Minimum Checks for Section 199
Explanation and Law

1. **Does the taxpayer's business make sense with the activity requirements of the domestic production deduction (DPD)?**
   a. The deduction only applies to income from certain domestic production activities. See these activities listed below.
   b. Most resellers and service based taxpayers should not be claiming the deduction. For example, clothing stores and wholesalers will not typically qualify since they are resellers and do not produce the products they sell. Professional service companies will not typically qualify since they are selling their services even if in this process they provide a tangible item such as a legal document.
   c. The taxpayer generally must derive gross receipts from the lease, rental, license, sale, exchange or other disposition of domestically produced property to take the deduction. So, for example, if the taxpayer produces computer software for internal purposes, that taxpayer will not have DPGR related to the computer software production to include in its calculation. Also, for some aspects of Section 199 there are special rules. For example, income from construction will only qualify if construction activities are performed in the United States by a taxpayer that, at the time the taxpayer constructs the real property, is 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. Although a taxpayer in an unrelated business may engage in construction when building a new plant the taxpayer will not be entitled to include the proceeds from the ultimate sale of the plant in its calculation for the domestic production deduction because the taxpayer does not meet the trade or business rules described in detail in §1.199-3(m).
   d. Items to review to understand the taxpayer's business
      1. Taxpayer's web site
      2. Explanation from the taxpayer
      3. Annual report
   e. Law –

      Section 199(c)

      (4) Domestic production gross receipts.--

      (A) In general.--The term "domestic production gross receipts" means the gross receipts of the taxpayer which are derived from--

      (i) any lease, rental, license, sale, exchange, or other disposition of--

      (I) qualifying production property which was manufactured, produced, grown, or extracted 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 produced by the taxpayer in the United States,

(ii) construction performed in the United States, or

(iii) engineering or architectural services performed in the United States for construction projects in the United States.

(B) Exceptions.--Such term shall not include gross receipts of the taxpayer which are derived from--

(i) the sale of food and beverages prepared by the taxpayer at a retail establishment, and

(ii) the transmission or distribution of electricity, natural gas, or potable water.

(5) Qualifying production property.--The term "qualifying production property" means--

(A) tangible personal property,

(B) any computer software, and

(C) any property described in section 168(f)(4).

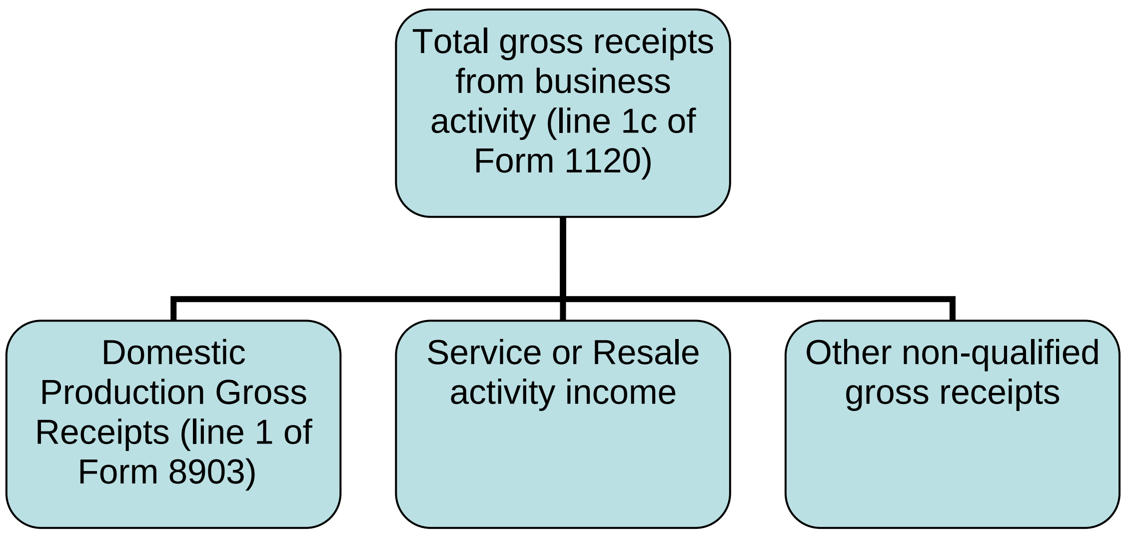
(6) Qualified film.--The term "qualified film" means any property described in section 168(f)(3) if not less than 50 percent of the total compensation relating to the production of such property is compensation for services performed in the United States by actors, production personnel, directors, and producers. Such term does not include property with respect to which records are required to be maintained under section 2257 of title 18, United States Code.

2. **Comparison of the domestic production gross receipts (DPGR) reported on Form 8903 to the gross receipts or sales less returns and allowances on the taxpayer's tax return, line 1c of the Form 1120**
    a. Gross receipts reported on line 1c of the 1120 should be greater then the domestic production gross receipts reported on line of the Form 8903.
        i. Although there are circumstances where the domestic production gross receipts could be higher, it is more likely that domestic production gross receipts will be less than total gross receipts.
        ii. Reasons for DPGR greater than total gross receipts
            1. Partnership flow through income that is not reflected on the face of the Form 1120.
            2. S-Corporation flow through income that is not reflected on the face of the Form 1120.

