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The Domestic Production Activities Deduction—Proposed Regulations Under Section 199

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On October 22, 2004, President Bush signed into law one of the most significant pieces of tax legislation since the Tax Reform Act of 1986—The American Jobs Creation Act of 2004 (the "Act"). Although far-reaching in its scope, the impetus for the Act was the World Trade Organization's ruling in January 2002 that the extra-territorial income exclusion regime of prior law was a prohibited export subsidy. One of the key provisions of the Act is a new deduction for domestic production activities, now contained in section 199 of the Internal Revenue Code. This new deduction, which phases in over six years and is designed to reduce the effective corporate tax rate for eligible taxpayers from 35 percent to 32 percent, is effective for taxable years beginning after December 31, 2004. In January the Internal Revenue Service (the "Service") published initial guidance under section 199 in Notice 2005-14, 2005-7 I.R.B. 498, inviting public comment and indicating its intent to issue proposed regulations. The proposed regulations were published on October 20, 2005.

Lengthy and complex, the proposed regulations respond to over 80 public comments and a July 21, 2005 letter to Secretary of the Treasury John W. Snow from Senators Charles E. Grassley, Jr. and Max Baucus, Chairman and Ranking Member, respectively, of the Senate Finance Committee and Congressman William M. Thomas, Chairman of the House Ways and Means Committee (the "Congressional Letter"), sent in connection with introduction of the Tax Technical Corrections Act of 2005, H.R. 3376 and S. 1447. Although a laudable effort to address a new and complex provision of the law, the proposed regulations present a number of significant compliance challenges for taxpayers.

This bulletin provides an overview of the proposed regulations, describes significant changes from Notice 2005-14 and highlights some of the key issues facing taxpayers as they grapple with interpreting and complying with the proposed regulations.

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Overview of the Qualified Production Activities Deduction ("QPAD")

Under section 199, the QPAD is equal to a percentage of the lesser of (a) income derived from qualified production activities for the taxable year ("QPAI") or (b) taxable income.[1] The percentage is three percent in 2005 and 2006, six percent in 2007-2009 and nine percent in 2010 when the deduction is fully phased in. QPAD is limited to 50 percent of W-2 Wages (as defined) paid during the calendar year ending during the taxpayer's taxable year.[2]

QPAI is calculated by subtracting from domestic production gross receipts ("DPGR") for the taxable year (1) cost of goods sold ("CGS") that are allocable to such receipts, (2) other deductions directly allocable to such receipts and (3) a ratable portion of other deductions.[3]

DPGR include gross receipts derived from any lease, rental, sale, exchange or other disposition of (a) qualifying production property ("QPP") (tangible personal property, computer software and sound recordings),[4] which was manufactured, produced, grown or extracted ("MPGE") by the taxpayer in whole or in significant part within the U.S., (b) any qualified film produced by the taxpayer and (c) electricity, natural gas or potable water produced by the taxpayer in the U.S. DPGR also include gross receipts derived from construction performed in the U.S. and from engineering or architectural services performed in the U.S. for construction projects in the U.S.[5] DPGR exclude those gross receipts derived from the sale of food and beverages prepared at retail establishments, as well as the transmission or distribution of electricity, natural gas or potable water.[6] DPGR do not include gross receipts derived from property leased, licensed or rented to a related person (as defined).[7]

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[1] I.R.C. § 199(a).

[2] I.R.C. § 199(b).

[3] I.R.C. § 199(c)(1).

[4] I.R.C. § 199(c)(5).

[5] I.R.C. § 199(c)(4)(A).

[6] I.R.C. § 199(c)(4)(B).

[7] I.R.C. § 199(c)(7).

Key Aspects of the Proposed Regulations

Calculation of QPAI
(Prop.Income Tax Regs. § 1.199-1)

Item-by-item application. The proposed regulations retain an unpopular requirement of Notice 2005-14 that QPAI must be calculated on an item-by-item basis and aggregated, rejecting requests for a less burdensome approach such as calculating the deduction on a division or product-line basis.[8] The proposed regulations attempt to clarify the definition of an item and provide a new "shrink-back" rule. An "item" is the property offered for sale that meets all of the requirements of Prop.Income Tax Regs. § 1.199-3. If the property sold by the taxpayer does not so qualify, *e.g.,* because it is not manufactured in whole or significant part in the U.S., the taxpayer must treat whatever portion of the property that does qualify as the item.[9] This provision is a source of concern because the vast majority of taxpayers do not have cost accounting systems that easily lend themselves to this component-by-component calculation. However, the ability to "shrink back" may be essential for some taxpayers to qualify for a deduction under section 199.

