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Notice 2005-14

Section 199—Income Attributable to Domestic Production Activities

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SECTION 1. PURPOSE

The Internal Revenue Service and Treasury Department currently are developing regulations under § 199 of the Internal Revenue Code, enacted as part of the American Jobs Creation Act of 2004, Pub. L. No. 108-357 (the Act), regarding the deduction relating to income attributable to domestic production activities. This notice provides interim guidance on which taxpayers may rely until the regulations are issued. The Service and Treasury Department expect that the regulations will incorporate the rules set forth in this notice and will be effective for taxable years beginning after December 31, 2004, the effective date of § 199. *See* § 102(e) of the Act. This notice requests comments on the interim guidance provided herein and any additional guidance that should be provided in regulations. Comments must be received by March 31, 2005.

SECTION 2. OVERVIEW OF § 199

.01 *In General.* (1) Section 199(a)(1) allows a deduction equal to 9 percent (3 percent in the case of taxable years beginning in 2005 and 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 § 199) for the taxable year (or, in the case of an individual, under § 199(d)(2), adjusted gross income).

(2) 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, § 199(b)(2) defines the term “W-2 wages” to mean the sum of the aggregate amounts the taxpayer is required under § 6051(a)(3) and (8) to include on the Forms W-2 of the taxpayer’s employees during the calendar year ending during the taxpayer’s taxable year. Section 199(b)(3) provides that the Secretary shall prescribe rules for the application of § 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.

.02 *Qualified Production Activities Income.* (1) Under § 199(c)(1), QPAI is the excess of domestic production gross receipts (DPGR) over the sum of: (a) the cost of goods sold (CGS)

allocable to such receipts; (b) other deductions, expenses, or losses directly allocable to such receipts; and (c) a ratable portion of deductions, expenses, and losses not directly allocable to such receipts or another class of income.

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

(3) 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.

(4) Section 199(c)(4)(A) defines DPGR to mean the taxpayer's gross receipts that are derived from: (a) 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 produced by the taxpayer in the United States; (b) construction performed in the United States; or (c) engineering or architectural services performed in the United States for construction projects in the United States. Section 199(c)(4)(B) excepts from DPGR gross receipts of the taxpayer that are derived from: (a) the sale of food and beverages prepared by the taxpayer at a retail establishment; and (b) the transmission or distribution of electricity, natural gas, or potable water.

(5) Section 199(c)(5) defines QPP to mean: (a) tangible personal property; (b) any computer software; and (c) any property described in § 168(f)(4) (certain sound recordings).

(6) Section 199(c)(6) defines a qualified film to mean any property described in § 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).

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

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

(2) Notwithstanding the general rule that § 199 is applied at the shareholder, partner, or similar level, § 199(d)(1)(B) provides that, for purposes of applying the wage limitation of § 199(b), a shareholder, partner, or similar person that is allocated QPAI from an S corporation, partnership, estate, trust, or other pass-thru entity is also treated as having been allocated W-2 wages from such entity in an amount equal to the lesser of: (i) such person's allocable share of such wages (without regard to this rule) 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 and 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the QPAI allocated to such person for the taxable year.

.04 Individuals. In the case of individuals, § 199(d)(2) provides that the deduction is equal to the applicable percent of the lesser of the taxpayer's (1) QPAI for the taxable year, or (2) adjusted gross income (AGI) for the taxable year determined after applying §§ 86, 135, 137, 219, 221, 222, and 469, and without regard to § 199.

.05 Patrons of Certain Cooperatives. (1) Section 199(d)(3) provides special rules under which a taxpayer receiving certain patronage dividends or certain qualified per-unit retain allocations from a cooperative (to which subchapter T applies) engaged in the MPGE, in whole or in significant part, or in the marketing, of any agricultural or horticultural product is allowed a deduction under § 199 with respect to the amount of the patronage dividends or qualified per-unit retain allocations that are: (a) allocable to the portion of the cooperative's QPAI that would be deductible by the cooperative; and (b) designated as such by the cooperative in a written notice mailed to its patrons during the payment period described in § 1382. Such an amount, however, does not reduce the taxable income of the cooperative under § 1382.

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

.06 Expanded Affiliated Groups. (1) Section 199(d)(4)(A) provides that all members of an expanded affiliated group (EAG) are treated as a single corporation for purposes of § 199. Section 199(d)(4)(B) provides that an EAG is an affiliated group as defined in § 1504(a), determined by substituting "50 percent" for "80 percent" each place it appears, and without regard to § 1504(b)(2) and (4).

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

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

.08 Alternative Minimum Tax. Section 199(d)(6) provides rules to coordinate the deduction allowed under § 199 with the alternative minimum tax (AMT) imposed by § 55. The deduction is allowed for purposes of the AMT, except that the deduction is equal to the applicable percent of the lesser of the taxpayer's: (1) QPAI, determined without regard to subchapter A, Part IV, of the Code; or (2) alternative minimum taxable income (AMTI). For purposes of the preceding sentence, in the case of an individual, AGI (determined without regard to § 199) shall be substituted for AMTI.

.09 *Authority to Prescribe Regulations.* Section 199(d)(7) authorizes the Secretary to prescribe such regulations as are necessary to carry out the purposes of § 199.

SECTION 3. EXPLANATION OF INTERIM GUIDANCE

.01 *In General.* Section 199 provides a deduction from gross income for an applicable percentage of QPAI subject to certain limits. Section 199 raises a number of complex issues. In general, the interim guidance provided in this notice is intended to balance the goals of: (1) ensuring compliance with the intent and purpose of § 199; and (2) providing clear, administrable rules that minimize, to the extent possible, the administrative burden on taxpayers and the Service.

.02 *Wage Limitation.* (1) *In general.* Section 4.02(1) of this notice provides rules that are used in determining the amount of “W-2 wages” of a taxpayer. Section 4.02(1) provides that for purposes of § 199(b)(2), the term “taxpayer” means “employer.” Section 4.02(1) provides that only amounts from Forms W-2, “*Wage and Tax Statement*,” issued for employees of the taxpayer for employment by the taxpayer are included in calculating this amount. For purposes of this calculation, employees of the taxpayer are limited to employees as defined by § 3121(d)(1) and (d)(2) (that is, officers of a corporate taxpayer and employees of the taxpayer under the common law rules). Section 4.02(1)(b) provides generally that any discussion of the term “wages” in this notice is solely for purposes of § 199 and has no application in determining whether amounts are wages for purposes of the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), federal income tax withholding, or any other wage related determination.

(2) *Wages paid by other entities.* Section 4.02(1) of this notice provides that a taxpayer may take into account wages paid and reported by other entities to employees of that taxpayer for employment by that taxpayer. Thus, a taxpayer may take into account wages paid by agents of the taxpayer on behalf of the taxpayer to employees of the taxpayer that are included on Forms W-2 issued by the agent. A taxpayer also may take into account wages paid by a person defined as an employer under § 3401(d)(1), to employees of the taxpayer if the wages are included on Forms W-2 issued by the § 3401(d)(1) employer.

(3) *Acquisitions and dispositions of a trade or business (or major portion).* Section 4.02(1)(d) of this notice provides that if a taxpayer (the successor) acquires the major portion of a trade or business or the major portion of a separate unit of a trade or business from another taxpayer (the predecessor), the successor may not take into account wages paid to common law employees of the predecessor employer in respect of services rendered to the predecessor employer, even if those wages are reported on Forms W-2 furnished by the successor.

(4) *Non-duplication rule.* Section 4.02(1)(e) of this notice includes a non-duplication rule, which provides that amounts that are treated as W-2 wages for any taxable year may not be treated as W-2 wages for any other taxable year. Thus, an amount of nonqualified deferred compensation that is treated as W-2 wages under the Unmodified Box Method in section 4.02(2)(b)(i) for a taxable year may not be treated as W-2 wages in any other taxable year.

(5) *Definition of W-2 wages.* (a) *In general.* Section 4.02(2) of this notice provides rules for determining the “W-2 wages” of a taxpayer. The term “W-2 wages” includes amounts that are required to be included on statements under § 6051(a)(3) and (8) with respect to employees of the taxpayer. Because § 6051(a)(3) and (8) include the total amount of wages as defined in § 3401(a), the total amount of elective deferrals (within the meaning of § 402(g)(3)), the compensation deferred under § 457, and (for tax years beginning after December 31, 2005) the amount of designated Roth contributions (as defined in § 402A), there is no single box on the Form W-2 that necessarily includes all these items of information without including other items. Therefore, no single box on the Form W-2 meets the § 199(b)(2) definition of W-2 wages.

(b) *Methods for calculating W-2 wages.* Because no single box on Form W-2 satisfies the definition of W-2 wages under § 199(b)(2), section 4.02(2)(b) of this notice provides three alternative methods for calculating W-2 wages only for purposes of § 199. The first option allows for a simplified calculation while the last two options provide greater accuracy. Under the first option, a taxpayer may treat as the taxpayer's W-2 wages under § 199(b)(2) the lesser of (A) the total entries in Box 1 of all Forms W-2 filed with the Social Security Administration (SSA) by the taxpayer with respect to employees of the taxpayer or (B) the total entries in Box 5 of all Forms W-2 filed with the SSA by the taxpayer with respect to employees of the taxpayer. Under the second option, the W-2 wages are calculated by subtracting from the total amounts reported in Box 1 of Forms W-2 with respect to employees of the taxpayer (1) amounts that are included in Box 1 that are not wages under § 3401(a) and (2) items that are treated as wages under § 3402(o) (for example, supplemental unemployment compensation benefits), and then adding those elective deferrals that are reported in Box 12 of Forms W-2 with Codes D, E, F, G, and S. Under the third option, a taxpayer may track the actual amount of wages subject to federal income tax withholding, subtract supplemental unemployment compensation benefits that were included in this amount, and then add specific elective deferrals that are reported in Box 12 of Forms W-2 with Codes D, E, F, G, and S.

.03 *Determining Qualified Production Activities Income.* Section 4.03 of this notice provides rules for determining a taxpayer's QPAI for the taxable year. This notice provides that QPAI is determined on an item-by-item basis (and not, for example, on a division-by-division, a product line-by-product line, or a transaction-by-transaction basis) and is the sum of the QPAI derived by the taxpayer from each item. For purposes of this determination, QPAI from each item may be positive or negative. Section 4.04 provides rules for determining a taxpayer's DPGR, the definition of the terms "gross receipts," "manufactured, produced, grown, or extracted," "by the taxpayer," "in whole or in significant part," and "derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property," as well as rules for determining whether property qualifies as QPP (that is, tangible personal property, computer software, and sound recordings). *See* section 3.04 for an explanation of these rules. Section 4.05 provides rules for determining a taxpayer's costs (including CGS) for purposes of computing QPAI. *See* section 3.05 for an explanation of the rules relating to costs. Generally, if a taxpayer is engaged exclusively in the manufacture of QPP within the United States and has no other sources of income, it is anticipated that QPAI will equal taxable income.

.04 *Determining Domestic Production Gross Receipts.* (1) *In general.* Section 4.04 of this notice generally provides rules for determining DPGR. A taxpayer must determine the portion of its total gross receipts that are DPGR. For example, if a taxpayer manufactures QPP at a facility inside the United States (that otherwise qualifies under § 199) and QPP at a facility outside the United States, the taxpayer generally must determine the portion of its gross receipts that are attributable to QPP manufactured inside the United States and the portion of its gross receipts that are attributable to QPP manufactured outside the United States to determine the taxpayer's DPGR. However, section 4.03(2) provides a safe harbor under which a taxpayer with less than 5 percent of total gross receipts from items other than DPGR may treat all gross receipts as DPGR and is therefore not required to allocate its gross receipts. For example, interest and late fees relating to QPP manufactured in the United States by a taxpayer and sold by the taxpayer on credit are not DPGR, but may be treated as DPGR if the taxpayer's interest and late fees, when aggregated with other non-DPGR, are collectively less than 5 percent of the taxpayer's total gross receipts. The Service and Treasury Department do not believe that the interim guidance should mandate a single method of determining DPGR because the Service and Treasury Department have not identified a single method that would be appropriate for all taxpayers. Accordingly, section 4.03(2) provides that a taxpayer's method for determining DPGR and non-

DPGR must be a reasonable method that accurately identifies the gross receipts derived from activities described in § 199(c)(4) based on all of the information available to the taxpayer to substantiate the allocation. Among the factors that the Service will take into consideration in determining whether a taxpayer's method is reasonable is whether the taxpayer is using the most accurate information available to the taxpayer; the relationship between the gross receipts and the 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, state, or foreign income tax purposes; the time, burden, and cost of using various methods; and whether the taxpayer applies the method consistently from year to year. For example, a taxpayer that uses a specific identification method (that is, a method that specifically identifies where the item was MPGE) for any other purpose is required to use that method to determine DPGR. Similarly, a taxpayer that has the information readily available to use a specific identification method even if it does not use that method for any other purpose generally is required to use a specific identification method to determine DPGR and the taxpayer's use of a different, less accurate method to determine DPGR generally is not considered reasonable. However, a taxpayer that does not currently use a specific identification method for any other purpose and does not have the information readily available to use the method generally is not required to use that method to determine DPGR. *See* section 3.05 for an explanation of rules relating to the allocation of costs.

(2) *Definition of "gross receipts."* For purposes of § 199, section 4.04(2) of this notice defines the term "gross receipts" using a definition that is derived from the definition under § 1.448-1T(f)(2)(iv)(A). In general, "gross receipts" for the taxable year are those that are properly recognized under the taxpayer's accounting method for federal income tax purposes.

(3) *Definition of "manufactured, produced, grown, or extracted."* (a) In general. In determining how this notice should define MPGE under § 199(c)(4)(A)(i)(I), the Service and Treasury Department considered how those terms have been defined under § 954 (see § 1.954-3(a)(4)(i) for the definition of manufactured or produced), and how the same or similar terms have been defined for purposes of § 38 (see § 1.48-1(d)(2)) and § 263A (see § 263A(g)(1) and § 1.263A-2(a)(1)(i)). Even though these and similar terms are used in other parts of the Code, the Service and Treasury Department believe that for this purpose the terms MPGE must be construed in light of the specific policies underlying § 199. Because the Service and Treasury Department believe that Congress intended for the deduction under § 199 to be available to taxpayers for a wide variety of production activities, section 4.04(3) of this notice defines MPGE broadly to include all of the activities specifically listed in §§ 199(c)(4)(A)(i)(I) and 263A(g)(1), and in §§ 1.48-1(d)(2) and 1.263A-2(a)(1)(i) (hereinafter referred to as "MPGE activities"). This interpretation is solely for purposes of § 199, based on the authority provided to the Secretary under § 199(d)(7), and does not affect the construction of these terms in other parts of the Code (for example, § 954(a)(1)(A)).

