What is the amount of the deduction?

- Special deduction for domestic production activities
  - Ultimate 9% of lesser of qualified production activities income (QPAI) of taxable income (or AMTI)
  - Not to exceed 50% of W-2 wages

- Effective for tax years beginning after Dec. 31, 2004

- Phase-in of 9% benefits:
  - 2005 – 2006: 3%
  - 2007 – 2009: 6%
  - 2010 – Forward: 9%

What is the overall formula for QPAI?

- Domestic production gross receipts (DPGR)
- Minus COGS allocable to DPGR
- Minus Deductions allocable to DPGR
- Equals QPAI
Taxable income limitation

For purposes of the taxable income limitation, the section 199 deduction may neither:

– Create an NOL carryback or carryover, nor
– Increase the amount of an NOL carryback or carryover

A brief glossary of acronyms

- QPAI = qualified production activities income
- DPGR = domestic production gross receipts
- MPGE = manufactured, produced, grown, or extracted
- QPP = qualifying production property
- EAG = expanded affiliated group

Steps for determining the section 199 deduction

1. Define the relevant entities, including EAG members and passthroughs; determine which have qualified activities.
2. Quantify domestic production gross receipts (DPGR) and non-DPGR (taking into account de minimis rules).
3. Allocate COGS between DPGR and non-DPGR.
4. Allocate other deductions between DPGR and non-DPGR.
5. Calculate qualified production activities income (QPAI) = DPGR, less allocated amounts from steps 3 & 4.
6. Compute the deduction by applying the appropriate percentage to the lesser of QPAI or taxable income.
7. Calculate W-2 wage limitation
Domestic production gross receipts (DPGR)

- Gross receipts derived from:
  - Lease, license, sale, exchange or other disposition of:
    - QPP that is:
      - Tangible personal property, computer software, or sound recordings
      - Manufactured, produced, grown, or extracted by taxpayer in whole or significant part in U.S.
    - Qualified film produced by taxpayer
    - Electricity, natural gas, or potable water produced by taxpayer in U.S.
    - Construction activities performed in U.S.
    - Engineering or architectural services performed in U.S. for U.S. construction projects

Qualified production activity – definition of MPGE*

MPGE of tangible personal property, software development or sound recordings is defined as:
- Manufacturing, producing, growing, extracting, installing, developing, improving, and creating
- Scrap, salvage, or junk
- Processing, manipulating, refining, or changing the form of an article
- Combining or assembling two or more articles
- Cultivating soil, raising livestock, fishing, and mining
- Storage, handling, processing of agricultural products in connection with MPGE of qualified production property (QPP)

*Manufactured, produced, grown, extracted. Taxpayer must follow section 263A, if applicable.

Additional Qualified production activities

- Film production provided at least 50% of the total compensation relating to the production of the film is compensation for specified production services performed in the US
- Production of electricity, natural gas, or potable water in the US
- Construction or substantial renovation of real property in the US including residential and commercial buildings
- Engineering and architectural services performed in the US relating to construction of real property in the US
Special rules for DPGR

- DPGR does not include gross receipts from:
  - Sale of food and beverages prepared by taxpayer at retail establishment
  - Transmission or distribution of electricity, natural gas, or potable water
  - Gross receipts from property leased, licensed, or rented to a related party
    - Except for sublease or sublicense to unrelated person for that person’s ultimate use

Special rules for DPGR (continued)

- Packaging, repacking, labeling, or minor assembly does not qualify as MPGE if the taxpayer engages in no other MPGE activity

- Installation
  - Without any other MPGE activity, no DPGR
  - If installing QPP MPGE by the taxpayer and taxpayer has benefits and burdens of ownership during installation, DPGR

- Gross receipts (not, e.g., net proceeds) count

De minimis rules

- If less than 5% of overall receipts are non-DPGR, all may be treated as DPGR

- If less than 5% of overall receipts are DPGR, all may be treated as non-DPGR
Allocation between DPGR and non-DPGR

- Allocation of gross receipts between DPGR and non-DPGR is required
- Taxpayer must use specific identification method to determine DPGR if:
  - Information is readily available and
  - Taxpayer can, without undue burden or expense, specifically identify whether receipts are DPGR
- Otherwise, reasonable method must be used

Production “by the taxpayer”

- Only one taxpayer entitled to §199 benefit for a particular production stage or process
- Taxpayer must have benefits and burdens of ownership during production process for:
  - Qualifying production property
  - Qualified film
  - Electricity, natural gas, or potable water
- Who has risk of loss and title
- Parties to contract manufacturing arrangements may not simply designate who has benefits and burdens

Production “in whole or significant part”

- Safe harbor test:
  - 20% or more of COGS or unadjusted depreciable basis is made up of direct labor and overhead
- MPGE activity may otherwise be deemed substantial in nature taking into account:
  - Relative value added
  - Relative cost
  - Nature of property
  - Nature of activity
  - Other relevant facts and circumstances
Expanded affiliated groups

- Expanded affiliated group as defined under section 1504(a) (substitute greater than 50% for 80%)
- The deduction is computed on an expanded affiliated group basis, not on a consolidated group basis.
- QPAI computed at entity level and aggregated
- QPAI allocated to member affiliates

Consolidated groups

- Consolidated group treated as single member of EAG
- Section 199 deduction allocated in proportion to each member’s QPAI

Wage limitation

- Allowable deduction for any taxable year may not exceed 50 percent of the “W-2 wages” of the taxpayer
- Wages must be for employees of the taxpayer who work in production activities
- Wages based on calendar year
Allocation of COGS

- Allocable COGS is specifically identified amount if
  - Information is readily available and
  - Taxpayer can, without undue burden or expense, specifically identify COGS allocable to DPGR
- Reasonable method
  - If not identifiable from books and records, use reasonable method
  - Presumption that reasonable method, if used, should be consistent for COGS and gross receipts

Section 861 method

- Default for allocation of other deductions
- Section 199 is operative section (consistency required between operative sections)
  - Step 1: Allocate to class of gross income
  - Step 2: Apportion between statutory grouping (DPGR) and residual grouping
- Consistency between years

Section 861 method (continued)

- Most SG&A: considerable latitude
- Interest
  - Tax book value method
  - Alternative tax book value method
  - Fair market value method
- R&D
  - Sales method
  - 2 gross income methods
  - No exclusive apportionment
- Charitable contributions: gross income
Simplified methods

- **Simplified deduction method**
  - Eligible taxpayers:
    - Average annual gross receipts of $100 million or less, or
    - Total assets at the end of the taxable year of $10 million or less,
  - Apportion deductions based on relative gross receipts

- **Small business simplified overall method**
  - Eligible taxpayers:
    - Average annual gross receipts of $5 million or less
    - Engaged in farming business
    - Eligible to use cash method
  - Apportion COGS and all deductions based on relative gross receipts