable to the component qualify as DPGR. Allowing more than one component to be treated as a single item would effectively permit taxpayers to define an item as any combination of components that, in the aggregate, meets the requirements of section 199, a result that the IRS and Treasury Department believe could lead to significant distortions. Thus, the IRS and Treasury Department believe that treating two or more components of the property offered for lease, rental, license, sale, exchange or other

disposition by the taxpayer as separate items is the appropriate result. The final regulations clarify that, if the property offered for lease, rental, license, sale, exchange or other disposition by the taxpayer does not meet the requirements of section 199, then each component that meets the requirements of § 1.199–3 must be treated as a separate item and such component may not be combined with a component that does not meet the requirements to be treated as an item. The final regulations provide examples illustrating this rule. It follows that the *de minimis* rule for embedded services and nonqualifying property, as well as any other *de minimis* exception that is applied at the item level, must be applied separately to each component of the property that is treated as a separate item.

The proposed regulations provide that gross receipts derived from a lease, rental, license, sale, exchange or other disposition of qualifying property constitute DPGR even if the taxpayer has already recognized gross receipts from a previous lease, rental, license, sale, exchange or other disposition of the property. The IRS and Treasury Department recognize that in some cases, such as where the original item (for example, steel) that was MPGE or produced by the taxpayer within the United States is disposed of by the taxpayer, and incorporated by another person into other property (for example, an automobile) that is subsequently acquired by the taxpayer, it would be extremely difficult for the taxpayer to identify the item the gross receipts of which constitute DPGR upon lease, rental, license, sale, exchange or other disposition of the acquired property. Therefore, the final regulations provide that if a taxpayer cannot reasonably determine without undue burden and expense whether the acquired property contains any of the original qualifying property, or the amount, grade, or kind of the original qualifying property, that the taxpayer MPGE or produced within the United States, then the taxpayer is not required to determine whether any portion of the acquired property qualifies as an item. In such cases, the taxpayer may treat any gross receipts derived from the disposition of the acquired property that are attributable to the original qualifying property as non-DPGR.

The proposed regulations provide that, for purposes of the requirement to allocate gross receipts between DPGR and non-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. One commentator observed that Notice 2005–14 applies a readily available rather than an undue burden or expense standard for this purpose, and questioned whether the proposed regulations were intended to impose a substantively different standard. The standard was changed in the proposed regulations in response to comments received on Notice 2005–14. The commentators were concerned that taxpayers would be required under Notice 2005–14 to use specific identification to allocate gross receipts under section 199 if their information systems contained the information necessary to use specific identification, even if capturing such information would require costly system reconfigurations. The undue burden and expense standard, however, was not intended to expand the scope of the requirement to use specific identification to include taxpayers for whom the information necessary to use that method is not readily available in their existing systems. Accordingly, the final regulations utilize both terms.

Commentators were concerned that the disposition of qualifying property would not give rise to DPGR if provided as part of a service related contract. However, the proposed regulations in *Example 4* in § 1.199–3(d)(5) already address this issue by illustrating a qualifying disposition resulting in DPGR as part of a service related contract. In that example, Y is hired to reconstruct and refurbish unrelated customers' tangible personal property. Y installs the replacement parts (QPP) that Y MPGE within the United States. The example concludes that Y's gross receipts from the MPGE of the replacement parts are DPGR. The final regulations retain this example and include other examples of service related contracts that also involve the disposition of qualifying property giving rise to DPGR if all of the other section 199 requirements are met.

The proposed regulations provide that, if a taxpayer recognizes and reports on a Federal income tax return for a taxable year gross receipts that the taxpayer identifies as DPGR, then the taxpayer must treat the CGS related to such receipts as relating to DPGR, even if they are incurred in a subsequent taxable year. The final regulations retain this rule in § 1.199–4(b)(2). One commentator questioned whether this rule applies to CGS incurred in a taxable year to which section 199 applies, if the gross receipts were recognized in a taxable year prior to the effective date of section 199 but would have qualified as DPGR in that taxable year if section 199 had been in effect. The IRS and Treasury Department believe that all gross receipts and costs must be allocated between DPGR and non-DPGR on a year-by-year basis, and the final regulations provide that for taxpayers using the section 861 method or the simplified deduction method, CGS that relates to gross receipts recognized in a taxable year prior to the effective date of section 199 must be allocated to non-DPGR.

For items that are disposed of under contracts that span two or more taxable years, the final regulations permit the use of historical data to allocate gross receipts between DPGR and non-DPGR. If a taxpayer makes allocations using historical data, and subsequently updates the data, then the taxpayer must use the more recent or updated data, starting in the taxable year in which the update is made.

Two commentators suggested that the final regulations permit taxpayers to classify multi-year contracts for purposes of section 199 with reference to their classification under section 460. For example, if a contract is classified as a construction contract under section 460, the commentators suggested that the contract also be classified as a construction contract under section 199. The IRS and Treasury Department have determined, however, that the statutory requirements under sections 199 and 460, and the regulations thereunder, are sufficiently different that it would not be appropriate for the final regulations to permit the classification of multi-year contracts under section 460 to determine whether the requirements of section 199 are met with respect to that contract. Accordingly, the final regulations do not adopt this suggestion.

By the Taxpayer

One commentator suggested a simplifying convention to determine which party to a contract manufacturing arrangement has the benefits and burdens of ownership under Federal income tax principles. The commentator requested that the final regulations permit unrelated parties to a contract manufacturing arrangement to designate, through a written and signed agreement between the parties, which of them shall be treated for purposes of section 199 as engaging in MPGE activities conducted pursuant to the arrangement. The final regulations do not adopt the commentator's suggestion. The IRS and Treasury Department continue to believe that the benefits and burdens of ownership must be determined based on all of the facts and circumstances and a designation of

benefits and burdens would not be appropriate.

Government Contracts

Section 403(a)(7) of the GOZA added new section 199(c)(4)(C), which contains a special rule for certain government contracts. The final regulations clarify that the special rule for government contracts also applies to gross receipts derived from certain subcontracts to manufacture or produce property for the Federal government. See The Joint Committee on Taxation Staff, *Technical Explanation of the Revenue Provisions of H.R. 4440, The Gulf Opportunity Zone Act of 2005,* 109th Cong., 1st Sess. 77 (2005).

In Whole or in Significant Part

The proposed regulations, like Notice 2005–14, provide generally that QPP is MPGE in whole or in significant part by the taxpayer within the United States only if the taxpayer's MPGE activity in the United States is substantial in nature. Although some language in the section 199 substantial-in-nature requirement bears similarities to language in the definition of manufacture in § 1.954–3(a)(4), the two standards are different both in purpose and in substance. Whether operations are substantial in nature is relevant under section 954 in determining whether manufacturing has occurred. By contrast, the substantial-in-nature requirement under section 199 is relevant in determining whether the MPGE activity, already determined to have occurred under the requirement provided in § 1.199–3(d) of the proposed regulations (§ 1.199–3(e) of the final regulations), was performed in whole or in significant part by the taxpayer within the United States. Accordingly, as stated in the preamble to Notice 2005–14, case law and other precedent under section 954 are not relevant for purposes of the substantial-in-nature requirement under section 199. Nor are they relevant for purposes of determining whether an activity is an MPGE activity under section 199. Similarly, the regulations under section 199 are not relevant for purposes of section 954.

Because the substantial-in-nature requirement is generally applied by taking into account all of the facts and circumstances, both the proposed regulations and Notice 2005–14 provide a safe harbor under which the in-whole-or-in-significant-part requirement is satisfied if the taxpayer's conversion costs (that is, direct labor and related factory burden) are 20 percent or more of the taxpayer's CGS with respect to the property. Commentators expressed confusion concerning the related factory burden component of this safe harbor, and suggested that overhead be substituted for related factory burden in the final regulations. Commentators further noted that not all transactions yielding DPGR under section 199 involve CGS (for example, a lease, rental, or license of QPP). In response to these comments, the IRS and Treasury Department have changed the safe harbor in the final regulations. The final regulations provide that the in-whole-or-in-significant-part requirement is satisfied if the taxpayer's direct labor and overhead to MPGE the QPP within the United States account for 20 percent or more of the taxpayer's CGS, or in a transaction without CGS (for example, a lease, rental, or license) account for 20 percent or more of the taxpayer's unadjusted depreciable basis of the QPP. No inference is intended regarding any similar safe harbor under the Code, including the safe harbor in § 1.954–3(a)(4)(iii). For taxpayers subject to section 263A, overhead is all costs required to be capitalized under section 263A except direct materials and direct labor. For taxpayers not subject to section 263A, overhead may be computed using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, but may not include any cost, or amount of any cost, that would not be required to be capitalized under section 263A if the taxpayer were subject to section 263A. In no event are section 174 costs, and the cost of creating intangible assets, attributable to tangible personal property ever treated as direct labor and overhead, and taxpayers should exclude such costs from their CGS or unadjusted depreciable basis, as applicable.

However, the final regulations also clarify that, in the case of computer software and sound recordings, research and experimental expenditures under section 174 relating to the computer software or sound recordings, the cost of creating intangible assets for computer software or sound recordings, and (in the case of computer software) costs of developing the computer software that are described in Rev. Proc. 2000–50 (2000–1 C.B. 601) (software development costs), are included in both direct labor and overhead and CGS or unadjusted depreciable basis for purposes of the safe harbor, even if the costs are incurred in a prior taxable year. In addition, the final regulations also clarify that this is the case whether the computer software or sound recording is itself the item for purposes of section 199, or is affixed or added to tangible personal property and the taxpayer treats the combined property as computer software or a sound recording under the rules of § 1.199–3(i)(5)). In the case where the taxpayer produces computer software and manufactures part of the tangible personal property to which the computer software is affixed, the taxpayer may combine the direct labor and overhead for the computer software and tangible personal property produced or manufactured by the taxpayer in determining whether it meets the safe harbor.

The final regulations provide that, in applying the safe harbor to an item for the taxable year, all computer software development costs, any cost of creating intangible assets for computer software or sound recordings, and section 174 costs (for computer software or sound recordings), including those paid or incurred in a prior taxable year, must be allocated over the estimated number of units of the item of which the taxpayer expects to dispose. An example of this rule is provided in the final regulations.

The proposed regulations provide that an EAG member must take into account all of the previous MPGE or production activities of the other members of the EAG in determining whether its MPGE or production activities are substantial in nature. It has been suggested that this rule be modified to allow the EAG member to take into account all MPGE or production activities of the other EAG members rather than just the previous MPGE or production activities of the members. The final regulations do not adopt this suggestion because the IRS and Treasury Department believe that the EAG member must determine whether its MPGE or production activities meet the substantial-in-nature requirement at or before the time EAG member disposes of the property. Similar rules apply for purposes of the safe harbor under § 1.199–3(g)(3)(i).

Section 3.04(5)(d) of Notice 2005–14 generally provides that design and development activities must be disregarded in applying the general substantial-in-nature requirement and the safe harbor for tangible personal property. The proposed regulations clarify that research and experimental activities under section 174 and the creation of intangibles do not qualify as substantial in nature. A commentator questioned whether, with respect to tangible personal property, activities that constitute both an MPGE activity as well as a section 174 activity must nonetheless be excluded from the determination of whether the taxpayer's MPGE of the QPP is substantial in nature because all section 174 activities are disregarded in making such a

determination. The IRS and Treasury Department continue to believe that, with the exception of computer software and sound recordings, it is not appropriate to include any section 174 activities in the determination of whether the MPGE of QPP is substantial in nature. However, the IRS and Treasury Department recognize that, although section 174 costs are not required to be capitalized under section 263A to the produced property, a taxpayer may capitalize such costs to the QPP under section 263A. Accordingly, the final regulations permit, as a matter of administrative convenience, a taxpayer to include such costs as CGS or unadjusted depreciable basis for purposes of the 20 percent safe harbor.

A commentator asked that the final regulations clarify that gross receipts relating to computer software updates that are provided as part of a computer software maintenance contract qualify as DPGR if all of the requirements of section 199(c)(4) are met. The final regulations include an example demonstrating that gross receipts relating to computer software updates may qualify as DPGR even if the computer software updates are provided pursuant to a computer software maintenance agreement.

The preamble to the proposed regulations states that the creation and licensing of copyrighted business information reports do not constitute the MPGE of QPP because the database is not QPP. However, it has come to the attention of the IRS and Treasury Department that some business information reports published by the taxpayer may qualify as QPP, for example, business information reports published by the taxpayer in books that qualify as QPP. Therefore, no inference should be drawn from the preamble to the proposed regulations as to whether business information reports qualify for the section 199 deduction.

The proposed regulations provide in § 1.199–3(f)(2) that QPP will be treated as MPGE in significant part by the taxpayer within the United States 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.

One commentator suggested that, if a taxpayer manufactures a key component of QPP and purchases the rest of the components, the fact that the taxpayer manufactured the key component should satisfy the substantial-in-nature requirement with respect to the QPP that incorporates the key component. For example, X manufactures computer chips within the United States. X installs the computer chips that it manufactures in computers that X purchases from unrelated persons and sells the finished computers individually to customers. Although the computer chips are key components of the computers and the computers will not operate without them, the manufacture of the key components does not, by itself, satisfy the substantial-in-nature requirement with respect to the finished computers and the taxpayer's activities with respect to the finished computers must meet either the substantial-in-nature requirement under § 1.199–3(g)(2) or the safe harbor under § 1.199–3(g)(3) of the final regulations. The final regulations contain an example to illustrate this rule.

In *Example 4* in § 1.199–3(f)(4) of the proposed regulations, X licenses a qualified film to Y for duplication of the film onto DVDs. Y purchases the DVDs from an unrelated person. The example concludes that unless Y satisfies the safe harbor under § 1.199–3(f)(3) of the proposed regulations, Y's income for duplicating X's qualified film onto DVDs is non-DPGR because the duplication is not substantial in nature relative to the DVD with the film. One commentator disagreed with the conclusion in this example because duplicating a DVD may involve considerable activities. This example and other examples illustrating the substantial-in-nature requirement have been removed from the final regulations because the determination of what is substantial in nature is determined based on all the facts and circumstances. No inference should be drawn as to whether an activity is, or is not, substantial in nature by the removal of any example.

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

Section 1.199–3(h)(1) of the proposed regulations provides that applicable Federal income tax principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition of QPP, whether it is a service, or whether it is some combination thereof. In the preamble to the proposed regulations, 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. The preamble further states that 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 and provides an example of a video arcade that features video game machines that the taxpayer MPGE. The machines remain in the taxpayer's possession during the customers' use. The example concludes that 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. While the general rule stated in § 1.199–3(h)(1) of the proposed regulations is retained in the final regulations under § 1.199–(3)(I)(1), the preamble example is not included in the final regulations because the determination of whether a transaction is a service or a rental is based upon all the facts and circumstances. No inference should be drawn as to whether the transaction constitutes a service or rental (or some combination thereof) by the removal of the example.

Section 1.199–3(h)(1) of the proposed regulations provides that 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, a qualified film produced by the taxpayer, or utilities produced by the taxpayer in the United States, for an unrelated person's property is DPGR for the taxpayer. However, unless the taxpayer meets all of the requirements under section 199 with respect to any further MPGE by the taxpayer of the QPP or any further production by the taxpayer of the film or utilities received in the taxable exchange, any gross receipts derived from the sale by the taxpayer of the property received in the taxable exchange are non-DPGR, because the taxpayer did not MPGE or produce such property, even if the property was QPP, a qualified film, or utilities in the hands of the other party to the transaction.

A commentator requested that, with regard to certain taxable exchanges, the final regulations provide a safe harbor that would accommodate long-standing industry accounting practices for these exchanges. The final regulations provide a safe harbor whereby the gross receipts derived by the taxpayer from the sale of eligible property (as defined later) received in a taxable exchange, net of any adjustments between the parties

involved in the taxable exchange to account for differences in the eligible property exchanged (for example, location differentials and product differentials), may be treated as the value of the eligible property received by the taxpayer in the taxable exchange. In addition, if the taxpayer engages in any further MPGE or production activity with respect to the eligible property received in the taxable exchange, then, unless the taxpayer meets the in-whole-or-in significant-part requirement under § 1.199–3(g)(1) with respect to the property sold, the taxpayer must also value the property sold without taking into account the gross receipts attributable to the further MPGE or production activity. The final regulations define eligible property as oil, natural gas, and petrochemicals, or products derived from oil, natural gas, petrochemicals, or any other property or product designated by publication in the Internal Revenue Bulletin. Under the safe harbor, the taxable exchange is deemed to occur on the date of the sale of the eligible property received in the exchange to the extent that the sale occurs no later than the last day of the month following the month in which the exchanged eligible property is received by the taxpayer.

The proposed regulations provide that, in the case of gross receipts derived from a lease of QPP or a qualified film, the entire amount of the lease income, including any interest that is not separately stated, is considered derived from the lease of the QPP or qualified film. Commentators noted that many leases of personal property separately state a finance or interest component. The IRS and Treasury Department believe that Congress intended for all financing or interest components of a lease of qualifying property to be considered DPGR (assuming all the other requirements of section 199 are met). Accordingly, the final regulations provide that all financing and interest components of a lease of qualifying property are considered to be derived from the lease of such qualifying property.

Section 1.199–3(h)(4) of the proposed regulations provides exceptions to the general rule that DPGR does not include gross receipts derived from services or nonqualifying property. The exceptions are for embedded qualified warranties, delivery, operating manuals, and installation. The final regulations retain these exceptions and provide a new exception for embedded computer software maintenance contracts. None of these exceptions, which allow gross receipts attributable to such embedded services and nonqualifying property to be treated as DPGR, is available if, in the normal course of the taxpayer's trade or business, the price for the service or nonqualifying property is separately stated or is separately offered to the customer.

One commentator asked for clarification concerning the meaning of the term normal course of a taxpayer's trade or business and when something would be considered to be separately stated or separately offered to a customer. The purpose of the exceptions is to reduce the burden on a taxpayer of having to allocate a portion of its gross receipts to these commonly occurring types of services and property if the taxpayer does not normally price or offer such items separately. Whether a taxpayer separately offers or states the price for such an item in the normal course of its trade or business depends on the facts and circumstances. If, for example, a taxpayer separately states the price for installation for a few of its customers on a case by case basis, then the taxpayer may be considered to have not separately stated the price of installation in the normal course of its trade or business. The requirements have been changed in the final regulations to clarify that the normal-course-of-trade-or-business requirement applies to both the separately stated price prong and the separately offered prong of the embedded services and nonqualifying property rules.

Several comments were received concerning the rule in the proposed regulations under which gross receipts attributable to advertising in newspapers, magazines, telephone directories, or periodicals may qualify as DPGR to the extent that the gross receipts, if any, derived from the disposition of those printed materials qualifies as DPGR. The final regulations clarify that this list is not limited to these four types of printed materials, and that the rule applies to other similar printed materials.

Section 3 of Notice 2005–14 explains that the basis for the rule relating to advertising income is that such income is inextricably linked to the gross receipts (if any) derived from the disposition of the printed materials listed in the proposed regulations. After considering the comments received, the IRS and Treasury Department believe that the same reasoning applies in the case of a qualified film (for example, a television program). Accordingly, the rule for advertising has been extended in the final regulations to apply to qualified films. The wording of the advertising rule has been changed to clarify that the amount of gross receipts attributable to the disposition of the printed materials or qualified film does not limit the amount of gross receipts attributable to the advertising that may be treated as DPGR under the rule. In addition, the final regulations clarify that there need be no gross receipts attributable to the disposition of the printed materials or qualified film for the gross receipts from the advertising to qualify as DPGR.

One commentator requested that the final regulations recognize that gross receipts derived from the sale of advertising slots in live or delayed television broadcasts (that are produced by the taxpayer and that otherwise meet the requirements for a qualified film) are DPGR. While live and delayed television programming may otherwise meet the requirements to be treated as a qualified film, in order for the gross receipts derived from advertising slots to be DPGR, there must also be a qualifying disposition of the qualified film. The IRS and Treasury Department continue to believe that a live or delayed television broadcast of a qualified film is not a lease, rental, license, sale, exchange or other disposition of the qualified film. Commentators noted, however, that if the live or delayed television programming is licensed to an unrelated cable company, then the license of the programming is a qualifying disposition that gives rise to DPGR and if the rule for advertising were extended to qualified films, then the portion of the advertising receipts relating to the license of the qualified film would also be DPGR. The IRS and Treasury Department agree with these comments, and the final regulations provide examples to clarify these points.

Qualifying Production Property

Under § 1.199–3(i)(5)(i) of the proposed regulations, if a taxpayer MPGE computer software or sound recordings that is affixed or added to tangible personal property by the taxpayer (for example, a computer diskette or an appliance), then the taxpayer may treat the tangible personal property as computer software or sound recordings, as applicable. A commentator questioned whether this rule should apply if, for example, a taxpayer hires an unrelated person to affix computer software or sound recordings produced by the taxpayer to a compact disc. In response to this comment, the final regulations have dropped the by-the-taxpayer requirement in this context. A similar rule has been provided for qualified films.

Qualified Films

Section § 1.199–3(j)(1) of the proposed regulations provides that, a 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. One commentator was concerned that the list of production personnel described under § 1.199–3(j)(1) of the proposed regulations diminishes the general rule under § 1.199–3(j)(5) that 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). The commentator also stated that it may be difficult to determine which persons are production personnel. The final regulations under § 1.199–3(k)(1) clarify that the list of production personnel is not exclusive, and that compensation for services includes all direct and indirect compensation costs required to be capitalized under § 1.263A–1(e)(2) and (3).

In response to questions received by the IRS and Treasury Department, the final regulations clarify that actors may include players, newscasters, or any other persons performing in a qualified film. The final regulations also clarify that the not-less-than-50-percent-of-the-total-compensation requirement is determined by reference to all compensation paid in the production of the film and is calculated using a fraction. The numerator of the fraction is the compensation paid by the taxpayer to actors, production personnel, directors, and producers for services relating to the production of the film (production services) performed in the United States, and the denominator is the sum of the total compensation paid by the taxpayer to all such individuals regardless of where the production services are performed and the total compensation paid by others to all such individuals regardless of where the production services are performed. The final regulations provide an example of this calculation.

Tangible Personal Property and Real Property

Commentators requested that the final regulations define tangible personal property and real property for purposes of section 199. The final regulations define tangible personal property as any tangible property other than land, real property described in the construction rules in § 1.199–3(m)(1), computer software described in § 1.199–3(j)(3), sound recordings described in § 1.199–3(j)(4), a qualified film described in § 1.199–3(k)(1), and utilities described in § 1.199–3(l). In response to commentators' suggestions, the final regulations further define tangible personal property as also including any gas (other than natural gas described in § 1.199–3(l)(2)), chemicals, and similar property, for example, steam, oxygen, hydrogen, and nitrogen.

The final regulations define the term real property to mean buildings (including items that are structural components of such buildings), inherently permanent structures (as defined in § 1.263A–8(c)(3)) other than machinery (as defined in § 1.263A–8(c)(4)) (including items that are structural components of such inherently permanent structures), inherently permanent land improvements, oil and gas wells, and infrastructure (as defined in § 1.199–3(m)(4)). Property MPGE by a taxpayer that is not real property in the hands of such taxpayer, but that may be incorporated into real property by another taxpayer, is not treated as real property by the producing taxpayer (for example, bricks, nails, paint, and windowpanes). Structural components of buildings and inherently permanent structures include property such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property. In addition, an entire utility plant including both the shell and the interior will be treated as an inherently permanent structure.

Construction of Real Property

One commentator recommended that DPGR derived from the construction of real property as well as DPGR from engineering and architectural services for a construction project include W–2 wages earned as an employee. At the time the taxpayer performs construction activities, or engineering or architectural services, the taxpayer must be engaged in a trade or business that is considered construction, engineering or architectural services for purposes of the North American Industry Classification System (NAICS). W–2 wages earned by an employee are not earned in connection with a trade or business that is considered construction, or engineering or architectural services, for purposes of the NAICS. Consequently, this recommendation has not been adopted in the final regulations.

The proposed regulations include within the definition of construction services activities relating to drilling an oil well and mining 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 IRS and Treasury Department are aware that in many situations taxpayers provide these services with respect to property owned by another party, and therefore such taxpayers are ineligible to claim the deductions for such costs under the provisions described above. The language of the final regulations has been changed to clarify that taxpayers providing such services are engaging in construction services that may qualify under section 199.

The preamble to the proposed regulations states that commentators requested that qualifying construction activities include construction activities related to oil and gas wells. The preamble further states that the proposed regulations provide as a matter of administrative grace that qualifying construction activities include activities relating to drilling an oil well. Similarly, under § 1.199–3(l)(2) of the proposed regulations, construction activities include activities relating to drilling an oil well. A commentator noted the inadvertent omission of gas wells and the final regulations correct the omission.

The proposed regulations provide that DPGR does not include gross receipts attributable to the sale or other disposition of land (including zoning, planning, entitlement costs, and other costs capitalized into the land such as grading and demolition of structures under section 280B). Commentators contended that grading and demolition are construction-related activities, and that gross receipts attributable to these activities should qualify as DPGR. After considering the comments, the IRS and Treasury Department believe it is appropriate to apply to grading and demolition activities the same rule that the proposed regulations apply to other construction activities, such as landscaping and painting. Accordingly, services such as grading, demolition, clearing, excavating, and any other activities that physically transform the land are activities constituting construction only if these services are performed in connection with other activities (whether or not by the same taxpayer) that constitute the erection or substantial renovation of real property. The IRS and Treasury Department

continue to believe that gross receipts attributable to the sale or other disposition of land (including zoning, planning, and entitlement costs) are properly considered gross receipts attributable to the land, not to a qualifying construction activity, and, therefore, are non-DPGR.

In response to a suggestion by a commentator, the final regulations provide that a taxpayer engaged in a construction activity must make a reasonable inquiry or a reasonable determination whether the activity relates to the erection or substantial renovation of real property in the United States.

The proposed regulations contain an example of an electrical contractor who purchases wires, conduits, and other electrical materials that the contractor installs in construction projects in the United States and that are considered structural components. The example concludes that the gross receipts that the contractor derives from installing these materials are derived from construction, but that the gross receipts attributable to the purchased materials are not. Commentators objected to this result, contending that it places an unreasonable administrative burden on taxpayers performing construction activities. The final regulations, including the example, provide that, in such circumstances, the taxpayer performing the construction services is not required to allocate gross receipts to the purchased materials and treat such gross receipts as non-DPGR, provided the materials and supplies are consumed in the construction project or become part of the constructed real property.

Section 199(c)(4)(A), as amended by the GOZA, requires that a taxpayer be engaged in the active conduct of a construction trade or business for the taxpayer's construction activity to qualify under section 199. The proposed regulations provide that a taxpayer may not treat as DPGR gross receipts derived from construction unless the taxpayer is engaged in a construction trade or business on a regular and ongoing basis. Commentators expressed concern that this requirement would preclude construction project-specific joint ventures or partnerships, a common business structure in the construction industry, from qualifying under section 199. Typically, such entities are formed for the purpose of a specific construction project, and are terminated or dissolved when the project is completed. The final regulations continue to require that a taxpayer be engaged in a regular and ongoing construction trade or business, but provide a safe harbor rule under which entities formed specifically for purposes of a particular construction project may qualify. Under the safe harbor rule, if a taxpayer is engaged in a construction trade or business, then the taxpayer will be considered to be engaged in such trade or business on a regular and ongoing basis if the taxpayer derives gross receipts from an unrelated person by selling or exchanging the constructed real property within 60 months of the date on which construction is complete.

Commentators also expressed concern that taxpayers would not meet the requirement of being engaged in a construction business on a regular and ongoing basis if the taxpayer is newly-formed or otherwise is in the first taxable year of a new construction trade or business. Although some taxpayers may meet the regular-and-ongoing-business requirement under the safe harbor rule discussed previously, the final regulations provide that, in the case of a newly-formed trade or business or a taxpayer in its first taxable year, the taxpayer will satisfy the regular-and-ongoing-basis requirement if it reasonably expects to be engaged in a construction trade or business on a regular and ongoing basis.

The IRS and Treasury Department received a comment requesting clarification of the land safe harbor of § 1.199–3(l)(5)(ii) of the proposed regulations. Under the land safe harbor, the taxpayer is permitted to allocate gross receipts between real property other than land, and land, according to a formula. The taxpayer must reduce gross receipts by the costs of the land and any other costs capitalized to the land, plus a percentage of those costs, and costs related to DPGR must be reduced by the costs of the land and any other costs capitalized to the land. The percentage ranges from 5 to 15 percent, depending upon the length of time the taxpayer held the land. The commentator asked whether the holding period of a previous owner of the land would be attributed to the new owner, and what rules apply for purposes of computing the new owner's cost basis. Generally, if an existing provision of the Code or regulations would apply to require attribution of the holding period of a previous owner of property to a new owner, the same rules will apply in the case of a previous owner's holding period in land for purposes of the land safe harbor rule of section 199. For example, the holding period of the previous owner (P) would carry over to the new owner (N) under existing Federal income tax principles if P were a partner in partnership N, and P contributed the land to N. The same result would apply if, instead, the land was distributed by partnership P to N, its partner. In the case of partnership or other pass-thru entity, the land safe harbor is applied at the partnership or other pass-thru entity level and is not applied at the partner or owner level.

With regard to the land safe harbor discussed in the preceding paragraph, the proposed regulations state that the length of time a taxpayer is deemed to hold the land begins on 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. Commentators stated that development of the land generally does not begin until the land is acquired and any option to acquire land is based on the land's fair market value. Because developers are paying fair market value, the commentators suggested that the period for determining the percentage should not include any option period. The IRS and Treasury Department generally agree with the commentator's suggestion, and the final regulations do not include the option period except where the option does not include provisions to adjust the purchase price to approximate fair market value.