Allocation of gross receipts. Taxpayers are required to allocate gross receipts to arrive at DPGR using a "reasonable method," and factors are provided that are relevant to the determination of whether an allocation method is reasonable. The proposed regulations make clear that 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, the taxpayer must use that specific identification method to determine DPGR.[10] These allocation rules will also pose a challenge for most taxpayers under their current cost accounting systems and the meaning of "undue burden or expense" is subject to differing interpretations. However, a *de minimis* rule provides that all of a taxpayer's gross receipts may be treated as DPGR if less than five percent of the taxpayer's total gross receipts are non-DPGR.[11]

Impact on NOLs. In response to the Congressional Letter, the proposed regulations provide that the deduction provided by section 199 is not taken into account in calculating taxable income for purposes of determining a taxpayer's net operating loss carryback or carryover.[12]

Wage Limitation
(Prop.Income Tax Regs. § 1.199-2)

The proposed regulations provide guidance as to how to calculate the wage limitation provided by section 199(b).[13] In response to comments, the preamble to the proposed regulations clarifies that payments to independent contractors and self-employment income, including guaranteed payments made to partners, do not constitute "W-2 Wages" for purposes of section 199.

Domestic Production Gross Receipts
(Prop.Income Tax Regs. § 1.199-3)

Related persons. The proposed regulations clarify, consistent with the legislative history, that the exclusion for gross receipts derived from property leased, licensed or rented by the taxpayer for use by any related person does not apply if the property 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.[14] In such a case, the party that MPGE the property is eligible for the deduction.

Manufactured, produced, grown or extracted. The proposed regulations define MPGE broadly to include 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 taxpayer must have the benefits and burdens of ownership of the QPP during the MPGE activities in order for gross receipts to qualify as DPGR.[15] Packaging, repackaging, labeling and minor assembly do not qualify as MPGE if the taxpayer engages in no other MPGE activity.[16] Similarly, installation activities do not qualify as MPGE unless the taxpayer installs an item MPGE by the taxpayer and the taxpayer has the benefits and burdens of ownership during installation.[17]

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[8] Prop.Income Tax Regs. § 1.199-1(c)(1).

[9] Prop.Income Tax Regs. § 1.199-1(c)(2).

[10] Prop.Income Tax Regs. § 1.199-1(d)(1).

[11] Prop.Income Tax Regs. § 1.199-1(d)(2).

[12] Prop.Income Tax Regs. § 1.199-1(b)(1).

[13] Prop.Income Tax Regs. § 1.199-2.

[14] Prop.Income Tax Regs. § 1.199-3(b)(2).

[15] Prop.Income Tax Regs. § 1.199-3(d)(1).

[16] Prop.Income Tax Regs. § 1.199-3(d)(2).

[17] Prop.Income Tax Regs. § 1.199-3(d)(3).

The proposed regulations indicate that a taxpayer that has MPGE QPP for purposes of section 199 must also treat itself as a producer for purposes of section 263A.[18] However, the preamble makes clear that the reverse is not necessarily true. For example, a taxpayer that has property produced for it under contract may be considered a producer for purposes of section 263A but will not be considered to have MPGE QPP for purposes of section 199.

By the taxpayer. Generally, only one taxpayer may claim a deduction with respect to any qualifying activity performed in connection with an item of QPP. If an item is MPGE pursuant to a contract, only the party with the benefits and burdens of ownership during the qualifying activity is treated as engaging in the qualifying activity.[19] In response to the Congressional Letter, an exception has been provided for certain federal government contracts where the Federal Acquisition Regulations require that title or risk of loss pass to the federal government during production.[20] Although taxpayers have questioned the "benefits and burdens of ownership" test in general, Treasury and Service officials have emphasized the test is not solely dependent upon who has title to the property.