(b) *Consistency with § 263A.* The Service and Treasury Department believe that the term "producer" has been interpreted broadly under § 263A and includes within its scope all of the MPGE activities. Accordingly, the Service and Treasury Department believe that if a taxpayer claims it has MPGE QPP for the taxable year for purposes of § 199(c)(4)(A)(i)(I), it is fundamentally inconsistent for the taxpayer to claim it is not a "producer" under § 263A with respect to the QPP for the taxable year. Therefore, section 4.04(3)(b) of this notice provides that a taxpayer that has MPGE QPP for the taxable year should also consistently treat itself as a producer under § 263A with respect to the QPP for the taxable year unless the taxpayer is not subject to § 263A under the Code, regulations, or other published guidance. Taxpayers that currently are not properly accounting for their production activities under § 263A, and that wish to change their method of accounting to comply with the producer requirements of § 263A, must

follow the procedures of Rev. Proc. 97-27, 1997-1 C.B. 680 (as modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, as amplified and clarified by Rev. Proc. 2002-54, 2002-2 C.B. 432), or Rev. Proc. 2002-9, 2002-1 C.B. 327 (as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432), whichever applies.

(4) *Definition of “by the taxpayer.”* With the exception of the rules applicable to an EAG, the Service and Treasury Department believe that the requirement of § 199(c)(4)(A)(i) that property be MPGE “by the taxpayer” means that only one taxpayer may claim the deduction under § 199 with respect to the same function performed with respect to the same property. For example, if A enters into an agreement with an unrelated customer B to manufacture 100 widgets for B, only one of the taxpayers is treated as having MPGE the widgets for purposes of § 199(c)(4)(A)(i)(I). Section 4.04(4) of this notice provides that in contract manufacturing situations, if one taxpayer performs activities that constitute the MPGE of QPP or the production of a qualified film, electricity, natural gas, or potable water (collectively “qualifying activity”) pursuant to a contract with an unrelated party, then only the taxpayer that has the benefits and burdens of ownership of the property under federal income tax principles during the period the qualifying activity occurs is treated as engaging in the qualifying activity. This standard is based on the principles under § 936 and § 263A. In considering which standard to apply in contract manufacturing situations, the Service and Treasury Department concluded that it is not appropriate to treat property as being manufactured by the customer in a contract manufacturing situation if the customer does not have the benefits and burdens of owning the property under federal income tax principles during the period the qualifying activity occurs. This rule applies even if the customer exercises direct supervision and control over the activities of the contractor or is treated as a producer of the property pursuant to § 263A(g)(2) for other reasons. If a contractor does not have the benefits and burdens of owning the property under federal income tax principles during the period the qualifying activity occurs, the contractor is more appropriately viewed as performing a service for the customer. As a result, a contractor that does not satisfy the “by the taxpayer” requirements of § 199(c)(4)(A)(i) is considered to be deriving gross receipts from the provision of services and the receipts are not considered to be “derived from any lease, rental, license, sale, exchange, or other disposition of” the property within the meaning of § 199(c)(4)(A)(i) (see section 4.04(7)(a)). Thus, a taxpayer that does not have the benefits and burdens of ownership of the property under federal income tax principles during the period the qualifying activity occurs does not qualify under the contract manufacturing rule for purposes of § 199. To illustrate this rule, if, in the example above, A owns the widgets during the period the qualifying activity occurs (that is, A bears the benefits and burdens of ownership under federal income tax principles), the widgets will be treated as manufactured by A and not the unrelated customer B for purposes of § 199(c)(4)(A)(i)(I). Conversely, if B is the owner of the widgets (that is, B bears the benefits and burdens under federal income tax principles) during the period the qualifying activity occurs, the widgets will be treated as manufactured by B, not A, for purposes of § 199(c)(4)(A)(i)(I). Under this rule, either A or B may qualify for the deduction, but both cannot obtain the benefit of the deduction for the same activity. No inference is intended concerning the definition of “by the taxpayer” or “contract manufacturing” for purposes of any other provision of the Code.

(5) *Definition of “in whole or in significant part.”* (a) *In general.* To qualify for the § 199 deduction, QPP must be MPGE “in whole or in significant part by the taxpayer within the United States.” Under § 199, the gross receipts that are considered DPGR are not limited to the gross receipts attributable to QPP MPGE entirely by a taxpayer. For example, if a taxpayer purchases partially manufactured QPP from another taxpayer and the taxpayer satisfies the “in whole or in significant part” requirement with respect to the manufacture of the QPP, the taxpayer’s gross

receipts derived from the lease, rental, license, sale, exchange, or other disposition of that QPP will be considered DPGR (assuming all other requirements of § 199(c) are met). Likewise, if a taxpayer imports QPP that it partially manufactured outside the United States, and the taxpayer satisfies the “in whole or in significant part” requirement with respect to its United States manufacturing activity associated with that QPP, the taxpayer’s gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of that QPP will be considered DPGR (assuming all other requirements of § 199(c) are met). Similarly, if a taxpayer manufactures QPP in significant part in the United States and exports the goods for further manufacture outside the United States, the taxpayer’s gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of that 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 (and assuming all other requirements of § 199(c) are met). See section 4.04(7) of this notice for a discussion of the definition of “derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property.”

(b) *Substantial in nature.* Section 4.04(5)(b) of this notice provides, generally, that the “in whole or in significant part” requirement is satisfied if the taxpayer’s MPGE activity within the United States with respect to the QPP is “substantial in nature.” Whether a taxpayer’s MPGE activity is “substantial in nature” for purposes of § 199 generally depends upon all of the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer’s MPGE activity in the United States, the nature of the property, and the nature of the MPGE activity that the taxpayer performs in the United States. Although this “substantial in nature” requirement applies on a facts and circumstances basis like the “substantial in nature” requirement in § 1.954-3(a)(4)(iii), this “substantial in nature” requirement is not the same as the requirements underlying the “not the property which it purchased” standard in § 1.954-3(a)(4). In particular, the substantial transformation test of § 1.954-3(a)(4)(ii) is not relevant to the determination of “substantial in nature” for purposes of § 199(c)(4)(A)(i)(I). The Service and Treasury Department considered whether the general rule for determining whether the taxpayer satisfies the “in whole or in significant part” requirement should be based upon a single, quantitative criterion, such as relative value, or relative cost, of the United States activity. However, the Service and Treasury Department concluded that such a general rule would not be suitable in all circumstances. For example, assume that a taxpayer purchases gemstones and precious metal and then uses these materials to produce jewelry in the United States (for example, by cutting and polishing the gemstones, melting and shaping the metal, and combining the finished materials). The Service and Treasury Department believe that the taxpayer is properly regarded as manufacturing or producing the QPP in significant part within the United States. The value added by the taxpayer’s United States manufacturing, however, may not be substantial when compared to the value of the final product because of the relatively high value of the purchased materials. Similarly, the cost of the taxpayer’s United States manufacturing may not be substantial when compared to the total cost of the product (and therefore also may not meet the safe harbor discussed below). However, the nature of the product, and the nature of the taxpayer’s United States MPGE activity, is such that the United States MPGE activity is “substantial in nature.” Accordingly, the Service and Treasury Department believe that the “substantial in nature” test should be applied by considering all of the facts and circumstances.

(c) *Safe harbor.* Section 4.04(5)(c) of this notice provides a safe harbor under which a taxpayer will be treated as MPGE property in whole or in significant part within the United States if, in connection with the property, conversion costs (direct labor and related factory burden) to MPGE the property are incurred by the taxpayer within the United States and the costs account for 20 percent or more of the total CGS of the property. This rule would operate similarly to the safe harbor provided under § 1.954-3(a)(4)(iii) for determining whether, for purposes of computing

foreign base company sales income, the sale of property is treated as the sale of a manufactured product rather than the sale of a component part, when purchased components constitute part of the property.

(d) *Certain activities and costs disregarded.* The Service and Treasury Department believe that, in connection with the MPGE of QPP, packaging, repackaging, labeling, and minor assembly operations should not be considered in applying the general “substantial in nature” test, and that the costs of those activities should not be considered in applying the safe harbor. This rule is similar to the test applied in § 1.954-3(a)(4)(iii). For example, a taxpayer whose United States activities consist solely of affixing a label to a plastic bottle otherwise manufactured entirely outside the United States will not be regarded as having met the “in whole or in significant part” requirement, regardless of the value added to the bottle by the label or the relative cost incurred by the taxpayer with respect to the labeling activity. In addition, the Service and Treasury Department do not believe it is appropriate to regard a taxpayer as meeting the “in whole or in significant part” requirement if the taxpayer manufactures tangible personal property entirely outside the United States, even if the design and development activities that lead to the tangible personal property occur entirely within the United States because the design and development activities with respect to tangible personal property give rise to the creation of an intangible asset. Thus, with respect to tangible personal property, design and development activities also are disregarded for purposes of the general “substantial in nature” test, and the costs of those activities are disregarded for purposes of the safe harbor in section 4.04(5)(c) of this notice. However, with respect to computer software and sound recordings, intangible property that may constitute QPP under § 199, the Service and Treasury Department believe that a significant portion of the “production” may be viewed as design and development (for example, writing the programming code in the case of computer software, and recording and editing the master copy in the case of sound recordings). Accordingly, in the case of computer software and sound recordings, design and development activities are not disregarded for purposes of applying the “substantial in nature” test and the costs of those activities are not disregarded for purposes of the safe harbor in section 4.04(5)(c).

(6) *Definition of “United States.”* Section 7701(a)(9) generally provides that, for purposes of the Code, the term “United States” when used in a geographical sense includes only the 50 states and the District of Columbia. For purposes of § 199, the term United States follows the § 7701(a)(9) definition and includes 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. However, because neither § 199 nor the legislative history explicitly include possessions and territories of the United States or the airspace over the United States and these areas within the definition of United States, the term “United States” does not include possessions and territories of the United States or the airspace over the United States and these areas for purposes of § 199. *See*, for example, § 638 and § 301.7701(b)-1(c)(2)(ii).

(7) *Definition of “derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property.”* (a) *In general.* Section 4.04(7) of this notice provides that gross receipts “derived from” an activity described in section 4.04(3) are limited to the direct proceeds from the lease, rental, license, sale, exchange, or other disposition of the QPP. Thus, for example, the “derived from the sale of QPP” requirement is met with respect to direct proceeds from the sale of QPP manufactured in whole or in significant part within the United States by a taxpayer for sale (assuming all other requirements of § 199(c) are met), as well as for direct proceeds from the sale of self-constructed QPP manufactured in whole or in significant part in the United States by a taxpayer and used in the taxpayer’s trade or business (assuming all other

requirements of § 199(c) are met) (*see* section 3.05 for a discussion of determining costs with respect to the disposition of self-constructed assets). In addition, business interruption insurance and payments not to produce are treated as gross receipts “derived from the lease, rental, license, sale, exchange, or other disposition of” an activity described in section 4.04(7)(a) to the extent the payments are substitutes for gross receipts that would be so treated (assuming all other requirements of § 199(c) are met). Except as provided in section 4.04(7)(c) with respect to certain advertising income and section 4.04(7)(e) with respect to certain oil and gas partnerships, the Service and Treasury Department believe that no other receipts are within the language of § 199(c)(4)(A)(i). For purposes of the “derived from the lease, rental, license, sale, exchange, or other disposition of” requirement of § 199(c)(4)(A)(i), existing federal income tax law principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange or other disposition, or whether it is a service. *See* for example, Rev. Rul 88-65, 1988-2 C.B. 32, which treats a short-term rental as a service. For an explanation of the rules relating to determining gross receipts “derived from” construction performed in the United States, *see* section 3.04(11)(e).

(b) *Allocation of gross receipts — embedded services.* With certain exceptions discussed below, gross receipts derived from the performance of services do not qualify as DPGR. Accordingly, in the case of the lease, rental, license, sale, exchange, or other disposition of property that contains a service element (embedded service), section 4.04(7)(b) of this notice generally requires that the taxpayer allocate the gross receipts (as well as the costs — *see* section 4.05) between the property and the embedded service. The portion of the gross receipts that are considered “derived from the lease, rental, license, sale, exchange, or other disposition” of the property may not exceed the selling price of the property without the service element. Section 4.04(7)(b) provides two exceptions to the allocation requirement. First, a taxpayer may include in DPGR gross receipts from a qualified warranty (that is, a warranty that is provided in connection with the sale of QPP if (1) in the normal course of its business, the charge for the warranty is included in the price charged for the lease, rental, license, sale, exchange, or other disposition of the QPP and (2) the warranty is neither separately offered by the taxpayer nor separately bargained for with the customer (that is, the customer cannot purchase the QPP without the warranty)). This exception is consistent with a similar exception provided in section 3.07 of Rev. Proc. 71-21, 1971-2 C.B. 549 (modified and superseded by Rev. Proc. 2004-34, 2004-22 I.R.B. 991), regarding the deferral of certain advance payments for services. Second, a *de minimis* amount of gross receipts from embedded services for each item of property may qualify as DPGR. A *de minimis* amount of gross receipts from embedded services is equal to less than 5 percent of the gross receipts of the property. If one of these exceptions is met, the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of property and the gross receipts from the embedded services are treated as “derived from the lease, rental, license, sale, exchange, or other disposition” of the property and are treated as DPGR (assuming all other requirements of § 199(c) are met). The 5 percent *de minimis* rule is consistent with § 1.451-5(a)(3), which generally provides that if less than 5 percent of an advance payment for goods is allocable to the provision of services, the portion so allocable will be considered as an advance payment for goods. For purposes of applying this *de minimis* rule, the gross receipts from a qualified warranty that are included in the price charged for the lease, rental, license, sale, exchange, or other disposition of property are not treated as gross receipts for services.

(c) *Advertising income.* The Service and Treasury Department believe that advertising income attributable to the sale or other disposition of newspapers and magazines should be considered “derived from” the sale or other disposition of the newspapers and magazines because the advertising income is inextricably linked to the gross receipts derived from the lease, rental, sale, exchange or other disposition of the newspapers and magazines. For example, a newspaper

manufacturer's receipts from an advertiser to publish display advertising or classified advertisements in its newspaper are treated as gross receipts derived from the sale of the newspapers for purposes of § 199 (assuming all other requirements of § 199(c) are met).