Example 1 in § 1.199–3(m)(5)(iii) of the proposed regulations provides that X, who is in a construction trade or business under NAICS Code 23 on a regular and ongoing basis, purchases a building and retains Y, a general contractor, to perform construction services in connection with a substantial renovation of the building. The example concludes that X's gross receipts derived from the disposition of the building are non-DPGR, and that Y's gross receipts from amounts paid to it by X are DPGR. In addition, the example illustrates that gross receipts of subcontractors hired by Y qualify as DPGR. Some commentators inferred from this example that the taxpayer must, at a minimum, be a legally designated general contractor before its gross receipts may qualify as DPGR. The example was not intended to imply that a taxpayer must be a licensed general contractor. The final regulations clarify that activities constituting construction include activities typically performed by a general contractor, or that constitute general contractor-level work, such as activities relating to management and oversight of the construction process (for example, approvals, periodic inspection of the progress of the construction project, and required job modifications). The example has been modified in the final regulations to illustrate that the person

hired by the building owner, although not a licensed general contractor, qualifies as engaging in construction activities by virtue of providing management and oversight of the construction process.

Several commentators recommended that the final regulations provide that, for purposes of the de minimis exception of § 1.199–3(l)(5)(ii) (regarding construction services), gross receipts attributable to land be disregarded for purposes of calculating the de minimis exception. In response to the comments, the final regulations clarify that, if a taxpayer applies the land safe harbor, then the gross receipts excluded under the land safe harbor are excluded in determining total gross receipts under the de minimis exception. The final regulations also provide that, if a taxpayer does not apply the land safe harbor and uses any reasonable method (for example, an appraisal of the land) to allocate gross receipts attributable to the land to non-DPGR, then a taxpayer applies the de minimis exception by excluding such gross receipts derived from the sale, exchange, or other disposition of the land from total gross receipts.

A commentator requested that the definition of construction activities not be limited to direct activities and should include services incidental to the performance of such activities. As an administrative convenience, the final regulations provide that construction activities include certain administrative support services such as billing and secretarial services performed by the taxpayer. The final regulations provide a similar rule for engineering and architectural services.

Engineering and Architectural Services

A commentator suggested that the definition of engineering and architectural services include services related to the inspection or evaluation of real property after construction has been completed. The final regulations do not adopt this suggestion because engineering and architectural services relating to post-construction activities are not activities constituting construction.

Allocation of Cost of Goods Sold and Deductions

A commentator requested clarification as to whether a taxpayer's CGS allocable to DPGR is determined using the methods of accounting used to compute CGS for the taxpayer's books or financial statements or the methods of accounting used to compute CGS in determining Federal taxable income. Section 1.199–4(b) of the proposed regulations provides that CGS is determined under the methods of accounting that the taxpayer uses to compute Federal taxable income. Accordingly, this section has not been modified and the final regulations continue to provide that, in determining CGS allocable to DPGR, CGS is determined using the methods of accounting that the taxpayer uses to compute its Federal taxable income.

Consistent with both the proposed regulations and Notice 2005–14, the final regulations continue to provide three methods for allocating and apportioning deductions (that is, the section 861 method, the simplified deduction method, and the small business simplified overall method). However, modifications have been made in the final regulations to the qualification requirements of the simplified deduction method.

Under the simplified deduction method, a taxpayer's expenses, losses, or deductions (deductions) (other than a net operating loss deduction) are apportioned between DPGR and non-DPGR based on relative gross receipts. The proposed regulations permit a taxpayer to 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. Several commentators requested that the average annual gross receipts threshold for the simplified deduction method be either increased or removed. In response to these comments, the IRS and Treasury Department have modified the eligibility requirements for the simplified deduction method. Under the final regulations, a taxpayer may use the simplified deduction method if it has average annual gross receipts of $100,000,000 or less, or total assets at the end of the taxable year of $10,000,000 or less. The IRS and Treasury Department continue to believe that for taxpayers above these thresholds the section 861 method is the appropriate method for allocating and apportioning deductions for purposes of determining QPAI.

Under the land safe harbor provided in § 1.199–3(l)(5)(ii) of the proposed regulations, a taxpayer may allocate gross receipts between the proceeds from the sale, exchange, or other disposition of real property constructed by the taxpayer and land by reducing its costs related to DPGR under § 1.199–4 by the cost of land and other costs capitalized to the land (land costs) and reducing its DPGR by those land costs plus a percentage. Under the small business simplified overall method, a taxpayer's CGS and deductions are apportioned between DPGR and other receipts based on relative gross receipts. Commentators have questioned whether a taxpayer that uses the small business simplified overall method would have to reallocate land costs using the allocation formula provided by that method even though such costs have already been allocated in accordance with the land safe harbor. The final regulations clarify that a taxpayer that uses the land safe harbor to allocate gross receipts between real property constructed by the taxpayer and land does not take into account under the small business simplified overall method provided in § 1.199–4(f) the costs that have already been taken into account for purposes of section 199 pursuant to the land safe harbor.

Expanded Affiliated Groups

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, a qualified film, or utilities MPGE or 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 film, or utilities in determining whether its gross receipts are DPGR. A question arose as to when the determination of whether corporations are members of the same EAG for purposes of the attribution of activities is to be made. The final regulations clarify that attribution of activities between members of the same EAG is tested at the time that the disposing member disposes of the QPP, qualified film, or utilities. Examples are provided to illustrate this provision.

Section 1.199–1(d) of the proposed regulations provides a de minimis rule that allows a taxpayer to treat all of its gross receipts as DPGR if less than 5 percent of the taxpayer's total gross receipts are non-DPGR. The proposed regulations provide that the 5 percent threshold is determined at the corporation level, rather than at the EAG or consolidated group level. Several commentators requested that the IRS and Treasury Department reconsider this position and apply the threshold at the EAG or consolidated group level.

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. Applying this de minimis rule at the EAG level would create many burdensome issues for the EAG and its

members, including additional information reporting and circularity problems that could require members to compute QPAI twice and, thus, would not further the policy goals of providing de minimis rules to ease a taxpayer's administrative burdens. As a result, the IRS and Treasury Department continue to believe that, with respect to a corporation that is a member of an EAG but not a member of a consolidated group, the application of this threshold at the EAG member level is appropriate.

However, with respect to a consolidated group, § 1.1502–13(c)(1)(i) and (c)(4) requires that the separate entity attributes of a company's intercompany items or corresponding items must be redetermined to the extent necessary to produce the effect as if the consolidated group members engaged in an intercompany transaction were divisions of a single corporation. If the de minimis rule were applied at the consolidated group member level, then a different result could apply to the consolidated group than would apply if the consolidated group members were divisions of a single corporation. Accordingly, with respect to a consolidated group, the final regulations provide that the de minimis rule is applied at the consolidated group level, rather than at the consolidated group member level.

Similarly, with respect to a corporation that is a member of an EAG but not a member of a consolidated group, the new de minimis rule that allows a taxpayer to treat all of its gross receipts as non-DPGR if less than 5 percent of the taxpayer's total gross receipts are DPGR is determined at the EAG member level, rather than at the EAG group level. However, with respect to a consolidated group, the final regulations provide that this de minimis rule is applied at the consolidated group level, rather than at the consolidated group member level.

Consolidated Groups

A commentator was concerned that the license of an intangible asset between members of a consolidated group could reduce the section 199 deduction available to the members of a consolidated group, because the licensee member's royalty expense would reduce the group's QPAI, but the licensor member's royalty income from the license would not increase the group's QPAI. The commentator requested that language be added to the final regulations to provide that the intercompany transaction rules of § 1.1502–13 shall be taken into account for purposes of determining the QPAI and DPGR of a consolidated group.

As specifically noted in the preamble to the proposed regulations, the regulations under § 1.1502–13(c) already ensure that the section 199 deduction cannot be reduced on account of an intercompany transaction. As discussed above concerning the application of the de minimis rules that allow treatment of gross receipts as DPGR or non-DPGR, § 1.1502–13(c)(1)(i) and (c)(4) requires that the separate entity attributes of a company's intercompany items or corresponding items must be redetermined to the extent necessary to produce the effect as if the consolidated group members engaged in an intercompany transaction were divisions of a single corporation. There is nothing in the proposed regulations that would prevent this rule from applying. In fact, several examples specifically illustrate the application of these rules. An additional example concerning the license of an intangible between members of a consolidated group has been added to the final regulations.

Another commentator requested clarification of the application of § 1.199–7(b)(2) of the proposed regulations where the EAG is comprised of more than one consolidated group. Section 1.199–7(b)(2) of the proposed regulations (§ 1.199–7(b)(3) of the final regulations) provides that, in determining the taxable income of an EAG, if a member of an EAG has an 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. The final regulations continue to treat a consolidated group as a single member of the EAG. Accordingly, if a consolidated group has a consolidated NOL (CNOL) carryback or carryover, the amount of the CNOL used to offset taxable income cannot exceed the consolidated group's taxable income, and may not be used to offset taxable income of other members of the EAG, whether separate corporations or consolidated groups. An example has been provided to illustrate this provision.

Trade or Business Requirement

Pursuant to section 199(d)(5), §§ 1.199–1 through 1.199–9 are applied by taking into account only items that are attributable to the actual conduct of a trade or business. An individual engaged in the actual conduct of a trade or business must apply §§ 1.199–1 through 1.199–9 by taking into account in computing QPAI only items that are attributable to that trade or business (or trades or businesses) and any items allocated from a pass-thru entity engaged in a trade or business. Compensation received by an individual employee for services performed as an employee is not considered gross receipts for purposes of computing QPAI under §§ 1.199–1 through 1.199–9. Similarly, any costs or expenses paid or incurred by an individual employee with respect to those services performed as an employee are not considered CGS or deductions of that employee for purposes of computing QPAI under §§ 1.199–1 through 1.199–9. For purposes of the trade-or-business requirement, a trust or estate is treated as an individual.

Pass-Thru Entities

As noted above, section 514(b) of TIPRA amended section 199(d)(1)(A)(iii) with respect to a partner's or shareholder's share of W–2 wages from a partnership or S corporation for taxable years beginning after May 17, 2006. Section 1.199–9 of the final regulations contains guidance for pass-thru entities with taxable years beginning on or before May 17, 2006. A taxpayer must apply § 1.199–9 to a taxable year beginning on or before May 17, 2006, if that taxpayer applies §§ 1.199–1 through 1.199–8 to the taxable year. The portions of § 1.199–3 relating to qualifying in-kind partnerships and EAG partnerships, and all of § 1.199–5 relating to pass-thru entities, in the final regulations are reserved for taxable years beginning after May 17, 2006. The IRS and Treasury Department intend to issue regulations that take into account the amendments made to section 199(d)(1)(A)(iii) for 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. Generally, section 199 is applied at the shareholder, partner, or similar level. For a non-grantor trust or estate, this level may refer to one or more beneficiaries, the trust or estate, or both.

Section 199(d)(1)(A)(iii), however, limits the amount of W–2 wages from a partnership or S corporation that may be used by each partner or shareholder to compute the partner's or shareholder's section 199 deduction. Pursuant to the authority granted in section

199(d)(1)(C), the final regulations provide that this wage limitation will apply to non-grantor trusts and estates in the same way it applies to partnerships and S corporations. Thus, for all purposes of this wage limitation, references in the final regulations to pass-thru entities include not only partnerships and S corporations, but also all non-grantor trusts and estates.

The final regulations clarify that the section 199 deduction has no effect on a shareholder's adjusted basis in the stock of an S corporation or a partner's adjusted basis in an interest in a partnership because the section 199 deduction is not described in section 1367(a) or section 705(a). However, the shareholder's or partner's proportionate or distributive share of the S corporation or partnership items that are included in computing the shareholder's or partner's section 199 deduction will affect the shareholder's or partner's adjusted basis under the rules of section 1367(a) or section 705(a).

The proposed regulations provide that 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, or 704(d), or any other provision of the 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 partner's share of the partnership's qualified production activities, determined in a manner consistent with sections 465, 469, and 704(d), and any other applicable provision of the Code (disallowed losses), is taken into account in computing the section 199 deduction for that taxable year. To the extent that any of the disallowed losses are allowed in a later taxable year, the partner takes into account a proportionate share of those losses in computing its QPAI for that later taxable year.

In response to comments received, the IRS and Treasury Department intend to issue separate guidance by publication in the Internal Revenue Bulletin regarding the treatment of disallowed losses in determining a taxpayer's section 199 deduction. As a matter of administrative convenience and to reduce complexity for taxpayers, the final regulations clarify that disallowed losses of the taxpayer that are disallowed for taxable years beginning on or before December 31, 2004, are not taken into account in a later taxable year for purposes of computing the taxpayer's QPAI for that later taxable year regardless of whether the disallowed losses are allowed for other purposes. The final regulations provide that similar rules concerning disallowed losses apply to taxpayers that are not partners or S corporation shareholders. See § 1.199–8(h).

Generally, in the case of a pass-thru entity, the calculations required to determine QPAI (that is, the allocation or apportionment of gross receipts, CGS, or deductions) are performed at the owner level. Notice 2005–14 and the proposed regulations provide that a partnership or S corporation that is a qualifying small taxpayer may use the small business simplified overall method to apportion CGS and deductions between DPGR and non-DPGR. This rule is not included in the final regulations, except that § 1.199–9(k) permits a partnership or S corporation that is a qualifying small taxpayer to use the small business simplified overall method to apportion CGS and deductions between DPGR and non-DPGR at the entity level under § 1.199–4(f) of the proposed regulations. In addition, § 1.199–9(b)(1)(ii) and (c)(1)(ii) of the final regulations provides that the Secretary may, by publication in the Internal Revenue Bulletin, permit a partnership or S corporation to calculate a partner's or shareholder's share of QPAI at the entity level.

If a partnership or S corporation calculates a partner's or shareholder's share of QPAI at the entity level, the owner's share of QPAI and W–2 wages from the partnership or S corporation are combined with the owner's QPAI and W–2 wages from other sources. The final regulations also clarify that, if a pass-thru entity calculates QPAI at the entity level, then generally the owner of the pass-thru entity is not permitted to use another cost allocation method to reallocate the costs of the pass-thru entity regardless of the method used by the pass-thru entity's owner to allocate or apportion costs. A taxpayer that receives QPAI from a partnership or S corporation does not take into account any gross receipts, income, assets, deductions, or other items of the partnership or S corporation when the taxpayer allocates and apportions deductions to determine the taxpayer's QPAI from other sources.

Regarding the rule allowing partnerships that extract, refine, or process oil or natural gas to attribute these activities to their partners, some commentators requested that the rule be expanded to other industries that operate in a substantially similar manner. The exception for the oil and gas industry was provided in the proposed regulations to prevent a clearly qualifying activity from being disqualified under section 199 because of several decades-long industry practices. Among the historical industry practices taken into account by the IRS and Treasury Department in establishing the oil and gas exception was the fact that for decades the oil and gas industry generally has operated in a business model in which a partnership produces qualifying property and distributes such property in-kind to its partners (generally engaged themselves in the production of oil and gas), generally the partnership does not derive any gross receipts from the produced property, the property is marketed and sold exclusively and separately by each partner as competitors, and generally there is no marketing or sale by the partnership of the produced property, and no joint marketing or sale of the distributed property by any of the partners. In addition, the partnership typically qualifies to elect out of subchapter K.

In response to the requests that this attribution rule be expanded to industries that historically have operated in a manner substantially similar to the oil and gas industry, the final regulations provide that, if a partnership that MPGE or produces property is a qualifying in-kind partnership (as defined later), then each partner may be treated as MPGE or producing the property MPGE or produced by the partnership that is distributed to that partner. If a partner of a qualifying in-kind partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of the property that was MPGE or produced by the qualifying in-kind partnership, then, provided such partner is a partner of the qualifying in-kind partnership at the time the partner disposes of the property, the partner is treated as conducting the MPGE or production activities previously conducted by the qualifying in-kind partnership with respect to that property. For this purpose, a qualifying in-kind partnership is defined in § 1.199–9(i)(2) of the final regulations to include only certain partnerships operating solely in a designated industry: oil and gas, petrochemical, or electricity generation. Partnerships in other industries with substantially similar historical industry practices may be designated by the IRS and Treasury Department as qualifying in-kind partnerships by publication in the Internal Revenue Bulletin.

The proposed regulations provide that, if an EAG partnership (as defined

in § 1.199–9(j)(2) of the final regulations) MPGE or produces property and distributes, leases, rents, licenses, sells, exchanges, or otherwise disposes of that property to a member of an EAG of 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 disposing member of the EAG. Similarly, if one or more members of an EAG of 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. A question arose as to when a corporation needs to be a member of an EAG of which the partners of the EAG partnership are members (and vice versa) for attribution of MPGE or production activities to take place. The final regulations clarify that attribution of such activities between an EAG partnership and members of the EAG of which the partners of the EAG partnership are members is determined at the time that the EAG partnership disposes of the property (in the case of property MPGE or produced by an EAG member or members) or at the time that the member or members of the EAG of which the partners of the EAG partnership are members dispose of the property (in the case of property MPGE or produced by the EAG partnership). Attribution is effective only for those taxable years that the disposing or producing member is a member of the EAG of which the partners of the EAG partnership are members for the entire taxable year of the EAG partnership. The final regulations also clarify that EAG partnerships, the partners of which are members of the same EAG, may attribute their production activities between themselves on a similar basis, provided that the producing EAG partnership and the disposing EAG partnership are owned by members of the same EAG for the entire taxable year of the respective EAG partnership that includes the date on which the disposing EAG partnership disposes of the property.

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 and the proposed regulations, 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.

One commentator stated that many commercial real estate developers dispose of commercial real property by selling interests in special purpose partnerships that hold commercial real property. Because a sale, exchange or other disposition of the commercial real property may result in section 1231 gain rather than ordinary income, the commentator suggested that the definition of inventory items be expanded for purposes of § 1.199–9(e) by treating section 751(d) as not containing the words ''and other than property described in section 1231.'' As a result, a sale or exchange of an interest in a partnership that holds commercial real property would generate DPGR if a sale or exchange of the commercial real property would generate DPGR regardless of whether the sale or exchange would result in ordinary income. The final regulations do not include the commentator's suggestion because the rule in § 1.199–9(e) applies aggregate treatment to a sale or exchange of a partnership interest only to the extent section 751 specifically allows such treatment. Modifying the explicit terms of section 751(d) as suggested would be inconsistent with the purposes of section 751 and section 199.

Statistical Sampling

In the preamble to the proposed regulations, the IRS and Treasury Department invited taxpayers to submit comments on issues relating to section 199 including whether 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. Comments were received on statistical sampling and the IRS and Treasury Department are considering those comments and intend to issue subsequent guidance addressing the application of statistical sampling for purposes of section 199.

Elections Under the Section 861 Regulations

The preamble to the proposed regulations states that, because the provisions of section 199 may cause taxpayers to reconsider previously made elections under §§ 1.861–8 through 1.861–17 and §§ 1.861–8T through 1.861–14T (the section 861 regulations), the IRS and Treasury Department intend to issue a revenue procedure granting taxpayers automatic consent to change certain of those elections. In the proposed regulations, the IRS and Treasury Department requested comments on which elections should be included in such a revenue procedure and the appropriate time period during which the automatic consent should apply. Several commentators urged promulgation of such a revenue procedure, and several comments specifically requested that the revenue procedure provide taxpayers automatic consent for more than one taxable year to change previously made elections.

The IRS and Treasury Department intend to issue a revenue procedure that provides taxpayers automatic consent to change certain elections relating to the apportionment of interest expense and research and experimental expenditures under the section 861 regulations. It is intended that the automatic consent afforded under the revenue procedure will provide taxpayers the consent required by §§ 1.861–8T(c)(2) and 1.861–9(i)(2), with respect to the apportionment of interest expense, and by § 1.861–17(e), with respect to the apportionment of research and experimental expenditures, to change an election, effective for a taxpayer's first taxable year beginning after December 31, 2004 (the taxpayer's 2005 taxable year). In addition, it is intended that the revenue procedure will provide taxpayers the consent required by those regulations for a taxpayer's taxable year immediately following the taxpayer's 2005 taxable year, but, in such case, a taxpayer would not be provided automatic consent to change any election that first took effect with respect to the taxpayer's 2005 taxable year.

Financial and Administrative Burden

Several commentators objected to the complexity of the proposed regulations, and to the financial and administrative burden that the commentators believe the regulations will impose on taxpayers (particularly on small businesses). The complexity and burden of the regulations are a function of the statutory language and framework of section 199, which are complex and contain many requirements. For example, with the exception of a few specific services (namely, construction, architecture, and engineering) only gross receipts derived from certain dispositions of certain property qualify under the statute. In addition, in the case of manufacturing activities, the property must be manufactured by the taxpayer in whole or in significant part

within the United States. Also, under section 199, costs must be allocated between qualifying and nonqualifying gross receipts. All of these statutory requirements (and others) potentially necessitate that taxpayers obtain information, make determinations and computations, and retain records that might not otherwise be required for business purposes. In the case of partnerships and S corporations, the statute requires that the deduction be computed at the owner level, necessitating the sharing between entity and owner of information that might not be needed for purposes other than section 199. Both the proposed and the final regulations provide a number of safe harbors and *de minimis* rules that are intended to balance the need for compliance with these statutory requirements against the burden imposed on taxpayers.

In the preamble to the proposed regulations, the IRS and Treasury Department certify that the collection of information required under the proposed regulations (relating to information to be provided by cooperatives to their patrons) will not have a significant economic impact on a substantial number of small entities, and therefore that a Regulatory Flexibility Analysis is not required by the Regulatory Flexibility Act (RFA). One commentator asserted that the certification did not provide sufficient information for small entities to determine the impact the regulations will have on their businesses. The commentator also contended that the IRS and Treasury Department, in making the certification, failed to consider burdens imposed by the proposed regulations on other small entities, such as partnerships and S corporations, that are required under the regulations to provide certain information to their owners.

The IRS and Treasury Department believe that the certification for the proposed regulations, as well as for these final regulations, is appropriate and complies with the requirements of the RFA. With respect to cooperatives, the regulations provide cooperatives with specific rules about the information they must provide to patrons under section 199. The IRS and Treasury Department believe that cooperatives have the necessary information to comply with this requirement. The IRS and Treasury Department continue to believe that this requirement is the only collection of information in the regulations that is within the scope of the RFA. Certain other recordkeeping and reporting requirements of the regulations relating to information sharing between pass-thru entities (partnerships and S corporations) and their owners are subsumed within other existing income tax regulations that currently require that such entities report to their owners all information that is necessary for the owners to determine their tax liability.

Effective Date

Section 199 applies to taxable years beginning after December 31, 2004. Sections 1.199–1 through 1.199–8 are applicable for taxable years beginning on or after June 1, 2006. For a taxable year beginning on or before May 17, 2006, the enactment date of TIPRA, a taxpayer may apply §§ 1.199–1 through 1.199–9 provided that the taxpayer applies all provisions in §§ 1.199–1 through 1.199–9 to the taxable year. For a taxable year beginning after May 17, 2006, and before June 1, 2006, a taxpayer may apply §§ 1.199–1 through 1.199–8 provided that the taxpayer applies all provisions in §§ 1.199–1 through 1.199–8 to the taxable year. Section 1.199–9 may not be applied to a taxable year that begins after May 17, 2006.

For a taxpayer who chooses not to rely on these final regulations for a taxable year beginning before June 1, 2006, the guidance on section 199 that applies to such taxable year is contained in Notice 2005–14 (2005–1 C.B. 498). In addition, a taxpayer also may rely on the provisions of REG–105847–05 (2005–47 I.R.B. 987) (see § 601.601(d)(2) of this chapter) for a taxable year beginning before June 1, 2006. If Notice 2005–14 and REG–105847–05 include different rules for the same particular issue, then a taxpayer may rely on either the rule set forth in Notice 2005–14 or the rule set forth in REG–105847–05. However, if REG–105847–05 includes a rule that was not included in Notice 2005–14, then a taxpayer is not permitted to rely on the absence of a rule to apply a rule contrary to REG–105847–05. For taxable years beginning after May 17, 2006, and before June 1, 2006, a taxpayer may not apply Notice 2005–14, REG–105847–05, or any other guidance under section 199 in a manner inconsistent with amendments made to section 199 by section 514 of TIPRA. In determining the deduction under section 199, items arising from a taxable year of a partnership, S corporation, estate, or trust beginning before January 1, 2005, shall not be taken into account for purposes of section 199(d)(1). Members of an EAG that are not members of a consolidated group may each apply the effective date rules without regard to how other members of the EAG apply the effective date rules.

Effect on Other Documents

Notice 2005–14 (2005–1 C.B. 498) is obsolete for taxable years beginning on or after June 1, 2006.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. 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 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, the notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

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

List of Subjects

26 CFR Part I

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

■ Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by adding entries 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).

Section 1.199–9 also issued under 26 U.S.C. 199(d). * * *

■ **Par. 2.** Sections 1.199–0 through 1.199–9 are added to read as follows:

§ 1.199–0 Table of contents.

This section lists the section headings that appear in §§ 1.199–1 through 1.199–9.

§ 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.
(d) Allocation of gross receipts.
(1) In general.
(2) Reasonable method of allocation.
(3) De minimis rules.
(i) DPGR.
(ii) Non-DPGR.
(4) Example.
(e) Certain multiple-year transactions.
(1) Use of historical data.
(2) Percentage of completion method.
(3) Examples.

§ 1.199–2 Wage limitation.

(a) Rules of application.
(1) In general.
(2) Wages paid by entity other than common law employer.
(3) Requirement that wages must be reported on return filed with the Social Security Administration.
(i) In general.
(ii) Corrected return filed to correct a return that was filed within 60 days of the due date.
(iii) Corrected return filed to correct a return that was filed later than 60 days after the due date.
(4) Joint return.
(b) Application in the case of a taxpayer with a short taxable year.
(c) Acquisition or disposition of a trade or business (or major portion).
(d) Non-duplication rule.
(e) Definition of W–2 wages.
(1) In general.
(2) Limitation on W–2 wages for taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005. [Reserved].
(3) Methods for calculating W–2 wages.

§ 1.199–3 Domestic production gross receipts.

(a) In general.
(b) Related persons.
(1) In general.
(2) Exceptions.
(c) Definition of gross receipts.
(d) Determining domestic production gross receipts.
(1) In general.
(2) Special rules.
(3) Exception.
(4) Examples.
(e) 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.
(f) Definition of by the taxpayer.
(1) In general.
(2) Special rule for certain government contracts.
(3) Subcontractor.
(4) Examples.
(g) Definition of in whole or in significant part.
(1) In general.
(2) Substantial in nature.
(3) Safe harbor.
(i) In general.
(ii) Unadjusted depreciable basis.
(iii) Computer software and sound recordings.
(4) Special rules.
(i) Contract with unrelated persons.
(ii) Aggregation.
(5) Examples.
(h) Definition of United States.
(i) Derived from the lease, rental, license, sale, exchange, or other disposition.
(1) In general.
(i) Definition.
(ii) Lease income.
(iii) Income substitutes.
(iv) Exchange of property.
(A) Taxable exchanges.
(B) Safe harbor.
(C) Eligible property.
(2) Examples.
(3) Hedging transactions.
(i) In general.
(ii) Currency fluctuations.
(iii) Effect of identification and nonidentification.
(iv) Other rules.
(4) Allocation of gross receipts.
(i) Embedded services and non-qualified property.
(A) In general.
(B) Exceptions.
(ii) Non-DPGR.
(iii) Examples.
(5) Advertising income.
(i) Tangible personal property.
(ii) Qualified film.
(iii) Examples.
(6) Computer software.
(i) In general.
(ii) through (v) [Reserved].
(7) Qualifying in-kind partnership for taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005. [Reserved].
(8) Partnerships owned by members of a single expanded affiliated group for taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005. [Reserved].
(9) Non-operating mineral interests.
(j) Definition of qualifying production property.
(1) In general.
(2) Tangible personal property.
(i) In general.
(ii) Local law.
(iii) Intangible property.
(3) Computer software.
(i) In general.
(ii) Incidental and ancillary rights.
(iii) Exceptions.
(4) Sound recordings.
(i) In general.
(ii) Exception.
(5) Tangible personal property with computer software or sound recordings.
(i) Computer software and sound recordings.
(ii) Tangible personal property.
(k) Definition of qualified film.
(1) In general.
(2) Tangible personal property with a film.
(i) Film not produced by a taxpayer.
(ii) Film produced by a taxpayer.
(A) Qualified film.
(B) Nonqualified film.
(3) Derived from a qualified film.
(i) In general.
(ii) Exceptions.
(4) Compensation for services.
(5) Determination of 50 percent.
(6) Exception.
(7) Examples.
(l) Electricity, natural gas, or potable water.
(1) In general.
(2) Natural gas.
(3) Potable water.
(4) Exceptions.
(i) Electricity.
(ii) Natural gas.
(iii) Potable water.
(iv) De minimis exception.
(A) DPGR.
(B) Non-DPGR.
(5) Example.
(m) Definition of construction performed in the United States.
(1) Construction of real property.
(i) In general.
(ii) Regular and ongoing basis.
(A) In general.
(B) New trade or business.
(iii) De minimis exception.
(A) DPGR.
(B) Non-DPGR.
(2) Activities constituting construction.
(i) In general.
(ii) Tangential services.
(iii) Other construction activities.
(iv) Administrative support services.
(v) Exceptions.
(3) Definition of real property.
(4) Definition of infrastructure.
(5) Definition of substantial renovation.
(6) Derived from construction.
(i) In general.
(ii) Qualified construction warranty.
(iii) Exceptions.
(iv) Land safe harbor.
(A) In general.
(B) Determining gross receipts and costs.
(v) Examples.
(n) Definition of engineering and architectural services.
(1) In general.
(2) Engineering services.
(3) Architectural services.
(4) Administrative support services.
(5) Exceptions.