In whole or significant part. QPP is treated as manufactured in whole or significant part by the taxpayer in the U.S. if the MPGE activities are substantial in nature taking into account all facts and circumstances, including the relative value added by and relative cost of the taxpayer's MPGE activity within the U.S., the nature of the property and the nature of the MPGE activity that the taxpayer performs in the U.S.[21] A safe harbor is provided for taxpayers whose conversion costs in the U.S. (direct labor and related factory burden) account for 20 percent or more of the taxpayer's cost of goods sold of the QPP. Research and experimental expenditures under section 174 and the costs of creating intangibles do not qualify as conversion costs except in the case of computer software and sound recordings. Also, in the case of tangible property, these same costs may be excluded from CGS for purposes of determining whether a taxpayer meets the safe harbor.[22] Note, however, that ultimately section 174 costs must be allocated to (and subtracted from) DPGR in arriving at QPAI.[23] This is a troubling inconsistency, which merits further comment.

[18] Prop.Income Tax Regs. § 1.199-3(d)(4).

[19] Prop.Income Tax Regs. § 1.199-3(e)(1).

[20] Prop.Income Tax Regs. § 1.199-3(e)(2).

[21] Prop.Income Tax Regs. § 1.199-3(f)(2).

[22] Prop.Income Tax Regs. § 1.199-3(f)(3).

[23] Prop.Income Tax Regs. § 1.199-4(d)(3).

Derived from the lease, rental, license, sale, exchange or other disposition. Gross receipts must be "directly derived" from the lease, rental, license, sale, exchange or other disposition of certain types of property to qualify as DPGR and may so qualify even if the taxpayer has already recognized gross receipts from a previous lease, rental, license, sale, exchange or other disposition of the same property. The proposed regulations clarify that the entire amount of lease income including any interest that is not separately stated also qualifies as DPGR.[24] For the first time, the proposed regulations also address how hedging transactions related to QPP should be taken into account for purposes of calculating CGS and DPGR.[25]

To calculate DPGR, a taxpayer generally must allocate gross receipts among qualifying activities and items and non-qualifying activities and items such as embedded services (*i.e.,* services for which the price is not separately stated) or non-qualified property such as replacement parts.[26] There are exceptions to this rule for certain warranties, distribution or delivery services, operating manuals and installation activities—all generally where a price is not separately stated and the item or service is not separately bargained for. There is also an exception for *de minimis* gross receipts from embedded services and non-qualified property, defined as less than five 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.[27] Although the proposed regulations expand upon the exceptions provided by Notice 2005-14, taxpayers not falling within one of these exceptions will still face the difficult task of determining the fair market value of embedded services in performing the allocations necessary to calculate DPGR.

Expanding upon the treatment of advertising income in Notice 2005-14, the proposed regulations clarify that income from advertisements placed in newspapers, magazines, telephone directories or periodicals qualify as DPGR provided the gross receipts derived from the disposition of the newspapers, magazines, telephone directories or periodicals are DPGR.[28] Income from

[24] Prop.Income Tax Regs. § 1.199-3(h)(1).

[25] Prop.Income Tax Regs. § 1.199-3(h)(3).

[26] Prop.Income Tax Regs. § 1.199-3(h)(4).

[27] Prop.Income Tax Regs. § 1.199-3(h)(4)(ii)(e).

[28] Prop.Income Tax Regs. § 1.199-3(h)(5)(i). Advertising income related to online newspapers does not qualify as DPGR under Prop.Income Tax Regs. § 1.199-3(h)(6), discussed below. *See* Prop.Income Tax Regs. § 1.199-3(h)(6)(ii), Ex. 2.

product placement in films similarly qualifies as DPGR.[29]

The proposed regulations retain the controversial stance taken in Notice 2005-14 that gross receipts derived from the disposition of computer software do not include gross receipts derived from the use of such software online. Thus, gross receipts exclude Internet access services, online services, customer and technical support, telephone services, online electronic books and journals, games played through a website, provider-controlled software online services and other similar services.[30] The Congressional Letter urged Treasury "to consider further the treatment of online access to computer software" while also noting that "gross receipts from the provision of services are not treated as domestic production gross receipts, regardless of the fact that computer software may be used to facilitate such service transactions." The preamble to the proposed regulations specifically invites further comments on this issue and Treasury and Service officials have stated that they are struggling with where to draw the line between access to software online and services.