(d) *Computer software.* The determination of whether a transfer of computer software is a sale or exchange of property, a license generating royalty income, or a lease generating rental income is made taking into account all facts and circumstances. The form adopted by the parties to a transaction, the classification of the transaction under copyright law, and the physical or electronic or other medium used to effectuate the transfer of computer software are not determinative. *See* § 1.861-18. A service provided using computer software that does not involve a transfer of the computer software does not result in gross receipts that are derived from the lease, rental, license, sale, exchange, or other disposition of computer software. Thus, with respect to computer software that is developed in the United States and sold to customers who take delivery of the software by downloading the software from the Internet, the manufacturer's gross receipts from the sales are DPGR (assuming all other requirements of § 199(c) are met). Except as provided in the safe harbor described in section 3.04(7)(b) of this notice, gross receipts derived by a taxpayer from software that is merely offered for use to customers online for a fee are not DPGR. In addition, gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of computer software do not include gross receipts derived from: (i) providing customer support in connection with the sale of computer software; (ii) online services; or (iii) providing Internet access or telephone services over the Internet. These receipts are not DPGR because these receipts are attributable to the provision of a service and are not derived from the lease, rental, license, sale, exchange, or other disposition of the software.

(8) *Definition of "qualifying production property."* (a) *In general.* Section 199(c)(5) provides that the term "qualifying production property" includes: (1) tangible personal property; (2) computer software; and (3) sound recordings.

(b) *Tangible personal property.* The definition of "tangible personal property" provided in section 4.04(8)(b) of this notice is derived primarily from, and is generally consistent with, the definition of that term under § 1.48-1(c). Consistent with § 1.48-1(c), section 4.04(8)(b) provides that local law is not controlling for purposes of determining whether property is tangible personal property under § 199(c)(5)(A). In addition to many of the items specifically referenced in § 1.48-1(c), section 4.04(8)(b) includes in the term "tangible personal property" videocassettes, computer diskettes, books, and similar items. *See* § 1.263A-2(a)(2)(ii). No inference is intended concerning whether these items are tangible or intangible property for purposes of any other section of the Code (for example, § 197). Treating these items as tangible personal property is consistent with the definitions provided for "computer software," "sound recordings," and "qualified films," that do not include the tangible personal property (if any) in which computer software, a sound recording, or a qualified film is fixed. As a result, "tangible personal property" excludes any property that falls within the definition of computer software, a sound recording, or a qualified film. For example, a sale of a computer game on a CD-ROM has both a tangible personal property element (the disc) and a computer software element (the program fixed on the disc), but a sale of the same program effected instead by an internet download involves computer software only.

(c) *Computer software.* (i) *In general.* The definition of "computer software" provided in section 4.04(8)(c) of this notice is derived from the definition of that term under § 1.197-2(c)(4)(iv), but also includes the machine-readable coding for video games and similar programs, regardless of whether the program is designed to operate on a "computer" (as defined under § 168(i)(2)(B)). The term "computer software" includes all property described in section 4.04(8)(c). Thus, DPGR includes the gross receipts from computer software that was developed by the taxpayer, provided

the gross receipts are derived from the lease, rental, license, sale, exchange, or other disposition of computer software as required by § 199(c)(4)(A)(i).

(ii) *Tangible personal property not included.* “Computer software” does not include diskettes or other tangible property on which machine-readable coding is placed, as the property is considered tangible personal property for purposes of § 199. For example, assume B, who is unrelated to A, develops software outside the United States and licenses the rights to manufacture and distribute the software to A, and A manufactures in the United States compact discs encoded with the software. Assume further that A sells the compact discs encoded with the software. A’s gross receipts from the sale of the compact discs are derived in part from the sale of tangible personal property (the compact discs), and in part from the sale of computer software. Therefore, A must allocate its gross receipts between those attributable to the software (which are not DPGR) and those attributable to the compact discs (which are DPGR, assuming all other requirements of § 199(c) are met). Assume in the alternative that A is an integrated software developer and producer that designs the software outside the United States and manufactures the compact discs within the United States. Assume further that A sells the compact discs encoded with the software. A’s gross receipts from the sale of the compact discs are derived in part from the sale of tangible personal property (the compact discs), and in part from the sale of computer software. Therefore, A must allocate its gross receipts between those attributable to the software (which are not DPGR because the software was developed outside the United States) and those attributable to the compact discs (which are DPGR, assuming all other requirements of § 199(c) are met).

(d) *Sound recordings.* Section 199(c)(5)(C) provides that QPP includes any property described in § 168(f)(4). Section 4.04(8)(d) of this notice defines the term “sound recording” consistent with § 168(f)(4). Consistent with the definitions of computer software and qualified films, the definition of “sound recording” does not include tangible personal property in which the sound recording is fixed, such as a compact disc. This interpretation does not affect any other section of the Code (for example, § 168(f)(4)). Consequently, the results in the examples provided in section 3.04(8)(c)(ii) would be the same if, instead of software, the examples involved the production of sound recordings and compact discs that contain the sound recordings.

(9) *Definition of “qualified film.”* (a) *In general.* Section 199(c)(6) provides that the term “qualified film” means any property described in § 168(f)(3). Accordingly, section 4.04(9) of this notice defines a “qualified film” to include any motion picture film or video tape (other than certain sexually explicit visual depictions), as well as live or delayed television programming (*see* H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. 273 (fn. 30) (2004) (Conference Report) (hereinafter referred to collectively as “film”) if not less than 50 percent of the total compensation relating to the production of the property is compensation for services performed in the United States by actors, production personnel, directors, and producers. Qualified films include all property described in section 4.04(9). Consistent with the definitions of “computer software” and “sound recordings,” the definition of “qualified film” is limited to the master copy of the film (or other copy from which the holder is licensed to make and produce copies), and does not include tangible personal property embodying the qualified film, such as DVDs or videocassettes. This interpretation does not affect any other section of the Code (for example, § 168(f)(3)). In no event will ticket sales for viewing qualified films constitute DPGR. Thus, for example, if A produces a qualified film, fixes the film to a tangible medium purchased from an unrelated taxpayer, and leases or licenses the qualified film and medium containing the qualified film to unrelated commercial theaters, A’s gross receipts from the lease or license of the qualified film are “derived from” (i) the lease of tangible personal property (the tangible medium on which the copy is fixed), that are not DPGR, and (ii) the license of the qualified film (the right to publicly display the film), that are DPGR. If, instead, A licenses a qualified film to unrelated

taxpayer B, and B reproduces the film on DVDs or videocassettes manufactured by B in the United States, B's gross receipts from the sale of the DVDs and videocassettes are "derived from" the sale of (i) tangible personal property (the DVDs and videocassettes), that are DPGR, and (ii) the qualified film (the motion picture fixed on the DVDs and cassettes), that are not DPGR. A taxpayer that merely writes a screenplay or other similar material is not considered to have produced a qualified film under § 199(c)(4)(A)(i)(II). Therefore, amounts that a taxpayer receives from the sale of a script or screenplay, even if it 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. Finally, gross receipts derived from a license of the right to use the film characters are not gross receipts "derived from" a qualified film.

(b) *Production personnel.* For purposes of § 199(c)(6), the term "production personnel" includes all personnel (other than actors, directors, and producers) who are directly involved in the production of the film. Thus, "production personnel" under section 4.04(9)(a) of this notice include 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. "Production personnel" do not include, however, individuals whose activities are ancillary to the production, such as advertisers and promoters, distributors, studio administrators and managers, studio security personnel, and personal assistants to actors.

(c) *Compensation for services.* Under section 4.04(9)(b) of this notice, compensation for services includes all payments for services performed by actors, production personnel, directors, and producers, including participations and residuals. *See* Conference Report at 273 (fn. 31). In the case of a taxpayer that uses the income forecast method of § 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 purposes of § 199 that it uses for purposes of § 167(g). In the case of a taxpayer that excludes participations and residuals from adjusted basis of the qualified film under § 167(g)(7)(D)(i), the taxpayer must determine the compensation expected to be paid as participations and residuals based on the total forecasted income used in determining income forecast depreciation.

(d) *Determination of 50 percent.* The Service and Treasury Department do not believe that a single method of allocating compensation between services performed within the United States and services performed outside the United States is appropriate for all taxpayers. Accordingly, section 4.04(9)(c) of this notice provides that a taxpayer may use any reasonable method of making the allocation. 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.

(10) *Electricity, natural gas, and potable water.* (a) *In general.* DPGR includes gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States (assuming all other requirements of § 199(c) are met). DPGR does not include, however, gross receipts of the taxpayer derived from the transmission or distribution of these items. The Conference Report at 272-3 (fn. 28) explains that an integrated producer that both produces and delivers electricity, natural gas, or potable water, must allocate its gross receipts between: (i) production that qualifies as DPGR; and (ii) distribution and transmission (that do not qualify as DPGR). Thus, section 4.04(10)(d) of this notice generally requires such allocation. However, if less than 5 percent of a taxpayer's gross receipts derived from a sale of electricity, natural gas, or potable water are attributable to the transmission and distribution of such electricity, natural gas, or

potable water, then the gross receipts derived from that sale that are attributable to the transmission and distribution of such items will be treated for purposes of § 199 as being DPGR.

(b) *Natural gas.* Section 4.04(10)(b) of this notice defines the term “natural gas” in a manner consistent with § 613A(e)(2) and generally includes only natural gas extracted from a natural deposit. Thus, natural gas would not include, for example, methane gas extracted from a landfill. Consistent with the Conference Report at 272-3 (fn. 28), section 4.04(10)(b) provides that, 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.

(c) *Potable water.* Section 4.04(10)(c) of this notice provides that, consistent with the Conference Report at 272-3 (fn. 28), production activities with respect to potable water 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. Thus, gross receipts derived from any of these activities performed in the United States are included in DPGR (assuming all other requirements of § 199(c) are met). DPGR does not include, however, gross receipts derived from the storage of potable water after completion of treatment of the potable water, or delivery of potable water to customers. The Service and Treasury Department believe that Congress intended for the provision relating to potable water to apply to water utilities, not to taxpayers engaged in the trade or business of producing bottled water. As a result, for purposes of § 199 the production of bottled water will be treated as the production of tangible personal property under § 199(c)(5)(A) and not the production of potable water under § 199(c)(4)(A)(i)(III). Accordingly, with respect to a taxpayer that produces bottled water in the United States, the gross receipts from which would otherwise qualify as DPGR, DPGR also includes the gross receipts attributable to the distribution of the bottled water and no allocation between the production and distribution of the bottled potable water is required.

(11) *Definition of “construction performed in the United States.”* (a) *Construction of real property.* Section 4.04(11)(a) of this notice defines the term “construction” under § 199(c)(4)(A)(ii) to mean the construction of real property (that is, residential and commercial buildings (including items that are structural components of such buildings), inherently permanent structures other than tangible property in the nature of machinery, inherently permanent land improvements, and infrastructure). Section 4.04(11)(a) makes clear that local law is not controlling for purposes of determining whether or not property is real property for purposes of “construction” under § 199(c)(4)(A)(ii). *See* Conference Report at 271 (fn. 26). Tangible personal property (as defined under section 4.04(8)(b)) (for example, appliances, furniture and fixtures) that is sold as part of a construction project is not considered real property for this purpose. Under section 4.04(11)(a), however, if more than 95 percent of the total gross receipts derived by a taxpayer from a construction project are attributable to real property (as defined in § 1.263A-8(c)), the total gross receipts derived by the taxpayer from the project are DPGR from construction (assuming all other requirements of § 199 are met).

(b) *Activities constituting construction.* The Service and Treasury Department believe the term “construction” includes most activities that are typically performed in connection with the erection or substantial renovation of real property, but does not include tangential services such as hauling trash and debris, and delivering materials, even if the tangential services are essential for construction. However, if a taxpayer performing construction also, in connection with the construction project, provides tangential services such as delivering materials to the construction site and removing its construction debris, the gross receipts derived from such tangential services are DPGR. Improving land (for example, grading and landscaping) and painting are activities that are considered “construction,” but only if they 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 term “construction” does not include any activity that is within the definition of “engineering and architectural services” (see section 4.04(11)(b) of this notice).

(c) *Definition of “infrastructure.”* The term “infrastructure,” for purposes of § 199, includes roads, power lines, water systems, railroad spurs, and communications facilities. See § 168(j)(4)(C)(ii). The term also includes sewers, sidewalks, cable, and wiring. See § 1.263A-12(e)(2)(iii). The term also includes inherently permanent oil and gas platforms.

(d) *Definition of “substantial renovation.”* The Service and Treasury Department believe that the standard to be applied in determining whether there has been a substantial renovation of real property is the standard applied under § 263(a) to determine whether a taxpayer’s activities result in permanent improvements or betterments of property, such that the cost of the activities must be capitalized. Accordingly, consistent with the rules under § 263(a), section 4.04(11)(d) of this notice defines the term “substantial renovation” to mean 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. See § 263(a) and the regulations thereunder.

(e) *“Derived from construction.”* (i) *In general.* Section 199(c)(4)(A)(ii) does not provide that DPGR “derived from construction” performed in the United States are gross receipts derived from “any lease, rental, license, sale, exchange, or other disposition of” property. The Service and Treasury Department believe that gross receipts from the rental of real property that the taxpayer constructs are not derived from construction, but are instead compensation for the use or forbearance of the property. Accordingly, in the case of construction, DPGR does not include gross receipts from the lease or rental of constructed real property. However, DPGR may include the proceeds of a sale, exchange, or other disposition of real property constructed in the United States (whether or not the property is sold immediately after construction is completed) if all other requirements of § 199(c) are met. DPGR also includes compensation received for construction services performed in the United States (assuming all other requirements of § 199(c) are met).

(ii) *Taxpayers deriving gross receipts from construction.* The Service and Treasury Department believe that it is appropriate, in certain situations, for more than one taxpayer to be regarded as deriving gross receipts from construction with respect to the same activity and the same construction project. For example, if X (who is not in the trade or business of construction and is the owner, under federal income tax principles, of a building within the United States) retains Y (a general contractor) to oversee a “substantial renovation” of the building, and Y retains Z (a subcontractor) to install a new electrical system in the building as part of that substantial renovation, the amounts that Y receives from X, and amounts that Z receives from Y, qualify as DPGR. The proceeds that X receives from the subsequent sale of the building do not qualify as DPGR because X did not engage in any activity constituting construction.