§ 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). The provisions of this section apply solely for purposes of section 199 of the Internal Revenue Code.

(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, except that taxable income is determined without regard to section 199 and without regard to any amount excluded from gross income pursuant to section 114 or pursuant to section 101(d) of the American Jobs Creation Act of 2004, Public Law 108–357, 118 Stat. 1418 (Act). 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 and without regard to any amount excluded from gross income pursuant to section 114 or pursuant to section 101(d) of the Act. For purposes of determining the tax imposed by section 511, paragraph (a) of this section is applied using unrelated business taxable income. Except as provided in § 1.199–7(c)(2), the deduction under section 199 is not taken into account in computing any net operating loss or the amount of any net operating loss carryback or carryover.

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

Example 1. X, a 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 and an NOL deduction) of $600 in 2010. During 2010, X incurs W–2 wages as defined in § 1.199–2(e) 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 ($600 taxable income—$500 NOL)). Because the wage limitation is $150 (50% × $300), X's deduction is not limited.

Example 2. (i) *Facts.* X, a 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 that reduces its taxable income for 2010 to $0. 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.* QPAI for any taxable year is an amount equal to the excess (if any) of the taxpayer's domestic production gross receipts (DPGR) (as defined in § 1.199–3) over the sum of—

(1) The cost of goods sold (CGS) that is allocable to such receipts; and

(2) Other expenses, losses, or deductions (other than the deduction allowed under this section) that are properly allocable to such receipts. See §§ 1.199–3 and 1.199–4.

(d) *Allocation of gross receipts*—(1) *In general.* A taxpayer must determine the portion of its gross receipts for the taxable year 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 the gross receipts of which may constitute DPGR (assuming all the other requirements of § 1.199–3 are met), whether it is a service the gross receipts of which may constitute non-DPGR, or some combination thereof. For example, if a taxpayer leases qualifying production property (QPP) (as defined in § 1.199–3(j)(1)) and in connection with that lease, also provides services, the taxpayer must allocate its gross receipts from the transaction using any 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 and non-DPGR.

(2) *Reasonable method of allocation.* Factors taken into consideration in determining whether the taxpayer's method of allocating gross receipts between DPGR and non-DPGR is reasonable include whether the taxpayer uses the most accurate information available; the relationship between the gross receipts 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 or other business purposes; whether the method is used for other Federal or state income tax purposes; the time, burden, and cost of using alternative methods; and whether the taxpayer applies the method consistently from year to year. Thus, if a taxpayer has the information readily available and can, without undue burden or expense, specifically identify whether the gross receipts derived from an item are DPGR, then the taxpayer must use that specific identification to determine DPGR. If a taxpayer does not have information readily available to specifically identify whether the gross receipts derived from an item are DPGR or cannot, without undue burden or expense, specifically identify whether the gross receipts derived from an item are DPGR, then the taxpayer is not required to use a method that specifically identifies whether the gross receipts derived from an item are DPGR.

(3) *De minimis rules*—(i) *DPGR.* 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 the exceptions provided in § 1.199–

3(i)(4)(i)(B), (l)(4)(iv)(A), (m)(1)(iii)(A), (n)(6)(i), and (o)(2) that may result in gross receipts being treated as DPGR). If the amount of the taxpayer's gross receipts that are non-DPGR equals or exceeds 5 percent of the taxpayer's total gross receipts, then, except as provided in paragraph (d)(3)(ii) of this section, 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, but is not a member of a consolidated group, then the determination of whether less than 5 percent of the taxpayer's total gross receipts are non-DPGR is made at the corporation level. If a corporation is a member of a consolidated group, then the determination of whether less than 5 percent of the taxpayer's total gross receipts are non-DPGR is made at the consolidated group level. In the case of an S corporation, partnership, trust (to the extent not described in § 1.199–9(d)) or estate, 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 of the owner from its other trade or business activities and the owner's share of the gross receipts of the pass-thru entity.

(ii) *Non-DPGR.* All of a taxpayer's gross receipts may be treated as non-DPGR if less than 5 percent of the taxpayer's total gross receipts are DPGR (after application of the exceptions provided in § 1.199–3(i)(4)(ii), (l)(4)(iv)(B), (m)(1)(iii)(B), and (n)(6)(ii) that may result in gross receipts being treated as non-DPGR). If a corporation is a member of an EAG, but is not a member of a consolidated group, then the determination of whether less than 5 percent of the taxpayer's total gross receipts are DPGR is made at the corporation level. If a corporation is a member of a consolidated group, then the determination of whether less than 5 percent of the taxpayer's total gross receipts are DPGR is made at the consolidated group level. In the case of an S corporation, partnership, trust (to the extent not described in § 1.199–9(d)) or estate, or other pass-thru entity, the determination of whether less than 5 percent of the pass-thru entity's total gross receipts are 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 DPGR is made at the owner level, taking into account all gross receipts of the owner from its other trade or business activities and the owner's share of the gross receipts of the pass-thru entity.

(4) *Example.* The following example illustrates the application of this paragraph (d):

Example. 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 by purchase from an unrelated person. If at least 5% of X's gross receipts are derived from gasoline refined by X within the United States (that qualify as DPGR if all the other requirements of § 1.199–3 are met) and at least 5% of X's gross receipts are derived from the resale of the acquired gasoline (that do not qualify as DPGR), then X does not qualify for the *de minimis* rules under paragraphs (d)(3)(i) and (ii) of this section, and X must allocate its gross receipts between the gross receipts derived from the sale of gasoline refined by X within the United States and the gross receipts derived from the resale of the acquired gasoline. If less than 5% of X's gross receipts are derived from the resale of the acquired gasoline, then, X may either allocate its gross receipts between the gross receipts derived from the gasoline refined by X within the United States and the gross receipts derived from the resale of the acquired gasoline, or, pursuant to paragraph (d)(3)(i) of this section, X may treat all of its gross receipts derived from the sale of the refined gasoline as DPGR. If X's gross receipts attributable to the gasoline refined by X within the United States constitute less than 5% of X's total gross receipts, then, X may either allocate its gross receipts between the gross receipts derived from the gasoline refined by X within the United States and the gross receipts derived from the resale of the acquired gasoline, or, pursuant to paragraph (d)(3)(ii) of this section, X may treat all of its gross receipts derived from the sale of the refined gasoline as non-DPGR.

(e) *Certain multiple-year transactions*—(1) *Use of historical data.* If a taxpayer recognizes and reports gross receipts from advance payments or other similar payments on a Federal income tax return for a taxable year, then the taxpayer's use of historical data in making an allocation of gross receipts from the transaction between DPGR and non-DPGR may constitute a reasonable method. If a taxpayer makes allocations using historical data, and subsequently updates the data, then the taxpayer must use the more recent or updated data, starting in the taxable year in which the update is made.

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

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

Example 1. On December 1, 2007, X, a calendar year accrual method taxpayer, sells for $100 a one-year computer software maintenance agreement that provides for (i) computer software updates that X expects to produce in the United States, and (ii) customer support services. At the end of 2007, X uses a reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances to allocate 60% of the gross receipts ($60) to the computer software updates and 40% ($40) to the customer support services. X treats the $60 as DPGR in 2007. At the expiration of the one-year agreement on November 30, 2008, no computer software updates are provided by X. Pursuant to paragraph (e)(1) of this section, because X used a reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances to identify gross receipts as DPGR, X is not required to make any adjustments to its 2007 Federal income tax return (for example, by amended return) or in 2008 for the $60 that was properly treated as DPGR in 2007, even though no computer software updates were provided under the contract.

Example 2. X manufactures automobiles within the United States and sells 5-year extended warranties to customers. The sales price of the warranty is based on historical data that determines what repairs and services are performed on an automobile during the 5-year period. X sells the 5-year warranty to Y for $1,000 in 2007. Under X's method of accounting, X recognizes warranty revenue when received. Using historical data, X concludes that 60% of the gross receipts attributable to a 5-year warranty will be derived from the sale of parts (QPP) that X manufactures within the United States, and 40% will be derived from the sale of purchased parts X did not manufacture and non-qualifying services. X's method of allocating its gross receipts with respect to the 5-year warranty between DPGR and non-DPGR is a reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances. Therefore, X properly treats $600 as DPGR in 2007.

Example 3. The facts are the same as in *Example 2* except that in 2009 X updates its historical data. The updated historical data show that 50% of the gross receipts attributable to a 5-year warranty will be derived from the sale of parts (QPP) that X manufactures within the United States and 50% will be derived from the sale of purchased parts X did not manufacture and non-qualifying services. In 2009, X sells a 5-year warranty for $1,000 to Z. Under all of the facts and circumstances, X's method of allocation is still a reasonable method. Relying on its updated historical data, X properly treats $500 as DPGR in 2009.

Example 4. The facts are the same as in *Example 2* except that Y pays for the 5-year warranty over time ($200 a year for 5 years). Under X's method of accounting, X recognizes each $200 payment as it is received. In 2009, X updates its historical data and the updated historical data show that 50% of the gross receipts attributable to a 5-year warranty will be derived from the sale of QPP that X manufactures within the United States and 50% will be derived from the sale of purchased parts X did not manufacture and non-qualifying services. Under all of the facts and circumstances, X's method of allocation is still a reasonable method. When Y makes its $200 payment for 2009, X, relying on its updated historical data, properly treats $100 as DPGR in 2009.

§ 1.199–2 Wage limitation.

(a) *Rules of application*—(1) *In general.* The provisions of this section apply solely for purposes of section 199 of the Internal Revenue Code. 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 (as defined in paragraph (e) of this section) of the taxpayer. For this purpose, except as provided in paragraph (a)(3) of this section and paragraph (b) 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). See paragraph (a)(3) of this section for the requirement that W–2 wages must have been included in a return filed with the Social Security Administration (SSA) within 60 days after the due date (including extensions) of the return.

(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.

(3) *Requirement that wages must be reported on return filed with the Social Security Administration*—(i) *In general.* The term *W–2 wages* shall not include any amount that is not properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return. Under § 31.6051–2 of this chapter, each Form W–2 and the transmittal Form W–3, ''Transmittal of Wage and Tax Statements,'' together constitute an information return to be filed with SSA. Similarly, each Form W–2c, ''Corrected Wage and Tax Statement,'' and the transmittal Form W–3 or W–3c, ''Transmittal of Corrected Wage and Tax Statements,'' together constitute an information return to be filed with SSA. In determining whether any amount has been properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return, each Form W–2 together with its accompanying Form W–3 shall be considered a separate information return and each Form W–2c together with its accompanying Form W–3 or Form W–3c shall be considered a separate information return. Section 31.6071(a)–1(a)(3) of this chapter provides that each information return in respect of wages as defined in the Federal Insurance Contributions Act or of income tax withheld from wages which is required to be made under § 31.6051–2 of this chapter shall be filed on or before the last day of February (March 31 if filed electronically) of the year following the calendar year for which it is made, except that if a tax return under § 31.6011(a)–5(a) of this chapter is filed as a final return for a period ending prior to December 31, the information statement shall be filed on or before the last day of the second calendar month following the period for which the tax return is filed. Corrected Forms W–2 are required to be filed with SSA on or before the last day of February (March 31 if filed electronically) of the year following the year in which the correction is made, except that if a tax return under § 31.6011(a)–5(a) is filed as a final return for a period ending prior to December 31 for the period in which the correction is made, the corrected Forms W–2 are required to be filed by the last day of the second calendar month following the period for which the final return is filed.

(ii) *Corrected return filed to correct a return that was filed within 60 days of the due date.* If a corrected information return (Return B) is filed with SSA on or before the 60th day after the due date (including extensions) of Return B to correct an information return (Return A) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return A) and paragraph (a)(3)(ii) of this section does not apply, then the wage information on Return B must be included in determining W–2 wages. If a corrected information return (Return D) is filed with SSA later than the 60th day after the due date (including extensions) of Return D to correct an information return (Return C) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return C), then if Return D reports an increase (or increases) in wages included in determining W–2 wages from the wage amounts reported on Return C, then such increase (or increases) on Return D shall be disregarded in determining W–2 wages (and only the wage amounts on Return C may be included in determining W–2 wages). If Return D reports a decrease (or decreases) in wages included in determining W–2 wages from the amounts reported on Return C, then, in determining W–2 wages, the wages reported on Return C must be reduced by the decrease (or decreases) reflected on Return D.

(iii) *Corrected return filed to correct a return that was filed later than 60 days after the due date.* If an information return (Return F) is filed to correct an information return (Return E) that was not filed with SSA on or before the 60th day after the due date (including extensions) of Return E, then Return F (and any subsequent information returns filed with respect to Return E) will not be considered filed on or before the 60th day after the due date (including extensions) of Return F (or the subsequent corrected information return). Thus, if a Form W–2c (or corrected Form W–2) is filed to correct a Form W–2 that was not filed with SSA on or before the 60th day after the due date (including extensions) of the information return including the Form W–2 (or to correct a Form W–2c relating to an information return including a Form W–2 that had not been filed with SSA on or before the 60th day after the due date (including extensions) of the information return including the Form W–2), then the information return including this Form W–2c (or corrected Form W–2) shall not be considered to have been filed with SSA on or before the 60th day after the due date (including extensions) for this

information return including the Form W–2c (or corrected Form W–2), regardless of when the information return including the Form W–2c (or corrected Form W–2) is filed.

(4) *Joint return.* An individual and his or her spouse are considered one taxpayer for purposes of determining the amount of W–2 wages for a taxable year, provided that they file a joint return for the taxable year. Thus, an individual filing as part of a joint return may include the wages of employees of his or her spouse in determining W–2 wages, provided the employees are employed in a trade or business of the spouse and the other requirements of this section are met. However, a married taxpayer filing a separate return from his or her spouse for the taxable year may not include the wages of employees of the taxpayer's spouse in determining the taxpayer's W–2 wages for the taxable year.

(b) *Application in the case of a taxpayer with a 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 only those wages paid during the short taxable year to employees of the taxpayer, only those elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the taxpayer and only compensation actually deferred under section 457 during the short taxable year with respect to employees of the taxpayer. The Secretary shall have the authority to issue published guidance setting forth the method that is used to calculate W–2 wages in case of a taxpayer with a short taxable year. See paragraph (e)(3) of this section.

(c) *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.

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

(e) *Definition of W–2 wages*—(1) *In general.* Under section 199(b)(2), the term *W–2 wages* means, with respect to any person for any taxable year of such person, the sum of the amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable 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).

(2) *Limitation on W–2 wages for taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005.* [Reserved].

(3) *Methods for calculating W–2 wages.* The Secretary may provide by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter) for methods to be used in calculating W–2 wages, including W–2 wages for short taxable years. For example, see Rev. Proc. 2006–22 (2006–22 I.R.B.) (see § 601.601(d)(2) of this chapter).

§ 1.199–3 Domestic production gross receipts.

(a) *In general.* The provisions of this section apply solely for purposes of section 199 of the Internal Revenue Code (Code). Domestic production gross receipts (DPGR) are the gross receipts (as defined in paragraph (c) of this section) of the taxpayer that are—

(1) Derived from any lease, rental, license, sale, exchange, or other disposition (as defined in paragraph (i) of this section) of—

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

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

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

(2) Derived from, in the case of a taxpayer engaged in the active conduct of a construction trade or business, construction of real property (as defined in paragraph (m) of this section) performed in the United States by the taxpayer in the ordinary course of such trade or business; or

(3) Derived from, in the case of a taxpayer engaged in the active conduct of an engineering or architectural services trade or business, engineering or architectural services (as defined in paragraph (n) of this section) performed in the United States by the taxpayer in the ordinary course of such trade or business with respect to the construction of real property in the United States.

(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). Any other person is an unrelated person for purposes of §§ 1.199–1 through 1.199–9.

(2) *Exceptions.* Notwithstanding paragraph (b)(1) of this section, gross receipts derived from any QPP or qualified film leased or rented by the taxpayer to a related person may qualify as DPGR if the QPP or qualified film is held for sublease or rent, or is subleased or rented, by the related person to an unrelated person for the ultimate use of the unrelated person. Similarly, notwithstanding paragraph (b)(1) of this section, gross receipts derived from the license of QPP or a qualified film 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 may qualify as DPGR.

(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) *Determining domestic production gross receipts*—(1) *In general.* For purposes of §§ 1.199–1 through 1.199–9, a taxpayer determines, using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, whether gross receipts qualify as DPGR 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).

(i) The term *item* means the property offered by the taxpayer in the normal course of the taxpayer's business for lease, rental, license, sale, exchange, or other disposition (for purposes of this paragraph (d), collectively referred to as disposition) to customers, if the gross receipts from the disposition of such property qualify as DPGR; or

(ii) If paragraph (d)(1)(i) of this section does not apply to the property, then any component of the property described in paragraph (d)(1)(i) of this section is treated as the item, provided that the gross receipts from the disposition of the property described in paragraph (d)(1)(i) of this section that are attributable to such component qualify as DPGR. Each component that meets the requirements under this paragraph (d)(1)(ii) must be treated as a separate item and a component that meets the requirements under this paragraph (d)(1)(ii) may not be combined with a component that does not meet these requirements.

(2) *Special rules.* The following special rules apply for purposes of paragraph (d)(1) of this section:

(i) For purposes of paragraph (d)(1)(i) of this section, in no event may a single item consist of two or more properties unless those properties are offered for disposition, in the normal course of the taxpayer's business, as a single item (regardless of how the properties are packaged).

(ii) 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).

(iii) In the case of construction activities and services or engineering and architectural services, a taxpayer may use any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances to determine what construction activities and services or engineering or architectural services constitute an item.

(3) *Exception.* If a taxpayer MPGE QPP within the United States or produces a qualified film or produces utilities in the United States that it disposes of, and the taxpayer leases, rents, licenses, purchases, or otherwise acquires property that contains or may contain the QPP, qualified film, or the utilities (or a portion thereof), and the taxpayer cannot reasonably determine, without undue burden and expense, whether the acquired property contains any of the original QPP, qualified film, or utilities MPGE or produced by the taxpayer, then the taxpayer is not required to determine whether any portion of the acquired property qualifies as an item for purposes of paragraph (d)(1) of this section. Therefore, the gross receipts derived from the disposition of the acquired property may be treated as non-DPGR. Similarly, the preceding sentences shall apply if the taxpayer can reasonably determine that the acquired property contains QPP, a qualified film, or utilities (or a portion thereof) MPGE or produced by the taxpayer, but cannot reasonably determine, without undue burden or expense, how much, or what type, grade, etc., of the QPP, qualified film, or utilities MPGE or produced by the taxpayer the acquired property contains.

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

Example 1. Q manufactures leather and rubber shoe soles in the United States. Q imports shoe uppers, which are the parts of the shoe above the sole. Q manufactures shoes for sale by sewing or otherwise attaching the soles to the imported uppers. Q offers the shoes for sale to customers in the normal course of Q's business. If the gross receipts derived from the sale of the shoes do not qualify as DPGR under this section, then under paragraph (d)(1)(ii) of this section, Q must treat the sole as the item if the gross receipts derived from the sale of the sole qualify as DPGR under this section.

Example 2. The facts are the same as in *Example 1* except that Q also buys some finished shoes from unrelated persons and resells them to retail shoe stores. Q offers all shoes (manufactured and purchased) for sale to customers, in the normal course of Q's business, in individual pairs, and requires no minimum quantity order. Q ships the shoes in boxes, each box containing as many as 50 pairs of shoes. A full, or partially full, box may contain some shoes that Q manufactured, and some that Q purchased. Under paragraph (d)(2)(i) of this section, Q cannot treat a box of 50 (or fewer) pairs of shoes as an item, because Q offers the shoes for sale in the normal course of Q's business in individual pairs.

Example 3. R manufactures toy cars in the United States. R also purchases cars that were manufactured by unrelated persons. R offers the cars for sale to customers, in the normal course of R's business, in sets of three, and requires no minimum quantity order. R sells the three-car sets to toy stores. A three-car set may contain some cars manufactured by R and some cars purchased by R. If the gross receipts derived from the sale of the three-car sets do not qualify as DPGR under this section, then, under paragraph (d)(1)(ii) of this section, R must treat a toy car in the three-car set as the item, provided the gross receipts derived from the sale of the toy car qualify as DPGR under this section.

Example 4. The facts are the same as *Example 3* except that R offers the toy cars for sale individually to customers in the normal course of R's business, rather than in sets of three. R's customers resell the individual toy cars at three for $10. Frequently, this results in retail customers purchasing three individual cars in one transaction. In determining R's DPGR, under paragraph (d)(2)(i) of this section, each toy car is an item and R cannot treat three individual toy cars as one item, because the individual toy cars are not offered for sale in sets of three by R in the normal course of R's business.

Example 5. The facts are the same as in *Example 3* except that R offers the toy cars for sale to customers in the normal course of R's business both individually and in sets of three. The results are the same as *Example 3* with respect to the three-car sets. The results are the same as in *Example 4* with respect to the individual toy cars that are not included in the three-car sets and offered for sale individually. Thus, R has two items, an individual toy car and a set of three toy cars.

Example 6. S produces television sets in the United States. S also produces the same

model of television set outside the United States. In both cases, S packages the sets one to a box. S sells the television sets to large retail consumer electronics stores. S requires that its customers purchase a minimum of 100 television sets per order. With respect to a particular order by a customer of 100 television sets, some were manufactured by S in the United States, and some were manufactured by S outside the United States. Under paragraph (d)(2)(i) of this section, a minimum order of 100 television sets is the item provided that the gross receipts derived from the sale of the 100 television sets qualify as DPGR.

Example 7. T produces in bulk form in the United States the active ingredient for a pharmaceutical product. T 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 are met. FX uses the active ingredient to produce the finished dosage form drug. FX sells the drug in finished dosage to T, which sells the drug to customers. Assume that T knows how much of the active ingredient is in the finished dosage. Under paragraph (d)(1)(ii) of this section, if T's gross receipts derived from the sale of the finished dosage do not qualify as DPGR under this section, then T must treat the active ingredient component as the item because the gross receipts attributable to the active ingredient qualify as DPGR under this section. The exception in paragraph (d)(3) of this section does not apply because T can reasonably determine without undue burden or expense that the finished dosage contains the active ingredient and the quantity of the active ingredient in the finished dosage.

Example 8. U produces steel within the United States and sells its steel to a variety of customers, including V, an unrelated person, who uses the steel for the manufacture of equipment. V also purchases steel from other steel producers. For its steel operations, U purchases equipment from V that may contain steel produced by U. U sells the equipment after 5 years. If U cannot reasonably determine without undue burden and expense whether the equipment contains any steel produced by U, then, under paragraph (d)(3) of this section, U may treat the gross receipts derived from sale of the equipment as non-DPGR.

Example 9. The facts are the same as in *Example 8* except that U knows that the equipment purchased from V does contain some amount of steel produced by U. If U cannot reasonably determine without undue burden and expense how much steel produced by U the equipment contains, then, under paragraph (d)(3) of this section, U may treat the gross receipts derived from sale of the equipment as non-DPGR.

Example 10. W manufactures sunroofs, stereos, and tires within the United States. W purchases automobiles from unrelated persons and installs the manufactured components in the automobiles. W, in the normal course of W's business, sells the automobiles with the components to customers. If the gross receipts derived from the sale of the automobiles with the components do not qualify as DPGR under this section, then under paragraph (d)(1)(ii) of this section, W must treat each component (sunroofs, stereos, and tires) that it manufactures as a separate item if the gross receipts derived from the sale of each component qualify as DPGR under this section.

Example 11. X manufacturers leather soles within the United States. X purchases shoe uppers, metal eyelets, and laces. X manufactures shoes by sewing or otherwise attaching the soles to the uppers; attaching the metal eyelets to the shoes; and threading the laces through the eyelets. X, in the normal course of X's business, sells the shoes to customers. If the gross receipts derived from the sale of the shoes do not qualify as DPGR under this section, then under paragraph (d)(1)(ii) of this section, X must treat the sole as the item if the gross receipts derived from the sale of the sole qualify as DPGR under this section. X may not treat the shoe upper, metal eyelets or laces as part of the item because under paragraph (d)(1)(ii) of this section the sole is the component that is treated as the item.

Example 12. Y manufactures glass windshields for automobiles within the United States. Y purchases automobiles from unrelated persons and installs the windshields in the automobiles. Y, in the normal course of Y's business, sells the automobiles with the windshields to customers. If the automobiles with the windshields do not meet the requirements for being an item, then, under paragraph (d)(1)(ii) of this section, Y must treat each windshield that it manufactures as an item if the gross receipts derived from the sale of the windshield qualify as DPGR under this section. Y may not treat any other portion of the automobile as part of the item because under paragraph (d)(1)(ii) of this section the windshield is the component.

(e) *Definition of manufactured, produced, grown, or extracted*—(1) *In general.* Except as provided in paragraphs (e)(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. Pursuant to paragraph (f)(1) of this section, 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 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 does not qualify as MPGE with respect to that QPP.

(3) *Installing.* If a taxpayer installs QPP and engages in no other MPGE activity with respect to the QPP, the taxpayer's installing activity does not qualify as an MPGE activity. Notwithstanding paragraph (i)(4)(i)(B)(*4*) of this section, if the taxpayer installs QPP MPGE by the taxpayer and, except as provided in paragraph (f)(2) of this section, the taxpayer has the benefits and burdens of ownership of the QPP under Federal income tax principles during the period the installing activity occurs, then the portion of the installing activity that relates to the QPP is an MPGE activity.

(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 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 (e):

Example 1. A, B, and C are unrelated persons and are not cooperatives to which Part I of subchapter T of the Code applies. B grows agricultural products in the United States and sells them to A, who owns agricultural storage bins in the United States. A stores the agricultural products and has the benefits and burdens of ownership under Federal income tax principles of the agricultural products while they are being stored. A sells the agricultural products to C, who processes them 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 them into refined agricultural products outside the United States. Pursuant to paragraph (e)(1) of this section, the gross receipts derived by A from its sale of the agricultural products to C are DPGR from the MPGE of QPP within the United States. B's and C's respective MPGE 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 that constitute QPP in the customers' property. Y's installation of purchased replacement parts does not qualify as MPGE pursuant to paragraph (e)(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 under Federal income tax principles of the replacement parts during the reconstruction and refurbishment activity and while installing the parts. Y's gross receipts derived from the MPGE of the replacement parts and Y's gross receipts derived from the installation of the replacement parts, which is an MPGE activity pursuant to paragraph (e)(3) of this section, are DPGR (assuming all the other requirements of this section are met).

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 persons 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 (e)(2) of this section which is not an MPGE activity.

Example 7. 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 must determine whether its gross receipts derived from the sale of the pens and pencils qualify as DPGR. Y's status as a manufacturer of furniture in the United States does not carry over to its other activities.

Example 8. X produces computer software within the United States. In 2007, X enters into an agreement with Y, an unrelated person, under which X will manage Y's networks using computer software that X produced. Pursuant to the terms of the agreement, X also provides to Y for Y's use on Y's own hardware computer software that X produced (additional computer software). Assume that, based on all of the facts and circumstances, the transaction between X and Y relating to the additional computer software is a lease or sale of the additional computer software. Y pays X monthly fees of $100 under the agreement during 2007. No separate charge for the additional computer software is stated in the agreement or in the monthly invoices that X provides to Y. The portion of X's gross receipts that is derived from the lease or sale of the additional computer software is DPGR (assuming all the other requirements of this section are met).

(f) *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, qualifying in-kind partnerships under § 1.199–9(i), EAG partnerships under § 1.199–9(j), and government contracts under paragraph (f)(2) of this section, only one taxpayer may claim the deduction under § 1.199–1(a) with respect to any qualifying activity under paragraphs (e)(1), (k)(1), and (l)(1) of this section performed in connection with the same QPP, or the production of a qualified film or utilities. If one taxpayer performs a qualifying activity under paragraph (e)(1), (k)(1), or (l)(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 QPP, qualified film, or utilities under Federal income tax principles during the period in which the qualifying activity occurs is treated as engaging in the qualifying activity.

(2) *Special rule for certain government contracts.* Gross receipts derived from the MPGE of QPP in whole or in significant part within the United States will be treated as gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP MPGE by the taxpayer in whole or in significant part within the United States notwithstanding the requirements of paragraph (f)(1) of this section if—

(i) The QPP is MPGE by the taxpayer within the United States pursuant to a contract with the Federal government; and

(ii) The Federal Acquisition Regulation (Title 48, Code of Federal Regulations) requires that title or risk of loss with respect to the QPP be transferred to the Federal government before the MPGE of the QPP is completed.

(3) *Subcontractor.* If a taxpayer (subcontractor) enters into a contract or agreement to MPGE QPP on behalf of a taxpayer to which paragraph (f)(2) of this section applies, and the QPP under the contract or agreement is subject to paragraph (f)(2)(ii) of this section, then, notwithstanding the requirements of paragraph (f)(1) of this section, the subcontractor's gross receipts derived from the MPGE of the QPP in whole or in significant part within the United States will be treated as gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP MPGE by the subcontractor in whole or in significant part within the United States.

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

Example 1. X designs machines that it uses in its trade or business. X contracts with Y, an unrelated person, 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 (f)(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 person, for the manufacture of the machines. The contract between X and Y is a cost-reimbursable type contract. Assume that 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 (f)(1) of this section.

Example 3. X manufactures machines within the United States pursuant to a contract with the Federal government and the Federal Acquisition Regulation requires that the title or risk of loss with respect to the machines be transferred to the Federal government before X completes manufacture of the machines. X subcontracts with Y, an unrelated person, for the manufacture of components for the machines that Y manufactures within the United States.