Although the proposed regulations generally take the position that a taxpayer's own activities determine its DPGR, the proposed regulations clarify that if a partnership engaged solely in the extraction, refining or processing of oil or natural gas distributes the oil or natural gas or products derived therefrom to one or more partners, each partner is treated as extracting, refining or processing any oil or natural gas products extracted, refined or processed by the partnership and distributed to that partner.[31] This provision was added in response to comments from the oil and gas industry, but Treasury has indicated it will consider similar exceptions for industries with similar business models. In response to the Congressional Letter, Treasury also added an exception for EAG partnerships. Under this provision, if all of the interest in the capital and profits of a partnership are owned by members of a single EAG, then the EAG partnership and all members of the EAG are treated as a single taxpayer.[32]

Qualifying production property, qualified films and utilities. The proposed regulations provide definitions of the three types of QPP. Consistent with Notice 2005-14, tangible personal property generally includes any tangible property other than land or buildings (including structural components of buildings).[33] Definitions are also provided for computer software[34] and sound recordings.[35] In a change from Notice 2005-14 designed to ease administrative burden, the proposed regulations provide that if a taxpayer MPGE computer software or sound recordings that are fixed on or added to tangible personal property such as a computer diskette or appliance by the taxpayer, the taxpayer may treat the tangible personal property as computer software or a sound recording. Similarly, if the taxpayer MPGE the tangible personal property (but not the software or sound recording), the taxpayer may treat the software or sound recording as tangible personal property.[36]

Provisions related to qualified films are essentially unchanged from Notice 2005-14.[37] The proposed regulations also incorporate the rules in Notice 2005-14 related to electricity, natural gas and potable water.[38]

Construction performed in the United States. The proposed regulations expand upon the definition of construction activities contained in Notice 2005-14. Construction is defined as the construction or erection of real property, inherently permanent structures other than tangible personal property in the nature of machinery, inherently permanent land improvements, oil and gas wells and infrastructure. The taxpayer must be engaged in a trade or business that is considered construction for purposes of the North American Industry Classification System ("NAICS") on a regular and ongoing basis. This includes a construction activity under NAICS code 23 and any other construction activity related to real property in any other NAICS code, including 213111 (drilling oil and gas wells) and 213112 (support activities for oil and gas operations).[39] The proposed regulations also clarify that construction activities include activities relating to drilling oil wells and mining.[40]

As a result of clarifications made by the proposed technical corrections legislation, the proposed regulations retain the much-criticized stance of Notice 2005-14 that the phrase "derived from construction"

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[29] Prop.Income Tax Regs. § 1.199-3(h)(5)(ii).

[30] Prop.Income Tax Regs. § 1.199-3(h)(6)(i).

[31] Prop.Income Tax Regs. § 1.199-3(h)(7)(i).

[32] Prop.Income Tax Regs. § 1.199-3(h)(8)(i).

[33] Prop.Income Tax Regs. § 1.199-3(i)(2)(i).

[34] Prop.Income Tax Regs. § 1.199-3(i)(3).

[35] Prop.Income Tax Regs. § 1.199-3(i)(4).

[36] Prop.Income Tax Regs. § 1.199-3(i)(5).

[37] Prop.Income Tax Regs. § 1.199-3(j)(1).

[38] Prop.Income Tax Regs. § 1.199-3(k).

[39] Prop.Income Tax Regs. § 1.199-3(l)(1).