(12) *Definition of “engineering and architectural services.”* (a) *In general.* The definitions provided in section 4.04(12) of this notice of the terms “engineering services” and “architectural services” for purposes of § 199(c)(4)(A)(iii) are the same as those provided in § 1.924(a)-1T(e)(5) and -1T(e)(6) without regard to the special rules of § 1.924(a)-1T(e)(2) and -1T(e)(3). Section 199(c)(4)(A)(iii) provides that such services must be performed in the United States for a construction project in the United States. This notice requires that: (1) the engineering or architectural services relate to real property; (2) the services be performed in the United States; and (3) the taxpayer providing these services be able to substantiate that the services relate to a construction project within the United States.

(b) *Performance of services in the United States.* Section 4.04(12)(d) of this notice provides a safe harbor under which, if, in connection with a construction project in the United States, the

gross receipts derived from engineering or architectural services (1) performed outside the United States or (2) related to property other than real property are less than 5 percent of the total gross receipts derived from engineering or architectural services performed by the taxpayer with respect to the same construction project, the receipts will be treated as DPGR derived from engineering or architectural services performed in the United States for a construction project in the United States (assuming all other requirements of § 199(c) are met).

(c) *Construction projects within the United States.* Gross receipts from engineering or architectural services that otherwise would qualify as DPGR will not fail to qualify merely because the construction project planned for the United States ultimately is not undertaken or completed.

(13) *Exception for sales of certain food and beverages.* Under § 199(c)(4)(B), DPGR does not include gross receipts derived from the sale of food and beverages prepared by the taxpayer at a retail establishment. For purposes of this rule, section 4.04(13) of this notice adopts a definition of “retail establishment” that is similar to the definition of “retail space” under § 110 (regarding qualified lessee construction allowances for short-term leases). Under this definition, a retail establishment means real property leased, occupied, or otherwise used by the taxpayer in its trade or business of selling food or beverages to the public and at which the taxpayer makes retail sales. Thus, a taxpayer’s facility is not a retail establishment if the taxpayer only uses the facility to prepare food or beverages for wholesale sale. However, under a safe harbor provided in section 4.04(13), a facility at which food or beverages are prepared will not be treated as a retail establishment if less than 5 percent of the total gross receipts of the taxpayer for the taxable year that are derived from the sale of food or beverages prepared at the facility are attributable to retail sales at the facility. If a taxpayer’s facility is a retail establishment, then as a matter of administrative grace, the Service and Treasury Department will permit the taxpayer to allocate its gross receipts between gross receipts derived from the retail sale of the food and beverages prepared and sold at the retail establishment (which are non-DPGR) and gross receipts derived from the wholesale sale of the food and beverages prepared at the retail establishment (which are DPGR).

.05 *Determining Costs.* (1) *In general.* To determine its QPAI for the taxable year, a taxpayer must reduce its DPGR by the amount of CGS directly allocable to DPGR, the amount of deductions, expenses, and losses (deductions) directly allocable to DPGR and a ratable portion of other deductions not directly allocable to DPGR, or another class of income. Section 199(c)(2) directs the Secretary to prescribe rules for the proper allocation of these items. The legislative history of § 199 indicates that, when appropriate, these rules should be similar to, and consistent with, the relevant cost allocation rules provided by §§ 263A and 861. A taxpayer’s costs must be determined using the taxpayer’s accounting method for federal income tax purposes. Section 4.05 of this notice provides rules for determining CGS directly allocable to DPGR and rules to determine deductions allocated and apportioned to DPGR. Pursuant to the authority granted by § 199(c)(2), the cost determination rules provided in section 4.05 do not differentiate between deductions directly allocable to DPGR under § 199(c)(1)(B)(ii) and other deductions that are not directly allocable to DPGR or another class of gross income under § 199(c)(1)(B)(iii).

(2) *Allocation of cost of goods sold.* Section 4.05(2) of this notice provides rules for determining the CGS directly allocable to DPGR. Generally, CGS must be specifically identified with, or directly traced to, DPGR in accordance with the taxpayer’s books and records. However, if the taxpayer’s books and records do not allow the taxpayer to identify the CGS directly allocable to DPGR, the taxpayer may use a reasonable method to allocate CGS between DPGR and other gross receipts. If a method is used to allocate gross receipts between DPGR and non-DPGR, the taxpayer may not use a different method for purposes of allocating CGS. For purposes of § 199,

CGS includes the cost of inventoriable goods sold during the year as well as the adjusted basis of noninventory property sold or exchanged during the year.

(3) *Allocation and apportionment of deductions.* (a) *Three alternative methods.* Section 4.05 of this notice provides three methods for allocating and apportioning deductions. Under the first method (the § 861 method), which is available to all taxpayers, a taxpayer determines the deductions allocated and apportioned to DPGR by applying the allocation and apportionment rules provided by §§ 1.861-8 through 1.861-17 and §§ 1.861-8T through 1.861-14T (the § 861 regulations) subject to the provisions of this notice. This notice provides special rules for apportioning certain charitable deductions and research and experimentation deductions. The Service and Treasury Department recognize that these allocation and apportionment rules may be burdensome to certain taxpayers that otherwise would not be required to use these rules, particularly for taxpayers that are not currently using the section 861 cost allocation regime. Accordingly, section 4.05 provides two alternative apportionment methods for certain taxpayers, with a goal of minimizing the need for smaller taxpayers to devote additional resources to compliance. Any taxpayer with average annual gross receipts of \$25,000,000 or less may use the simplified deduction method. Under the simplified deduction method, a taxpayer's deductions generally are ratably apportioned between DPGR and other receipts based on relative gross receipts. The Service and Treasury Department invite comments on the appropriateness of the gross receipts threshold for use of the simplified deduction method. Alternatively, a qualifying small taxpayer may use the small business simplified overall method to allocate CGS and deductions to DPGR. A qualifying small taxpayer is a taxpayer that has average annual gross receipts of \$5,000,000 or less or a taxpayer that is eligible to use the cash method as provided in Rev. Proc. 2002-28, 2002-1 C.B. 815. For purposes of the simplified deduction method and the small business simplified overall method, a taxpayer meets the applicable average annual gross receipts test if the average annual gross receipts of the taxpayer for the 3 taxable years (or, if fewer, the taxable years during which the taxpayer was in existence) preceding the current taxable year do not exceed the applicable gross receipts threshold. Preceding taxable years are included even if one or more of such taxable years began before the effective date of § 199. In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts must be annualized by (a) multiplying the gross receipts for the short period by 12 and (b) dividing the result by the number of months in the short period. Whether the members of an EAG may use the simplified deduction method or the small business simplified overall method is determined by reference to the average annual gross receipts of the EAG. To compute the average annual gross receipts of an EAG, the gross receipts of each member of the EAG for its taxable year that ends with or within the taxable year of the member that is computing its § 199 deduction are aggregated, regardless of whether the computing member or the non-computing member was a member of the EAG during its entire taxable year. A member of an EAG that qualifies to use the simplified deduction method or the small business simplified overall method may do so only if all members of the EAG agree to and use the same method.

(b) *Treatment of certain deductions.* Section 4.05(3)(b) of this notice clarifies that certain deductions do not reduce DPGR or gross income attributable to DPGR under any of the three methods. A loss generated by the sale of property reduces DPGR or gross income attributable to DPGR only if the proceeds from the sale of the property are, or would have been, included in DPGR. A deduction allowed under § 172 for a net operating loss is not allocated or apportioned to DPGR or gross income attributable to DPGR. Under § 199(d)(5), deductions not attributable to the actual conduct of a trade or business are not taken into account under § 199 and, therefore, are not allocated or apportioned to DPGR or gross income attributable to DPGR.

.06 *Application of § 199 to Pass-thru Entities.* (1) *In general.* In the case of an S corporation, partnership, estate or trust, or other pass-thru entity, § 199 is applied at the partner, shareholder

or similar level. The Service and Treasury Department believe that Congress intended § 199 to be applied in a manner consistent with the economic arrangement of the owners of a pass-thru entity. The Service and Treasury Department believe that this objective can be accomplished by allowing each owner to compute its § 199 deduction by taking into account its distributive or proportionate share of the items (including items of income, gain, loss, deduction, cost of goods sold allocated to such items of income, and gross receipts that are included in such items of income) allocated or attributable, in accordance with section 4.06 of this notice, to the pass-thru entity's activities described in § 199(c)(4) (qualified production activities), provided the items are not otherwise disallowed by the Code. For purposes of computing the § 199(b) limitation, an owner's share of W-2 wages of a pass-thru entity is the lesser of the owner's allocable share of the pass-thru entity's W-2 wages or 2 times the applicable percentage of the owner's QPAI computed taking into account only the items of the pass-thru entity allocated to the owner for the taxable year. The owner of the pass-thru entity will aggregate its items of income or expense (including W-2 wages) allocated or attributable to the pass-thru entity's qualified production activities, including those expenses incurred by the owner of the pass-thru entity directly that are allocated to the pass-thru entity's qualified production activities, and the owner's items of income or expense (including W-2 wages) allocated or attributable to its other qualified production activities.

(2) *Gain or loss from the disposition of an interest in a pass-thru entity.* Because the sale of an interest in a pass-thru entity does not reflect the realization of QPAI by that entity, QPAI generally does not include gain or loss recognized on the sale, exchange or other disposition of an interest in the entity. However, if § 751(a) or (b) applies, gain or loss allocated to assets of the partnership the sale, exchange, or other disposition of which would give rise to an item of QPAI is taken into account in computing the partner's § 199 deduction.

(3) *Effective date of § 199 for pass-thru entities.* Section 199(e) provides that § 199 applies for taxable years beginning after December 31, 2004. Accordingly, section 4.06(3) of this notice provides that § 199 only applies to taxable years of pass-thru entities that begin on or after January 1, 2005. The Service and Treasury Department recognize that a pass-thru entity will need to provide certain information to its owners to allow those persons to compute the § 199 deduction. The Service and Treasury Department intend to provide rules relating to information reporting by pass-thru entities in future guidance.

.07 *Patrons of Agricultural and Horticultural Cooperatives.* Section 4.07 of this notice provides rules for the application of § 199 to agricultural and horticultural cooperatives and their patrons. The Service and Treasury Department recognize that a cooperative will need to provide certain information to its patrons to allow the patrons to compute the § 199 deduction. The Service and Treasury Department intend to provide rules relating to such information reporting by cooperatives in future guidance.

.08 *Expanded Affiliated Groups.* (1) *In general.* All members of an EAG are treated as a single corporation for purposes of § 199. An EAG is an affiliated group as defined in § 1504(a), determined by substituting "50 percent" for "80 percent" each place it appears, and without regard to § 1504(b)(2) and (4). Therefore, a single § 199 deduction is computed for the EAG and then that deduction is allocated among members of the EAG.

(2) *Computation of expanded affiliated group's § 199 deduction.* (a) *In general.* The Service and Treasury Department believe that the § 199 deduction of the EAG must be computed by aggregating each member's taxable income or loss, QPAI, and W-2 wages. For this purpose, a member's QPAI is the member's DPGR less the sum of the CGS allocable to the receipts and other costs required to be allocated under section 4.05 of this notice. 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.

However, pursuant to § 199(c)(7)(A), a member's DPGR shall not include any gross receipts of the member derived from property leased, licensed, or rented by it for use by any related person as defined in § 199(c)(7)(B).

(b) *Attribution of activities.* For purposes of determining whether gross receipts are DPGR, the Service and Treasury Department believe that each member of an EAG should be treated as conducting the activities conducted by each other member of the EAG. Thus, if Corporation X and Corporation Y are members of the same EAG and X manufactures QPP in the United States and sells the QPP to Y and Y then sells the same item to an unrelated party, X's production activities are attributed to Y. Accordingly, the proceeds of X's sale to Y and Y's sale to the unrelated party are DPGR for X and Y, respectively (assuming all other requirements of § 199 are met).

(c) *Anti-avoidance rule.* Although transactions between members of an EAG are disregarded in computing the EAG's § 199 deduction only to the extent provided in § 199(c)(7), if a transaction between members of an EAG is engaged in or structured with a principal purpose of qualifying for, or modifying the amount of, the § 199 deduction for one or more members of the EAG, adjustments must be made to eliminate the effect of the transaction on the computation of the § 199 deduction.

(3) *Allocation of expanded affiliated group's § 199 deduction.* The EAG's § 199 deduction is allocated among members of the EAG in proportion to each member's QPAI, if any, regardless of whether the EAG member has taxable income or loss for the taxable year and regardless of whether the EAG member has 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.

(4) *Special rules for consolidated groups.* The Service and Treasury Department believe that, for purposes of § 199, if an EAG includes members of a consolidated group (as defined in § 1.1502-1(h)), the members of the consolidated group should be treated as a single member of the EAG. Therefore, if an EAG includes corporations that are members of a consolidated group and corporations that are not members of a consolidated group, in computing the taxable income limitation of the EAG, the consolidated taxable income of the consolidated group, not the separate taxable income of the members of the consolidated group, is taken into account. If all of the members of an EAG are members of the same consolidated group, the consolidated group's § 199 deduction is determined based on the group's consolidated taxable income or loss, not the separate taxable income or loss of its members. The § 199 deduction of a consolidated group (or the § 199 deduction allocated to a consolidated group that is a member of an EAG) must be allocated to the members of the consolidated group in proportion to each consolidated group member's QPAI, if any, regardless of whether the consolidated group member has separate taxable income or loss for the taxable year and regardless of whether the member has W-2 wages for the taxable year. For purposes of allocating the § 199 deduction of a consolidated group among its members, if a consolidated group member has negative QPAI, the QPAI of the member shall be treated as zero.

(5) *Identification of members of the expanded affiliated group.* The Service and Treasury Department believe that whether a corporation is a member of an EAG must be determined on a daily basis. Therefore, a corporation may be a member of an EAG on January 1 but not a member of the EAG on January 2. 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.

(6) *Allocation of income and loss.* A corporation that is a member of an EAG for only a portion of its taxable year must allocate its taxable income or loss, QPAI, and W-2 wages between the portion of the taxable year during which it is a member of the EAG and the portion of the taxable year during which it is not a member of the EAG. In general, this allocation of items must be

made by using the *pro rata* allocation method described in section 4.09(6)(a)(i) of this notice. However, the corporation may elect to use the closing of the books method described in section 4.09(6)(a)(ii). Section 4.09(6)(a)(iii) prescribes rules for the time and manner of making the election to use the closing of the books method.

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

(b) *Closing of the books method.* Under the closing of the books method, taxable income or loss, QPAI, and W-2 wages for the period during which the corporation was a member of the 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.