Assume that the machines manufactured by X, and the components for the machines manufactured by Y, are QPP. Both the machines and components are subject to the Federal Acquisition Regulation that requires title or risk of loss with respect to the machines and components be transferred to the Federal government before manufacturing of the machines and components are complete. Under paragraph (f)(2) of this section, the gross receipts derived by X from the manufacture within the United States of the machines for the Federal government are treated as having been derived from the lease, rental, license, sale, exchange, or other disposition of the machines manufactured by X in whole or in significant part within the United States. Under paragraph (f)(3) of this section, the gross receipts derived by Y from the manufacture within the United States of the components for X are also treated as having been derived from the lease, rental, license, sale, exchange, or other disposition of the components manufactured by Y in whole or in significant part within the United States.

(g) *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 with an unrelated person for the unrelated person 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, pursuant to paragraph (f)(1) of this section, the taxpayer is considered to MPGE the QPP under this section. The unrelated person 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 (g)(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 (g)(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 QPP, and the nature of the MPGE activity that the taxpayer performs within the United States. The MPGE of a key component of QPP does not, in itself, meet the substantial-in-nature requirement with respect to the QPP under this paragraph (g)(2). In the case of tangible personal property (as defined in paragraph (j)(2) of this section), research and experimental activities under section 174 and the creation of intangible assets are not taken into account in determining whether the MPGE of QPP is substantial in nature for any QPP other than computer software (as defined in paragraph (j)(3) of this section) and sound recordings (as defined in paragraph (j)(4) of this section). Thus, for example, a taxpayer may take into account its design and development activities when determining whether its MPGE of computer software is substantial in nature.

(3) *Safe harbor*—(i) *In general.* A taxpayer will be treated as having MPGE QPP in whole or in significant part within the United States for purposes of paragraph (g)(1) of this section if, in connection with the QPP, the direct labor and overhead 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, or in a transaction without CGS (for example, a lease, rental, or license) account for 20 percent or more of the taxpayer's *unadjusted depreciable basis* (as defined in paragraph (g)(3)(ii) of this section) in the QPP. For taxpayers subject to section 263A, overhead is all costs required to be capitalized under section 263A except direct materials and direct labor. For taxpayers not subject to section 263A, overhead may be computed using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, but may not include any cost, or amount of any cost, that would not be required to be capitalized under section 263A if the taxpayer were subject to section 263A. Research and experimental expenditures under section 174 and the costs of creating intangible assets are not taken into account in determining direct labor or overhead for any tangible personal property. However, for a special rule regarding computer software and sound recordings, see paragraph (g)(3)(iii) of this section. In the case of tangible personal property (as defined in paragraph (j)(2) of this section), research and experimental expenditures under section 174 and any other costs incurred in the creation of intangible assets may be excluded from CGS or unadjusted depreciable basis for purposes of determining whether the taxpayer meets the safe harbor under this paragraph (g)(3).

(ii) *Unadjusted depreciable basis.* The term *unadjusted depreciable basis* means the basis of property for purposes of section 1011 without regard to any adjustments described in section 1016(a)(2) and (3). This basis does not reflect the reduction in basis for—

(A) Any portion of the basis the taxpayer properly elects to treat as an expense under section 179 or 179C; or

(B) Any adjustments to basis provided by other provisions of the Code and the regulations under the Code (for example, a reduction in basis by the amount of the disabled access credit pursuant to section 44(d)(7)).

(iii) *Computer software and sound recordings.* In determining direct labor and overhead under paragraph (g)(3)(i) of this section, the costs of direct labor and overhead for developing computer software as described in Rev. Proc. 2000–50 (2000–1 C.B. 601) (see § 601.601(d)(2) of this chapter), research and experimental expenditures under section 174, and any other costs of creating intangible assets for computer software and sound recordings are treated as direct labor and overhead. These costs must be included in the taxpayer's CGS or unadjusted depreciable basis of computer software and sound recordings for purposes of determining whether the taxpayer meets the safe harbor under paragraph (g)(3)(i) of this section. If the taxpayer expects to lease, rent, license, sell, exchange, or otherwise dispose of computer software or sound recordings over more than one taxable year, the costs of developing computer software as described in Rev. Proc. 2000–50 (2000–1 C.B. 601), research and experimental expenditures under section 174, and any other costs of creating intangible assets for computer software and sound recordings must be allocated over the estimated number of units that the taxpayer expects to lease, rent, license, sell, exchange, or otherwise dispose of.

(4) *Special rules*—(i) *Contract with an unrelated person.* If a taxpayer enters into a contract with an unrelated person for the unrelated person to MPGE QPP within the United States for the taxpayer, and the taxpayer is considered to MPGE the QPP pursuant to paragraph (f)(1) of this section, then, for purposes of the substantial-in-nature requirement under paragraph (g)(2) of this section and the safe harbor under paragraph (g)(3)(i) of this section, the taxpayer's MPGE or production activities or direct labor and overhead shall include both the taxpayer's MPGE or production activities or direct labor and overhead to MPGE the QPP within the United States as well as the MPGE or production activities or direct labor and overhead of the unrelated person to MPGE the QPP within the United States under the contract.

(ii) *Aggregation.* In determining whether the substantial-in-nature requirement under paragraph (g)(2) of this section or the safe harbor under

paragraph (g)(3)(i) of this section is met at the time the taxpayer disposes of an item of QPP—

(A) An EAG member must take into account all of the previous MPGE or production activities or direct labor and overhead of the other members of the EAG;

(B) An EAG partnership (as defined in § 1.199–9(j)) must take into account all of the previous MPGE or production activities or direct labor and overhead of all members of the EAG in which the partners of the EAG partnership are members (as well as the previous MPGE or production activities of any other EAG partnerships owned by members of the same EAG);

(C) A member of an EAG in which the partners of an EAG partnership are members must take into account all of the previous MPGE or production activities or direct labor and overhead of the EAG partnership (as well as those of any other members of the EAG and any previous MPGE or production activities of any other EAG partnerships owned by members of the same EAG); and

(D) A partner of a qualifying in-kind partnership (as defined in § 1.199–9(i)) must take into account all of the previous MPGE or production activities or direct labor and overhead of the qualifying in-kind partnership.

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

Example 1. X purchases from Y, an unrelated person, unrefined oil extracted outside the United States. 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 MPGE activities are substantial in nature under paragraph (g)(2) of this section. Therefore, X has MPGE the jewelry in significant part within the United States.

Example 3. (i) *Facts.* 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 person, 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
Direct labor and overhead: $325
Total cost of goods sold: $1,800
Gross profit: $700
Administrative and selling expenses: $300
Taxable income: $400

(ii) *Analysis.* Although X's direct labor and overhead are less than 20% of total CGS ($325/$1,800, or 18%) and X is not within the safe harbor under paragraph (g)(3)(i) of this section, the activities conducted by X in connection with the assembly of an automobile are substantial in nature under paragraph (g)(2) of this section taking into account 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 (g)(1) of this section.

Example 4. X imports into the United States QPP that is partially manufactured. Assume that 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 (g)(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 5. X manufactures QPP in significant part within the United States and exports the QPP for further manufacture outside the United States. X retains title to the QPP while the QPP is being further manufactured 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 6. X is a retailer within the United States 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 is substantial in nature.

Example 7. X incurs $1,000,000 in computer software development costs in direct labor and overhead to develop computer software. X begins producing the computer software and expects to license one million copies of the computer software. In determining its direct labor and overhead for the computer software under paragraph (g)(3)(i) of this section, X must allocate under paragraph (g)(3)(iii) of this section the $1,000,000 to the computer software X expects to produce. Thus, for each copy of the computer software produced by X, $1 ($1,000,000 in computer software development costs/one million estimated number of units to be licensed) in computer software development costs are treated as direct labor and overhead.

Example 8. X creates computer software for microwave ovens. X also manufactures the electric motors used in the ovens. X purchases the other components of the microwave ovens from unrelated persons. X sells each microwave oven individually to customers. Assume that X's assembly of the finished microwave ovens is not minor assembly. To determine whether the manufacture of the microwave ovens satisfies the safe harbor under paragraph (g)(3)(i) of this section, X's direct labor and overhead include X's direct labor and overhead for creating the computer software, manufacturing the electric motors, and assembling the finished microwave ovens that are offered for sale.

Example 9. X designs shirts within the United States, but X cuts and sews the shirts outside of the United States. Because X's design activity is the creation of an intangible, its design activity is not taken into account in determining whether the manufacture of the shirts is substantial in nature under paragraph (g)(2) of this section, and the costs X incurs in creating the design of the shirts are not direct labor or overhead under paragraph (g)(3)(i) of this section. Therefore, X has not MPGE the shirts in significant part within the United States.

Example 10. X manufactures computer chips within the United States. X installs the computer chips that it manufactures in computers that X purchases from unrelated persons and sells the finished computers individually to customers. The computer chips are key components of the computers and the computers will not operate without them. The manufacture of the computer chips is not, in itself, substantial in nature with respect to the finished computers. Therefore, the taxpayer's MPGE activities must meet either the substantial-in-nature requirement under paragraph (g)(2) of this section, or the safe harbor under paragraph (g)(3) of this section, in order to qualify with respect to the finished computers.

(h) *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.

(i) *Derived from the lease, rental, license, sale, exchange, or other disposition*—(1) *In general*—(i) *Definition.* 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 of QPP, a qualified film, or utilities, even if the taxpayer has already recognized gross receipts from a previous lease, rental, license, sale, exchange, or other disposition of the same QPP, qualified film, or utilities. Applicable Federal income tax principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition, whether it is a service, or whether it is some combination thereof.

(ii) *Lease income.* The financing and interest components of a lease of QPP or a qualified film are considered to be derived from the lease of such QPP or qualified film. However, any portion of the lease income that is attributable to services or non-qualified property as defined in paragraph (i)(4) of this section is not derived from the lease of QPP or a qualified film.

(iii) *Income substitutes.* 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.

(iv) *Exchange of property*—(A) *Taxable exchanges.* Except as provided in paragraph (i)(1)(iv)(B) of this section, the value of property received by a taxpayer in a taxable exchange of QPP MPGE in whole or in significant part by the taxpayer within the United States, a qualified film produced by the taxpayer, or utilities produced by the taxpayer within the United States is DPGR for the taxpayer (assuming all the other requirements of this section are met). However, unless the taxpayer meets all of the requirements under this section with respect to any further MPGE by the taxpayer of the QPP or any further production by the taxpayer of the film or utilities received in the taxable exchange, any gross receipts derived from the sale by the taxpayer of the property received in the taxable exchange are non-DPGR, because the taxpayer did not MPGE or produce such property, even if the property was QPP, a qualified film, or utilities in the hands of the other party to the transaction.

(B) *Safe harbor.* For purposes of paragraph (i)(1)(iv)(A) of this section, the gross receipts derived by the taxpayer from the sale of eligible property (as defined in paragraph (i)(1)(iv)(C) of this section) received in a taxable exchange, net of any adjustments between the parties involved in the taxable exchange to account for differences in the eligible property exchanged (for example, location differentials and product differentials), may be treated as the value of the eligible property received by the taxpayer in the taxable exchange. For purposes of the preceding sentence, the taxable exchange is deemed to occur on the date of the sale of the eligible property received in the taxable exchange by the taxpayer, to the extent the sale occurs no later than the last day of the month following the month in which the exchanged eligible property is received by the taxpayer. In addition, if the taxpayer engages in any further MPGE or production activity with respect to the eligible property received in the taxable exchange, then, unless the taxpayer meets the in-whole-or-in-significant-part requirement under paragraph (g)(1) of this section with respect to the property sold, for purposes of this paragraph (i)(1)(iv)(B), the taxpayer must also value the property sold without taking into account the gross receipts attributable to the further MPGE or production activity.

(C) *Eligible property.* For purposes of paragraph (i)(1)(iv)(B) of this section, eligible property is—

(*1*) Oil, natural gas (as described in paragraph (l)(2) of this section), or petrochemicals, or products derived from oil, natural gas, or petrochemicals; or

(*2*) Any other property or product designated by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter).

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

Example 1. X MPGE QPP in whole or in significant part within the United States and uses the QPP in its business. After several years X sells the QPP that it MPGE to Y. The gross receipts derived from the sale of the QPP to Y are 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 person. Y leases the QPP for 3 years to Z, a taxpayer unrelated to both X and Y, and shortly after Y enters into the lease with Z, 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 (including any financing and interest components of the lease), and from the sale of the QPP to Z all qualify as DPGR (assuming all the other requirements of this section are met).

Example 3. X MPGE QPP within the United States and sells the QPP to Y, an unrelated person, 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 4. Cable company X charges subscribers $15 a month for its basic cable television. Y, an unrelated person, produces a qualified film within the meaning of paragraph (k)(1) of this section that it licenses to X for $.10 per subscriber per month. The gross receipts derived by Y are derived from the license of a qualified film produced by Y and are DPGR (assuming all the other requirements of this section are met).

Example 5. X manufactures cars within the United States. X also manufactures replacement parts within the United States. The replacement parts are QPP under paragraph (j)(1) of this section. X offers extended warranties to its customers. X sells a car to Y. Y purchases an extended warranty and brings the car to X's service department for maintenance. X repairs the car and replaces damaged parts with replacement parts that X manufactured within the United States. The portion of X's gross receipts derived from the sale of the extended warranty relating to the manufactured parts are DPGR.

(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 relates to property described in section 1221(a)(8) consumed in an activity giving rise to DPGR, and provided that the transaction is a hedging transaction within the meaning of section 1221(b)(2)(A) and § 1.1221–2(b) and is properly identified as a hedging transaction in accordance with § 1.1221–2(f), 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) *Effect of identification and nonidentification.* If a taxpayer does not make an identification that satisfies all of the requirements of § 1.1221–2(f) but

the taxpayer has no reasonable grounds for treating the transaction as other than a hedging transaction, then a loss from the transaction is taken into account under this paragraph (i)(3). If the inadvertent identification rule of § 1.1221–2(g)(1)(ii) or the inadvertent error rule of § 1.1221–2(g)(2)(ii) applies, then the taxpayer is treated as not having identified the transaction as a hedging transaction or as having identified the transaction as a hedging transaction, as the case may be. If a taxpayer identifies a transaction as a hedging transaction in accordance with § 1.1221–2(f)(1), then—

(A) That identification is binding with respect to loss for purposes of this paragraph (i)(3), whether or not all of the requirements of § 1.1221–2(f) are satisfied and whether or not the transaction is in fact a hedging transaction within the meaning of section 1221(b)(2)(A) and § 1.1221–2(b), and

(B) This paragraph (i)(3) does not apply to require gain to be taken into account in determining CGS or DPGR, if the transaction is not in fact a hedging transaction within the meaning of section 1221(b)(2)(A) and § 1.1221–2(b).

(iv) *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, gains, or losses with respect to hedging transactions.

(4) *Allocation of gross receipts*—(i) *Embedded services and non-qualified property*—(A) *In general.* Except as otherwise provided in paragraph (i)(4)(i)(B), paragraph (m) (relating to construction), and paragraph (n) (relating to engineering and architectural 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, in the normal course of the taxpayer's business, is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of QPP, a qualified film, or utilities, DPGR include only the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP, a qualified film, or utilities (assuming all the other requirements of this section are met) and not any receipts attributable to the embedded service. 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). 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 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. In addition, see § 1.199–1(e) for other instances when an allocation of gross receipts attributable to embedded services or non-qualified property will be deemed reasonable.

(B) *Exceptions.* There are six exceptions to the rules under paragraph (i)(4)(i)(A) 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 QPP, qualified films, or utilities to which the embedded services or non-qualified property relate, the gross receipts derived from—

(*1*) A qualified warranty, that is, a warranty (other than a computer software maintenance agreement described in paragraph (i)(4)(i)(B)(*5*) of this section) that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of QPP, a qualified film, or utilities if, in the normal course of the taxpayer's business—

(*i*) 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 QPP, qualified film, or utilities; and

(*ii*) The warranty is neither separately offered by the taxpayer nor separately bargained for with customers (that is, a customer cannot purchase the QPP, qualified film, or utilities without the warranty);

(*2*) 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, in the normal course of the taxpayer's business—

(*i*) 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 QPP; and

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

(*3*) 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, a qualified film or utilities if, in the normal course of the taxpayer's business—

(*i*) 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 QPP, qualified film, or utilities;

(*ii*) The manual is neither separately offered by the taxpayer nor separately bargained for with customers (that is, a customer cannot purchase the QPP, qualified film, or utilities without the manual); and

(*iii*) The manual is not provided in connection with a training course for customers;

(*4*) A qualified installation, that is, an installation service (including minor assembly) for tangible personal property that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of the tangible personal property if, in the normal course of the taxpayer's business—

(*i*) 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 tangible personal property; and

(*ii*) The installation is neither separately offered by the taxpayer nor separately bargained for with customers (that is, a customer cannot purchase the tangible personal property without the installation service);

(*5*) Services performed pursuant to a qualified computer software maintenance agreement. A qualified computer software maintenance agreement is an agreement provided in connection with the lease, rental, license, sale, exchange, or other disposition of the computer software that entitles the customer to receive future updates, cyclical releases, rewrites of the underlying software, or customer support services for the computer software if, in the normal course of the taxpayer's business—

(*i*) The price for the agreement is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the computer software; and

(*ii*) The agreement is neither separately offered by the taxpayer nor separately bargained for with customers (that is, a customer cannot purchase the computer software without the agreement); and

(*6*) 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. In the case of gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP, a qualified film, or 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 for the entire period derived (and to be derived) from the lease, rental, license, sale, exchange, or other disposition of the item of QPP, qualified films, or utilities. For purposes of the preceding sentence, if a taxpayer treats gross receipts as DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as DPGR. The gross receipts that the taxpayer treats as DPGR under paragraphs (i)(4)(i)(B)(*1*), (*2*), (*3*), (*4*), and (*5*) and (l)(4)(iv)(A) of this section are treated as DPGR for purposes of applying this de minimis exception. This de minimis exception does not apply if the price of a service or non-qualified property is separately stated by the taxpayer, or if the service or non-qualified property is separately offered or separately bargained for with the customer (that is, the customer can purchase the QPP, qualified film, or utilities without the service or non-qualified property).

(ii) *Non-DPGR.* All of a taxpayer's gross receipts derived from the lease, rental, license, sale, exchange or other disposition of an item of QPP, qualified films, or utilities may be treated as non-DPGR if less than 5 percent of the taxpayer's total gross receipts derived from the lease, rental, license, sale, exchange or other disposition of that item are DPGR. In the case of gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP, a qualified film, and utilities that are received over a period of time (for example, a multi-year lease or installment sale), this paragraph (i)(4)(ii) is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from the lease, rental, license, sale, exchange, or other disposition of the item of QPP, qualified films, or utilities. For purposes of the preceding sentence, if a taxpayer treats gross receipts as non-DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as non-DPGR.

(iii) *Examples.* The following examples illustrate the application of this paragraph (i)(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. In the normal course of X's business, the QPP and training services are separately stated in the sales contract. Because, in the normal course of the X's business, the training services are separately stated, the training services are not treated as embedded services under the de minimis exception in paragraph (i)(4)(i)(B)(*6*) of this section.

Example 2. The facts are the same as in *Example 1* except that, in the normal course of X's business, 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% of the gross receipts derived from the sale of X's QPP to Z, after applying the exceptions under paragraphs (i)(4)(i)(B)(*1*) through (*5*) of this section, then the gross receipts may be included in DPGR under the de minimis exception in paragraph (i)(4)(i)(B)(*6*) 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. In the normal course of X's business, the price of the QPP and the delivery fee are separately stated in X's sales contracts. Because, in the normal course of X's business, the delivery fee is separately stated, the delivery fee does not qualify as DPGR under the qualified delivery exception in paragraph (i)(4)(i)(B)(*2*) of this section or the de minimis exception under paragraph (i)(4)(i)(B)(*6*) of this section. The result would be the same even if the retailer's customers cannot purchase the QPP without paying the delivery fee.

Example 4. (i) *Facts.* X manufactures industrial sewing machines within the United States that X offers for sale individually to customers. X enters into a single, lump-sum priced contract with Y, an unrelated person, and the contract has the following terms: X will manufacture industrial sewing machines within the United States for Y; X will deliver the industrial sewing machines to Y; X will provide a one-year warranty on the industrial sewing machines; X will provide operating manuals with the industrial sewing machines; X will provide 100 hours of training and training manuals to Y's employees on the use and maintenance of the industrial sewing machines; X will provide purchased spare parts for the industrial sewing machines; and X will provide a 3-year service agreement for the industrial sewing machines. In the normal course of X's business, none of the services or property described above are separately stated, separately offered or separately bargained for.

(ii) *Analysis.* The receipts for the manufacture of the industrial sewing machines are DPGR under paragraphs (e)(1) and (g) of this section (assuming all the other requirements of this section are met). X may include in DPGR the gross receipts derived from delivering the industrial sewing machines, which is a qualified delivery under paragraph (i)(4)(i)(B)(*2*) of this section; the gross receipts derived from the one-year warranty, which is a qualified warranty under paragraph (i)(4)(i)(B)(*1*) of this section; and the gross receipts derived from the operating manuals, which is a qualified operating manual under paragraph (i)(4)(i)(B)(*3*) of this section. If the gross receipts allocable to each industrial sewing machine 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% of the gross receipts derived from the sale of each industrial sewing machine to Y (after applying the exceptions under paragraphs (i)(4)(i)(B)(*1*) through (*5*) of this section), then those gross receipts may be included in DPGR under the de minimis exception in paragraph (i)(4)(i)(B)(*6*) of this section. If, however, the gross receipts allocable to each industrial sewing machine 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, in total, 5% of the gross receipts derived from the sale of each industrial sewing machine to Y (after applying the exceptions under paragraphs (i)(4)(i)(B)(*1*) through (*5*) of this section), then those gross receipts do not qualify as DPGR under the de minimis exception in paragraph (i)(4)(i)(B)(*6*) of this section (and X must allocate gross receipts between DPGR and non-DPGR under § 1.199–1(d)(1)).

(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, periodicals, and other similar printed publications that are MPGE in whole or in significant part within the United States include advertising income from advertisements placed in those media, but only if 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 (or would be) DPGR.

(ii) *Qualified film.* A taxpayer's gross receipts that are derived from the lease, rental, license, sale, exchange, or other disposition of a qualified film include advertising income and product-placement income with respect to that qualified film, that is, compensation for placing or integrating advertising or a product into the qualified film, but only if the gross receipts, if any, derived from the qualified film are (or would be) DPGR.

(iii) *Examples.* The following examples illustrate the application of this paragraph (i)(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 disposes of the newspapers free of charge to customers, rather than selling them. X's gross receipts from the display advertising or classified advertisements are DPGR.

Example 3. X produces two live television programs that are qualified films. X licenses the first television program to Y's television station and X licenses the second television program to Z's television station. Z broadcasts the second television program on its station. Both television programs contain product placements and advertising for which X received compensation. X and Y are unrelated persons. X and Z are non-consolidated members of an EAG. The gross receipts derived by X from licensing the first television program to Y are DPGR. As a result, pursuant to paragraph (i)(5)(ii) of this section, all of X's product placement and advertising 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 second television program to Z are non-DPGR under paragraph (b)(1) of this section. Paragraph (b)(2) of this section does not apply because Z's broadcast of the second television program on Z's television station is not a lease, rental, license, sale, exchange, or other disposition of the second television program. As a result, pursuant to paragraph (i)(5)(ii) of this section, none of X's product placement and advertising income for the second television program is treated as gross receipts derived from the qualified film.

Example 4. The facts are the same as in *Example 3* except that Z sublicenses to an unrelated person the television program instead of broadcasting the television program on its station. The gross receipts derived by X from licensing the television program to Z are DPGR under paragraph (b)(2) of this section. As a result, pursuant to paragraph (i)(5)(ii) of this section, X's product placement and advertising income for the television program licensed to Z is treated as gross receipts derived from the qualified film. In addition, Z's receipts from the sublicense of the qualified film are DPGR under § 1.199–7(a)(3)(i).

Example 5. X produces television programs that are qualified films. X licenses the qualified films to Y, an unrelated person, and the license agreement provides that X will receive advertising time slots as part of its payments from Y under the license agreement. X's gross receipts derived from the license of the qualified films to Y include income attributable to the advertising time slots and are DPGR under paragraph (b)(2) of this section.

(6) *Computer software*—(i) *In general.* DPGR include the gross receipts of the taxpayer that are derived from the lease, rental, license, sale, exchange, or other disposition of computer software MPGE by the taxpayer in whole or in significant part within the United States. Such gross receipts qualify as DPGR even if the customer provides the computer software to its employees or others over the Internet.

(ii) through (v). [Reserved]. For further guidance see § 1.199–3T(i)(6)(ii) through (v).

(7) *Qualifying in-kind partnership for taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005.* [Reserved].

(8) *Partnerships owned by members of a single expanded affiliated group for taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005.* [Reserved].

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

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

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

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

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

(2) *Tangible personal property*—(i) *In general.* The term *tangible personal property* is any tangible property other than land, real property described in paragraph (m)(3) of this section, and any property described in paragraph (j)(3), (j)(4), (k)(1), or (l) of this section. For purposes of the preceding sentence, tangible personal property also includes any gas (other than natural gas described in paragraph (l)(2) of this section), chemical, and similar property, for example, steam, oxygen, hydrogen, and nitrogen. Property such as 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 (j)(2)(i). Except as provided in paragraphs (j)(5)(ii) and (k)(2)(i) of this section, computer software, sound recordings, and qualified films are not treated as tangible personal property regardless of whether they are affixed to a tangible medium. However, the tangible medium to which such property may be affixed (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) *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. Thus, for example, an electronic book available online or for download is not computer software. For purposes of this paragraph (j)(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 (j)(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, then 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 (j)(5) of this section, if the medium (such as compact discs, tapes, or other phonorecordings) in which the sounds may be embodied is tangible, then the medium is considered tangible personal property for purposes of paragraph (j)(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 in whole or in significant part computer software or sound recordings within the United States that is affixed or added to tangible personal property (for example, a computer diskette, or an appliance), whether or not the taxpayer MPGE such tangible personal property in whole or in significant part within the United States, 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 computer software and the tangible personal property as computer software, activities the cost of which are described in Rev. Proc. 2000–50 (2000–1 C.B. 601), activities giving rise to research and experimental expenditures under section 174, and the creation of intangible assets for computer software are considered in determining whether the taxpayer's MPGE activity is substantial in nature under paragraph (g)(2) of this section. In determining direct labor and overhead under paragraph (g)(3)(i) of this section, the costs of direct labor and overhead for developing the computer software as described in Rev. Proc. 2000–50 (2000–1 C.B. 601), research and experimental expenditures under section 174, and any other costs of creating intangible assets for the computer software are treated as direct labor and overhead. These costs must be included in the taxpayer's CGS of the computer software for purposes of determining whether the taxpayer meets the safe harbor under paragraph (g)(3)(i) of this section. However, any costs under section 174, and the costs to create intangible assets, attributable to the tangible personal property are not considered in determining whether the taxpayer's activity is substantial in nature under paragraph (g)(2) of this section and are not direct labor and overhead under paragraph (g)(3)(i) 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 sound recordings and the tangible personal property as sound recordings, activities giving rise to research and experimental expenditures under section 174 and the creation of intangible assets for sound recordings are considered in determining whether the taxpayer's MPGE activity is substantial in nature under paragraph (g)(2) of this section. In determining direct labor and overhead under paragraph (g)(3)(i) of this section, research and experimental expenditures under section 174 and any other costs of creating intangible assets for sound recordings are treated as direct labor and overhead. These costs must be included in the taxpayer's CGS of sound recordings for purposes of determining whether the taxpayer meets the safe harbor under paragraph (g)(3)(i) of this section. However, any costs under section 174, and the costs to create intangible assets, attributable to the tangible personal property are not considered in determining whether the taxpayer's activity is substantial in nature under paragraph (g)(2) of this section and are not direct labor and overhead under paragraph (g)(3)(i) of this section.

(ii) *Tangible personal property.* If a taxpayer MPGE tangible personal property (for example, a computer diskette or an appliance) in whole or in significant part within the United States but not the computer software or sound recordings that is affixed or added to such tangible personal property, 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 (j)(2) of this section. Any costs under section 174, and the costs to create intangible assets, attributable to the tangible personal property are not considered in determining whether the taxpayer's activity is substantial in nature under paragraph (g)(2) of this section and are not direct labor or overhead under paragraph (g)(3)(i) of this section. For purposes of paragraph (g)(3) of this section, the taxpayer's CGS (or unadjusted depreciable basis, if applicable) for each item of tangible personal property includes the taxpayer's cost of leasing, renting, licensing, buying, or otherwise acquiring the computer software or sound recordings.

(k) *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 actors, production personnel, directors, and producers relating to the production of the motion picture film, video tape, or television programming is compensation paid by the taxpayer for services relating to the production of the film performed in the United States by those individuals. For purposes of this paragraph (k), actors include players, newscasters, or any other persons performing in a qualified film. The term *production personnel* includes, for example, 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. Except as provided in paragraph (k)(2) of this section, the definition of *qualified film* does not include tangible personal property embodying the qualified film, such as DVDs or videocassettes.