[40] Prop.Income Tax Regs. § 1.199-3(l)(2).

does not encompass gross receipts attributable to the disposition of land.[41] The proposed regulations add a safe harbor under which taxpayers can allocate gross receipts between proceeds from the disposition of real property and those attributable to the disposition of land. Taxpayers may reduce their gross receipts by the cost of land plus a percentage based on the number of years that elapse between the time the taxpayer acquires the land and the date on which the taxpayer sells an item of real property on the land.[42] The proposed regulations also clarify, consistent with the proposed technical corrections, that architectural or engineering services must be performed in connection with the construction of real property.[43]

Food and beverages sold at retail establishments. The proposed regulations clarify that a taxpayer that sells food and beverages at a retail establishment may allocate its gross receipts between gross receipts derived from the retail sale of food and beverages and gross receipts derived from the wholesale sale of food and beverages.[44] An example is provided of a taxpayer who roasts coffee beans and sells both the beans and brewed coffee at retail establishments. The example indicates that gross receipts allocable to the value of the coffee beans are DPGR, presenting another allocation challenge for taxpayers.[45]

Cost Allocation Rules (Prop.Income Tax Regs. § 1.199-4)

To determine QPAI, a taxpayer must subtract from DPGR the CGS allocable to DPGR, the amount of expenses or losses directly allocable to DPGR and a ratable portion of other deductions not directly allocable to DPGR or another class of income.[46]

Determining cost of goods sold allocable to DPGR. In the case of a disposition of inventory, CGS is calculated using the methods of accounting that the taxpayer uses to determine taxable income.[47] To determine the CGS allocable to DPGR of non-inventory dispositions, CGS includes the adjusted basis of the property and the proposed regulations clarify that CGS must be taken into account even if the corresponding gross receipts will or have been included in the computation of gross income for a different taxable year.[48]

Taxpayers must use reasonable methods of allocating CGS between DPGR and non-DPGR and reasonableness is based on all the facts and circumstances.[49] If the CGS allocable to DPGR can be specifically identified from books and records without undue burden, that is the amount that should be used regardless of whether the taxpayer uses another method to allocate gross receipts between DPGR and non-DPGR.[50]

Other deductions allocable or apportioned to domestic production gross receipts or gross income attributable to domestic production gross receipts. Taxpayers must subtract from DPGR the deductions that are directly allocable to DPGR and a ratable portion of deductions that are not directly allocable to DPGR or to another class of income.[51] Generally, deductions must be allocated and apportioned using the section 861 method; however, certain taxpayers may use the simplified deduction method or the small business simplified overall method detailed below. If either of these methods is used it must be used for all deductions.[52] Qualified taxpayers may opt to use the section 861 method, simplified deduction method or small business simplified overall method at any time for a taxable year.[53]

Section 861 method. Section 199 is treated as an operative section of section 861; thus deductions for section 199 must be allocated and apportioned using the 861 method.[54] This will present a challenge for taxpayers to which section 861 otherwise does not apply. If a taxpayer uses the 861 method for an operative section of 861 other than section 199, the taxpayer must use the same method of allocation and the same principles of apportionment for purposes of all operative sections.[55]

Simplified deduction method. The proposed regulations expand the availability of the simplified deduction method for apportioning deductions other than CGS between DPGR and non-DPGR to not only taxpayers with average annual gross receipts of $25 million or less, as provided in Notice 2005-14, but also to

[41] Prop.Income Tax Regs. § 1.199-3(l)(5)(i).

[42] Prop.Income Tax Regs. § 1.199-3(l)(5)(ii).

[43] Prop.Income Tax Regs. § 1.199-3(m).

[44] Prop.Income Tax Regs. § 1.199-3(n)(1).

[45] Prop.Income Tax Regs. § 1.199-3(n)(2).

[46] Prop.Income Tax Regs. § 1.199-4(a).

[47] Prop.Income Tax Regs. § 1.199-4(b)(1).

[48] Prop.Income Tax Regs. § 1.199-4(b)(1).

[49] Prop.Income Tax Regs. § 1.199-4(b)(2).

[50] Prop.Income Tax Regs. § 1.199-4(b)(2).

[51] Prop.Income Tax Regs. § 1.199-4(c)(1).

[52] Prop.Income Tax Regs. § 1.199-4(c)(1).

[53] Prop.Income Tax Regs. § 1.199-4(c)(1).

[54] Prop.Income Tax Regs. § 1.199-4(d)(1).