(7) *Total § 199 deduction for a corporation that is a member of an expanded affiliated group for some or all of its taxable year.* If a corporation is a member of an EAG for its entire taxable year, the corporation's § 199 deduction for the taxable year is the amount of the § 199 deduction of the EAG allocated to the corporation by the EAG. If a corporation is a member of an EAG 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 § 199 deduction for the taxable year is the sum of its § 199 deductions for each portion of the taxable year.

(8) *Computation of § 199 deduction for members of Expanded Affiliated Group with different taxable years.* If members of an EAG have different taxable years, in computing the § 199 deduction of a member (the "computing member"), with respect to each member of the EAG, the computing member is required to take into account the taxable income or loss, QPAI, and W-2 wages that are both (1) attributable to the period during which the member of the EAG and the computing member are both members of the EAG, and (2) taken into account in a taxable year that begins after the effective date of § 199 and ends with or within the taxable year of the computing member with respect to which the § 199 deduction is computed.

SECTION 4. INTERIM GUIDANCE

.01 *In General.* Under § 199(a)(1), a taxpayer may deduct an amount equal to 9 percent (3 percent in the case of taxable years beginning in 2005 and 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of the taxpayer's QPAI (as defined in section 4.03 of this notice) for the taxable year, or the taxpayer's taxable income (determined without regard to § 199) for the taxable year. For purposes of the preceding sentence, the definition of taxable income under § 63 shall apply.

.02 *Wage Limitation.* (1) *Rules of application.* (a) *In general.* Pursuant to § 199(b)(1), the amount of the deduction allowable to the taxpayer under § 199(a) for any taxable year shall not exceed 50 percent of the W-2 wages of the taxpayer. For this purpose, except as provided in section 4.02(1)(c) of this notice, the Forms W-2 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 this purpose and for purposes of section 4.02, employees of the taxpayer are limited to employees of the taxpayer as defined in § 3121(d)(1) and (d)(2) (that is, officers of a corporate taxpayer and employees of the taxpayer under the common law rules). For purposes of § 199(b)(2), the term "taxpayer" means "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 § 3401(d)(1) because of control of the payment of wages (that is, the taxpayer is not the common law employer of the payee of the wages), the payment of wages may not be included in determining W-2 wages of the taxpayer. If the taxpayer is paying wages as an agent of another entity to individuals who are not employees of the taxpayer, the wages may not be included in determining the W-2 wages of the taxpayer.

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

(c) *Application in case of taxpayer with short taxable year.* In the case of a taxpayer with a short taxable year, subject to the rules of section 4.02(1)(a) of this notice, the W-2 wages of the taxpayer for the short taxable year shall include those wages paid during the short taxable year to employees of the taxpayer as determined under the tracking wages method. Under the tracking wages method described in section 4.02(2)(b)(iii), the taxpayer must calculate W-2 wages by tracking wages actually paid during the short taxable year to employees, subject to the modifications that in step (B) only the supplemental unemployment compensation benefits paid during the short taxable year are required to be deducted and that in step (C) of such method only the portions of the amounts reported in Box 12, Codes D, E, F, G, and S actually deferred or contributed during the short taxable year may be included in the W-2 wages.

(d) *Acquisition or disposition of a trade or business (or major portion).* If a taxpayer (a successor) acquires 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), the W-2 wages of each of the successor and predecessor for purposes of computing the § 199 deduction shall be computed pursuant to the rules of this notice, including sections 4.02(1) and 4.02(2) of this notice, regardless of whether the W-2 wages are reported on Forms W-2 furnished by the successor or Forms W-2 furnished by the predecessor.

(e) *Non-duplication rule.* Amounts that are treated as W-2 wages for a taxable year under any method may not be treated as W-2 wages of any other taxable year.

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

(b) *Methods for calculating W-2 wages.* Taxpayers may use one of three methods in calculating W-2 wages. These three methods are subject to the non-duplication rule provided in section 4.02(1)(e) of this notice, and the tracking wages method is subject to the rule provided in section 4.02(1)(c), if applicable.

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

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

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

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

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

(B) Subtract from the total in Step (A) amounts included in Box 1 of Forms W-2 that are not wages for federal income tax withholding purposes and amounts included in Box 1 of Forms W-2 that are treated as wages under § 3402(o) (for example, supplemental unemployment compensation benefits); and

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

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

(A) Total the amounts of wages subject to federal income tax withholding that are paid to employees of the taxpayer for employment by the taxpayer and that are reported on Forms W-2 for the calendar year;

(B) Subtract from the total in Step (A) the supplemental unemployment compensation benefits (as defined in § 3402(o)(2)(A)) that were included in the total in Step A; and

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

.03 *Determining Qualified Production Activities Income.* (1) *In general.* 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 (as defined in section 4.04 of this notice), over (B) the sum of (i) the CGS that are allocable to such receipts (*see* section 4.05), (ii) other deductions, expenses, or losses directly allocable to such receipts (*see* section 4.05), and (iii) a ratable portion of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income (*see* section 4.05). For purposes of § 199, QPAI is determined on an item-by-item basis (and not, for example, on a division-by-division, product line-by-product line, or transaction-by-transaction basis) and is the sum of QPAI derived by the taxpayer from each item. For purposes of this determination, QPAI from each item may be positive or negative. For example, if a taxpayer manufactures a shirt and a hat in the United States, and the QPAI derived from the manufacture of the shirt is \$3 and the QPAI derived from the manufacture of the hat is (\$1), the taxpayer's QPAI is \$2.

(2) *Allocation of gross receipts.* A taxpayer must determine the portion of its gross receipts that are DPGR and the portion of its gross receipts that are not DPGR. For example, if a taxpayer leases, rents, licenses, sells, exchanges, or otherwise disposes of QPP, the gross receipts of which constitute DPGR, and engages in transactions with respect to similar property, the gross receipts of which do not constitute DPGR, the taxpayer must allocate its gross receipts from all the transactions based on a reasonable method that is satisfactory to the Secretary and that accurately identifies the gross receipts that constitute DPGR. Factors taken into consideration in determining whether the method is reasonable include whether the taxpayer uses the most accurate information available; the relationship between the gross receipts and the apportionment 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, state, or foreign income tax purposes; the time, burden, and cost of using various methods; and whether the taxpayer applies the method consistently from year to year. All of a taxpayer's gross receipts are treated as DPGR if less than 5 percent of the taxpayer's total gross receipts are non-DPGR (after application of other *de minimis* safe harbors provided in section 4 of this notice that result in gross receipts being treated as DPGR). If the amount of the taxpayer's gross receipts that do not qualify as DPGR equals or exceeds 5 percent of the total gross receipts, the taxpayer is required to allocate all gross receipts between DPGR and non-DPGR. For example, if a taxpayer only derives gross receipts from the sale of gasoline refined by the taxpayer in the United States and the sale of gasoline the taxpayer acquired (either by purchase or in exchange for gasoline refined by the taxpayer in the United States) from an unrelated party, the taxpayer must allocate its gross receipts between the gross receipts attributable to the gasoline refined by the taxpayer in the United States (that qualify as DPGR assuming all other requirements of § 199 are met) and the taxpayer's gross receipts derived from the resale of the acquired gasoline (that do not qualify as DPGR) if 5 percent or more of the taxpayer's total gross receipts are not from the sale of gasoline refined by the taxpayer in the United States. Similarly, a taxpayer that manufactures the same type of QPP at facilities within the United States and outside the United States must allocate its gross receipts between the receipts from the QPP manufactured in the United States and receipts from the QPP not manufactured in the United States if 5 percent or more of its total gross receipts are non-DPGR.

(3) *Treatment of advance payments.* If a taxpayer recognizes an advance payment for goods, services, use of property, etc., in gross receipts in a taxable year earlier than the taxable year the goods, services, use of property, etc., to which the advance payment relates are delivered, performed, provided, etc., the taxpayer must accurately identify based on a reasonable method that is satisfactory to the Secretary whether the receipts (and corresponding CGS and expenses) qualify as DPGR. *See* section 4.03(2) of this notice for the factors taken into consideration in determining whether the taxpayer's method is reasonable.

.04 *Determining Domestic Production Gross Receipts.* (1) *In general.* Section 199(c)(4)(A) defines DPGR as the gross receipts (as defined in section 4.04(2) of this notice) of the taxpayer that are derived from (as defined in section 4.04(7)):

(a) Any lease, rental, license, sale, exchange, or other disposition of:

(i) QPP (as defined in section 4.04(8)) that is MPGE (as defined in section 4.04(3)) by the taxpayer (as defined in section 4.04(4)) in whole or in significant part (as defined in section 4.04(5)) within the United States (as defined in section of 4.04(6)),

(ii) Any qualified film (as defined in section 4.04(9)) produced by the taxpayer (in accordance with section 4.04(9)), or

(iii) Electricity, natural gas, or potable water (as defined in section 4.04(10)) produced by the taxpayer in the United States (in accordance with section 4.04(10)),

(b) Construction (as defined in section 4.04(11)) performed in the United States (in accordance with section 4.04(11)), or

(c) Engineering or architectural services (as defined in section 4.04(12)) performed in the United States for construction projects in the United States (in accordance with 4.04(12)).

(2) *Definition of “gross receipts.”* The term “gross receipts” means the taxpayer’s receipts for the taxable year that are recognized under the taxpayer’s method of accounting used in that taxable year for federal income tax purposes. 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 § 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 CGS or by the cost of property sold if such property is described in § 1221(a)(1), (2), (3), (4) or (5). Gross receipts do not include the 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 § 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.

(3) *Definition of “manufactured, produced, grown, or extracted.”* (a) *In general.* The terms MPGE in § 199(c)(4)(A)(i)(I) include activities relating to 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 terms also include 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. For example, assume A, B, and C are unrelated taxpayers. A owns grain storage bins in the United States in which it stores for a fee B’s corn that was grown in the United States. B sells its corn to C. C processes B’s corn into corn syrup in the United States. The gross receipts from A’s, B’s, and C’s activities are DPGR from the MPGE of QPP.

(b) *Consistency with § 263A.* A taxpayer that has MPGE QPP for the taxable year should treat itself as a producer under § 263A with respect to the QPP for the taxable year unless the taxpayer is not subject to § 263A under the Code, regulations, or other published guidance. A taxpayer that currently is not properly accounting for its production activities under § 263A, and wishes to change its method of accounting to comply with the producer requirements of § 263A, must follow the procedures of Rev. Proc. 97-27 or Rev. Proc. 2002-9, whichever applies.

(4) *Definition of “by the taxpayer.”* With the exception of the rules provided in section 4.09(2)(b) of this notice applicable to an EAG, if one taxpayer performs a qualifying activity under § 199(c)(4)(A)(i) pursuant to a contract with another party, then only the taxpayer that has the benefits and burdens of ownership of the property under federal income tax

principles during the period the qualifying activity occurs is treated as engaging in the qualifying activity.

(5) *Definition of “in whole or in significant part.”* (a) *In general.* QPP described in § 199(c)(4)(A)(i)(I) must be MPGE in whole or in significant part by the taxpayer within the United States. Except in the case of a related person transaction under § 199(c)(7), DPGR includes all of the taxpayer’s gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP for which the taxpayer MPGE the QPP in whole or in significant part in the United States. For example, if a taxpayer imports QPP that is partially manufactured, the taxpayer completes the manufacture of the QPP in the United States, and the taxpayer’s completion of the manufacturing of the QPP in the United States satisfies the “in significant part” requirement, then the taxpayer’s gross receipts from the sale of the QPP qualify as DPGR (assuming all other requirements of § 199(c) are met). In addition, if a taxpayer manufactures QPP in significant part in the United States and exports the QPP for further manufacture outside the United States, the taxpayer’s gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of that 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 (assuming all other requirements of § 199(c) are met). If a taxpayer enters into a contract with another party and the taxpayer has the benefits and burdens of ownership of the QPP under federal income tax principles during the period the MPGE activity occurs and the taxpayer is considered to MPGE the QPP under § 199, then the taxpayer must determine whether the MPGE performed by the other party on behalf of the taxpayer is performed in whole or in significant part within the United States.

(b) *Substantial in nature.* QPP will be treated as MPGE in significant part by the taxpayer within the United States if the MPGE of the QPP performed by the taxpayer within the United States is substantial in nature taking into account all the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer’s MPGE activity in the United States, the nature of the property, and the nature of the MPGE activity that the taxpayer performs in the United States. For example, if property is MPGE by the taxpayer outside the United States or by an unrelated party within the United States and the property is used as a component part of the QPP produced by the taxpayer within the United States, the QPP (including the component part) will be treated as MPGE in significant part by the taxpayer within the United States if the production of the QPP performed by the taxpayer within the United States is substantial in nature. In addition, if a taxpayer purchases unrefined oil extracted outside the United States by an unrelated party and the taxpayer refines the oil in the United States, the refining of the oil by the taxpayer in the United States will be treated as MPGE that is substantial in nature within the United States. However, packaging, repackaging, labeling, and minor assembly operations do not qualify as substantial in nature. In addition, development activities and the creation or licensing of intangibles do not qualify as substantial in nature for any QPP other than computer software and sound recordings.

(c) *Safe harbor.* A taxpayer will be treated as having MPGE property in whole or in significant part within the United States if, in connection with the property, conversion costs (direct labor and related factory burden) to MPGE the property are incurred by the taxpayer within the United States and the costs account for 20 percent or more of the total CGS of the property. For purposes of this safe harbor, development costs and the cost of any intangibles do not qualify as conversion costs for any QPP other than computer software and sound recordings. In addition, the costs of packaging, repackaging, labeling, and minor assembly operations do not qualify as conversion costs.

(6) *Definition of “United States.”* For purposes of § 199, 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 over the United States and these areas.

(7) *Definition of “derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property.”* (a) *In general.* The term “derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property” is defined as, and limited to, the gross receipts directly from the lease, rental, license, sale, exchange, or other disposition of QPP. For example, “derived from the sale of QPP” includes gross receipts from the sale of QPP manufactured in whole or in significant part in the United States by a taxpayer for sale, as well as gross receipts from the sale of self-constructed QPP manufactured in whole or in significant part in the United States by a taxpayer and used in the taxpayer’s trade or business before being sold. In addition, the proceeds from business interruption insurance and payments not to produce are treated as gross receipts “derived from the lease, rental, license, sale, exchange, or other disposition of QPP” to the extent that they are substitutes for gross receipts that would qualify as DPGR. The value of property received in an exchange of QPP that was MPGE by the taxpayer for QPP that was MPGE by an unrelated taxpayer is DPGR for the taxpayer. The value of property acquired by a taxpayer in exchange for QPP is gross receipts derived from an exchange of the QPP, and is DPGR if the QPP was MPGE by the taxpayer in whole or in significant part within the United States. However, any gross receipts from the subsequent sale by the taxpayer of the property that the taxpayer acquired in the exchange are not DPGR, because the taxpayer did not MPGE the property acquired in the exchange, even if that property is QPP that had been MPGE within the United States by the other party to the exchange.