(2) *Tangible personal property with a film*—(i) *Film not produced by a taxpayer.* If a taxpayer MPGE tangible personal property (for example, a DVD) in whole or in significant part in the United States and a film not produced by a taxpayer is affixed to the tangible personal property, then the taxpayer may treat the tangible personal property with the affixed film as tangible personal property, regardless of whether the film is a qualified film. The determination of whether the 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 film are DPGR is made under the rules of this section. For purposes of paragraph (g)(2) of this section, in determining whether the taxpayer's MPGE activity is substantial in nature, the taxpayer must consider the value of the licensed film. For purposes of paragraph (g)(3) of this section, the taxpayer's CGS (or unadjusted depreciable basis, as applicable) for each item of tangible personal property includes the taxpayer's cost of leasing, renting, licensing, buying, or otherwise acquiring the film.

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

(A) *Qualified film.* If the film is a qualified film, the taxpayer may treat the tangible personal property, whether or not the taxpayer MPGE such tangible personal property, to which the qualified film is affixed as part of the qualified film; and

(B) *Nonqualified film.* If the film is not a qualified film (nonqualified film), a taxpayer cannot treat the tangible personal property to which the nonqualified film is affixed as part of the nonqualified film.

(3) *Derived from a qualified film*—(i) *In general.* DPGR include the gross receipts of a taxpayer that are derived from any lease, rental, license, sale, exchange, or other disposition of any qualified film produced by such taxpayer.

(ii) *Exceptions.* The showing of a qualified film (for example, in a movie theater or by broadcast on a television station) by a taxpayer is not a lease, rental, license, sale, exchange, or other disposition of the qualified film by such taxpayer. Ticket sales for viewing a qualified film 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 (k)(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 or exploit the film characters are not gross receipts derived from a qualified film.

(4) *Compensation for services.* The term *compensation for services* means all payments for services performed by actors (as described in paragraph (k)(1) of this section), 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.

(5) *Determination of 50 percent.* The not-less-than-50-percent-of-the-total-compensation requirement under paragraph (k)(1) of this section is determined by reference to all compensation paid in the production of the film and is calculated using a fraction. The numerator of the fraction is the compensation paid by the taxpayer to actors, production personnel, directors, and producers for services relating to the production of the film (production services) performed in the United States, and the denominator is the sum of the total compensation paid by the taxpayer to all such individuals regardless of where the production services are performed and the total compensation paid by others to all such individuals regardless of where the production services are performed. A taxpayer may use any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, including all historic information available, to determine the compensation for services performed in the United States by actors (as described in paragraph (k)(1) of this section), production personnel, directors, and producers, and the total compensation paid to those individuals for services relating to the production of the film. 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 from one taxable year to another.

(6) *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.

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

Example 1. X produces a qualified film and duplicates the film onto purchased DVDs. X sells the DVDs with the qualified film to customers. Under paragraph (k)(2)(ii)(A) of this section, X treats 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 not-less-than-50-percent-of-the-total-compensation requirement under (k)(1) of this section and X manufactures the DVDs in the United States. Under paragraph (k)(2)(ii)(B) of this section, X cannot treat the DVD as part of the nonqualified film. 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 live 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 a qualified film on a television station is not a lease, rental, license, sale, exchange, or other disposition pursuant to paragraph (k)(3)(ii) of this section, the advertising income X receives from advertisers is not derived from the lease, rental, license, sale, exchange, or other disposition of the qualified films and is non-DPGR.

Example 4. The facts are the same as in *Example 3* except that X also licenses the qualified films to Y, an unrelated cable company that broadcasts X's qualified films. As part of the license agreement, X can sell

advertising time slots. Because X's gross receipts from Y are derived from the licensing of qualified films pursuant to paragraph (k)(3)(i) of this section, X's gross receipts derived from licensing the qualified film are DPGR. In addition, the gross receipts derived from the advertising income X receives that is related to the qualified films licensed to Y is DPGR pursuant to paragraph (i)(5)(ii) of this section. Because showing a qualified film on a television station is not a lease, rental, license, sale, exchange, or other disposition pursuant to paragraph (k)(3)(ii) of this section, the portion of the advertising income X derives from advertisers for the qualified films it broadcasts on its own television station is not derived from the lease, rental, license, sale, exchange, or other disposition of the qualified films and is non-DPGR.

Example 5. X produces a qualified film and contracts with Y, an unrelated person, 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 (g)(3) of this section. Y's gross receipts from manufacturing the DVDs and duplicating the film onto the DVDs are DPGR (assuming all the other requirements of this section are met). X's gross receipts from the sale of the DVDs to customers are DPGR (assuming all the other requirements of this section are met).

Example 6. X creates a television program in the United States that includes scenes from films licensed by X from unrelated persons Y and Z. Assume that Y and Z produced the films licensed by X. The not-less-than-50-percent-of-the-total-compensation requirement under paragraph (k)(1) of this section is determined by reference to all compensation paid in the production of the television program, including the films licensed by X from Y and Z, and is calculated using a fraction as described in paragraph (k)(5) of this section. The numerator of the fraction is the compensation paid by X to actors, production personnel, directors, and producers for production services performed in the United States, and the denominator is the sum of the total compensation paid by X to such individuals regardless of where the production services are performed and the total compensation paid by Y and Z to actors, production personnel, directors, and producers relating to the production of the films licensed by X (regardless of where the services are performed). However, for purposes of calculating the denominator, in determining the total compensation paid by Y and Z, X need only include the total compensation paid by Y and Z to actors, production personnel, directors, and producers for the production of the scenes used by X in creating its television program.

(l) *Electricity, natural gas, or potable water*—(1) *In general.* DPGR include 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 (l)(4) of this section that describes certain gross receipts that do not qualify as 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 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*—(A) *DPGR.* Notwithstanding paragraphs (l)(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 and the storage of portable water after completion of treatment of the potable water, then the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the utilities that are attributable to the transmission and distribution of the utilities and the storage of portable water after completion of treatment of the potable water may be treated as being DPGR (assuming all other requirements of this section are met). In the case of gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of 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 for the entire period derived (and to be derived) from the lease, rental, license, sale, exchange, or other disposition of the utilities. For purposes of the preceding sentence, if a taxpayer treats gross receipts as DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as DPGR.

(B) *Non-DPGR.* If less than 5 percent of a taxpayer's gross receipts derived from a sale, exchange, or other disposition of utilities are DPGR, then the gross receipts derived from the sale, exchange, or other disposition of the utilities may be treated as non-DPGR. In the case of gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of 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 for the entire period derived (and to be derived) from the lease, rental, license, sale, exchange, or other disposition of the utilities. For purposes of the preceding sentence, if a taxpayer treats gross receipts as non-DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as non-DPGR.

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

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 and contracts with Y to transmit 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 from the sale of electricity produced at the wind turbine are DPGR. The gross receipts of Y derived from transporting X's electricity to Z are non-

DPGR under paragraph (l)(4)(i) of this section. Likewise, the gross receipts of Z derived from distributing the electricity are non-DPGR under paragraph (l)(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 (l)(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 among the production activities (that are DPGR), and the transmission and distribution activities (that are non-DPGR).

(m) *Definition of construction performed in the United States*—(1) *Construction of real property*—(i) *In general.* The term *construction* means activities and services relating to the construction or erection of real property (as defined in paragraph (m)(3) of this section) 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). For purposes of this paragraph (m), the term *construction project* means the construction activities and services treated as the item under paragraph (d)(2)(iii) of this section. 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 (m)(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 (m)(1)(i) even though under local law the property is considered tangible personal property.

(ii) *Regular and ongoing basis*—(A) *In general.* For purposes of paragraph (m)(1)(i) of this section, a taxpayer engaged in a construction trade or business will be considered to be engaged in such trade or business on a regular and ongoing basis if the taxpayer derives gross receipts from an unrelated person by selling or exchanging the constructed real property described in paragraph (m)(3) of this section within 60 months of the date on which construction is complete (for example, on the date a certificate of occupancy is issued for the property).

(B) *New trade or business.* In the case of a newly-formed trade or business or a taxpayer in its first taxable year, the taxpayer is considered to be engaged in a trade or business on a regular and ongoing basis if the taxpayer reasonably expects that it will engage in a trade or business on a regular and ongoing basis.

(iii) *De minimis exception*—(A) *DPGR.* For purposes of paragraph (m)(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 (m)(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 may be treated as DPGR from construction. If a taxpayer applies the land safe harbor under paragraph (m)(6)(iv) of this section, for a construction project (as described in paragraph (m)(1)(i) of this section), then the gross receipts excluded under the land safe harbor are excluded in determining total gross receipts under this paragraph (m)(1)(iii)(A). If a taxpayer does not apply the land safe harbor and uses any reasonable method (for example, an appraisal of the land) to allocate gross receipts attributable to the land to non-DPGR, then a taxpayer applies this paragraph (m)(1)(iii)(A) by excluding such gross receipts derived from the sale, exchange, or other disposition of the land from total gross receipts. In the case of gross receipts derived from construction that are received over a period of time (for example, an installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from construction. For purposes of the preceding sentence, if a taxpayer treats gross receipts as DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as DPGR.

(B) *Non-DPGR.* For purposes of paragraph (m)(1)(i) of this section, if less than 5 percent of the total gross receipts derived by a taxpayer from a construction project qualify as DPGR, then the total gross receipts derived by the taxpayer from the construction project may be treated as non-DPGR. In the case of gross receipts derived from construction that are received over a period of time (for example, an installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from construction. For purposes of the preceding sentence, if a taxpayer treats gross receipts as non-DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as non-DPGR.

(2) *Activities constituting construction*—(i) *In general.*

Activities constituting construction are activities performed in connection with a project to erect or substantially renovate real property, including activities performed by a general contractor or that constitute activities typically performed by a general contractor, for example, activities relating to management and oversight of the construction process such as approvals, periodic inspection of the progress of the construction project, and required job modifications.

(ii) *Tangential services.* Activities constituting construction 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, then the gross receipts derived from the tangential services are DPGR.

(iii) *Other construction activities.* 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 (m)(1) of this section. Services such as grading, demolition (including demolition of structures under section 280B), clearing, excavating, and any other activities that physically transform the land are activities constituting construction only if these services 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 (m)(1) of this section. A taxpayer engaged in these activities must make a reasonable inquiry or a reasonable determination as to 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 or gas well and mining and include any activities the cost of which are intangible drilling and development costs within the meaning of § 1.612–4 or development expenditures for a mine or natural deposit under section 616.

(iv) *Administrative support services.* If the taxpayer performing construction activities also provides, in connection with the construction project, administrative support services (for example, billing and secretarial services) incidental and necessary to such construction project, then these administrative support services are considered construction activities.

(v) *Exceptions.* The lease, license, or rental of equipment, for example, bulldozers, generators, or computers, for use in the construction of real property is not a construction activity under this paragraph (m)(2). The term construction does not include any activity that is within the definition of engineering and architectural services under paragraph (n) of this section.

(3) *Definition of real property.* The term *real property* means buildings (including items that are structural components of such buildings), inherently permanent structures (as defined in § 1.263A–8(c)(3)) other than machinery (as defined in § 1.263A–8(c)(4)) (including items that are structural components of such inherently permanent structures), inherently permanent land improvements, oil and gas wells, and infrastructure (as defined in paragraph (m)(4) of this section). For purposes of the preceding sentence, an entire utility plant including both the shell and the interior will be treated as an inherently permanent structure. Property produced by a taxpayer that is not real property in the hands of that taxpayer, but that may be incorporated into real property by another taxpayer, is not treated as real property by the producing taxpayer (for example, bricks, nails, paint, and windowpanes). For purposes of this paragraph (m)(3), structural components of buildings and inherently permanent structures include property such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property.

(4) *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.

(5) *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.

(6) *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 completed). DPGR derived from the construction of real property includes compensation for the performance of construction services by the taxpayer in the United States. DPGR derived from the construction of real property includes gross receipts derived from materials and supplies consumed in the construction project or that become part of the constructed real property, assuming all the requirements of this section are met.

(ii) *Qualified construction warranty.* 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, in the normal course of the taxpayer's business—

(A) 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 customers (that is, the customer cannot purchase the constructed real property without the construction warranty).

(iii) *Exceptions.* DPGR derived from the construction of real property performed in the United States does not include gross receipts derived from the sale, exchange, or other disposition of real property acquired by the taxpayer even if the taxpayer originally constructed the property. In addition, 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 (m)(2)(iii) of this section, gross receipts derived from the sale or other disposition of land (including zoning, planning, entitlement costs, and other costs capitalized to the land).

(iv) *Land safe harbor*—(A) *In general.* For purposes of paragraph (m)(6)(i) of this section, a taxpayer may allocate gross receipts between the gross receipts derived from the sale, exchange, or other disposition of real property constructed by the taxpayer and the gross receipts derived from the sale, exchange, or other disposition of land by reducing its costs related to DPGR under § 1.199–4 by the 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 (except costs for activities listed in paragraph (m)(2)(iii) of this section) 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. Generally, the percentage is based on the number of months that elapse between the date the taxpayer acquires the land (not including any options to acquire the land) and ends on the date the taxpayer sells each item of real property on the land. However, a taxpayer will be deemed, for purposes of this paragraph (m)(6)(iv)(A), to acquire the land on the date the taxpayer entered into an option agreement to acquire the land if the taxpayer acquired the land pursuant to such option agreement and the purchase price of the land under the option agreement does not approximate the fair market value of the land. In the case of a sale or disposition of land between related persons (as defined in paragraph (b)(1) of this section) for less than fair market value, for purposes of determining the percentage, the purchaser or transferee of the land must include the months during which the land was held by the seller or transferor. The percentage is 5 percent for land held not more than 60 months, 10 percent for land held more than 60 months but not more than 120 months, and 15 percent for land held more than 120 months but not more than 180 months. Land held by a taxpayer for more than 180 months is not eligible for the safe harbor under this paragraph (m)(6)(iv)(A).

(B) *Determining gross receipts and costs.* In the case of a taxpayer that uses the small business simplified overall method of cost allocation under § 1.199–4(f), gross receipts derived from the sale, exchange, or other disposition of land, and costs attributable to the land, pursuant to the land safe harbor under

paragraph (m)(6)(iv)(A) of this section, are not taken into account for purposes of computing QPAI under §§ 1.199–1 through 1.199–9 except that the gross receipts are taken into account for determining eligibility for that method of cost allocation. All other taxpayers must treat the gross receipts derived from the sale, exchange, or other disposition of land, pursuant to the land safe harbor under paragraph (m)(6)(iv)(A) of this section, as non-DPGR. In the case of a pass-thru entity, if the pass-thru entity would be eligible to use the small business simplified overall method of cost allocation if the method were applied at the pass-thru entity level, then the gross receipts derived from the sale, exchange, or other disposition of land, and costs allocated to the land, pursuant to the land safe harbor under paragraph (m)(6)(iv)(A) of this section, are not taken into account by the pass-thru entity or its owner or owners for purposes of computing QPAI under §§ 1.199–1 through 1.199–9. For purposes of the preceding sentence, in determining whether the pass-thru entity would be eligible for the small business simplified overall method of cost allocation, the gross receipts excluded pursuant to the land safe harbor under paragraph (m)(6)(iv)(A) of this section are taken into account for determining eligibility for that method of cost allocation. All other pass-thru entities (including all trusts and estates described in § 1.199–9(e)) must treat the gross receipts attributable to the sale, exchange, or other disposition of land, pursuant to the land safe harbor under paragraph (m)(6)(iv)(A) of this section, as non-DPGR.

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

Example 1. A, 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 B, an unrelated person, to oversee a substantial renovation of the building (within the meaning of paragraph (m)(5) of this section). Although not licensed as a general contractor, B performs general contractor level work and activities relating to management and oversight of the construction process such as approvals, periodic inspection of the progress of the construction project, and required job modifications. B retains C (a general contractor) to oversee day-to-day operations and hire subcontractors. C hires D (a subcontractor) to install a new electrical system in the building as part of that substantial renovation. The amounts that B receives from A for construction services, the amounts that C receives from B for construction services, and the amounts that D receives from C for construction services qualify as DPGR under paragraph (m)(6)(i) of this section provided B, C, and D meet all of the requirements of paragraph (m)(1) of this section. The gross receipts that A receives from the subsequent sale of the building do not qualify as DPGR because A did not engage in any activity constituting construction under paragraph (m)(2) of this section even though A is in the trade or business of construction. The results would be the same if A, B, C, and D were members of the same EAG under § 1.199–7(a). However, if A, B, C, and D 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 (m)(1) of this section. In addition, pursuant to paragraph (m)(6)(i) of this section, X's gross receipts derived from the purchased materials qualify as DPGR because the wires, conduits, and other electrical materials are consumed during the construction of the building or become structural components of the building.

Example 3. X is engaged in a trade or business on a regular and ongoing basis that is considered construction under the two-digit NAICS code of 23. X buys unimproved land in the United States. X gets the land zoned for residential housing through an entitlement process. X grades the land and sells the land to home builders who construct houses on the land. The gross receipts that X derives from the sale of the land that are attributable to the grading qualify as DPGR under paragraphs (m)(2)(iii) and (6)(i) of this section because those services are undertaken in connection with a construction project in the United States. X's gross receipts derived from the land including capitalized costs of entitlements (including zoning) do not qualify as DPGR under paragraph (m)(6)(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 constructs roads, sewers, and sidewalks, and installs power and water lines on the land. X conveys the roads, sewers, sidewalks, and power and water lines to the local government and utilities. The gross receipts that X derives from the sale of lots that are attributable to grading, and the construction of the roads, sewers, sidewalks, and power and water lines (that qualify as infrastructure under paragraph (m)(4) of this section) are DPGR. X's gross receipts derived from the land including capitalized costs of entitlements (including zoning) do not qualify as DPGR under paragraph (m)(6)(i) of this section because the gross receipts are not derived from the construction of real property.

Example 5. (i) *Facts.* X, who is engaged in the trade or business of construction under NAICS code 23 on a regular and ongoing basis, constructs housing that is real property under paragraph (m)(3) of this section. On June 1, 2007, X pays $50,000,000 and acquires 1,000 acres of land that X will develop as a new housing development. In November 2007, 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, 2012, 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 of $55,000 per lot include $30,000 in land costs underlying the common improvements.

(ii) *Land safe harbor.* Pursuant to the land safe harbor under paragraph (m)(6)(iv) of this section, X calculates the basis for each house sold 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 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, 2007, for each house sold on the land between January 31, 2012, and June 1, 2012, the percentage reduction for X is 5% because X has held the land for not more than 60 months from the date of acquisition. Thus, X's DPGR for each house is $237,000 ($300,000 − $60,000 − $3,000) with costs for each house of $195,000 ($255,000 − $60,000). For each house sold on the land between June 2, 2012 and June 1, 2017, the percentage reduction for X is 10% because X has held the land for more than 60 months but not more than 120 months from the date of acquisition. Thus, of the $300,000 of gross receipts, X's DPGR for each house is $234,000 ($300,000 − $60,000 − $6,000) with costs for each house of $195,000 ($255,000 − $60,000).

Example 6. The facts are the same as in *Example 5* except that on December 31, 2007, after X received the permits to begin construction, X sold the entitled land to Y, an unrelated corporation, for $75,000,000. Y is engaged in a trade or business on a regular and ongoing basis that is considered construction under NAICS code 23. Y subsequently incurred the construction costs and the costs of the common improvements, and Y sold the houses. Because X did not perform any construction activities, none of X's $75,000,000 in gross receipts derived from Y are DPGR and none of X's costs are allocable to DPGR. Pursuant to the land safe harbor under paragraph (m)(6)(iv) of this section, Y calculates the basis for each house sold as $195,000 (total costs of $270,000 ($170,000 in construction costs plus $62,500 in common improvements (including $37,500 in land costs) plus $37,500 in land costs for the lot), which are reduced by land costs of $75,000). Y calculates the DPGR for

each house sold by taking the gross receipts of $300,000 and reducing that amount by land costs of $75,000 plus a percentage of $75,000. As Y acquired the land on December 31, 2007, for the houses sold on the land between January 31, 2012, and December 31, 2012, the percentage reduction for Y is 5% because Y held the land for not more than 60 months from the date of acquisition. Thus, of the $300,000 of gross receipts, the DPGR for each house is $221,250 ($300,000 − $75,000 − $3,750) with costs for each house of $195,000. For the houses sold on the land between January 1, 2013, and December 31, 2017, the percentage reduction for Y is 10% because Y held the land for more than 60 months but not more than 120 months from the date of acquisition. Thus, of the $300,000 of gross receipts, the DPGR for each house is $217,500 ($300,000 − $75,000 − $7,500) with costs for each house of $195,000. The results would be the same if X and Y were members of the same EAG, provided X and Y were not members of the same consolidated group.

Example 7. The facts are the same as in *Example 6* except that Y is a member of the same consolidated group as X. Pursuant to § 1.1502–13(c)(1)(ii), Y's holding period in the land includes the period of time X held the land. In order to produce the same effect as if X and Y were divisions of a single corporation (see § 1.1502–13(c)(1)(i)), for each house sold between January 31, 2012, and June 1, 2012, Y's DPGR are redetermined to be $237,000, the same as X's DPGR for houses sold between January 31, 2012, and June 1, 2012, in *Example 5.* Y's costs for each house do not have to be redetermined because Y's costs are $195,000, the same as the costs would be if X and Y were divisions of a single corporation. For each house sold between June 2, 2012, and June 1, 2017, Y's DPGR are redetermined to be $234,000, the same as X's DPGR for each house sold between June 2, 2012, and June 1, 2017, in *Example 5.* Y's costs for each house do not have to be redetermined because Y's costs are $195,000, the same as the costs would be if X and Y were divisions of a single corporation.

Example 8. X, who is engaged in the trade or business of construction under NAICS code 23 on a regular and ongoing basis, purchases land for development and builds an office building on the land. Y enters into a contract with X to purchase the office building. As part of the contract, X is required to furnish the office space with desks, chairs, and lamps. Upon completion of the sale of the building, X uses the land safe harbor under paragraph (m)(6)(iv) of this section to account for the land. After application of the land safe harbor, X uses the *de minimis* exception under paragraph (m)(1)(iii)(A) of this section in determining whether the gross receipts derived from the sale of the desks, chairs, and lamps qualify as DPGR. If the gross receipts derived from the sale of the desks, chairs, and lamps are less than 5% of the total gross receipts derived by X from the sale of the furnished office building (excluding any gross receipts taken into account under the land safe harbor pursuant to paragraph (m)(6)(iv)(B) of this section), then all of the gross receipts derived from the sale of the furnished office building, after the reduction under the land safe harbor, may be treated as DPGR.

(n) *Definition of engineering and architectural services*—(1) *In general.* DPGR include gross receipts derived from engineering or architectural services performed in the United States for a construction project described in paragraph (m)(1)(i) 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. In the case of a newly-formed trade or business or a taxpayer in its first taxable year, a taxpayer is considered to be engaged in a trade or business on a regular and ongoing basis if the taxpayer reasonably expects that it will engage in a trade or business on a regular and ongoing basis. DPGR include 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) or erection, in connection with any construction project.

(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) *Administrative support services.* If the taxpayer performing engineering or architectural services also provides administrative support services (for example, billing and secretarial services) incidental and necessary to such engineering or architectural services, then these administrative support services are considered engineering or architectural services.

(5) *Exceptions.* Engineering or architectural services do not include post-construction services such as annual audits and inspections.

(6) *De minimis exception for performance of services in the United States*—(i) *DPGR.* 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 (m)(1)(i) of this section) are derived from services not relating to a construction project (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 may be treated as DPGR from engineering or architectural services performed in the United States for the construction project. In the case of gross receipts derived from engineering or architectural services that are received over a period of time (for example, an installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from engineering or architectural services. For purposes of the preceding sentence, if a taxpayer treats gross receipts as DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as DPGR.

(ii) *Non-DPGR.* 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 qualify as DPGR, then the total gross receipts derived by the taxpayer from engineering or architectural services performed in the United States for the construction project may be treated as non-DPGR. In the case of gross receipts derived from engineering or architectural services that are received over a period of time (for example, an installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from engineering or architectural services. For purposes of the preceding sentence, if a taxpayer treats gross receipts as non-DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as non-DPGR.

(7) *Example.* The following example illustrates the application of this paragraph (n):

Example. X is engaged in the trade or business of providing engineering services under NAICS code 541330 on a regular and ongoing basis. Y buys unimproved land. Y hires X to provide engineering services for roads, sewers, sidewalks, and power and water lines that qualify as infrastructure under paragraph (m)(4) of this section and that will be constructed on Y's land. X's gross receipts from engineering services for the infrastructure are DPGR. X's gross receipts from engineering services relating to land (except as provided in paragraph (m)(2)(iii) of this section) do not qualify as DPGR under paragraph (n)(1) of this section because the gross receipts are not derived from engineering services for a construction project described in paragraph (m)(1)(i) of this section.

(o) *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) owned, 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 for take out service or delivery is a retail establishment (for example, a caterer). If a taxpayer's facility is a retail establishment, then, for purposes of this section, the taxpayer may allocate its gross receipts between the gross receipts derived from the retail sale of the food and beverages prepared and sold at the retail establishment (that are non-DPGR) and gross receipts derived from the wholesale sale of the food and beverages prepared and sold at the retail establishment (that are DPGR assuming all the other requirements of section 199 are met). Wholesale sales are defined as food and beverages held for resale 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) *De minimis exception.* A taxpayer may treat a facility at which food or beverages are prepared as not being a retail establishment if less than 5 percent of the gross receipts derived from the sale of food or beverages at that facility during the taxable year are attributable to retail sales.

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

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 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 are derived from the sale of coffee beans roasted at the facility, the receipts are DPGR (assuming all the other requirements of this section are met). To the extent the gross receipts of X's retail establishments are derived 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(d)(1)(ii), 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 within the United States. Bottles of wine produced by Y at the bonded winery are sold to consumers at the taxpaid premises. Pursuant to paragraph (o)(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 (o)(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 gross receipts derived from the sales of the wine are DPGR (assuming all the other requirements of this section are met).

(p) *Guaranteed payments.* DPGR does not include guaranteed payments under section 707(c). Thus, partners, including partners in partnerships described in § 1.199–9(i) and (j), may not treat guaranteed payments as DPGR. See § 1.199–9(b)(6) *Example 5.*

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

(a) *In general.* The provisions of this section apply solely for purposes of section 199 of the Internal Revenue Code (Code). 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 and other expenses, losses, or deductions (deductions), other than the deduction allowed under section 199, that are properly allocable to such receipts. Paragraph (b) of this section provides rules for determining CGS allocable to DPGR. Paragraph (c) of this section provides rules for determining the deductions that are properly allocable to DPGR. Paragraph (d) of this section provides that a taxpayer generally must determine deductions allocable to DPGR or to gross income attributable to DPGR using §§ 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 subtract from DPGR 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. If section 263A requires a taxpayer to include additional section 263A costs (as defined in § 1.263A–1(d)(3)) in inventory, additional section 263A costs must be included in determining CGS. CGS allocable to DPGR also includes inventory valuation adjustments such as writedowns under the lower of cost or market method. 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(j)(1)), a qualified film (as defined in § 1.199–3(k)(1)), or electricity, natural gas, and potable water (as defined in § 1.199–3(l)) (collectively, utilities) that will generate (or have generated) DPGR notwithstanding that the gross receipts attributable to the sale, lease, rental, license, exchange, or other disposition of the QPP, qualified film, or utilities will be, or have been, included in the

computation of gross income for a different taxable year. For example, advance payments that are 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. If gross receipts are treated as DPGR pursuant to § 1.199–1(d)(3)(i) or § 1.199–3(i)(4)(i)(B)(*6*), (l)(4)(iv)(A), (m)(1)(iii)(A), (n)(6)(i), or (o)(2), then CGS must be allocated to such DPGR. Similarly, if gross receipts are treated as non-DPGR pursuant to § 1.199–1(d)(3)(ii) or § 1.199–3(i)(4)(ii), (l)(4)(iv)(B), (m)(1)(iii)(B), or (n)(6)(ii), then CGS must be allocated to such non-DPGR. See § 1.199–3(m)(6)(iv) for rules relating to treatment of certain costs in the case of a taxpayer that uses the land safe harbor under that paragraph.

(2) *Allocating cost of goods sold*—(i) *In general.* A taxpayer must use a reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances 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 or 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 alternative methods; and whether the taxpayer applies the method consistently from year to year. 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. Ordinarily, if a taxpayer uses a method to allocate gross receipts between DPGR and non-DPGR, then 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. However, if a taxpayer has information readily available to specifically identify CGS allocable to DPGR and can specifically identify that amount without undue burden or expense, 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 does not have information readily available to specifically identify CGS allocable to DPGR and that cannot, without undue burden or expense, specifically identify that amount is not required to use a method that specifically identifies CGS allocable to DPGR.

(ii) *Gross receipts recognized in an earlier taxable year.* If a taxpayer (other than a taxpayer that uses the small business simplified overall method of paragraph (f) of this section) recognizes and reports gross receipts on a Federal income tax return for a taxable year, and incurs CGS related to such gross receipts in a subsequent taxable year, then regardless of whether the gross receipts ultimately qualify as DPGR, the taxpayer must allocate the CGS to—

(A) DPGR if the taxpayer identified the related gross receipts as DPGR in the prior taxable year; or

(B) Non-DPGR if the taxpayer identified the related gross receipts as non-DPGR in the prior taxable year or if the taxpayer recognized under the taxpayer's methods of accounting those gross receipts in a taxable year to which section 199 does not apply.