[55] Prop.Income Tax Regs. § 1.199-4(d)(1).

taxpayers with total assets at the end of the taxable year of $10 million or less.[56] Under the simplified deduction method, a taxpayer's deductions (except the net operating loss deduction and deductions not attributable to the actual conduct of a trade or business) are ratably apportioned between DPGR and non-DPGR based on relative gross receipts.[57]

Whether an owner of a pass-through entity may use the simplified deduction method is determined at the level of the owner of the pass-through entity.[58] Rules are also provided for trusts and estates[59] and for the application of the method by an EAG.[60]

Small business simplified overall method. Under the small business simplified overall method, a taxpayer's total costs for the current taxable year are apportioned between DPGR and other receipts based on relative gross receipts.[61] Taxpayers eligible to use this method include taxpayers that have both average annual gross receipts and total costs for the current taxable year of $5 million or less, taxpayers engaged in the trade or business of farming that are not required to use the accrual method of accounting under section 447 and taxpayers eligible to use the cash method of accounting.[62] In the case of a pass-through entity, whether the small business simplified overall method may be used by such entity is determined at the pass-through entity level and, if such entity is eligible, the small business simplified overall method is applied at the pass-through entity level.[63] Special rules are provided for EAG's.[64] However, qualifying oil and gas partnerships, EAG partnerships and trusts and estates may not use the small business simplified overall method.[65]

Application of Section 199 to Pass-Through Entities (Prop.Income Tax Regs. § 1.199-5)

In the case of partnerships, the section 199 deduction is determined at the partner level.[66] Thus, each partner computes its section 199 deduction separately, but it need not be engaged in the business of the partnership. The proposed regulations contain detailed examples illustrating the application of the rules to partnerships. Treasury rejected a request by commentators that an aggregate approach be used where (1) qualified production activities are conducted by a partnership which distributes or sells the property to a partner for further disposition or (2) the qualified production activities are conducted by a partner that contributes or sells the property to the partnership for further disposition. The proposed regulations provide that except in the case of certain qualifying oil and gas partnerships and EAG partnerships, the owner of a pass-through entity is not treated as conducting the qualified production activities of the pass-through entity and *vice versa*.[67] The proposed regulations also contain special rules for S corporations[68] and trusts and estates.[69]

Expanded Affiliated Groups (Prop.Income Tax Regs. § 1.199-7)

Members of an expanded affiliated group are treated as a single corporation for purposes of section 199.[70] An EAG is an affiliated group as defined by section 1504(a), determined by substituting "more than 50 percent" for "at least 80 percent."[71] Subject to an anti-avoidance rule, if a member of an EAG disposes of property otherwise eligible for section 199 that was 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 for purposes of determining whether its gross receipts are DPGR. This attribution of activities does not apply, however, for purposes of the construction of real property or the performance of engineering or architectural services unless the disposing member and other EAG members are members of the same consolidated group.[72]

The section 199 deduction for an EAG is determined by aggregating each member's taxable income or loss, QPAI and W-2 Wages.[73] An EAG's section 199 deduction is allocated among the members of the EAG in proportion to each member's QPAI regardless of

[56] Prop.Income Tax Regs. § 1.199-4(e)(1).

[57] Prop.Income Tax Regs. § 1.199-4(e)(1).

[58] Prop.Income Tax Regs. § 1.199-4(e)(1).

[59] Prop.Income Tax Regs. § 1.199-4(e)(1).

[60] Prop.Income Tax Regs. § 1.199-4(e)(2).

[61] Prop.Income Tax Regs. §1.199-4(f)(1).

[62] Prop.Income Tax Regs. § 1.199-4(f)(2).

[63] Prop.Income Tax Regs. §1.199-4(f)(1).

[64] Prop.Income Tax Regs. §1.199-4(f)(3).

[65] Prop.Income Tax Regs. §1.199-4(f)(4).

[66] Prop.Income Tax Regs. § 1.199-5(a)(1).

[67] Prop.Income Tax Regs. § 1.199-5(g).

[68] Prop.Income Tax Regs. § 1.199-5(b).

[69] Prop.Income Tax Regs. § 1.199-5(c), (d).

[70] Prop.Income Tax Regs. § 1.199-7(a).

[71] Prop.Income Tax Regs. § 1.199-7(a)(1).