(b) *Allocation of gross receipts — embedded services.* Except with respect to construction or engineering or architectural services described in § 199(c)(4)(ii) and (iii), gross receipts “derived from” the performance of services do not qualify as DPGR. In the case of an embedded service, that is, a service the price of which is included in the amount charged for the lease, rental, license, sale, exchange, or other disposition of property, DPGR includes only the receipts from the lease, rental, license, sale, exchange, or other disposition of the property and not any receipts attributable to the embedded service (assuming all other requirements of § 199(c) are met). There are two exceptions to this general rule regarding embedded services. First, a taxpayer may include in DPGR (assuming all other requirements of § 199(c) are met) gross receipts from a qualified warranty (that is, a warranty that is provided in connection with the sale of QPP if (1) in the normal course of its business, the charge for the warranty is included in the price charged for the lease, rental, license, sale, exchange, or other disposition of the QPP and (2) the warranty is neither separately offered by the taxpayer nor separately bargained for with the customer (that is, the customer cannot purchase the QPP without the warranty)). Second, a *de minimis* amount of gross receipts from embedded services for each item of property may qualify as DPGR. A *de minimis* amount of gross receipts from embedded services is less than 5 percent of the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the property. For purposes of applying this *de minimis* test, gross receipts from qualified warranties are not treated as gross receipts for services.

(c) *Advertising income.* Gross receipts that are “derived from” the sale or other disposition of newspapers and magazines include advertising income. For example, a newspaper manufacturer’s gross receipts from an advertiser to publish display advertising or classified advertisements in its newspaper are treated as gross receipts derived from the sale of the newspapers (assuming all other requirements of § 199 are met).

(d) *Computer software.* Gross receipts derived from computer software (as defined in section 4.04(8)(c)) do not include gross receipts derived from Internet access services, online services, customer support, telephone services, games played through a website, provider-controlled software online access services, and other services that do not constitute the lease, rental, license, sale, exchange, or other disposition of computer software that was developed by the taxpayer.

(e) *Exception for certain oil and gas partnerships.* If a partnership is engaged solely in the extraction, refining, processing, etc., of oil or gas and distributes the oil or gas or products derived from the oil or gas (products) to its partners who then sell the oil or gas or products, then, for purposes of § 199, the gross receipts derived by the partners from the sale of the oil or gas or products are treated as gross receipts derived by the partnership from the MPGE of QPP. The partnership must follow the rules provided in section 4.06 of this notice regarding the application of § 199 to pass-thru entities to ensure that the costs attributable to oil or gas or products are properly taken into account.

(8) *Definition of “qualifying production property.”* (a) In general. Qualifying production property includes: (1) tangible personal property, as defined in section 4.04(8)(b); (2) computer software, as defined in section 4.04(8)(c); and (3) sound recordings, as defined in section 4.04(8)(d).

(b) *Tangible personal property.* The term “tangible personal property” is any tangible property other than land, buildings, (including items that are structural components of such buildings) and any property described under § 199(c)(4)(A)(i)(II) and (III), or § 199(c)(5)(B) and (C). Thus, qualified films, computer software, and sound recordings are not tangible personal property regardless of whether they are fixed on a tangible medium. However, the tangible medium on which the property is fixed (for example, a videocassette, a computer diskette, or other similar tangible item) is tangible personal property. In determining whether property is “tangible personal property,” the fact that property is personal property or tangible property under local law is not controlling. Conversely, property may be tangible personal property for purposes of § 199(c)(5)(A) even though under local law the property is considered a fixture and therefore real property. Thus, property such as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs that is contained in or attached to a building constitutes tangible personal property for purposes of § 199(c)(5)(A). Further, property that is in the nature of machinery (other than structural components of a building) is tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, is considered tangible personal property. A structure that is property in the nature of machinery or is essentially an item of machinery or equipment is not an inherently permanent structure and is tangible personal property. In the case, however, of a building or inherently permanent structure that includes property in the nature of machinery as a structural component, the property in the nature of machinery is real property. The term “tangible personal property” does not include the creation of copyrighted material such as a manuscript in a form other than in a tangible medium.

(c) *Computer software.* 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. Computer software also includes the machine-readable coding for video games and similar programs, regardless of whether the program is designed to operate on a “computer” (as defined in § 168(i)(2)(B)). 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 § 199. Therefore, if a taxpayer develops a software program that it reproduces and sells on diskettes, the program fixed on the diskette is treated as computer

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

(d) *Sound recordings.* The term "sound recordings" means any works that result from the fixation of a series of musical, spoken, or other sounds. If the medium (such as compact discs, tapes, or other phonorecordings) in which the sounds are embodied is tangible, the medium is considered tangible personal property for purposes of § 199. Therefore, the sale of an audio cassette involves both a sound recording (the sounds fixed on the tape) and tangible personal property (the cassette itself). See section 4.04(8)(c) of this notice. 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 written on paper or other similar material.

(9) *Definition of "qualified film."* (a) *In general.* The term "qualified film" means any motion picture film, video tape, or live or delayed television programming if not less than 50 percent of the total compensation relating to the production of the property is compensation for services performed in the United States by actors, production personnel, directors, and producers. The term "production personnel" includes writers, choreographers and composers providing services during the production of a film, casting agents, camera operators, set designers, lighting technicians, make-up artists, and others whose activities are directly related to the production of the film. "Production personnel" do not include, however, individuals whose activities are ancillary to the production, such as advertisers and promoters, distributors, studio administrators and managers, studio security personnel, and personal assistants to actors. If the medium on which a qualified film is fixed is tangible (such as a DVD), such medium is treated as tangible personal property. Therefore, a DVD copy of a motion picture consists of both a qualified film (the motion picture content embodied in the disc) and tangible personal property (the disc itself).

(b) *Compensation for services.* The term "compensation for services" means all payments for services performed by actors, production personnel, directors, and producers, including participations and residuals. In the case of a taxpayer that uses the income forecast method of § 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 purposes of § 199 that it uses for purposes of § 167(g). In the case of a taxpayer that excludes participations and residuals from adjusted basis of the qualified film under § 167(g)(7)(D)(i), the taxpayer must determine the compensation expected to be paid as participations and residuals based on the total forecasted income used in determining income forecast depreciation.

(c) *Determination of 50 percent.* A taxpayer may use any reasonable method of making the allocation. 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.

(d) *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 (1) contains one or more visual depictions made after November 1, 1990, of actual sexually explicit conduct and (2) 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.

(10) *Electricity, natural gas, and potable water.* (a) *In general.* DPGR includes gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States (assuming all other requirements of § 199(c) are met). DPGR does not include gross receipts of the taxpayer derived from the transmission or distribution of these items.

(b) *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.

(c) *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 (assuming all other requirements of § 199(c) are met). DPGR does not include, however, gross receipts derived from the storage of potable water after completion of treatment of the potable water, or delivery of potable water to customers.

(d) *Exceptions.* In the case of an integrated producer that both produces and delivers electricity, natural gas, or potable water, the taxpayer must allocate its gross receipts between production (DPGR) and distribution and transmission (non-DPGR). However, if less than 5 percent of a taxpayer's gross receipts derived from a sale of electricity, natural gas, or potable water are attributable to the transmission or distribution of the electricity, natural gas, or potable water, then the gross receipts derived from that sale that are attributable to the transmission and distribution of the electricity, natural gas, or potable water will be treated for purposes of § 199 as being DPGR (assuming all other requirements of § 199(c) are met).

(i) *Electricity.* Gross receipts attributable to the transmission of electricity from the generating facility to a point of local distribution and gross receipts attributable to the distribution of electricity to final customers are not DPGR.

(ii) *Natural gas.* Gross receipts attributable to the transmission of pipeline quality gas from a natural gas field (or from a natural gas processing plant) to a local distribution company's citygate (or to another customer) are not DPGR. Likewise, gross receipts of a local gas distribution company attributable to distribution from the citygate to the local customers are not 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 not DPGR.

(11) *Definition of "construction performed in the United States."* (a) Construction of real property. The term "construction" means the construction or erection of real property (that is, residential and commercial buildings (including items that are structural components of such buildings), inherently permanent structures other than tangible personal property in the nature of

machinery (*see* section 4.04(8)(b) of this notice), inherently permanent land improvements, and infrastructure) by a taxpayer that is in a trade or business that is considered construction for purposes of the North American Industry Classification System (NAICS codes). Tangible personal property (as defined under section 4.04(8)(b)) (for example, appliances, furniture and fixtures) that is sold as part of a construction project is not considered real property for this purpose. However, if more than 95 percent of the total gross receipts derived by a taxpayer from a construction project are derived from real property (as defined in § 1.263A-8(c)), then the total gross receipts derived by the taxpayer from the project are DPGR from construction (assuming all other requirements of § 199(c) are met). 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 § 199(c)(4)(A)(ii) even though under local law the property is considered tangible personal property.

(b) *Activities constituting construction.* Activities constituting construction include activities performed in connection with a project to erect or substantially renovate real property, but do not include tangential services such as hauling trash and debris, and delivering materials, even if the tangential services are essential for construction. However, if the taxpayer performing construction also, in connection with the construction project, provides tangential services such as delivering materials to the construction site and removing its construction debris, the gross receipts derived from the tangential services are DPGR. Improving land (for example, grading and 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. The taxpayer engaged in these activities must make a reasonable inquiry to determine whether the activity relates to the erection or substantial renovation of real property. The term “construction” does not include any activity that is within the definition of “engineering and architectural services” (*see* section 4.04(12) of this notice).

(c) *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.

(d) *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.

(e) *“Derived from construction.”* Assuming all other requirements of § 199(c) 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). DPGR derived from the construction of real property also includes compensation for the performance of construction services by the taxpayer in the United States. However, DPGR derived from the construction of real property does not include gross receipts from the lease or rental of real property constructed by the taxpayer or gross receipts attributable to the sale or other disposition of land.

(12) *Definition of “Engineering and architectural services.”* (a) *In general.* DPGR includes gross receipts derived from engineering or architectural services performed in the United States for construction projects in the United States (assuming all other requirements of § 199(c) are met). The engineering or architectural services must relate to real property, must be performed in the United States, and the taxpayer providing these services must be able to substantiate that the services relate to a construction project within the United States. DPGR includes gross receipts derived from engineering or architectural services even if the planned construction project is not

undertaken or is not completed (subject to the taxpayer substantiating that the services relate to a construction project that would have been within the United States if it had been undertaken and assuming all other requirements of § 199(c) are met).

(b) *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.

(c) *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.

(d) *De minimis exception for performance of services in the United States.* If gross receipts derived from engineering or architectural services (1) performed outside the United States or (2) related to property other than real property for a construction project inside the United States total less than 5 percent of the total gross receipts of the taxpayer derived from engineering or architectural services performed by the taxpayer with regard to the same construction project, such receipts will be treated as DPGR.

(13) *Exception for sales of certain food and beverages.* 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 real property leased, occupied, or otherwise used by the taxpayer in its trade or business of selling food or beverages to the public at which retail sales are made. A facility at which food or beverages are prepared will not be treated as a retail establishment if less than 5 percent of the food or beverages that are sold at that facility during the taxable year are retail sales. If a taxpayer’s facility is a retail establishment, then, as a matter of administrative grace, the taxpayer may allocate its gross receipts between gross receipts derived from the retail sale of the food and beverages prepared and sold at the retail establishment (which are non-DPGR) and gross receipts derived from the wholesale sale of the food and beverages prepared at the retail establishment (which are DPGR). The exception for sales of certain food and beverages also applies to food and beverages for non-human consumption.

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

.05 *Determining Costs.* (1) *In general.* To determine its QPAI for the taxable year, a taxpayer must reduce its DPGR by the amount of CGS directly allocable to DPGR, the amount of deductions directly allocable to DPGR and a ratable portion of other deductions not directly allocable to DPGR, or another class of income. Section 4.05(2) of this notice provides rules for determining CGS directly allocable to DPGR. Section 4.05(3) provides rules for determining the deductions allocated and apportioned to DPGR and a ratable portion of deductions not directly allocable to DPGR or another class of income. Section 4.05(3) generally provides that a taxpayer must determine deductions allocated and apportioned to DPGR using the rules of the regulations under § 861 of the Code. Section 4.05(3) provides, however, that a taxpayer with average annual gross receipts of \$25,000,000 or less may determine deductions apportionable to DPGR using the simplified deduction method. Section 4.05(4) provides a simplified overall method that a qualifying small taxpayer may use to allocate and apportion CGS and deductions to DPGR.

Consistent with the rule in section 4.09(1) that treats all members of an EAG as a single corporation for purposes of § 199, whether the members of an EAG may use the simplified deduction method or the small business simplified overall method is determined at the EAG level. In addition, a member of an EAG that may use the simplified deduction method or the small business simplified overall method may do so only if all members of the EAG agree to and use the same method.

(2) *Cost of goods sold allocable to domestic production gross receipts.* (a) *In general.* Section 199(c)(1)(B)(i) requires a taxpayer to reduce DPGR by the CGS directly allocable to DPGR. A taxpayer must allocate CGS in accordance with this section 4.05(2) of this notice or, if applicable, section 4.05(4). CGS is equal to beginning inventory plus purchases and production costs incurred during the taxable year less ending inventory. For purposes of § 199, CGS allocable to DPGR includes the costs that would have been included in ending inventory under the principles of §§ 263A, 471, and 472 if the goods sold during the taxable year were on hand at the end of the taxable year. CGS allocable to DPGR includes inventory valuation adjustments such as writedowns under the lower of cost or market method. For purposes of § 199, CGS also includes the adjusted basis of noninventory property, the gross receipts from the sale or other disposition of which are included in DPGR.

(b) *Allocating cost of goods sold.* If a taxpayer can identify from its books and records CGS allocable to DPGR, CGS allocable to DPGR is that amount. However, if a taxpayer's books and records do not allow the taxpayer to identify CGS allocable to DPGR, the taxpayer must use a reasonable method to allocate CGS between DPGR and other gross receipts. If a taxpayer uses a method to allocate gross receipts between DPGR and non-DPGR, the taxpayer may not use a different method for purposes of allocating CGS. In other cases, whether an allocation method is reasonable is based on all of the facts and circumstances including the relationship between CGS and the 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 and other business purposes; whether the method is used for other federal or state income tax purposes; the availability of costing information; and the time, burden, and cost of using various methods. 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.