(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(h)) 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. Similarly, the adjusted basis of leased or rented property that gives rise to DPGR that has been brought into the United States (as defined in § 1.199–3(h)) without an arm's length transfer price may not be treated as less than its value immediately after it entered the United States. 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, then CGS allocable to DPGR includes inventory adjustments to QPP that is MPGE in whole or in significant part within the United States, a qualified film produced by the taxpayer, or utilities produced by the taxpayer 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 alternative methods; and whether the taxpayer applies the method consistently from year to year. If a taxpayer has information readily available to specifically identify the proper amount of inventory valuation adjustments allocable to DPGR, then the taxpayer must allocate that amount to DPGR. A taxpayer that does not have information readily available to specifically identify the proper amount of inventory valuation adjustments allocable to DPGR and that cannot, without undue burden or expense, specifically identify the proper amount of inventory valuation adjustments allocable to DPGR, is not required to use a method that specifically identifies inventory valuations 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 that is satisfactory to the Secretary based on all of the facts and circumstances. 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, then

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 the grouping or pool. 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, a qualified film, or 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, qualified film, or 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, the 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) and assume that the taxpayer does not use the small business simplified overall method provided in paragraph (f) of this section:

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 and other gross receipts derived from the sale of furniture in gross income when the payments are received. In December 2007, 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 2008, T produces and sells the furniture to X. In 2008, 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 2008. Assuming that in 2007, T can reasonably determine that all the requirements of §§ 1.199–1 and 1.199–3 will be met with respect to the furniture, the advance payment qualifies as DPGR in 2007. Assuming further that all the requirements of §§ 1.199–1 and 1.199–3 are met with respect to the furniture in 2008, the remaining $15,000 of the contract price must be included in income and DPGR when received by T in 2008. T must include the $14,000 it incurred to produce the furniture in CGS and CGS allocable to DPGR in 2008. See § 1.199–4(b)(2)(ii) 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 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 2007 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 2007 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 the sales of item A during the taxable year are $45,000 ((2,000 × $5) + (5,000 × $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 2007, 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 within the United States and the sales of item A generate DPGR. Y does not produce item B 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, 2007, 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 2007, 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 pool at December 31, 2007, contains 3,000 units of item A and 2,500 units of item B. The closing inventory of the pool at December 31, 2007, 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, 2007, 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%). 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 2008, Y experiences an inventory decrement. During 2008, 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, 2008, contains 2,000 units of item A and 2,500 units of item B. The closing inventory of the pool at December 31, 2008, 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, 2008, amounts to $20,000, and is less than the $25,000 base-year cost of the opening inventory for that taxable 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, 2008 is:

	Base cost	Index	LIFO value
January 1, 2008, base cost	$15,000	1.00	$15,000
December 31, 2008, 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 properly allocable 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 properly allocable to DPGR. 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 qualifying 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 for any taxable year 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 for any taxable year to use the simplified deduction method or the section 861 method for a taxable year.

(2) *Treatment of 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.

(3) *W–2 wages.* Although only W–2 wages as described in § 1.199–2 are taken into account in computing the W–2 wage limitation, all wages paid (or incurred in the case of an accrual method taxpayer) in a taxpayer's trade or business during the taxable year are taken into account in computing QPAI for that taxable year.

(d) *Section 861 method*—(1) *In general.* Under the section 861 method, a taxpayer must allocate and apportion its deductions using the allocation and apportionment rules provided under the section 861 regulations 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, if applicable, its distributive share of deductions from pass-thru entities) to gross income attributable to DPGR. Gross receipts that are allocable to land under the safe harbor provided in § 1.199–3(m)(6)(iv) are treated as non-DPGR. See § 1.199–3(m)(6)(iv)(B). If the taxpayer applies the allocation and apportionment rules of the section 861 regulations for section 199 and another operative section, then 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 section 170 and section 873(b)(2) or 882(c)(1)(B)) must be ratably apportioned between gross income attributable to DPGR and gross income attributable to non-DPGR based on the relative amounts of gross income.

(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 allocated or apportioned to gross receipts treated as domestic production gross receipts.* If gross receipts are treated as DPGR pursuant to § 1.199–1(d)(3)(i) or § 1.199–3(i)(4)(i)(B)(*6*), (l)(4)(iv)(A), (m)(1)(iii)(A), (n)(6)(i), or (o)(2), then deductions must be allocated or apportioned to the gross income attributable to such DPGR. Similarly, if gross receipts are treated as non-DPGR pursuant to § 1.199–1(d)(3)(ii) or § 1.199–3(i)(4)(ii), (l)(4)(iv)(B), (m)(1)(iii)(B), or (n)(6)(ii), then deductions must be allocated or apportioned to the gross income attributable to such non-DPGR.

(5) *Treatment of items from a pass-thru entity reporting qualified production activities income.* If, pursuant to § 1.199–9(e)(2) or to the authority granted in § 1.199–9(b)(1)(ii) or (c)(1)(ii), a taxpayer must combine QPAI and W–2 wages from a partnership, S corporation, trust (to the extent not described in § 1.199–9(d)) or estate with the taxpayer's total QPAI and W–2 wages from other sources, then for purposes of apportioning the taxpayer's interest expense under this paragraph § 1.199–4(d), the taxpayer's interest in such partnership (and, where relevant in apportioning the taxpayer's interest expense, the partnership's assets), the taxpayer's shares in such S corporation, or the taxpayer's interest in such trust shall be disregarded.

(6) *Examples.* The following examples illustrate the operation of the section 861 method. Assume in the following examples that all corporations are calendar year taxpayers, that all taxpayers have sufficient W–2 wages as defined in § 1.199–2(e) so that the section 199 deduction is not limited under section 199(b)(1), and that, with respect to the allocation and apportionment of interest expense, § 1.861–10T does not apply.

Example 1. Section 861 method and no EAG. (i) *Facts.* 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 are not includible in CGS and not properly allocable to any gross income. For 2010, the adjusted basis of X's assets is $5,000, $4,000 of which generates gross

income attributable to DPGR and $1,000 of which generates gross income attributable to non-DPGR. 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	(600)
CGS allocable to non-DPGR	(1,800)
Section 162 selling expenses	(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 allocates and apportions 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 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 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	(600)
Section 162 selling expenses ($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) is $119 (.09 × (lesser of QPAI of $1,320 and taxable income of $1,380)). Because the facts of this example assume that X's W–2 wages as defined in § 1.199–2(e) are sufficient to avoid a limitation on the section 199 deduction, 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% of the total voting power of stock of Y and 80% 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 is $45,000, $21,000 of which generates gross income attributable to DPGR and $24,000 of which generates gross income attributable to non-DPGR. 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 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 allocated to DPGR	(1,200)
CGS allocated to non-DPGR	(1,200)
Section 162 selling expenses	(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	(600)
Section 162 selling expenses ($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	(1,200)
Section 162 selling expenses ($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)). Because the facts of this example assume that the W–2 wages of X and Y are sufficient to avoid a limitation on the section 199 deduction, 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.* An eligible taxpayer may use the simplified deduction method to apportion deductions between DPGR and non-DPGR. The simplified deduction method 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) of this section) are ratably apportioned between DPGR and non-DPGR based on relative gross receipts. Accordingly, the amount of deductions for the current taxable year apportioned to DPGR is equal to the same proportion of the total deductions for the current taxable year that the amount of DPGR bears to total gross receipts. Gross receipts that are allocable to land under the safe harbor provided in § 1.199–3(m)(6)(iv) are treated as non-DPGR. See § 1.199–3(m)(6)(iv)(B). Whether a trust (to the extent not described in § 1.199–9(d)) or an estate may use the simplified deduction method is determined at the trust or estate level. If a trust or estate qualifies to use the simplified deduction method, the simplified deduction method must be 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. Whether the owner of a pass-thru entity may use the simplified deduction method is determined at the level of the entity's owner. If the owner of a pass-thru entity qualifies and uses the simplified deduction method, then 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) *Eligible taxpayer.* For purposes of this paragraph (e), an eligible taxpayer is—

(i) A taxpayer that has average annual gross receipts (as defined in paragraph (g) of this section) of $100,000,000 or less; or

(ii) A taxpayer that has total assets (as defined in paragraph (e)(3) of this section) of $10,000,000 or less.

(3) *Total assets*—(i) *In general.* For purposes of the simplified deduction method, total assets means the total assets the taxpayer has at the end of the taxable year. 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 Form 1120, ''United States Corporation Income Tax Return,'' in accordance with the Form 1120 instructions.

(ii) *Members of an expanded affiliated group.* To compute the total assets of an EAG, the total assets at the end of the 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 (as described in § 1.199–7(h)) are aggregated. For purposes of this paragraph, a consolidated group is treated as one member of the EAG.

(4) *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 all the members of the EAG. If the average annual gross receipts of the EAG are less than or equal to $100,000,000 or the total assets of the EAG are less than or equal to $10,000,000, then 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)(4)(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) 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 $20,000,000, $70,000,000, and $5,000,000, 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 $100,000,000, 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 $15,000,000. Because the average annual gross receipts of the EAG are greater than $100,000,000 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 (f)(3) of this section) are apportioned between DPGR and non-DPGR 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. Total gross receipts for this purpose do not include gross receipts that are allocated to land under the land safe harbor provided in § 1.199–3(m)(6)(iv). See § 1.199–3(m)(6)(iv)(B).

(2) *Qualifying small taxpayer.* Except as provided in paragraph (f)(5), for purposes of this paragraph (f), a *qualifying small taxpayer* is—

(i) A taxpayer that has average annual gross receipts (as defined in paragraph (g) of this section) 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) *Total costs for the current taxable year*—(i) *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) of this section) for the current taxable year. Total costs for the current taxable year are determined under the methods of accounting that the taxpayer uses to compute taxable income.

(ii) *Land safe harbor.* A taxpayer that uses the land safe harbor provided in § 1.199–3(m)(6)(iv) must reduce total costs for the current taxable year by the costs of land and any other costs capitalized to the land (except costs for activities listed in § 1.199–3(m)(2)(iii)) prior to applying the small business simplified overall method. See § 1.199–3(m)(6)(iv)(B). For example, if a taxpayer has $1,000 of total costs for the current taxable year and $600 of such costs is attributable to land under the land safe harbor, then only $400 of such costs is apportioned between DPGR and non-DPGR under the small business simplified overall method.

(4) *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 the average annual gross receipts 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)(4)(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) 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 for the current taxable year of $1,000,000, $1,500,000, and $2,000,000, respectively. Because the average annual gross receipts 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.

(5) *Trusts and estates.* Trusts and estates under § 1.199–9(e) 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 (including gross receipts attributable to the sale, exchange, or other disposition of land under the land safe harbor provided in § 1.199–3(m)(6)(iv)) 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 expanded affiliated group.* 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 are aggregated. For purposes of this paragraph, a consolidated group is treated as one member of the EAG.

§ 1.199–5 Application of section 199 to pass-thru entities for taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005. [Reserved].

§ 1.199–6 Agricultural and horticultural cooperatives.

(a) *In general.* A patron who receives a qualified payment (as defined in paragraph (e) of this section) from a specified agricultural or horticultural cooperative (cooperative) (as defined in paragraph (f) of this section) is allowed a deduction under § 1.199–1(a) (section 199 deduction) for the taxable year the qualified payment is received for the portion of the cooperative's section 199 deduction passed through to the patron and identified by the cooperative in a written notice mailed to the person during the payment period described in section 1382(d). The provisions of this section apply solely for purposes of section 199 of the Internal Revenue Code (Code).

(b) *Cooperative denied section 1382 deduction for portion of qualified payments.* A cooperative must reduce its section 1382 deduction by an amount equal to the portion of any qualified payment that is attributable to the cooperative's section 199 deduction passed through to the patron.

(c) *Determining cooperative's taxable income.* For purposes of determining its section 199 deduction, 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).

(d) *Special rule for marketing cooperatives.* In the case of a cooperative engaged in the marketing of agricultural and/or horticultural products described in paragraph (f) of this section, the cooperative is treated as having manufactured, produced, grown, or extracted (MPGE) (as defined in § 1.199–3(e)) in whole or in significant part (as defined in § 1.199–3(g)) within the United States (as defined in § 1.199–3(h)) any agricultural or horticultural products marketed by the cooperative that its patrons have MPGE.

(e) *Qualified payment.* The term *qualified payment* means any amount of a patronage dividend or per-unit retain allocation, as described in section 1385(a)(1) or (3) received by a patron from a cooperative, that is attributable to the portion of the cooperative's qualified production activities income (QPAI) (as defined in § 1.199–1(c)), for which the cooperative is allowed a section 199 deduction. For this purpose, patronage dividends and per-unit retain allocations include any advances on patronage and per-unit retains paid in money during the taxable year.

(f) *Specified agricultural* or *horticultural cooperative.* A *specified agricultural* or *horticultural cooperative* means a cooperative to which Part I of subchapter T of the Code applies and the cooperative has MPGE in whole or significant part within the United States 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.

(g) *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 identify in a written notice the patron's portion of the section 199 deduction that is attributable to the portion of the cooperative's QPAI for which the cooperative is allowed a section 199 deduction. This written notice 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.

(h) *Additional rules relating to passthrough of section 199 deduction.* The cooperative may, at its discretion, pass through all, some, or none of the section 199 deduction to its patrons. However, the cooperative may not apply section 199(d)(3) and this section to any portion of the section 199 deduction that is not passed through 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).

(i) *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.

(j) *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 an amended return, then recapture of the excess will occur at the cooperative level in the taxable year the cooperative took the excess section 199 deduction amount into account.

(k) *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.

(l) *No double counting.* To the extent a cooperative passes through the section 199 deduction to a patron, a qualified payment received by the patron of the cooperative is not taken in account for purposes of section 199.

(m) *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, 2007, Cooperative X has gross receipts of $1,500,000, all derived from the sale of corn grown by its members within the United States. Cooperative X pays $370,000 for its members' corn and its W–2 wages (as defined in § 1.199–2(e)) for 2007 total $130,000. 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 2007 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 a cooperative described in paragraph (f) 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 is $1,000,000. Cooperative X's section 199 deduction for its taxable year 2007 is $60,000 (.06 × $1,000,000). Because this amount is less than 50% of Cooperative X's W–2 wages, the entire amount is allowed as a section 199 deduction subject to the rules of section 199(d)(3) and this section.

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 2007 taxable year of $1,000,000, which it pays on March 15, 2008. Pursuant to paragraph (g) of this section, Cooperative X notifies members in written notices that accompany the patronage dividend notification that it is allocating to them the section 199 deduction it is entitled to claim in the taxable year 2007. On March 15, 2008, Patron A receives a $10,000 patronage dividend that is a qualified payment under paragraph (e) of this section from Cooperative X. In the notice that accompanies the patronage dividend, Patron A is designated a $600 section 199 deduction. Under paragraph (a) of this section, Patron A must claim a $600 section 199 deduction for the taxable year ending December 31, 2008, 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 Patron A for the calendar year 2008.

(ii) Under paragraph (b) of this section, Cooperative X is required to reduce its patronage dividend deduction of $1,000,000 by the $60,000 section 199 deduction passed through to members (whether or not Cooperative X pays patronage on book or Federal income tax net earnings). As a consequence, Cooperative X is entitled to a patronage dividend deduction for the taxable year ending December 31, 2007, in the amount of $940,000 ($1,000,000 − $60,000) and to a section 199 deduction in the amount of $60,000 ($1,000,000 × .06). Its taxable income for 2007 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 2007, 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 paragraph (b) of this section and section 1382, Cooperative X is allowed a patronage dividend deduction of

$440,000 ($500,000 − $60,000 section 199 deduction), whether patronage net earnings are distributed on book or Federal income tax net earnings.

(ii) The patrons will have received a gross amount of $1,000,000 in qualified payments under paragraph (e) of this section from Cooperative X ($500,000 paid during the taxable year as advances and the additional $500,000 paid as patronage dividends). If Cooperative X passes through its entire section 199 deduction to its members by providing the notice required by paragraph (g) of this section, then the patrons will be allowed a $60,000 section 199 deduction, resulting in a net $940,000 taxable distribution from Cooperative X. Pursuant to paragraph (l) of this section, the $1,000,000 received by the patrons from Cooperative X is not taken into account for purposes of section 199 in the hands of the patrons.

§ 1.199–7 Expanded affiliated groups.

(a) *In general.* The provisions of this section apply solely for purposes of section 199 of the Internal Revenue Code (Code). 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 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(e)). 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*—(i) *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(i)) of qualifying production property (QPP) (as defined in § 1.199–3(j)) that was manufactured, produced, grown or extracted (MPGE) (as defined in § 1.199–3(e)), in whole or in significant part (as defined in § 1.199–3(g)) in the United States (as defined in § 1.199–3(h)), a qualified film (as defined in § 1.199–3(k)), or electricity, natural gas, or potable water (as defined in § 1.199–3(l)) (collectively, utilities) that was produced in the United States, such property was MPGE or produced by another corporation (or corporations), and the disposing member is a member of the same EAG as the other corporation (or corporations) at the time that the disposing member disposes of the QPP, qualified film, or utilities, then the disposing member is treated as conducting the previous activities conducted by such other corporation (or corporations) 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)). With respect to a lease, rental, or license, the disposing member is treated as having disposed of the QPP, qualified film, or utilities on the date or dates on which it takes into account the gross receipts derived from the lease, rental, or license under its methods of accounting. With respect to a sale, exchange, or other disposition, the disposing member is treated as having disposed of the QPP, qualified film, or utilities on the date on which it ceases to own the QPP, qualified film, or utilities for Federal income tax purposes, even if no gain or loss is taken into account.

(ii) *Special rule.* Attribution of activities does not apply for purposes of the construction of real property under § 1.199–3(m) or the performance of engineering and architectural services under § 1.199–3(n). A member of an EAG must engage in a construction activity under § 1.199–3(m)(2), provide engineering services under § 1.199–3(n)(2), or provide architectural services under § 1.199–3(n)(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. Assume that all taxpayers are calendar year taxpayers. The examples are as follows:

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. For purposes of this example, assume that 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 2007 year, Corporations A and B are members of the same EAG. A is engaged solely in the trade or business of MPGE machinery in the United States. A and B each own 45% of partnership C and unrelated persons own the remaining 10%. C is engaged solely in the trade or business of MPGE the same type of machinery in the United States as A. In 2007, B purchases and then resells the machinery MPGE in 2007 by A and C. B also resells machinery 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 at the time B disposes of the machinery B is a member of the EAG that includes A, B is Treated as conducting A's previous MPGE activities in determining whether B's gross receipts from the sale of the machinery MPGE by A 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 from the sale of the machinery MPGE by C are DPGR. Accordingly, B's gross receipts attributable to its sale of the machinery 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 machinery it purchases from C and from the unrelated persons are non-DPGR because no member of the EAG MPGE the machinery and because C does not qualify as an EAG partnership.

Example 3. The facts are the same as in *Example 2* except that rather than reselling the machinery, B rents the machinery it acquired from A to unrelated persons and B takes the gross receipts attributable to the rental of the machinery into account under its methods of accounting in 2007, 2008, and 2009. In addition, as of the close of business on December 31, 2008, A and B cease to be members of the same EAG. With respect to the machinery acquired from C and the unrelated persons, B's gross receipts attributable to the rental of the machinery in 2007, 2008, and 2009 are non-DPGR because no member of the EAG MPGE the machinery and because C does not qualify as an EAG partnership. With respect to machinery acquired from A, B's gross receipts in 2007 and 2008 attributable to the rental of the machinery are DPGR because at the time B takes into account the gross receipts derived from the rental of the machinery into account under its methods of accounting, B is a member of the same EAG as A and B is treated as conducting A's previous MPGE activities. However, with respect to the rental receipts in 2009, because A and B are not members of the same EAG in 2009, B's rental receipts are non-DPGR.

Example 4. For the entire 2007 year, Corporation P owns over 50% of the stock of Corporation S. In 2007, P MPGE QPP in the United States and transfers the QPP to S. On February 28, 2008, P disposes of stock of S, reducing P's ownership of S below 50% and P and S cease to be members of the same EAG. On June 30, 2008, S sells the QPP to an unrelated person. Unless P's transfer of the QPP to S took place in a transaction to which section 381(a) applies (see § 1.199–8(e)(3)), because S is not a member of the same EAG as P on June 30, 2008, S is not treated as conducting the activities conducted by P in determining if S's receipts are DPGR, notwithstanding that P and S were members of the same EAG when P MPGE the QPP and when P transferred the QPP to S.

Example 5. For the entire 2007 year, Corporations X and Y are unrelated corporations. In 2007, X MPGE QPP in the United States and sells the QPP to Y. On August 31, 2008, X acquires over 50% of the stock of Y, thus making X and Y members of the same EAG. On November 30, 2008, Y sells the QPP to an unrelated person. Because X and Y are members of the same EAG on November 30, 2008, Y is treated as conducting the activities conducted by X in 2007 in determining if Y's receipts are DPGR, notwithstanding that X and Y were not members of the same EAG when X MPGE the QPP nor when X sold the QPP to Y.

(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 the EAG by aggregating each member's taxable income or loss, QPAI, and W–2 wages, if any. 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) *Example.* The following example illustrates the application of paragraph (b)(1) of this section:

Example. Corporations X, Y, and Z, calendar year taxpayers, are the only members of an EAG and are not members of a consolidated group. X has taxable income of $50,000, QPAI of $15,000, and W–2 wages of $1,000. Y has taxable income of ($20,000), QPAI of ($1,000), and W–2 wages of $750. Z has $0 taxable income and $0 QPAI, but has W–2 wages of $2,000. In determining the EAG's section 199 deduction, the EAG aggregates each member's taxable income or loss, QPAI, and W–2 wages. Accordingly, the EAG has taxable income of $30,000 ($50,000 + ($20,000) + $0), QPAI of $14,000 ($15,000 + ($1,000) + $0), and W–2 wages of $3,750 ($1,000 + $750 + $2,000).

(3) *Net operating loss carrybacks and 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 as determined in paragraph (b)(1) of this section 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), 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 (as the terms intercompany transaction, S, and B are defined in § 1.1502–13(b)(1)), S takes the 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)(ii) of this section, a disposing member (as described in paragraph (a)(3)(i) of this section) is treated as conducting the previous activities conducted by each other member of its consolidated group with respect to the construction of real property under § 1.199–3(m) and the performance of engineering and architectural services under § 1.199–3(n), but only with respect to activities performed during the period of consolidation.

(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 using its members' DPGR, non-DPGR, cost of goods sold (CGS), and all other deductions, expenses, or losses (deductions), determined after application of § 1.1502–13.

(4) *Determining the section 199 deduction*—(i) *Expanded affiliated group consists of consolidated group and non-consolidated group members.* In determining the section 199 deduction, if an EAG includes corporations that are members of the same consolidated group and corporations that are not members of the same consolidated group, the consolidated taxable income or loss, QPAI, and W–2 wages, if any, of the consolidated group (and 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, if any, 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), then 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, if any, of the A consolidated group are aggregated with the taxable income or loss, QPAI, and W–2 wages, if any, 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 using the consolidated group's consolidated taxable income or loss, QPAI, and W–2 wages, rather than 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) 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. In allocating the section 199 deduction of a consolidated group among its members, any redetermination of a corporation's receipts, CGS, or other deductions from an intercompany transaction under § 1.1502–13(c)(1)(i) or (c)(4) for purposes of section 199 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 (a) through (d) of this section:

Example 1. Corporations X and Y are members of the same EAG but are not members of a consolidated group. All the activities described in this example take place during the same taxable year. 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 intercompany items or Y's corresponding items, or both, 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 redetermined 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. Corporations P and S are members of the same EAG but are not members of a consolidated group. P and S each use the section 861 method for allocating and apportioning their deductions and are both calendar year taxpayers. In 2007, P incurs $1,000 in research and development expenses in creating an intangible asset and deducts these expenses in 2007. P anticipates that it will license the intangible asset to S. On January 1, 2008, P licenses the intangible asset to S for $2,500. S uses the intangible asset in manufacturing QPP within the United States. S incurs $2,000 of additional costs in manufacturing the QPP. On December 31, 2008, S sells the QPP to unrelated persons for $10,000. Because on December 31, 2007, P anticipates that it will license the intangible asset to S, a related person, and also because the intangible asset is not QPP, P's license receipts from S will be non-DPGR. Accordingly, P's research and development expenses in 2007 are not attributable to DPGR. In 2008, S has $5,500 of QPAI (S's $10,000 DPGR received from unrelated persons − S's $2,000 additional costs in manufacturing the QPP − S's $2,500 of license expense), P has $0 of QPAI, and the EAG has $5,500 of QPAI.

Example 4. (i) *Determination of consolidated group's QPAI.* The facts are the same as in *Example 3* except that P and S are members of the same consolidated group. Pursuant to section 199(c)(7) and § 1.199–3(b), and also because the intangible asset is not QPP, P's license income ordinarily would not be DPGR (and its related costs would not be allocable to DPGR). However, because P and S are members of the same consolidated group, § 1.1502–13(c)(1)(i) provides that the separate entity attributes of P's intercompany items or S's corresponding items, or both, may be redetermined in order to produce the same effect as if P and S were divisions of a single corporation. If P and S were divisions of a single corporation, in 2007 the single corporation would have $1,000 of expenses allocable to the anticipated DPGR from the sale of the QPP to unrelated persons, resulting in a negative QPAI (from this individual item) of $1,000. In 2008, the single corporation would have QPAI of $8,000 ($10,000 DPGR received from unrelated persons − $2,000 additional costs in manufacturing the QPP). To obtain this same result for the consolidated group, P's license income from S is redetermined as DPGR. P's research and development expenses are allocable to DPGR. This results in the consolidated group having negative QPAI in 2007 (from the research and development expense) of $1,000. In 2008, the consolidated group has $12,500 of DPGR (the sum of S's DPGR of $10,000 + P's DPGR of $2,500) and $4,500 of costs allocable to DPGR (the sum of S's $2,000 additional costs + S's $2,500 license expense), resulting in $8,000 of QPAI in 2008.

(ii) *Allocation of deduction.* Since the consolidated group has no QPAI in 2007, there is no section 199 deduction to be allocated between P and S in 2007. In 2008, the consolidated group has $8,000 of QPAI and, assuming that the group has positive taxable income and W–2 wages, the consolidated group will have a section 199 deduction. For purposes of determining how much of the consolidated group's section 199 deduction is allocated to P and S, pursuant to paragraph (d)(5) of this section, the redetermination of P's license income as DPGR under § 1.1502–13(c)(1)(i) is not taken into account. Accordingly, for purposes of allocating the consolidated group's section 199 deduction between P and S, P is deemed to have $0 DPGR and $0 QPAI in 2008. S has $5,500 of QPAI (S's $10,000 DPGR − S's $2,000 in additional costs allocable to such receipts − S's $2,500 of license expense). Accordingly, P is allocated $0/($0 + $5,500) of the consolidated group's section 199 deduction in 2008 and S is allocated $5,500/($0 + $5,500) of the consolidated group's section 199 deduction.

Example 5. (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 $100,000,000 and A and B each use the simplified deduction method under § 1.199–4(e). In 2007, 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 2007, B sells the televisions it purchased from A to unrelated persons for $4,100,000. B also pays $100,000 for administrative services performed in 2007. 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 × $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 × $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 6. (i) *Facts.* The facts are the same as in *Example 5* except that A and B are members of the same consolidated group, B does not sell the televisions purchased from A until 2008, and B's $100,000 paid for administrative services are paid in 2008 for services performed in 2008. In addition, in 2008, 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 2007 QPAI.* The consolidated group's DPGR and total gross receipts in 2007 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 2007. 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 × $10,000,000/$13,000,000) is allocated to DPGR. Accordingly, the consolidated group's QPAI for 2007 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 2007 section 199 deduction to its members.* Because B's only activity during 2007 is the purchase of televisions from A, B has no DPGR or deductions and thus, no QPAI, in 2007. Accordingly, the entire section 199 deduction in 2007 for the consolidated group will be allocated to A.

(iv) *Consolidated group's 2008 QPAI.* Pursuant to paragraph (d)(1) of this section and § 1.1502–13(c), A's sale of televisions to B in 2007 is taken into account in 2008 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 intercompany items or B's corresponding items, or both, 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 as not being gross receipts for purposes of allocating costs between DPGR and non-DPGR, 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 as not being gross receipts for purposes of allocating costs between DPGR and non-DPGR, 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 2008 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 × $4,100,000/$7,100,000) is allocated to DPGR. Accordingly, the consolidated group's QPAI for 2008 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 2008 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 is disregarded. Accordingly, for this purpose, A's DPGR are $2,000,000 (receipts from the sale of televisions to B taken into account in 2008) 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 × $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 × $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 2008 is allocated $100,000/($100,000 + $2,000,000) to A and $2,000,000/($100,000 + $2,000,000) to B.

Example 7. Corporations S and B are members of the same consolidated group that files its Federal income tax returns on a calendar year basis. In 2007, 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 intercompany items or B's corresponding items, or both, 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 2007.

Example 8. (i) *Facts.* A and B are members of the same consolidated group that files its Federal income tax returns on a calendar year basis. On January 1, 2007, A MPGE QPP which is 10-year recovery property for $100 and depreciates it under the straight-line method. On January 1, 2009, A sells the property to B for $130. Under section 168(i)(7), B is treated as A for purposes of section 168 to the extent B's $130 basis does not exceed A's adjusted basis at the time of the sale. B's additional basis is treated as new 10-year recovery property for which B elects the straight-line method of recovery. (To simplify the example, the half-year convention is disregarded.)

(ii) *Depreciation; intercompany gain.* A claims $10 of depreciation for each taxable year 2007 and 2008 and has an $80 basis at the time of the sale to B. Thus, A has a $50 intercompany gain from its sale to B. For each taxable year 2009 through 2016, B has $10 of depreciation with respect to $80 of its basis (the portion of its $130 basis not exceeding A's adjusted basis) and $5 of depreciation with respect to the $50 of its additional basis that exceeds A's adjusted basis. For each taxable year 2017 and 2018, B has $5 of depreciation with respect to the

$50 of its additional basis that exceeds A's adjusted basis.