3. Member of an expanded affiliated group in which income other then that of the taxpayer is included in the computation.

b. If the gross receipts on the Form 8903 match the gross receipts on line 1(c) of the Form 1120, the taxpayer may have not allocated to non-DPGR nonqualified income amounts such as gross receipts for services or for resale items, if applicable. (This assumes the de minimis rule of §1.199-(c)(B)(i) does not apply.)

c. Understand the types of income earned by the taxpayer and what was included as domestic production gross receipts
    - i. Income items were included in domestic production gross receipts
    - ii. Income items not included in domestic production gross receipts (Taxpayers are not permitted to only include profitable items; loss items must be included in the calculation as well).



d. The taxpayer is required to begin its Section 199 computation with the determination of DPGR at the item level then compute cost of goods sold and other expenses independently instead of beginning with a net income figure. See law below.

e. Law

§1.199-3(d) **<u>Determining domestic production gross receipts</u>—**

(1) **<u>In general</u>**. 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 <u>item</u> 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) **<u>Special rules</u>**. 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. **Is the taxpayer required to allocate gross receipts to remove nonqualified embedded service income, or determine the qualified income portion of a component of an item? If so, how did the taxpayer determine an allocation method?**
    a. In certain circumstances, the taxpayer will be required to allocate gross receipts between items that qualify and the items that do not qualify. For example, if the taxpayer produces/sells widgets and buys/sells widgets, only the gross receipts from producing/selling widgets will qualify. The taxpayer must perform an allocation to determine the qualifying portion.
    b. In other circumstances, the taxpayer will be required to allocate the gross receipts of an individual item between a qualifying and non-qualifying portion. For example, if the taxpayer produces/sells an

item that includes non-qualifying services, the taxpayer will need to perform an allocation in order to determine the qualifying portion.

c. Allocation is not required when the service portion is one of the following and it is not separately stated or separately offered by the taxpayer*:

    (1) A qualified warranty
    (2) A qualified delivery
    (3) A qualified operating manual
    (4) A qualified installation
    (5) Services performed pursuant to a qualified computer software maintenance agreement
    (6) A 5% de minimis amount of gross receipts from embedded services and non-qualified property for each item of QPP, qualified films, or utilities.

    ***** See §1.199-3(i)(4) for additional rules related to the exceptions.

d. The allocation method selected by the taxpayer must be reasonable. See below.

e. Law

§1.199-3(d) Determining domestic production gross receipts—**(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.

§1.199-1(d) Allocation of Gross Receipts
(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.

4. **If the taxpayer is required to use Section 861 method to allocate and apportion deductions, has the taxpayer used it and is it consistent with the application of Section 861 for purposes of the foreign tax credit, if applicable?**
    a. A taxpayer must use the Section 861 method to allocate and apportion deductions if it has average annual gross receipts of more than $100,000,000 or total assets at the end of the taxable year of more than $10,000,000.
    b. Within Section 861, there are various methods taxpayers can use to make allocations such as the gross receipts method and the asset method. Taxpayers must be consistent with the chosen methods.
    c. Law –
    §1.199-4(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).

5. **Has the taxpayer applied the wage and taxable income limitations?**
   a. The taxpayer's DPD calculation is subject to the taxable income limitation and the wage limitation.
   b. If your taxpayer is a member of an expanded affiliated group, which is a company with ownership by another entity of more than 50% and less than 80%, the taxable income limitation only applies to the expanded affiliated group as a whole, not to the individual member.
   c. For the W-2 wage limitation, taxpayers with tax years beginning on or before May 17, 2006 are permitted to include all the W-2 wages paid during the year for the calculation.
   d. For the W-2 wage limitation, taxpayers with tax years beginning after May 17, 2006, must only include W-2 wages properly allocable to domestic production gross receipts (DPGR) for the limitation.
   e. Law-

      §199(a) Allowance of deduction.--

      (1) In general.--There shall be allowed as a deduction an amount equal to 9 percent (see 2 below for earlier years lesser percentages) of the lesser of--

      (A) the qualified production activities income of the taxpayer for the taxable year, or

      (B) taxable income (determined without regard to this section) for the taxable year.

      (2) Phase in.--In the case of any taxable year beginning after 2004 and before 2010, paragraph (1) and subsections (d)(1) and (d)(6) shall be applied by substituting for the percentage contained therein the transition percentage determined under the following table:

For taxable years transition beginning in	The percentage is
2005 or 2006	3
2007, 2008 or 2009	6
2010 and later	9

(b) Deduction limited to wages paid.--

(1) In general.--The amount of the deduction allowable under subsection (a) for any taxable year shall not exceed 50 percent of the W-2 wages of the employer for the taxable year.