(c) *Special rules for imported items or services.* Under § 199(c)(3), the cost of any item or service brought into the United States is treated as not less than its value immediately after it entered the United States for purposes of determining the CGS to be used in the computation of QPAI. When an item or service is brought 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 brought back into the United States after further manufacture. For this purpose, the value of property is its customs value as defined in § 1059A(b)(1).

(3) *Other deductions allocable or apportionable to domestic production gross receipts.* (a) *In general.* Section 199(c)(1)(B)(ii) and (iii) requires a taxpayer to reduce DPGR by deductions that are directly allocable to DPGR, and a ratable portion of deductions that are not directly allocable to DPGR or another class of income. Any cost that may not be taken into account in computing taxable income for the taxable year is not treated as a deduction for purposes of this section. A taxpayer generally must allocate and apportion these deductions using the rules provided in the § 861 regulations, subject to the rules provided in this section 4.05(3) (the § 861 method). In lieu of the § 861 method, a taxpayer with average annual gross receipts of \$25,000,000 or less may apportion these deductions using the simplified deduction method. A taxpayer electing the simplified deduction method must use that method for all deductions. See also section 4.05(4) for the small business simplified overall method available to a qualified small taxpayer.

(b) *Rules that apply to all allocation and apportionment methods.* (i) *In general.* The rules provided in section 4.05(3)(b)(ii) through (v) apply to losses, net operating losses, and certain other deductions when allocating and apportioning deductions to DPGR or gross income attributable to DPGR under the § 861 method (section 4.05(3)(c)), the simplified deduction method (section 4.05(3)(d)), or the small business simplified overall method (section 4.05(4)).

(ii) *Losses.* A deduction under § 165 for a loss related to property (including theft, casualty, or abandonment losses) is allocated or apportioned to DPGR or gross income attributable to DPGR only if the proceeds from the sale of the property are, or would have been, included in DPGR.

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

(iv) *Deductions not attributable to the actual conduct of a trade or business.* Deductions not attributable to the actual conduct of a trade or business are not allocated or apportioned to DPGR or gross income attributable to DPGR. *See* § 199(d)(5). For example, the standard deduction provided by § 63(c) and the deduction for personal exemptions provided by § 151 are not allocated or apportioned to DPGR or gross income attributable to DPGR.

(v) *Deductions related to de minimis gross receipts and embedded services included in domestic production gross receipts.* If a taxpayer is permitted to treat non-DPGR as DPGR pursuant to a safe harbor or *de minimis* rule provided in this notice (e.g., section 4.03(2) or section 4.04(10)(d) of this notice), deductions related to such non-DPGR treated as DPGR must be allocated or apportioned to DPGR or gross income attributable to DPGR. If the gross receipts related to embedded services are included in DPGR under section 4.04(7), the deductions related to providing such services must be allocated or apportioned to DPGR or gross income attributable to DPGR.

(c) *Section 861 method.* (i) *In general.* A taxpayer must allocate and apportion its deductions using the allocation and apportionment rules provided by the § 861 regulations, subject to the modifications provided in section 4.05(3)(b)(ii) through (v) and section 4.05(3)(c)(ii) and (iii) of this notice. Under this method, § 199 is treated as an “operative section” described in § 1.861-8(f). Accordingly, the taxpayer applies the rules of the § 861 regulations to allocate and apportion deductions (including its distributive shares of deductions) to gross income attributable to DPGR. Generally, the taxpayer allocates deductions to the relevant class of gross income and apportions (if necessary) such deductions within the class of gross income between gross income attributable to DPGR (the statutory grouping) and other income (the residual grouping). The § 861 regulations generally are applied on a single entity basis, although the rules are applied on the basis of the affiliated group (as determined under the § 861 regulations) for certain expenses such as interest expense and research and experimental expenses. Consistent with these rules, allocation and apportionment of deductions generally are determined on an aggregate basis by the owner of the pass-thru entity. *See* for example, §§ 1.861-9T(e) and -17(f). If the taxpayer uses the allocation and apportionment rules of the § 861 regulations for another operative section of the Code, it must use the same method of allocation and the same principles for apportionment for purposes of all operative sections (subject to, in the case of the § 861 method, the rules provided in section 4.05(3)(b)(ii) through (v) and section 4.05(3)(c)(ii) and (iii) of this notice). *See* § 1.861-8(f)(2)(i).

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

(iii) *Research and experimental expenditures.* Research and experimental expenditures must be allocated and apportioned in accordance with § 1.861-17. Because an apportionment based on

geographic sources is not required for purposes of § 199, the exclusive apportionment rule of § 1.861-17(b) does not apply for purposes of the § 861 method.

(d) *Simplified deduction method.* A taxpayer with average annual gross receipts (as defined in section 4.05(5) of this notice) of \$25,000,000 or less may use the simplified deduction method. Under the simplified deduction method, except as provided in section 4.05(3)(b) of this notice, a taxpayer's deductions are ratably apportioned between DPGR and non-DPGR based on relative gross receipts. Accordingly, the amount of deductions apportioned to DPGR is equal to the same proportion of the deductions that the amount of DPGR bears to total gross receipts. In the case of an owner of a pass-thru entity, the simplified deduction method (including whether the method may be used) is applied at the level of the owner of the pass-thru entity taking into account the owner's DPGR, receipts, and other items from all sources including its distributive or allocable share of those items of the pass-thru entity.

(4) *Small business simplified overall method.* (a) *In general.* A qualifying small taxpayer may use the small business simplified overall method to allocate and apportion CGS and deductions between DPGR and non-DPGR. Under the small business simplified overall method, a taxpayer's total CGS and deductions (except as provided in section 4.05(3)(b) of this notice) are ratably apportioned between DPGR and other receipts based on relative gross receipts. Accordingly, the amount of CGS and deductions apportioned to DPGR is equal to the same proportion of CGS and deductions that the amount of DPGR bears to total gross receipts.

(b) *Qualifying small taxpayer.* For purposes of section 4.05(4)(a) of this notice, a qualifying small taxpayer is a taxpayer that has average annual gross receipts (as described in section 4.05(5) of this notice) of \$5,000,000 or less or a taxpayer that is eligible to use the cash method as provided in Rev. Proc. 2002-28, 2002-1 C.B. 815. (That is, any taxpayer with average annual gross receipts of \$10,000,000 or less that is not prohibited from using the cash method under § 448, including a partnership, an S corporation, a C corporation, or an individual.)

(5) *Average annual gross receipts.* For purposes of the simplified deduction method in section 4.05(3)(d) of this notice and the small business simplified overall method in section 4.05(4), average annual gross receipts means the average annual gross receipts of the taxpayer for the 3 taxable years (or, if fewer, the taxable years during which the taxpayer was in existence) preceding the current taxable year, even if one or more of such taxable years began before the effective date of § 199. In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts shall be annualized by (a) multiplying the gross receipts for the short period by 12 and (b) dividing the result by the number of months in the short period. Whether the members of an EAG may use the simplified deduction method or the small business simplified overall method is determined by reference to the average annual gross receipts of the EAG. To compute the average annual gross receipts of an EAG, the gross receipts of each member of the EAG for its taxable year that ends with or within the taxable year of the computing member (as defined in section 4.09(8) of this notice) are aggregated, regardless of whether the computing member or the non-computing member was a member of the EAG during its entire taxable year. A member of an EAG that qualifies to use the simplified deduction method or the small business simplified overall method may do so only if all members of the EAG agree to and use the same method.

.06 *Application of § 199 to Pass-thru Entities.* (1) *Allocations to partners, shareholders, and similar interest holders.* (a) *Partnerships.* (i) *Determination at partner level.* The § 199 deduction is determined at the partner level. As a result, each partner must compute its deduction separately. Each partner is allocated, in accordance with §§ 702 and 704, its share of items (including items of income, gain, loss, deduction, cost of goods sold allocated to such items of income, and gross receipts that are included in such items of income) allocated or attributable to the partnership's activities described in § 199(c)(4) (qualified production activities), along with

any other items of income, gain, loss, deduction or credit of the partnership. To determine its § 199 deduction for the taxable year, a partner aggregates its share of the items allocated or attributable to the partnership's qualified production activities, any expenses incurred by the partner directly that are allocated to the partnership's qualified production activities, and those items of the partner that are allocated or attributable to qualified production activities from sources other than the partnership. A partnership may specially allocate items of income, gain, loss, or deduction allocated or attributable to the partnership's qualified production activities, subject to the rules of § 1.704-1(b), including the rules for determining substantial economic effect under § 1.704-1(b)(2)(iii).

(ii) *Expenses*. Each partner must take into account the partner's distributive share of expenses allocated to the qualified production activities of the partnership, regardless of whether the partnership otherwise has taxable income. However, expenses of a partnership that otherwise would be taken into account for purposes of computing the partner's § 199 deduction shall only be taken into account if and to the extent the partner's distributive share of the losses and deductions from all of the partnership's activities is not disallowed by §§ 465, 469, 704(d), or any other provision of the Code. In the event that only a portion of the partner's distributive share of the losses or deductions are allowed for a taxable year, a proportionate share of the losses or deductions that reflect expenses allocated to the partnership's qualified production activities, determined in a manner consistent with §§ 465, 469 and 704(d), shall be taken into account for purposes of computing the § 199 deduction for that taxable year. To the extent that any of the disallowed losses or deductions are allowed in a later taxable year, the partner shall take into account a proportionate share of the expenses reflected in those losses or deductions in computing its QPAI for that later taxable year.

(iii) *W-2 wages*. Under § 199(d)(1)(B), a partner's share of W-2 wages of the partnership for purposes of determining the partner's § 199(b) limitation is the lesser of the partner's allocable share of the wages (without regard to § 199(d)(1)(B)) as determined under regulations prescribed by the Secretary, or 2 times 9 percent (3 percent in the case of taxable years beginning in 2005 and 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the QPAI computed taking into account only the items of the partnership allocated to the partner for the taxable year of the partnership. In determining a partner's share of the W-2 wages of a partnership, allocations by the partnership of W-2 wages, otherwise meeting the requirements of § 704(b), shall be taken into account by the partner for purposes of § 199(d)(1)(B). Thus, a partner's share of W-2 wages of the partnership is the lesser of the amount of W-2 wages allocated to the partner under § 704, or 2 times the applicable percentage of the QPAI computed taking into account only the items of the partnership allocated to the partner for the taxable year of the partnership, determined at the partner level, in accordance with section 4.06(1)(a)(i) and (ii), by reference to the partner's distributive or allocable share of the partnership's items of income, gain, loss or deduction (including gross receipts and costs of goods sold), allocated or attributable to qualified production activities, and expenses incurred directly by the partner which are allocated to the partnership's qualified production activities, for the taxable year. Each partner must aggregate the W-2 wages allocated from the partnership with its W-2 wages from other sources for purposes of computing the partner's § 199(b) limitation for the taxable year. However, if QPAI computed taking into account only the items of the partnership allocated to the partner for the taxable year is not greater than zero, the partner may not take into account any W-2 wages of the partnership for purposes of computing the wage limitation under § 199(b) for the taxable year.

(b) *S corporations*. (i) *Determination at S corporation shareholder level*. The § 199 deduction is determined at the shareholder level. As a result, each shareholder must compute its deduction separately. Each shareholder is allocated, in accordance with § 1366, its *pro rata* share of items

(including items of income, gain, loss, and deduction) allocated or attributable to the qualified production activities of the S corporation. To the extent that such items represent items relevant to the computation of the § 199 deduction (for example, DPGR, CGS, other items allocable to DPGR, or W-2 wages of the S corporation), the shareholder will take such items into account in computing its § 199 deduction. To compute its § 199 deduction for the taxable year, the shareholder will aggregate its *pro rata* share of items allocated or attributable to the S corporation's qualified production activities, and those items of the shareholder that are allocated or attributable to qualified production activities from sources other than the S corporation.

(ii) *Expenses*. Each shareholder must take into account its *pro rata* share of expenses allocated to the qualified production activities of the S corporation, regardless of whether the S corporation otherwise has taxable income. However, expenses of the S corporation that otherwise would be taken into account for purposes of computing the shareholder's § 199 deduction shall only be taken into account if and to the extent the shareholder's *pro rata* share of the losses or deductions from all of the S corporation's activities are not disallowed by §§ 465, 469, 1366(d), or any other provision of the Code. In the event that only a portion of the shareholder's *pro rata* share of the losses or deductions is allowed for a taxable year, a proportionate share of the losses or deductions that reflect expenses allocated to the S corporation's qualified production activities, determined in a manner consistent with §§ 465, 469, and 1366(d), shall be taken into account for purposes of computing the § 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 shareholder shall take into account a proportionate share of the expenses reflected in those losses or deductions in computing its QPAI for that later taxable year.

(iii) *W-2 wages*. Under § 199(d)(1)(B), an S corporation shareholder's share of W-2 wages of the S corporation for purposes of determining the shareholder's § 199(b) limitation is the lesser of the shareholder's allocable share of the wages (without regard to § 199(d)(1)(B)) as determined under regulations prescribed by the Secretary, or 2 times 9 percent (3 percent in the case of taxable years beginning in 2005 and 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the QPAI computed taking into account only the items of the S corporation allocated to the shareholder for the taxable year. Each shareholder must aggregate the W-2 wages allocated from the S corporation with its W-2 wages from other sources for purposes of computing its § 199(b) limitation for the taxable year. However, if the shareholder is not allocated positive QPAI computed taking into account only the items of the S corporation allocated to the shareholder for the taxable year, the shareholder may not take into account any W-2 wages of the S corporation for purposes of computing the wage limitation under § 199(b) for the taxable year.

(2) *Gain or loss from the disposition of an interest in a pass-thru entity*. QPAI generally does not include gain or loss recognized on the sale, exchange, or other disposition of an interest in the entity. However, if § 751(a) or (b) applies, gain or loss allocable to assets of the partnership the sale, exchange, or other disposition of which would give rise to QPAI is taken into account in computing the partner's § 199 deduction.

(3) *Effective date of § 199 for pass-thru entities*. Section 199(e) provides that § 199 applies for taxable years beginning on or after January 1, 2005. Accordingly, § 199 does not apply to taxable years of pass-thru entities that begin before January 1, 2005. For example, assume a pass-thru entity has a taxable year beginning July 1, 2004, and ending June 30, 2005, and the owners of the pass-thru entity have taxable years beginning January 1, 2005, and ending December 31, 2005. The provisions of § 199 do not apply to the pass-thru entity until the first date of its first taxable year beginning on or after January 1, 2005. Thus, § 199 applies to the pass-thru entity for its taxable year beginning July 1, 2005. The owners of the pass-thru entity include their allocable or *pro rata* share of items allocated or attributable to the qualified production activities of the

pass-thru entity, for purposes of determining their respective § 199 deductions for their taxable years ending December 31, 2006.