(iii) *Timing.* A's $50 gain is taken into account to reflect the difference for each consolidated return year between B's depreciation taken into account with respect to the property and the depreciation that would have been taken into account if A and B were divisions of a single corporation. For each taxable year 2009 through 2016, B takes into account $15 of depreciation rather than the $10 of depreciation that would have been taken into account if A and B were divisions of a single corporation. For each taxable year 2017 and 2018, B takes into account $5 of depreciation rather than the $0 of depreciation that would have been taken into account if A and B were divisions of a single corporation (the QPP would have been fully depreciated after the 2016 taxable year if A and B were divisions of a single corporation). Thus, A takes $5 of gain into account in each of the 2009 through 2018 taxable years (10% of its $50 gain). Pursuant to § 1.199–7(d)(1), A takes its sale to B into account in computing the section 199 deduction at the same time and in the same proportion as A takes into account the income, gain, deduction, or loss from the intercompany transaction under § 1.1502–13. Thus, in each taxable year 2009 through 2018, A takes into account $13 of gross receipts (10% of its $130 gross receipts) from the sale to B. The group's income in each taxable year 2009 through 2016 is a $10 loss ($5 gain − $15 depreciation), the same net amount it would have been if A and B were divisions of a single corporation. The group's income in each taxable year 2017 and 2018 is $0 ($5 gain − $5 depreciation), the same net amount it would have been if A and B were divisions of a single corporation.

(iv) *Attributes.* If A and B were not members of a consolidated group, A's gross receipts on the sale of the QPP to B would be DPGR (assuming all the other requirements of § 1.199–3 are met). However, because A and B are members of a consolidated group, the separate entity attributes of A's DPGR may be redetermined under § 1.1502–13(c)(1)(i) or (c)(4) in order to produce the same effect as if A and B were divisions of a single corporation. If A and B were divisions of a single corporation, there would be no DPGR with respect to the QPP because there would be no lease, rental, license, sale, exchange, or other disposition of the QPP by the single corporation (and no CGS or other deductions allocable to DPGR). Thus, in order to produce the same effect as if A and B were divisions of a single corporation, A's $13 of gross receipts taken into account in each year is redetermined as non-DPGR. Accordingly, the consolidated group has no DPGR (and no CGS or other deductions allocable or apportioned to DPGR) and receives no section 199 deduction.

Example 9. 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 2007, X had no taxable income or loss. In 2007, 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 2007, the transition percentage under section 199(a)(2) is 6%. Thus, the EAG's section 199 deduction for 2007 is $480 (6% 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 $480 section 199 deduction is allocated to X, Y, and Z in proportion to their respective amounts of QPAI, that is $96 to X ($480 × $2,000/$10,000), $144 to Y ($480 × $3,000/$10,000), and $240 to Z ($480 × $5,000/$10,000). Although X's taxable income for 2007 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 2007 equal to $96. Because X's NOL for 2007 cannot be carried back to a previous taxable year, X's NOL carryover to 2008 will be $96.

Example 10. (i) *Facts.* Corporation P owns all of the stock of Corporations S and T and P, S, and T file a consolidated Federal income tax return on a calendar year basis. In 2007, P MPGE QPP in the United States at a cost of $1,000. On November 30, 2007, P sells the QPP to S for $2,500. On February 28, 2008, P disposes of 60% of the stock of S. On June 30, 2008, S sells the QPP to an unrelated person for $3,000.

(ii) *Analysis.* Because P and S are members of a consolidated group in 2007, pursuant to § 1.199–7(d)(1) and § 1.1502–13, neither P's $1,500 of gain on the sale of QPP to S nor P's $2,500 gross receipts from the sale are taken into account in 2007. Under § 1.1502–13(d), P takes the intercompany transaction into account immediately before S becomes a non-member of the consolidated group. In order to produce the same effect as if P and S were divisions of a single corporation, P's gross receipts from the sale of the QPP to S are redetermined under § 1.1502–13(c)(1)(i) as non-DPGR. Further, because P and S are not members of the same EAG when S sells the QPP to the unrelated person, and because P's transfer of the QPP to S did not take place in a transaction to which section 381(a) applies, S is not treated as conducting the activities conducted by P in determining if S's receipts are DPGR, notwithstanding that P and S were members of the same EAG when P MPGE the QPP and when P sold the QPP to S. Accordingly, neither the P consolidated group nor S will have DPGR with respect to the QPP.

Example 11. Corporation X is the common parent of a consolidated group, consisting of X and Y, which has filed a consolidated Federal income tax return for many years. Corporation P is the common parent of a consolidated group, consisting of P and S, which has filed a consolidated Federal income tax return for many years. The X and P consolidated groups each file their consolidated Federal income tax returns on a calendar year basis. X, Y, P and S are members of the same EAG in 2008. In 2007, the X consolidated group incurred a consolidated net operating loss (CNOL) of $25,000, none of which was carried back and used to offset taxable income of prior taxable years. Neither P nor S (nor the P consolidated group) has ever incurred an NOL. In 2008, the X consolidated group has (prior to the deduction under section 172) taxable income of $8,000 and the P consolidated group has taxable income of $20,000. The X consolidated group uses $8,000 of its CNOL from 2007 to offset the X consolidated group's taxable income in 2008. None of the X consolidated group's remaining CNOL may be used to offset taxable income of the P consolidated group under paragraph (b)(3) of this section. Accordingly, for purposes of determining the EAG's section 199 deduction, the EAG has taxable income of $20,000 (the X consolidated group's taxable income (after the deduction under section 172) of $0 plus the P consolidated group's taxable income of $20,000).

(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 is 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, then 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 2007 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 2007 and not a member of any EAG for the second half of 2007. During the 2007 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 2007 and a $150 taxable loss and ($200) of QPAI that is allocated to the second half of 2007. Taking into account Z's taxable income, QPAI, and W–2 wages allocated to the first half of 2007 pursuant to the section 199 closing of the books election, the EAG has positive taxable income and QPAI for 2007 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 2007, a portion of the EAG's section 199 deduction is allocated to Z. Because Z has negative QPAI for the second half of 2007, Z is allowed no section 199 deduction for the second half of 2007. Thus, despite the fact that Z has a $70 taxable loss and ($100) of QPAI for the entire 2007 taxable year, Z is entitled to a section 199 deduction for 2007 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, determined without regard to the section 199 deduction, QPAI, and W–2 wages of each other group member that are both—

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

(ii) Taken into account in a taxable year that begins after the effective date of section 199 and such taxable year 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. Z came into existence on July 1, 2007. Each corporation has taxable income that exceeds its QPAI and has sufficient W–2 wages to avoid the limitation under section 199(b). For the taxable year ending December 31, 2007, X's QPAI is $8,000 and Y's QPAI is ($6,000). For its taxable year ending June 30, 2008, Z's QPAI is $2,000.

(ii) In computing X's and Y's respective section 199 deductions for their taxable years ending December 31, 2007, X's and Y's taxable income, QPAI, and W–2 wages from their respective taxable years ending December 31, 2007, 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 2007, the transition percentage under section 199(a)(2) is 6%. Accordingly, the EAG's section 199 deduction is $120 ($2,000 × .06). The $120 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, 2007, is $120 ($120 × $8,000/($8,000 + $0)). Y's section 199 deduction for its taxable year ending December 31, 2007, is $0 ($120 × $0/($8,000 + $0)).

(iii) In computing Z's section 199 deduction for its taxable year ending June 30, 2008, X's and Y's items from their respective taxable years ending December 31, 2007, are taken into account. Therefore, X's and Y's taxable income or loss, determined without regard to the section 199 deduction, QPAI, and W–2 wages from their taxable years ending December 31, 2007, are aggregated with Z's taxable income or loss, QPAI, and W–2 wages from its taxable year ending June 30, 2008. 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 2007, the transition percentage under section 199(a)(2) is 6%. Accordingly, the EAG's section 199 deduction is $240 ($4,000 × .06). A portion of the $240 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 $240 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, 2008, is $48 ($240 × $2,000/($8,000 + $0 + $2,000)).

§ 1.199–8 Other rules.

(a) *In general.* The provisions of this section apply solely for purposes of section 199 of the Internal Revenue Code (Code). When calculating the deduction under § 1.199–1(a) (section 199 deduction), taxpayers are required to make numerous allocations under §§ 1.199–1 through 1.199–9. In making these allocations, taxpayers may use any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, unless the regulations under §§ 1.199–1 through 1.199–9 specify a method. A change in a taxpayer's method of allocating or apportioning gross receipts, cost of goods sold (CGS), expenses, losses, or deductions (deductions) does not constitute a change in method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply.

(b) *Individuals.* In the case of an individual, the 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.

(c) *Trade or business requirement*—(1) *In general.* Sections 1.199–1 through 1.199–9 are applied by taking into account only items that are attributable to the actual conduct of a trade or business.

(2) *Individuals.* An individual engaged in the actual conduct of a trade or business must apply §§ 1.199–1 through 1.199–9 by taking into account in computing QPAI only items that are attributable to that trade or business (or trades or businesses) and any items allocated from a pass-thru entity engaged in a trade or business. Compensation received by an individual employee for services performed as an employee is not considered gross receipts for purposes of computing QPAI under §§ 1.199–1 through 1.199–9. Similarly, any costs or expenses paid or incurred by an individual employee with respect to those services performed as an employee are not considered CGS or deductions of that employee for purposes of computing QPAI under §§ 1.199–1 through 1.199–9.

(3) *Trusts and estates.* For purposes of this paragraph (c), a trust or estate is treated as an individual.

(d) *Coordination with alternative minimum tax.* For purposes of determining alternative minimum taxable income (AMTI) under section 55, a taxpayer that is not a corporation must 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 must 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 non-grantor trust or estate, 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 (d) 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). The section 199 deduction is not taken into account in determining the amount of the alternative tax net operating loss deduction (ATNOL) allowed under section 56(a)(4). For example, assume that for the calendar year 2007, a corporation has both AMTI (before the NOL deduction and before the section 199 deduction) and QPAI of $1,000,000, and has an ATNOL carryover to 2007 of $5,000,000. Assume that the taxpayer has W–2 wages in excess of the section 199(b) wage limitation. Under section 56(d), the ATNOL deduction for 2007 is $900,000 (90 percent of $1,000,000), reducing AMTI to $100,000. The taxpayer must then further reduce the AMTI by the section 199 deduction of $6,000 (six percent of the lesser of $1,000,000 or $100,000) to $94,000. The ATNOL carryover to 2008 is $4,100,000.

(e) *Nonrecognition transactions*—(1) *In general*—(i) *Sections 351, 721, and 731.* Except as provided for an EAG partnership (as defined in § 1.199–9(j)) and an expanded affiliated group (EAG) (as defined in § 1.199–7), 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 solely 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 for a qualifying in-kind partnership (as defined in § 1.199–9(i)) and an EAG partnership, 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.

(ii) *Exceptions*—(A) *Section 708(b)(1)(B).* If property is deemed to be contributed by a partnership (transferor partnership) to another partnership (transferee partnership) as a result of a termination under section 708(b)(1)(B), then the transferee partnership shall be treated as performing those activities performed by the transferor partnership with respect to the transferred property of the transferor partnership.

(B) *Transfers by reason of death.* If property is transferred upon or by reason of the death of an individual (decedent), then the decedent's successor(s) in interest shall be treated as having performed those activities performed by or deemed to have been performed (pursuant to § 1.199–9(i)) by the decedent with respect to the transferred property. For this purpose, a transfer shall include without limitation the passing of the property by bequest, contractual provision, beneficiary designation, or operation of law, and successor in interest shall include without limitation the decedent's heirs or legatees, the decedent's estate or trust, or the beneficiary or beneficiaries of the decedent's estate or trust.

(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, then 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, such assets will give rise to DPGR if leased, rented, licensed, sold, exchanged, or otherwise disposed of by the acquiring corporation (assuming all the other requirements of § 1.199–3 are met).

(f) *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 1.199–9 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, 2006, is deemed to begin

on January 1, 2007, and the transition percentage for that taxable year is 6 percent.

(g) *Section 481(a) adjustments.* For purposes of determining QPAI, a section 481(a) adjustment, whether positive or negative, taken into account by a taxpayer during the taxable year that is solely attributable to either the taxpayer's gross receipts, CGS, or deductions must be allocated or apportioned between DPGR and non-DPGR using the methods used by a taxpayer to allocate or apportion gross receipts, CGS, and deductions between DPGR and non-DPGR for the current taxable year. See §§ 1.199–1 and 1.199–4 for rules related to the allocation and apportionment of gross receipts, CGS, and deductions, respectively. 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 and the taxpayer uses the small business simplified overall method to apportion CGS between DPGR and non-DPGR, the taxpayer is required to apportion the resulting section 481(a) adjustment, whether positive or negative, between DPGR and non-DPGR using the small business simplified overall method. 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, then 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 based on all of the facts and circumstances, and then allocated or apportioned between DPGR and non-DPGR using the same methods the taxpayer uses to allocate or apportion gross receipts, CGS, or deductions between DPGR and non-DPGR for the taxable year or taxable years that the section 481(a) adjustment is taken into account. 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 alternative methods. If a section 481(a) adjustment is spread over more than one taxable year, then a taxpayer must attribute the section 481(a) adjustment among gross receipts, CGS, or deductions, as applicable, in the same amount for each taxable year within the spread period. For example, if a taxpayer, using a reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, determines that a section 481(a) adjustment that is required to be spread over four taxable years should be attributed half to gross receipts and half to deductions, then the taxpayer must attribute the section 481(a) adjustment half to gross receipts and half to deductions in each of the four taxable years of the spread period. Further, if such taxpayer uses the simplified deduction method to apportion deductions between DPGR and non-DPGR in the first taxable year of the spread period, then the taxpayer must use the simplified deduction method to apportion half the section 481(a) adjustment for that taxable year between DPGR and non-DPGR for that taxable year. Similarly, if in the second taxable year of the spread period the taxpayer uses the section 861 method to apportion and allocate costs between DPGR and non-DPGR, then the taxpayer must use the section 861 method to allocate and apportion half the section 481(a) adjustment for that taxable year between DPGR and non-DPGR for that taxable year.

(h) *Disallowed losses or deductions.* Except as provided by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), losses or deductions of a taxpayer that otherwise would be taken into account in computing the taxpayer's section 199 deduction are taken into account only if and to the extent the deductions are not disallowed by section 465 or 469, or any other provision of the Code. If only a portion of the taxpayer's share of the losses or deductions is allowed for a taxable year, the proportionate share of those allowable losses or deductions that are allocated to the taxpayer's qualified production activities, determined in a manner consistent with section 465 and 469, and any other applicable provision of the Code, is taken into account in computing QPAI for purposes of 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 taxpayer takes into account a proportionate share of those losses or deductions in computing its QPAI for that later taxable year. Losses or deductions of the taxpayer that are disallowed for taxable years beginning on or before December 31, 2004, are not taken into account in a later taxable year for purposes of computing the taxpayer's QPAI and the wage limitation of section 199(d)(1)(A)(iii) under § 1.199–9 for that taxable year, regardless of whether the losses or deductions are allowed for other purposes. For taxpayers that are partners in partnerships, see § 1.199–9(b)(2). For taxpayers that are shareholders in S corporations, see § 1.199–9(c)(2).

(i) *Effective dates*—(1) *In general.* Section 199 applies to taxable years beginning after December 31, 2004. Sections 1.199–1 through 1.199–8 are applicable for taxable years beginning on or after June 1, 2006. For a taxable year beginning on or before May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. 109–222, 120 Stat. 345), a taxpayer may apply §§ 1.199–1 through 1.199–9 provided that the taxpayer applies all provisions in §§ 1.199–1 through 1.199–9 to the taxable year. For a taxable year beginning after May 17, 2006, and before June 1, 2006, a taxpayer may apply §§ 1.199–1 through 1.199–8 provided that the taxpayer applies all provisions in §§ 1.199–1 through 1.199–8 to the taxable year. For a taxpayer who chooses not to rely on these final regulations for a taxable year beginning before June 1, 2006, the guidance under section 199 that applies to such taxable year is contained in Notice 2005–14 (2005–1 C.B. 498) (see § 601.601(d)(2) of this chapter). In addition, a taxpayer also may rely on the provisions of REG–105847–05 (2005–47 I.R.B. 987) (see § 601.601(d)(2) of this chapter) for a taxable year beginning before June 1, 2006. If Notice 2005–14 and REG-105847–05 include different rules for the same particular issue, then a taxpayer may rely on either the rule set forth in Notice 2005–14 or the rule set forth in REG–105847–05. However, if REG–105847–05 includes a rule that was not included in Notice 2005–14, then a taxpayer is not permitted to rely on the absence of a rule in Notice 2005–14 to apply a rule contrary to REG–105847–05. For taxable years beginning after May 17, 2006, and before June 1, 2006, a taxpayer may not apply Notice 2005–14, REG–105847–05, or any other guidance under section 199 in a manner inconsistent with amendments made to section 199 by section 514 of the Tax Increase Prevention and Reconciliation Act of 2005.

(2) *Pass-thru entities.* In determining the deduction under section 199, items arising from a taxable year of a partnership, S corporation, estate, or trust beginning before January 1, 2005,

shall not be taken into account for purposes of section 199(d)(1).

(3) *Non-consolidated EAG members.* A member of an EAG that is not a member of a consolidated group may apply paragraph (i)(1) of this section without regard to how other members of the EAG apply paragraph (i)(1) of this section.

(4) *Computer software provided to customers over the Internet.* [Reserved]. For further guidance, see § 1.199–8T(i)(4).

§ 1.199–9 Application of section 199 to pass-thru entities for taxable years beginning on or before May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005.

(a) *In general.* The provisions of this section apply solely for purposes of section 199 of the Internal Revenue Code (Code).

(b) *Partnerships*—(1) *In general*—(i) *Determination at partner level.* The deduction with respect to the qualified production activities of the partnership 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. The section 199 deduction has no effect on the adjusted basis of the partner's interest in the partnership. Except as provided by publication pursuant to paragraph (b)(1)(ii) of this section, 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)) and regardless of the amount of the partner's share of W–2 wages (as defined in § 1.199–2(e)) of the partnership for the taxable year. 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. Guaranteed payments under section 707(c) are not considered allocations of partnership income for purposes of this section. Guaranteed payments under section 707(c) are deductions by the partnership that must be taken into account under the rules of § 1.199–4. See § 1.199–3(p) and paragraph (b)(6) *Example 5* of this section. Except as provided in paragraph (b)(1)(ii) of this section, to determine its section 199 deduction for the taxable year, a partner aggregates its distributive share of such items, to the extent they are not otherwise disallowed by the 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)).

(ii) *Determination at entity level.* The Secretary may, by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), permit a partnership to calculate a partner's share of QPAI at the entity level, instead of allocating, in accordance with sections 702 and 704, the partner's share of partnership items (including items of income, gain, loss, and deduction). If a partnership does calculate QPAI at the entity level—

(A) The partner is allocated its share of QPAI and W–2 wages (as defined in § 1.199–2(e)), which (subject to the limitations of paragraph (b)(2) of this section and section 199(d)(1)(A)(iii), respectively) are combined with the partner's QPAI and W–2 wages from other sources;

(B) For purposes of computing QPAI under §§ 1.199–1 through 1.199–9, a partner does not take into account the items from such a partnership (for example, a partner does not take into account items from such a partnership in determining whether a threshold or *de minimis* rule applies or when the partner allocates and apportions deductions in calculating its QPAI from other sources);

(C) A partner generally does not recompute its share of QPAI from the partnership using another method; however, the partner might have to adjust its share of QPAI from the partnership to take into account certain disallowed losses or deductions, or the allowance of suspended losses or deductions; and

(D) A partner's distributive share of QPAI from a partnership may be less than zero.

(2) *Disallowed losses or deductions.* Except as provided by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), losses or deductions of a partnership that otherwise would be taken into account in computing the partner's section 199 deduction for a taxable year are taken into account in that year only if and to the extent the partner's distributive share of those losses or deductions from all of the partnership's activities is not disallowed by section 465, 469, or 704(d), or any other provision of the 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, and 704(d), and any other applicable provision of the Code, is taken into account in computing QPAI and the wage limitation of section 199(d)(1)(A)(iii) 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. Losses or deductions of the partnership that are disallowed for taxable years beginning on or before December 31, 2004, are not taken into account in a later taxable year for purposes of computing the partner's QPAI or the wage limitation of section 199(d)(1)(A)(iii) for that taxable year, regardless of whether the losses or deductions are allowed for other purposes.

(3) *Partner's share of W–2 wages.* Under section 199(d)(1)(A)(iii), a partner's share of W–2 wages of a partnership for purposes of determining the partner's section 199(b) wage limitation is the lesser of the partner's allocable share of those wages (without regard to section 199(d)(1)(A)(iii)), or 2 times 3 percent 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. Except as provided by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), 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. The partnership must allocate W–2 wages (prior to the application of the wage limitation) among the partners in the same manner as wage expense. The partner must add the partner's share of the W–2 wages from the partnership, as limited by section 199(d)(1)(A)(iii), to the partner's W–2 wages from other sources, if any. If QPAI, computed by taking into account only the items of the partnership allocated to the partner for the taxable year (as required by the wage limitation of section 199(d)(1)(A)(iii)) is not greater than zero, then the partner may not take into account any W–2 wages of the partnership in applying the wage limitation of § 1.199–2 (but the partner will, nevertheless, aggregate its distributive share of partnership items including wage expense with those items not from the partnership in computing its QPAI when determining its section 199 deduction). See § 1.199–

2 for the computation of W–2 wages, and paragraph (g) of this section for rules regarding pass-thru entities in a tiered structure.

(4) *Transition percentage rule for W–2 wages.* With regard to partnerships, for purposes of section 199(d)(1)(A)(iii)(II) the transition percentages determined under section 199(a)(2) shall be determined by reference to the partnership's taxable year. Thus, if a partner uses a calendar year taxable year, and owns an interest in a partnership that has a taxable year ending on April 30, the partner's section 199(d)(1)(A)(iii) wage limitation for the partnership's taxable year beginning on May 1, 2006, would be calculated using 3 percent, even though the partner includes the partner's distributive share of partnership items from that taxable year on the partner's 2007 Federal income tax return.

(5) *Partnerships electing out of subchapter K.* For purposes of §§ 1.199–1 through 1.199–9, the rules of paragraph (b) of this section shall apply to all partnerships, including those partnerships electing under section 761(a) to be excluded, in whole or in part, from the application of subchapter K of chapter 1 of the Code.

(6) *Examples.* The following examples illustrate the application of this paragraph (b). 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 are 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. Both X and Y are engaged in a trade or business. 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 2006, the adjusted basis of PRS's 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 2006, 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 2006, X does not have any other such items. For 2006, the adjusted basis of X's non-PRS assets, all of which are investment assets, is $10,000. X's only gross receipts for 2006 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 2006 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 ($10,000) and X's share of PRS assets ($2,500)))	(24)
X's QPAI	366

(B) *Y's QPAI.* (*1*) For 2006, 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 2006, 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 other trade or business 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 2006 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 ($8,000) and Y's share of PRS DPGR assets ($2,000))/$12,500 (Y's non-PRS assets ($10,000) and Y's share of PRS assets ($2,500)))	(192)
Y's QPAI	642

(iv) *PRS W–2 wages allocated to X and Y under section 199(d)(1)(A)(iii).* Solely for purposes of calculating the PRS W–2 wages that are allocated to them under section 199(d)(1)(A)(iii) 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 that include W–2 wage expense on the basis of gross receipts, and must 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)(A)(iii) for purposes of the wage limitation of section 199(b) are$16, the lesser of $250 (partner's allocable share of PRS's W–2 wages ($100 included in total CGS, and $150 included in selling expenses) and $16 (2 × ($270 × .03)).

(v) *Section 199 deduction determination.* (A) X's tentative section 199 deduction is $11 (.03 × $366 (that is, QPAI determined at partner level)) subject to the wage limitation of $8 (50% × $16). Accordingly, X's section 199 deduction for 2006 is $8.

(B) Y's tentative section 199 deduction is $19 (.03 × $642 (that is, QPAI determined at the partner level) subject to the wage limitation of $133 (50% × ($16 from PRS and $250 from non-PRS activities)). Accordingly, Y's section 199 deduction for 2006 is $19.

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 each of which is engaged in a trade or business, 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 2006, 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 2006, X does not have any other such tax items. X's only gross receipts for 2006 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 2006 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 2006, 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 2006, 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 2006 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 ($1,500 from PRS and $4,500 from non-PRS activities))	(188)
Y's QPAI	1,282

(iv) *PRS W–2 wages allocated to X and Y under section 199(d)(1)(A)(iii).* Solely for purposes of calculating the PRS W–2 wages that are allocated to X and Y under section 199(d)(1)(A)(iii) 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 expenses that include 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)(A)(iii) for purposes of the wage limitation of section 199(b) are $32, 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 $32 (2 × ($540 × .03)).

(v) *Section 199 deduction determination.* (A) X's tentative section 199 deduction is $16 (.03 × $540 (QPAI determined at partner level)) subject to the wage limitation of $16 (50% × $32). Accordingly, X's section 199 deduction for 2006 is $16.

(B) Y's tentative section 199 deduction is $38 (.03 x $1,282 (QPAI determined at partner level) subject to the wage limitation of $144 (50% x $287 ($32 from PRS + $255 from non-PRS activities)). Accordingly, Y's section 199 deduction for 2006 is $38.

Example 3. Partnership with special allocations. (i) *In general.* X and Y are unrelated corporate partners in PRS and each is engaged in a trade or business. PRS is a partnership that 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 2006 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 2006 taxable year, X has gross receipts attributable to non-partnership trade or business 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 PRS 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 ($2,000 × 80%) for marketing and $200 of other expenses ($1,000 × 20%)). 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)(A)(iii) wage limitation, QPAI is computed taking into account only the items of PRS allocated to X for the taxable year of PRS. Thus, X apportions $1,350 of deductions to DPGR ($1,800 × ($3,000 DPGR/$4,000 total gross receipts from PRS)). Accordingly, X's QPAI for purposes of the section 199(d)(1)(A)(iii) 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) and $0 (2 × ($0 QPAI × .03)). X's tentative deduction is $2 ($50 QPAI × .03), subject to the section 199(b)(1) wage limitation of $100 (50% × $200 ($0 of PRS-related W–2 wages + $200 of non-PRS W–2 wages)). Accordingly, X's section 199 deduction for the 2006 taxable year is $2.

Example 4. Partnership with no W–2 wages. (i) *Facts.* A, an individual, and B, an individual, are partners in PRS. PRS is a partnership that engages in manufacturing activities that generate both DPGR and non-DPGR. A and B share all items of income, gain, loss, deduction, and credit equally. In the 2006 taxable year, PRS has total gross receipts of $2,000 ($1,000 of which is DPGR), CGS of $400 and deductions of $800. PRS has no W–2 wages. A and B each use the small business simplified overall method under § 1.199–4(f). A has trade or business activities outside of PRS. With respect to those activities, A has total gross receipts of $1,000 ($500 of which is DPGR), CGS of $400 (including $50 of W–2 wages) and deductions of $200 for the 2006 taxable year. B has no trade or business activities outside of PRS and pays $0 of W–2 wages directly for the 2006 taxable year. A's distributive share of the items of the partnership is $500 DPGR, $500 non-DPGR, $200 CGS, and $400 of deductions.

(ii) *Section 199(d)(1)(A)(iii) wage limitation.* A's CGS and deductions apportioned to DPGR from PRS equal $300 (($200 CGS + $400 of other deductions) × ($500 DPGR/$1,000 total gross receipts)). Accordingly, for purposes of the wage limitation of section 199(d)(1)(A)(iii), A's QPAI is $200 ($500 DPGR × $300 CGS and other deductions). A's share of partnership W–2 wages after application of the section 199(d)(1)(A)(iii) limitation is $0, the lesser of $0 (A's 50% allocable share of PRS's $0 of W–2 wages) or $12 (2 × ($200 QPAI × .03)). B's share of PRS's W–2 wages also is $0.

(iii) *Section 199 deduction computation.* A's total CGS and deductions apportioned to DPGR equal $600 (($200 PRS CGS + $400 outside trade or business CGS + $400 PRS deductions + $200 outside trade or business deductions) × ($1,000 total DPGR ($500 from PRS + $500 from outside trade or business)/$2,000 total gross receipts ($1,000 from PRS + $1,000 from outside trade or business)). Accordingly, A's QPAI is $400 ($1,000 DPGR × $600 CGS and deductions). A's tentative deduction is $12 ($400 QPAI × .03), subject to the section 199(b)(1) wage limitation of $25 (50% × $50 total W–2 wages). A's section 199 deduction for the 2006 taxable year is $12. B's total section 199 deduction for the 2006 taxable year is $0 because B has no W–2 wages for the 2006 taxable year.

Example 5. Guaranteed payment. (i) *Facts.* The facts are the same as *Example 4* except that in 2006 PRS also makes a guaranteed payment of $200 to A for services, and PRS pays $200 of W–2 wages to PRS employees, which is included within the $400 of CGS. See section 707(c). This guaranteed payment is taxable to A as ordinary income and is properly deducted by PRS under section 162. Pursuant to § 1.199–3(p), A may not treat any part of this payment as DPGR. Accordingly, PRS has total gross receipts of $2,000 ($1,000 of which is DPGR), CGS of $400 (including $200 of W–2 wages) and deductions of $1,000 (including the $200 guaranteed payment) for the 2006 taxable year. A's distributive share of the items of the partnership is $500 DPGR, $500 non-DPGR, $200 CGS, and $500 of deductions.