[72] Prop.Income Tax Regs. §§ 1.199-7(a)(3), 1.199-7(d)(2).

[73] Prop.Income Tax Regs. § 1.199-7(b)(1).

whether the EAG member has taxable income or loss or W-2 Wages for the taxable year.[74]

Special rules apply for members of the same consolidated group.[75] If an EAG includes corporations that are members of the same consolidated group and corporations that are not members of the same consolidated group, members of the same consolidated group are treated as a single member of the EAG.[76] If the members of an EAG are members of the same consolidated group, the consolidated group's section 199 deduction is determined by reference to the consolidated group's consolidated taxable income or loss, QPAI and W-2 Wages, not the separate taxable income or loss, QPAI and W-2 Wages of its members.[77] The section 199 deduction of a consolidated group is allocated to the members in proportion to each member's QPAI, regardless of whether the member has separate taxable income or loss or W-2 Wages for the taxable year.[78]

Effective Date

The regulations are proposed to be applicable to taxable years beginning after December 31, 2004. Until final regulations are published, taxpayers may rely on either Notice 2005-14 or the proposed regulations, although if the proposed regulations contain a provision not included in Notice 2005-14, taxpayers are to apply the proposed regulations.[79] Taxpayers have one more chance to comment on the rules. The public comment period expires January 3, 2006, and a public hearing has been scheduled for January 11, 2006. Treasury plans to issue final regulations no later than April 21, 2006, the 18-month from enactment window that permits the rules to be retroactive. Treasury officials have indicated the rules are unlikely to be retroactive to January 1, 2005, but may be retroactive to January 1, 2006.

Looking Forward

While thorough and comprehensive, the proposed regulations present a multitude of compliance challenges, particularly for taxpayers who currently do not keep records conducive to the tax reporting now required under section 199. Examples of such challenges include (1) "shrinking back" to arrive at an eligible "item," (2) allocating gross receipts among qualifying property and non-qualifying property and services and (3) allocating and apportioning deductions under the section 861 method for taxpayers who previously did not need to utilize section 861. Many taxpayers have already started modifying their systems in response to Notice 2005-14, and it is likely that further modifications will be necessary as a result of the proposed regulations and ultimately the final regulations. Our technical experts can assist taxpayers in making these modifications in the most efficient manner possible. We can also help taxpayers navigate the new rules and maximize their section 199 benefit.

Material Available On-Line

The following legislative and administrative material is available with the indicated file sizes:

- Notice of Proposed Rulemaking, including the proposed section 199 regulations, 70 Fed.Reg. 67220 (November 4, 2005) [316K].
- Notice 2005-14, 2005-7 I.R.B. 498 [319K].
- Statutory language of section 199 from the Conference Committee Report for the American Jobs Creation Act of 2004, H.Rpt. 108-755, pp. 7-12 [62K].
- Conference Committee explanation of section 199 from the Conference Committee Report for the American Jobs Creation Act of 2004, H.Rpt. 108-755, pp. 252-262 [71K].
- July 21, 2005 letter to Secretary of the Treasury John W. Snow from Senators Charles E. Grassley, Jr. and Max Baucus, Chairman and Ranking Member, respectively, of the Senate Finance Committee and Congressman William M. Thomas, Chairman of the House Ways and Means Committee [382K].

Important Notice to Readers

This material is not intended to constitute a complete analysis of all tax considerations. Internal Revenue Service regulations generally provide that, for the purpose of avoiding United States federal tax penalties, a taxpayer may rely only on formal written opinions meeting specific regulatory requirements. This material does not meet those requirements. Accordingly, this material was not intended or written to be used, and a taxpayer cannot use it, for the purpose of avoiding United States federal or other tax penalties or of promoting, marketing or recommending to another party any tax-related matters.

[74] Prop.Income Tax Regs. § 1.199-7(c)(1).

[75] Prop.Income Tax Regs. § 1.199-7(d).

[76] Prop.Income Tax Regs. § 1.199-7(d)(4)(i).

[77] Prop.Income Tax Regs. § 1.199-7(d)(4)(ii).

[78] Prop.Income Tax Regs. § 1.199-7(d)(5).

[79] Prop.Income Tax Regs. § 1.199-8(g).