.07 Patrons of Agricultural and Horticultural Cooperatives. Section 199(d)(3) and this section 4.07 apply in the case of a cooperative (to which Part I of Subchapter T applies), that is engaged in (1) the MPGE in whole or in significant part of any agricultural or horticultural product, or (2) the marketing of agricultural or horticultural products. Under § 199(d)(3) and this section, if any amount of a patronage dividend or qualified per-unit retain allocation paid in qualified per-unit retain certificates described in § 1385 is received by a patron from such a cooperative, and such amount is allocable to QPAI of the cooperative that is deductible under § 199(a) and section 4.01 of this notice by the cooperative, then the amount is deductible from the gross income of the patron. Such an amount, however, does not reduce the taxable income of the cooperative under § 1382. In order for the member to qualify for the deduction, § 199(d)(3)(A)(ii) requires the cooperative to designate the patron's portion of the income allocable to QPAI of the organization in a written notice mailed by the cooperative to its patron during the payment period described in § 1382(d) (that is, no later than the 15th day of the ninth month following the close of the taxable year). In determining the portion of the cooperative's QPAI that would be deductible by the cooperative under § 199(a) and section 4.01, the cooperative's taxable income is computed without taking into account any deduction allowable under § 1382(b) or (c) relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions and, in the case of a cooperative engaged in the marketing of agricultural and horticultural products, the cooperative is treated as having MPGE in whole or in significant part any QPP marketed by the cooperative that its patrons have MPGE. For purposes of § 199, agricultural or horticultural products also include fertilizer, diesel fuel and other supplies used in agricultural or horticultural production that are MPGE by the cooperative.

.08 Individuals. In the case of individuals, § 199(d)(2) provides that the deduction is equal to the applicable percent of the lesser of the taxpayer's (1) QPAI for the taxable year, or (2) adjusted gross income (AGI) for the taxable year determined after applying §§ 86, 135, 137, 219, 221, 222, and 469, and without regard to § 199.

.09 Expanded Affiliated Groups. (1) *In general.* All members of an EAG are treated as a single corporation for purposes of § 199. An EAG is an affiliated group as defined in § 1504(a), determined by substituting "50 percent" for "80 percent" each place it appears, and without regard to § 1504(b)(2) and (4).

(2) *Computation of expanded affiliated group's § 199 deduction.* (a) *In general.* The § 199 deduction for an EAG is determined by aggregating each member's taxable income or loss, QPAI, and W-2 wages. For this purpose, a member's QPAI is the member's DPGR less the sum of the CGS allocable to such receipts and other costs required to be allocated under section 4.05 of this notice. 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 method of accounting.

(b) *Attribution of activities.* Each member of an EAG is treated as conducting the activities conducted by each other member of the EAG. For example, Corporation A and Corporation B are members of the same EAG but do not file a consolidated return. A is engaged solely in the trade or business of manufacturing QPP in the United States. B is a reseller of the QPP manufactured by A. Without regard to the activities conducted by A, B would not qualify for the § 199 deduction. However, because B is a member of the EAG that includes A, B is treated as conducting A's manufacturing activities. Accordingly, B's gross receipts attributable to its sale of the QPP it purchases from A are DPGR (assuming all other requirements of § 199 are met).

(c) *Anti-avoidance rule.* If a transaction between members of an EAG is engaged in or structured with a principle purpose of qualifying for, or modifying the amount of, the § 199 deduction for

one or more members of the EAG, adjustments must be made to eliminate the effect of the transaction on the computation of the § 199 deduction.

(3) *Allocation of expanded affiliated group's § 199 deduction.* The EAG's § 199 deduction is allocated among members of the EAG in proportion to each member's QPAI, if any, regardless of whether the EAG member has taxable income or loss for the taxable year and regardless of whether the EAG member has W-2 wages. For this purpose, if a member has negative QPAI, the QPAI of the member shall be treated as zero.

(4) *Special rules for consolidated groups.* For purposes of § 199, a consolidated group is treated as a single member of the EAG. Therefore, if an EAG includes corporations that are members of a consolidated group and corporations that are not members of a consolidated group, in computing the taxable income limitation of the EAG, the consolidated taxable income of the consolidated group, not the separate taxable income of the members of the consolidated group, is taken into account. If all of the members of an EAG are members of the same consolidated group, the consolidated group's § 199 deduction is determined based on the group's consolidated taxable income or loss, not the separate taxable income or loss of its members. The § 199 deduction of a consolidated group (or the § 199 deduction allocated to a consolidated group that is a member of an EAG) must be allocated to the members of the consolidated group in proportion to each consolidated group member's QPAI, if any, regardless of whether the consolidated group member has separate taxable income or loss for the taxable year and regardless of whether the member has W-2 wages for the taxable year. For purposes of allocating the § 199 deduction of a consolidated group among its members, if a consolidated group member has negative QPAI, the QPAI of the member shall be treated as zero.

(5) *Identification of members of the expanded affiliated group.* A corporation must determine whether it is a member of an EAG on a daily basis. 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.

(6) *Allocation of income and loss.* (a) *In general.* A corporation that is a member of an EAG for only a portion of its taxable year must allocate its taxable income or loss, QPAI, and W-2 wages between the portion of the taxable year during which it is a member of the EAG and the portion of the taxable year during which it is not a member of the EAG. In general, this allocation of items must be made by using the *pro rata* allocation method described in section 4.09(6)(a)(i) of this notice. However, the corporation may elect to use the closing of the books method described in section 4.09(6)(a)(ii).

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

(ii) *Closing of the books method.* Under the closing of the books method, taxable income or loss, QPAI, and W-2 wages for the period during which the corporation was a member of the 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 § 199 closing of the books election.* A corporation makes the § 199 closing of the books election by making the following statement: "The § 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 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, an election under this section 4.09(6)(a)(iii) is irrevocable.

(b) *Coordination with rules relating to the allocation of income under § 1.1502-76(b).* If § 1.1502-76 (relating to the taxable year of members of a consolidated group) applies to a corporation that is a member of an EAG, any allocation of items required under this section 4.09(6) is made only after the allocation of the corporation's items pursuant to § 1.1502-76.

(7) *Total § 199 deduction for a corporation that is a member of an expanded affiliated group for some or all of its taxable year.* If a corporation is a member of an EAG for its entire taxable year, the corporation's § 199 deduction for the taxable year is the amount of the § 199 deduction allocated to the corporation by the EAG. If a corporation is a member of an EAG 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 § 199 deduction for the taxable year is the sum of its § 199 deductions for each portion of the taxable year. For example, Corporations X and Y, calendar year corporations, are members of the same EAG for the entire 2005 taxable year. Corporation Z, also a calendar year corporation, is a member of the EAG, of which X and Y are members, for the first half of 2005 and not a member of any EAG for the second half of 2005. During the 2005 taxable year, Z does not join in the filing of a consolidated return. Z makes a § 199 closing of the books election. As a result, Z has \$100 of QPAI and \$80 of taxable income that is allocated to the first half of the taxable year, and (\$200) of QPAI and a \$150 taxable loss that is allocated to the second half of the taxable year. Taking into account Z's QPAI and taxable income allocated to the first half of the taxable year pursuant to the § 199 closing of the books election, the EAG has positive QPAI and taxable income for the taxable year and W-2 wages in excess of the § 199(b) wage limitation. Because the EAG has both positive QPAI and taxable income and sufficient W-2 wages, and because Z has positive QPAI for the first half of the year, a portion of the EAG's § 199 deduction is allocated to Z. Z is allowed no § 199 deduction for the second half of the taxable year. Thus, despite the fact that Z has (\$100) of QPAI and a \$70 taxable loss for the entire 2005 taxable year, Z is still entitled to a § 199 deduction for the taxable year equal to the § 199 deduction allocated to Z as a member of the EAG.

(8) *Computation of § 199 deduction for members of expanded affiliated group with different taxable years.* If members of an EAG have different taxable years, in determining the § 199 deduction of a member (the "computing member"), with respect to each group member, the computing member is required to take into account the taxable income or loss, QPAI, and W-2 wages that are both (1) attributable to the period during which the member of the EAG and the computing member are both members of the EAG and (2) taken into account in a taxable year that begins after the effective date of § 199 and ends with or within the taxable year of the computing member with respect to which the § 199 deduction is computed.

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

.11 *Coordination with Alternative Minimum Tax.* Section 199(d)(6) provides rules to coordinate the deduction allowed under § 199 with the AMT imposed by § 55. The deduction is allowed for purposes of the AMT, except that the deduction is equal to the applicable percent of the lesser of the taxpayer's: (1) QPAI, determined without regard to subchapter A, Part IV, of the Code; or (2) AMTI (determined without regard to § 199), for the taxable year. For purposes of the preceding sentence, in the case of an individual, AGI (determined without regard to § 199) shall be substituted for AMTI.

.12 *Special rules.* (1) *Certain nonrecognition transactions.* Except as provided in section 4.09 of the notice (the rules applicable to EAGs), if property is transferred by the taxpayer to an entity in a transaction to which § 351 or 721 applies, then whether the gross receipts derived by the entity

are DPGR shall be determined based on the activities performed by the entity without regard to the activities performed by the taxpayer prior to the contribution of the property to the entity.

(2) *Section 1031 exchanges.* If a taxpayer exchanges property for replacement property in a transaction to which § 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.

(3) *Section 381 transactions.* If a corporation (the acquiring corporation) acquires the assets of another corporation (the target corporation) in a transaction to which § 381(a) applies, the acquiring corporation shall be treated as performing those activities of the target corporation with respect to the acquired assets of the target corporation. Therefore, to the extent that the acquired assets of the target corporation would have given rise to DPGR if leased, rented, licensed, sold, exchanged, or otherwise disposed of by the target corporation, then the assets will give rise to DPGR if leased, rented, licensed, sold, exchanged, or otherwise disposed of by the acquiring corporation (assuming all other requirements of § 199(c) are met).

(4) *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 § 199(a)(2) (the phase-in rule) to a taxable year “beginning after” a particular calendar year means a taxable year beginning after December 31st of that year. Similarly, any reference to a taxable year “beginning in” a particular calendar year means a taxable year beginning after December 31st of the preceding calendar year. For example, a 52-53 week taxable year that begins on December 26, 2004, is deemed to begin on January 1, 2005, and the transition percentage for that taxable year is 3 percent.

SECTION 5. EFFECTIVE DATE

This notice applies to taxable years beginning after December 31, 2004.

SECTION 6. REQUEST FOR COMMENTS

.01 *In General.* The Service and Treasury Department invite taxpayers to submit written comments on issues relating to § 199 and this notice. In particular, the Service and Treasury Department encourage taxpayers to submit written comments on the following issues:

(1) The Service and Treasury Department are aware that several provisions of the Code and regulations require computations based upon taxable income, and that there is confusion concerning the order in which these provisions are to be applied. Taxpayers are invited to submit a list of all provisions of the Code, regulations, and other administrative guidance (if any) that require computations based upon taxable income, and the order in which taxpayers believe they should be applied;

(2) The Service and Treasury Department are concerned that there may be situations in which a contractor does not bear the benefits and burdens of ownership with respect to property (for example, for security reasons), but nevertheless should be regarded as satisfying the “by the taxpayer” requirement of § 199(c)(4)(A)(i). Taxpayers are invited to submit comments on such situations;

(3) The Service and Treasury Department request comments on the application of § 199 to trusts and estates. In particular, comments are requested on whether the apportionment of distributable net income between the trust and estate and its beneficiaries should govern the determination of the § 199 deduction for the taxable year, what rules should apply if there is no distributable net income for the taxable year, how these rules should be applied to split-interest trusts, and the information reporting requirements that should be imposed on the trust or estate and its

beneficiaries. Comments are also requested on the application of §199 to pass-thru entities other than partnerships, S corporations, trusts and estates;

(4) The Service and Treasury Department request comments on whether taxpayers should be able to change any allocation or apportionment method of gross receipts or deductions on an amended return and whether there should be restrictions on a taxpayer's ability to change from one method to another;

(5) The Service and Treasury Department request comments on whether additional modifications or clarifications to the § 861 method would be appropriate, including modifications relating to the determination of the "affiliated group" for purposes of allocating and apportioning expenses that are allocated and apportioned on an affiliated group basis;

(6) The Service and Treasury Department request comments regarding whether members of an EAG should be required to use the same method of allocating and apportioning deductions to DPGR. If members of an EAG were to be able to use different methods of allocating and apportioning deductions, the Service and Treasury Department request comments regarding whether a member's ability to use the simplified deduction method or the small business simplified overall method should depend on the average annual gross receipts of that member alone or the aggregate average annual gross receipts of all members of the EAG;

(7) The Service and Treasury Department request comments related to the application of § 199 to computer software; and

(8) The Service and Treasury Department invite comments on the appropriateness of the \$25,000,000 gross receipts threshold for use of the simplified deduction method.

.02 Addresses for Comments. Send submissions to: CC:PA:LPD:PR (Notice 2005-14), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2005-14), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Submissions may also be sent electronically via the Internet to the following e-mail address: Notice.comments@irs.counsel.treas.gov. Include the notice number (Notice 2005-14) in the subject line.

.03 Deadline for Submission of Comments. Comments must be received on or before March 31, 2005.

SECTION 7. DRAFTING INFORMATION

The principal authors of this notice are Paul Handleman and Lauren Ross Taylor of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Mr. Handleman or Ms. Taylor at (202) 622-3040 (not a toll-free call). For further information regarding the application of § 199 to pass-through entities, contact James Quinn of the Office of Associate Chief Counsel (Passthroughs and Special Industries) at (202) 622-3080; regarding the determination of costs generally, contact Scott Rabinowitz of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 622-4970; regarding the cost allocation rules under § 861, contact Bethany Ingwalson of the Office of Associate Chief Counsel (International) at (202) 622-3850; regarding expanded affiliated groups, contact Lisa Fuller of the Office of Associate Chief Counsel (Corporate) at (202) 622-7750; or regarding the definition of W-2 wages, contact Alfred Kelley of the Office of Associate Chief Counsel (Tax Exempt and Government Entities) at (202) 622-6040 (not toll-free calls).