(ii) *Section 199(d)(1)(A)(iii) wage limitation.* A's CGS and deductions apportioned to DPGR from PRS equal $350 (($200 CGS + $500 of other deductions) × ($500 DPGR/$1,000 total gross receipts)). Accordingly, for purposes of the wage limitation of section 199(d)(1)(A)(iii), A's QPAI is $150 ($500 DPGR × $350 CGS and other deductions). A's share of partnership W–2 wages after application of the section 199(d)(1)(A)(iii) limitation is $9, the lesser of $100 (A's 50% allocable share of PRS's $200 of W–2 wages) or $9 (2 × ($150 QPAI × .03)). B's share of PRS's W–2 wages after application of section 199(d)(1)(A)(iii) also is $9.

(iii) *A's section 199 deduction computation.* A's total CGS and deductions apportioned to DPGR equal $591 (($200 PRS CGS + $400 outside trade or business CGS + $500 PRS deductions + $200 outside trade or business deductions) × ($1,000 total DPGR ($500 from PRS + $500 from outside trade or business)/$2,200 total gross receipts ($1,000 from PRS + $200 guaranteed payment + $1,000 from outside trade or business)). Accordingly, A's QPAI is $409 ($1,000 DPGR × $591 CGS and other deductions). A's tentative deduction is $12 ($409 QPAI × .03),

subject to the section 199(b)(1) wage limitation of $30 (50% × $59 ($9 PRS W–2 wages $50 + W–2 wages from A's trade or business activities outside of PRS)). A's section 199 deduction for the 2006 taxable year is $12.

(iv) *B's section 199 deduction computation.* B's QPAI is $150 ($500 DPGR × $350 CGS and other deductions). B's tentative deduction is $5 ($150 QPAI × .03), subject to the section 199(b)(1) wage limitation of $5 (50% × $9). Assuming that B engages in no other activities generating DPGR, B's section 199 deduction for the 2006 taxable year is $5.

(c) *S corporations*—(1) *In general*—(i) *Determination at shareholder level.* The section 199 deduction with respect to the qualified production activities of an S corporation is determined at the shareholder level. As a result, each shareholder must compute its deduction separately. The section 199 deduction will have no effect on the basis of a shareholder's stock in an S corporation. Except as provided by publication pursuant to paragraph (c)(1)(ii) of this section, 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, and regardless of the amount of the shareholder's share of the W–2 wages of the S corporation for the taxable year. Except as provided by publication under paragraph (c)(1)(ii) of this section, to determine its section 199 deduction for the taxable year, the shareholder aggregates its pro rata share of such items, to the extent they are not otherwise disallowed by the 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.

(ii) *Determination at entity level.* The Secretary may, by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), permit an S corporation to calculate a shareholder's share of QPAI at the entity level, instead of allocating, in accordance with section 1366, the shareholder's pro rata share of S corporation items (including items of income, gain, loss, and deduction). If an S corporation does calculate QPAI at the entity level—

(A) Each shareholder is allocated its share of QPAI and W–2 wages, which (subject to the limitations under paragraph (c)(2) of this section and section 199(d)(1)(A)(iii), respectively) are combined with the shareholder's QPAI and W–2 wages from other sources;

(B) For purposes of computing QPAI under §§ 1.199–1 through 1.199–9, a shareholder does not take into account the items from such an S corporation (for example, a shareholder does not take into account items from such an S corporation in determining whether a threshold or de minimis rule applies or when the shareholder allocates and apportions deductions in calculating its QPAI from other sources);

(C) A shareholder generally does not recompute its share of QPAI from the S corporation using another method; however, the shareholder might have to adjust its share of QPAI from the S corporation to take into account certain disallowed losses or deductions, or the allowance of suspended losses or deductions; and

(D) A shareholder's share of QPAI from an S corporation may be less than zero.

(2) *Disallowed losses or deductions.* Except as provided by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), losses or deductions of the S corporation that otherwise would be taken into account in computing the shareholder's section 199 deduction for a taxable year are taken into account in that year 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 is not disallowed by section 465, 469, or 1366(d), or any other provision of the Code. If only a portion of the shareholder's 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 S corporation's qualified production activities, determined in a manner consistent with sections 465, 469, and 1366(d), and any other applicable provision of the Code, is taken into account in computing the QPAI and the wage limitation of section 199(d)(1)(A)(iii) for that taxable year. To the extent that any of the disallowed losses or deductions are 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. Losses or deductions of the S corporation that are disallowed for taxable years beginning on or before December 31, 2004, are not taken into account in a later taxable year for purposes of computing the shareholder's QPAI or the wage limitation of section 199(d)(1)(A)(iii) for that taxable year, regardless of whether the losses or deductions are allowed for other purposes.

(3) *Shareholder's share of W–2 wages.* Under section 199(d)(1)(A)(iii), 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)(A)(iii)), or 2 times 3 percent of the QPAI computed by taking into account only the items of the S corporation allocated to the shareholder for the taxable year of the S corporation. Except as provided by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), 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. The S corporation must allocate W–2 wages (prior to the application of the wage limitation) among the shareholders in the same manner as wage expense. The shareholder must add the shareholder's share of W–2 wages from the S corporation, as limited by section 199(d)(1)(A)(iii), to the shareholder's W–2 wages from other sources, if any. If QPAI, computed by taking into account only the items of the S corporation allocated to the shareholder for the taxable year (as required by the wage limitation of section 199(d)(1)(A)(iii)), is not greater than zero, then the shareholder may not take into account any W–2 wages of the S corporation in applying the wage limitation of § 1.199–2 (but the shareholder will, nevertheless, aggregate its distributive share of S corporation items including wage expense with those items not from the S corporation in computing its QPAI when determining its section 199 deduction). See § 1.199–2 for the computation of W–2 wages, and paragraph (g) of this section for rules regarding pass-thru entities in a tiered structure.

(4) *Transition percentage rule for W–2 wages.* With regard to S corporations, for purposes of section 199(d)(1)(A)(iii)(II) the transition percentages determined under section 199(a)(2) shall be determined by reference to the S corporation's taxable year. Thus, if an S corporation shareholder uses a calendar year taxable year, and owns stock in an S corporation that has a taxable year ending on April 30, the shareholder's section 199(d)(1)(A)(iii) wage limitation for the S corporation's taxable year beginning on May 1, 2006, would be calculated using 3 percent, even though the shareholder includes the

shareholder's pro rata share of S corporation items from that taxable year on the shareholder's 2007 Federal income tax return.

(d) *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, such person (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)(A)(iii) wage limitation is not applicable to the owned portion of the trust. The provisions of paragraph (e) of this section do not apply to the owned portion of a trust.

(e) *Non-grantor trusts and estates*—(1) *Allocation of costs.* The trust or estate calculates each beneficiary's share (as well as the trust's or estate's own share, if any) of QPAI and W–2 wages from the trust or estate at the trust or estate level. The beneficiary of a trust or estate is not permitted to use another cost allocation method to recompute its share of QPAI from the trust or estate or to reallocate the costs of the trust or estate. Except as provided in paragraph (d) of this section, the QPAI of a trust or estate must be computed by allocating expenses described in section 199(d)(5) in one of two ways, depending on the classification of those expenses under § 1.652(b)–3. Specifically, directly attributable expenses within the meaning of § 1.652(b)–3 are allocated pursuant to § 1.652(b)–3, and expenses not directly attributable within the meaning of § 1.652(b)–3 (other expenses) are allocated under the simplified deduction method of § 1.199–4(e) (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, depletion and depreciation deductions described in section 642(e) and amortization deductions described in section 642(f) are treated as other expenses described in section 199(d)(5). Also 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)(5).

(2) *Allocation among trust or estate and beneficiaries*—(i) *In general.* The QPAI of a trust or estate (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 is allowed 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 as described in paragraph (e)(3) of this section) are aggregated with the beneficiary's QPAI and W–2 wages from other sources.

(ii) *Treatment of items from a trust or estate reporting qualified production activities income.* When, pursuant to this paragraph (e), a taxpayer must combine QPAI and W–2 wages from a trust or estate with the taxpayer's total QPAI and W–2 wages from other sources, the taxpayer, when applying §§ 1.199–1 through 1.199–9 to determine the taxpayer's total QPAI and W–2 wages from such other sources, does not take into account the items from such trust or estate. Thus, for example, a beneficiary of an estate that receives QPAI from the estate does not take into account the beneficiary's distributive share of the estate's gross receipts, gross income, or deductions when the beneficiary determines whether a threshold or de minimis rule applies or when the beneficiary allocates and apportions deductions in calculating its QPAI from other sources.

(3) *Beneficiary's share of W–2 wages.* The trust or estate must compute each beneficiary's share of W–2 wages from the trust or estate in accordance with section 199(d)(1)(A)(iii), as if the beneficiary were a partner in a partnership. The application of section 199(d)(1)(A)(iii) to each trust and estate 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, then the beneficiary may not take into account any W–2 wages of the trust or estate in applying the wage limitation of § 1.199–2 (but the beneficiary will, nevertheless, aggregate its QPAI from the trust or estate with its QPAI from other sources when determining the beneficiary's section 199 deduction). See paragraph (g) of this section for rules applicable to pass-thru entities in a tiered structure.

(4) *Transition percentage rule for W–2 wages.* With regard to trusts and estates, for purposes of section 199(d)(1)(A)(iii)(II), the transition percentages determined under section 199(a)(2) shall be determined by reference to the taxable year of the trust or estate.

(5) *Example.* The following example illustrates the application of this paragraph (e) and paragraph (g) of this section. Assume that the partnership, trust, and trust beneficiary all are calendar year taxpayers.

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 2006, PRS distributes $10,000 cash 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 non-DPGR ($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 its cash distribution in 2006 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 operated by Trust as a business	10,000
Real estate taxes	1,000
Trustee commissions	3,000
State income and personal property taxes	5,000
W–2 wages for rental business	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 $5,000 of CGS, $3,000 of selling expenses, and $2,000 of other expenses are subtracted from the gross receipts from PRS ($20,000), 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 2006, 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 receives from Trust, 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). The determination of Trust's QPAI under the simplified deduction method requires multiple steps to allocate costs. First, the Trust's expenses directly attributable to DPGR under § 1.652(b)–3(a) are subtracted from the Trust's DPGR. In this step, the directly attributable $5,000 of CGS and selling expenses of $3,000 are subtracted from the $15,000 of DPGR from PRS. Next, Trust must identify its other trade or business expenses directly related to non-DPGR trade or business income. In this example, the portion of the trustee commissions not directly attributable to the rental operation ($2,000), 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 allocates its other trade or business expenses on the basis of its total gross receipts from the conduct of a trade or business ($20,000 from PRS + $10,000 rental income). Trust then combines its non-directly attributable (other) business expenses ($2,000 from PRS + $4,000 ($1,000 of other expenses + $3,000 of income and property taxes) from its own activities) and then apportions this total between DPGR and other receipts on the basis of Trust's total trade or business gross receipts ($6,000 × $15,000 DPGR/$30,000 total trade or business gross receipts = $3,000). Thus, for purposes of computing Trust's and B's section 199 deduction, Trust's QPAI is $4,000 ($7,000 − $3,000). 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 $2,000.

(B) *Section 199(d)(1)(A)(iii) wage limitation*. The wage limitation under section 199(d)(1)(A)(iii) 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 $330 of W–2 wages from PRS (the lesser of Trust's allocable share of PRS's W–2 wages ($4,000) or 2 × 3% of Trust's QPAI from PRS ($5,500)). Trust's QPAI from PRS for purposes of the section 199(d)(1)(A)(iii) 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 $330 of W–2 wages to Trust's own $2,000 of W–2 wages (thus, $2,330). Because the $14,000 Trust distribution to B equals one-half of Trust's DNI, Trust and B each has W–2 wages of $1,165. After applying the section 199(d)(1)(A)(iii) wage limitation to B's share of the W–2 wages allocated from Trust, B has W–2 wages of $120 from Trust (lesser of $1,165 (allocable share of W–2 wages) or 2 × .03 × $2,000 (B's share of Trust's QPAI)). B has W–2 wages of $100 from non-Trust activities for a total of $220 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 that is added to the $2,000 QPAI from Trust for a total of $3,000 of QPAI. B's tentative deduction is $90 (.03 × $3,000), but it is limited under section 199(b) to $110 (50% × $220 W–2 wages). Accordingly, B's section 199 deduction for 2006 is $90.

(*2*) *Trust's computation*. Trust has sufficient adjusted gross income so that the section 199 deduction is not limited under section 199(a)(1)(B). Trust's tentative deduction is $60 (.03 × $2,000 QPAI), but it is limited under section 199(b) to $583 (50% × $1,165 W–2 wages). Accordingly, Trust's section 199 deduction for 2006 is $60.

(f) *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 a partnership, if section 751(a) or (b) applies, then 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 cash 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, exchanged, or otherwise disposed of by the partnership, the cash or property received by the partner 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, exchanged, or otherwise disposed of 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 to the extent not taken into account under the qualifying in-kind partnership rules. See § 1.751–1(b) and paragraph (i) of this section.

(g) *Section 199(d)(1)(A)(iii) 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, then the wage limitation of section 199(d)(1)(A)(iii) must be applied at each tier (that is, separately for each entity). For purposes of this wage limitation, references to pass-thru entities includes partnerships, S corporations, trusts (to the extent not described in paragraph (d) of this section) and estates. Thus, at each tier, the owner of a pass-thru entity (or the entity on behalf of the owner) calculates the amounts described in sections 199(d)(1)(A)(iii)(I) (owner's allocable share) and 199(d)(1)(A)(iii)(II) (twice the applicable percentage of the owner's 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)(A)(iii) 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)(A)(iii), 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)(A)(iii), 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. Except as provided by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter)—

(i) An upper-tier entity may compute its share of QPAI attributable to items from a lower-tier entity solely for purposes of section 199(d)(1)(A)(iii)(II) by applying either the section 861 method described in § 1.199–4(d) or the simplified deduction method described in § 1.199–4(e), provided the upper tier entity would otherwise qualify to use such method.

(ii) Alternatively, the upper-tier entity (other than a trust or estate described in paragraph (e) of this section) may compute its share of QPAI attributable to items from a lower-tier entity solely for purposes of section 199(d)(1)(A)(iii)(II) by applying the small business simplified overall method described in § 1.199–4(f), regardless of whether such upper-tier entity would otherwise qualify to use the small business simplified overall method.

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

Example. (i) In 2006, 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. LTP has $900 DPGR, $450 CGS (which includes W–2 wages of $100), and $50 other deductions. Before taking into account its share of items from LTP, UTP has $500 DPGR, $500 CGS (which includes W–2 wages of $200), and $500 other deductions. UTP chooses to compute its share of QPAI attributable to items from LTP for purposes of section 199(d)(1)(A)(iii)(II) by applying the small business simplified overall method described in § 1.199–4(f). For purposes of the wage limitation of section 199(d)(1)(A)(iii), UTP's distributive share of LTP's QPAI is $200 ($450 DPGR − $250 CGS and other deductions).

(ii) UTP's share of LTP's W–2 wages for purposes of the section 199(d)(1)(A)(iii) limitation is $12, the lesser of $50 (UTP's 50% allocable share of LTP's $100 of W–2 wages) or $12 (2 × ($200 QPAI × .03)). After taking into account its share of items from LTP, UTP has $950 DPGR, $725 CGS, and $525 other deductions. A is eligible for and uses the simplified deduction method described in § 1.199–4(e). For purposes of the wage limitation of section 199(d)(1)(A)(iii), A's distributive share of UTP's QPAI is ($151) ($475 DPGR − $363 CGS − $263 other deductions). A's wage limitation under section 199(d)(1)(A)(iii) with respect to A's interest in UTP is $0, the lesser of $106 (A's 50% allocable share of UTP's $212 of W–2 wages) or $0 (because A's share of UTP's QPAI ($151), is less than zero).

(h) *No attribution of qualified activities*. Except as provided in paragraph (i) of this section regarding qualifying in-kind partnerships and paragraph (j) of this section regarding EAG partnerships, an owner of a pass-thru entity is not treated as conducting the qualified production activities of the pass-thru entity, and vice versa. For example, if a partnership MPGE QPP within the United States, or produces a qualified film or produces utilities in the United States, and distributes or leases, rents, licenses, sells, exchanges, or otherwise disposes of such property to a partner who then, without performing its own qualifying MPGE or other production, leases, rents, licenses, sells, exchanges, or otherwise disposes of such property, then the partner's gross receipts from this latter lease, rental, license, sale, exchange, or other disposition are treated as non-DPGR. In addition, if a partner MPGE QPP within the United States, or produces a qualified film or produces utilities in the United States, and contributes or leases, rents, licenses, sells, exchanges, or otherwise disposes of such property to a partnership which then, without performing its own qualifying MPGE or other production, leases, rents, licenses, sells, exchanges, or otherwise disposes of such property, then the partnership's gross receipts from this latter disposition are treated as non-DPGR.

(i) *Qualifying in-kind partnership*—(1) *In general*. If a partnership is a qualifying in-kind partnership described in paragraph (i)(2) of this section, then each partner is treated as MPGE or producing the property MPGE or produced by the partnership that is distributed to that partner. If a partner of a qualifying in-kind partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of the property that was MPGE or produced by the qualifying in-kind partnership, then, provided such partner is a partner of the qualifying in-kind partnership at the time the partner disposes of the property, the partner is treated as conducting the MPGE or production activities previously conducted by the qualifying in-kind partnership with respect to that property. With respect to a lease, rental, or license, the partner is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts derived from the lease, rental, or license under its methods of accounting. With respect to a sale, exchange, or other disposition, the partner is treated as having disposed of the property on the date on which it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account.

(2) *Definition of qualifying in-kind partnership*. For purposes of this paragraph (i), a qualifying in-kind partnership is a partnership engaged solely in—

(i) The extraction, refining, or processing of oil, natural gas (as described in § 1.199–3(l)(2)), petrochemicals, or products derived from oil, natural gas, or petrochemicals

in whole or in significant part within the United States;

(ii) The production or generation of electricity in the United States; or

(iii) An activity or industry designated by the Secretary by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(3) *Special rules for distributions.* If a qualifying in-kind partnership distributes property to a partner, then, solely for purposes of section 199(d)(1)(A)(iii)(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 property at the time of distribution to the partner and the deemed gross receipts are allocated to that partner, provided that the partner derives gross receipts from the distributed property (and takes into account such receipts under its method of accounting) during the taxable year of the partner with or within which the partnership's taxable year (in which the distribution occurs) ends. For rules for taking costs into account (such as costs included in the adjusted basis of the distributed property), *see* § 1.199–4.

(4) *Other rules.* Except as provided in this paragraph (i), a qualifying in-kind partnership is treated the same as other partnerships for purposes of section 199. Accordingly, a qualifying in-kind partnership is subject to the rules of this section regarding the application of section 199 to pass-thru entities, including application of the section 199(d)(1)(A)(iii) wage limitation under paragraph (b)(3) of this section. In determining whether a qualifying in-kind partnership or its partners MPGE QPP in whole or in significant part within the United States, *see* § 1.199–3(g)(2) and (3).

(5) *Example.* The following example illustrates the application of this paragraph (i). Assume that PRS and X are calendar year taxpayers.

Example. X, Y and Z are partners in PRS, a qualifying in-kind partnership described in paragraph (i)(2) of this section. X, Y, and Z are corporations. In 2006, 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(e)), 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 2006, X, while it is a partner in PRS, sells the oil to a customer for $1,500, taking the gross receipts into account under its method of accounting in the same taxable year. Under paragraph (i)(1) of this section, X is treated as having extracted the oil. The extraction and refining of the oil qualify as an MPGE activity under § 1.199–3(e)(1). 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 2006. In addition, PRS is treated as having $1,000 of DPGR solely for purposes of applying the wage limitation in section 199(d)(1)(A)(iii) based on the applicable percentage of QPAI. Accordingly, X's share of PRS's W–2 wages determined under section 199(d)(1)(A)(iii) is $24, the lesser of $500 (X's allocable share of PRS's W–2 wages included in CGS) and $24 ($2 \times ($400 ($1,000 deemed DPGR less $600 of CGS) $\times$ .03)). X adds the $24 of PRS W–2 wages to its $100 of W–2 wages incurred in refining the oil for purposes of section 199(b).

(j) *Partnerships owned by members of a single expanded affiliated group*—(1) *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.

(2) *Attribution of activities*—(i) *In general.* If a member of an EAG (disposing member) derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE or produced by an EAG partnership, all the partners of which are members of the same EAG to which the disposing member belongs at the time that the disposing member disposes of such property, then the disposing member is treated as conducting the MPGE or production activities previously conducted by the EAG partnership with respect to that property. The previous sentence applies only for those taxable years in which the disposing member is a member of the EAG of which all the partners of the EAG partnership are members for the entire taxable year of the EAG partnership. With respect to a lease, rental, or license, the disposing member is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts from the lease, rental, or license under its methods of accounting. With respect to a sale, exchange, or other disposition, the disposing member is treated as having disposed of the property on the date on which it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account. Likewise, if an EAG partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE or produced by a member (or members) of the same EAG (the producing member) to which all the partners of the EAG partnership belong at the time that the EAG partnership disposes of such property, then the EAG partnership is treated as conducting the MPGE or production activities previously conducted by the producing member with respect to that property. The previous sentence applies only for those taxable years in which the producing member is a member of the EAG of which all the partners of the EAG partnership are members for the entire taxable year of the EAG partnership. With respect to a lease, rental, or license, the EAG partnership is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts derived from the lease, rental, or license under its methods of accounting. With respect to a sale, exchange, or other disposition, the EAG partnership is treated as having disposed of the property on the date on which it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account. See paragraph (j)(5) *Example 3* of this section.

(ii) *Attribution between EAG partnerships.* If an EAG partnership (disposing partnership) derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE or produced by another EAG partnership (producing partnership), then the disposing partnership is treated as conducting the MPGE or production activities previously conducted by the producing partnership with respect to that property, provided that the producing partnership and the disposing partnership are owned by members of the same EAG for the entire taxable year of the respective partnership in which the disposing partnership disposes of such property. With respect to a lease, rental, or license, the disposing partnership is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts from the lease, rental, or license under its methods of accounting. With respect to a sale, exchange, or other disposition, the disposing partnership is treated as having disposed of the property on the date on which it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account.

(iii) *Exceptions to attribution.* Attribution of activities does not apply for purposes of the construction of real property under § 1.199–3(m)(1) and the performance of engineering and architectural services under § 1.199–3(n)(2) and (3), respectively.

(3) *Special rules for distributions.* If an EAG partnership distributes property to a partner, then, solely for purposes of section 199(d)(1)(A)(iii)(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 that the partner derives gross receipts from the distributed property (and takes such receipts into account under its methods of accounting) during the taxable year of the partner with or within which the partnership's taxable year (in which the distribution occurs) ends. For rules for taking costs into account (such as costs included in the adjusted basis of the distributed property), *see* § 1.199–4.

(4) *Other rules.* Except as provided in this paragraph (j), 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 this section regarding the application of section 199 to pass-thru entities, including application of the section 199(d)(1)(A)(iii) wage limitation under paragraph (b)(3) of this section. In determining whether a member of an EAG or an EAG partnership MPGE QPP in whole or in significant part within the United States or produced a qualified film or produced utilities within the United States, see § 1.199–3(g)(2) and (3) and *Example 5* of paragraph (j)(5) of this section.

(5) *Examples.* The following examples illustrate the rules of this paragraph (j). Assume that PRS, X, Y, and Z all are calendar year taxpayers.

Example 1. Contribution. X and Y are the only partners in PRS, a partnership, for PRS's entire 2006 taxable year. X and Y are both members of a single EAG for the entire 2006 year. In 2006, X MPGE QPP within the United States and contributes the property to PRS. In 2006, PRS sells the QPP for $1,000. Under this paragraph (j), PRS is treated as having MPGE the QPP within the United States, and PRS's $1,000 gross receipts constitute DPGR. PRS, X, and Y must apply the rules of this section 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)(A)(iii) wage limitation under paragraph (b)(3) of this section.

Example 2. Sale. X, Y, and Z are the only members of a single EAG for the entire 2006 year. X and Y each own 50% of the capital and profits interests in PRS, a partnership, for PRS's entire 2006 taxable year. In 2006, 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 2006, X sells the QPP to customers for $10,000, incurring selling expenses of $2,000. Under this paragraph (j), X is treated as having MPGE the QPP within the United States, and X's $10,000 of gross receipts qualify as DPGR. PRS, X and Y must apply the rules of this section 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)(A)(iii) wage limitation under paragraph (b)(3) of this section. The results would be the same if PRS sold the property to Z rather than to X.

Example 3. Lease. X, Y, and Z are the only members of a single EAG for the entire 2005 year. X and Y each own 50% of the capital and profits interests in PRS, a partnership, for PRS's entire 2005 taxable year. In 2005, 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 2005, X rents the QPP it acquired from PRS to customers unrelated to X. X takes the gross receipts attributable to the rental of the QPP into account under its methods of accounting in 2005 and 2006. On July 1, 2006, X ceases to be a member of the same EAG to which Y, the other partner in PRS, belongs. For 2005, X is treated as having MPGE the QPP in the United States, and its gross receipts derived from the rental of the QPP qualify as DPGR. For 2006, however, because X and Y, partners in PRS, are no longer members of the same EAG for the entire year, the gross rental receipts X takes into account in 2006 do not qualify as DPGR.

Example 4. Distribution. X and Y are the only partners in PRS, a partnership, for PRS's entire 2006 taxable year. X and Y are both members of a single EAG for the entire 2006 year. In 2006, PRS MPGE QPP within the United States, incurring $600 of CGS, including $500 of W–2 wages (as defined in § 1.199–2(e)), 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 2006, X sells the QPP for $1,500 to an unrelated customer and takes the gross receipts into account under its method of accounting in the same taxable year. Under paragraph (j)(1) 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. In addition, PRS is treated as having DPGR of $1,000 solely for purposes of applying the wage limitation in section 199(d)(1)(A)(iii) based on the applicable percentage of QPAI.

Example 5. Multiple sales. (i) *Facts.* X and Y are the only partners in PRS, a partnership, for PRS's entire 2006 taxable year. X and Y are both non-consolidated members of a single EAG for the entire 2006 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 direct labor and overhead to MPGE the active ingredient within the United States are $15 and account for 15% of PRS's $100 CGS of the active ingredient. In 2006, 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 direct labor and overhead to MPGE the drug within the United States are $12 and account for 10% of X's $120 CGS of the drug. In 2006, X sells the drug in finished dosage to Y and Y sells the drug to customers. Assume that Y's own MPGE activity with respect to the drug is not substantial in nature, taking into account all of the facts and circumstances, and Y incurs $2 of direct labor and overhead and Y's CGS in selling the drug to customers is $130.

(ii) *Analysis.* 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 § 1.199–3(g)(3) because PRS's direct labor and overhead account for less than 20% 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 § 1.199–3(g)(3) because the $27 ($15 + $12) of direct labor and overhead incurred by PRS and X equals or exceeds 20% of X's total CGS ($120) of the drug at the time X disposes of the drug 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 § 1.199–3(g)(3) because the $29 ($15 + $12 + $2) of direct labor and overhead incurred by PRS, X, and Y equals or exceeds 20% of Y's total CGS ($130) of the drug at the time Y disposes of the drug to Y's customers.

(k) *Effective dates.* Section 199 applies to taxable years beginning after December 31, 2004. In determining the deduction under section 199, items arising from a taxable year of a partnership, S corporation, estate, or trust beginning before January 1, 2005, shall not be taken into account for purposes of section 199(d)(1). Section 1.199–9 does not apply to taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005 (Public Law 109–222, 120 Stat. 345). For taxable years beginning on or before May 17, 2006, a taxpayer must apply § 1.199–9 if the taxpayer applies §§ 1.199–1 through 1.199–8 to that taxable year. Notwithstanding the preceding sentence, a partnership or S corporation that is a qualifying small taxpayer under § 1.199–4(f) of REG–105847–05 (2005–47 I.R.B. 987) (see § 601.601(d)(2) of this chapter) may use the small business simplified overall method to apportion CGS and deductions between DPGR and non-DPGR at the entity level under § 1.199–4(f) of REG–105847–05 for taxable years

beginning on or before May 17, 2006. If a taxpayer chooses not to rely on §§ 1.199–1 through 1.199–9 (as provided in § 1.199–8(i)) for a taxable year beginning before June 1, 2006, the guidance under section 199 that applies to taxable years beginning before June 1, 2006, is contained in Notice 2005–14 (2005–1 C.B. 498) (see § 601.601(d)(2) of this chapter). In addition, a taxpayer also may rely on the provisions of REG-105847–05 for taxable years beginning before June 1, 2006. If Notice 2005–14 and REG–105847–05 include different rules for the same particular issue, then a taxpayer may rely on either the rule set forth in Notice 2005–14 or the rule set forth in REG–105847–05. However, if REG–105847–05 includes a rule that was not included in Notice 2005–14, then a taxpayer is not permitted to rely on the absence of a rule in Notice 2005–14 to apply a rule contrary to REG–105847–05. For taxable years beginning after May 17, 2006, and before June 1, 2006, a taxpayer may not apply Notice 2005–14, REG–105847–05, or any other guidance under section 199 in a manner inconsistent with amendments made to section 199 by section 514 of the Tax Increase Prevention and Reconciliation Act of 2005.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

■ **Par. 3.** The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

■ **Par. 4.** In § 602.101, paragraph (b) is amended by adding an entry to the table in numerical order to read, in part, as follows:

§ 602.101 OMB Control numbers.

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(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.199–6	1545–1966
* * * * *	

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

Approved: May 2, 2006.

Eric Solomon,

Acting Deputy Assistant Secretary of the Treasury.

[FR Doc. 06–4829 Filed 5–24–06; 11:47 am]

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