

DOMESTIC PRODUCTION ACTIVITIES DEDUCTION



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Corrections for all chapters and the *2006 National Income Tax Workbook Update* are available at <http://www.taxworkbook.com> (User Name: class2006 Password: class2006).

BACKGROUND

Prior to repeal by the American Jobs Creation Act of 2004, the I.R.C. §114 extraterritorial income (ETI) exclusion allowed taxpayers to exclude qualifying foreign trade income from their gross income. Qualifying foreign trade income was determined by taking the greatest of three computed amounts based on foreign trad-

ing gross receipts, foreign trade income, and foreign sale and leasing income.

The repeal is effective for transactions after December 31, 2004, with two exceptions.

1. Taxpayers can claim 80% of the exclusion in 2005 and 60% of the exclusion in 2006.

2. The repeal does not affect the exclusion for income attributable to transactions that were subject to a binding contract that was in effect on September 17, 2003.

The ETI exclusion was repealed because it violated World Trade Organization agreements that prohibit countries from subsidizing exports. The ETI exclusion was preceded by the foreign sales corporation (FSC) provisions and the domestic international sales corporation (DISC) provisions, which were also held to be in violation of World Trade Organization agreements.

Congress wanted to replace some of the tax benefits of the ETI exclusion and provide an incentive for U.S. producers to hire workers in the United States. However, it had to provide those incentives in a way that did not violate the World Trade Organization agreements. The result was new I.R.C. §199. Created by the 2004 Jobs Act, it allows certain taxpayers to claim a deduction for a percentage of their net income from qualified domestic production activities. In effect, it gives a tax break for certain kinds of production activities carried on in the United States, but only if there are employees working in the United States.

I.R.C. §199 was amended by the Gulf Opportunity Zone Act of 2005 (P.L. 109-135) and the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222). Final regulations (T.D. 9263) were published on May 24, 2006, replacing the earlier proposed regulations and Notice 2005-14, 2005-1 CB 498, effective for tax years beginning on or after June 1, 2006. Methods for determining wages are set out in Rev. Proc. 2006-22, 2006-22 IRB 1033, which was also published on May 24, 2006. The methods are included in a revenue procedure rather than in the final regulations, so that if changes are made to Form W-2, Wage and Tax Statement, a new revenue procedure can be issued reflecting those changes more promptly than an amendment could be made to the final regulations.

The domestic production activities deduction (DPAD) may provide a significant tax benefit for taxpayers who can take advantage of its provisions. The provisions are complex and will require new bookkeeping procedures for some taxpayers. Some taxpayers may need to restructure their business arrangements to take full advantage of the deduction.

OVERVIEW OF THE DPAD

The income tax deduction is limited to **employers with production activities within the United States**. For taxable years beginning in 2005 and 2006, the domestic production activities deduction (DPAD) equals the **smallest** of the following three amounts:

1. 3% of taxable income derived from a qualified production activity (QPAI)
2. 3% of adjusted gross income (AGI) for the tax year (taxable income for corporations)
3. 50% of the Form W-2 wages **paid** by the taxpayer during the calendar year that ends in the tax year

Both of the 3% DPAD limits increase to 6% for taxable years beginning in 2007, 2008, and 2009, and to 9% for taxable years beginning after 2009. Therefore, taxpayers have some time to organize their business activities in a way that

maximizes the benefit of the DPAD when it is fully phased in.

Most service activities do not qualify for the DPAD. If a taxpayer is engaged exclusively in the production of qualified property within the United States and has no other sources of income, qualified production activity taxable income is likely to equal overall taxable income.

I.R.C. §199(d)(5) provides that I.R.C. §199 is applied by taking into account only items that are attributable to the actual conduct of a trade or business.

The abbreviations used in this chapter are also used in the regulations and other guidance from the IRS, as well as in articles about the DPAD. To help readers keep track of these acronyms, they are listed in Figure 13.1.

FIGURE 13.1 List of Acronyms

Abbreviation	Term
DPAD	Domestic production activities deduction
QPAI	Qualified production activities income
DPGR	Domestic production gross receipts
non-DPGR	Gross receipts other than DPGR
CGS	Cost of goods sold
QPP	Qualifying production property
MPGE	Manufactured, produced, grown, or extracted
EAG	Expanded affiliated group

Form 8903

Taxpayers compute their DPAD on Form 8903, Domestic Production Activities Deduction. Individuals include their share of the DPAD from pass-through entities, such as partnerships, LLCs taxed as partnerships, and S corporations, as well as from proprietorships. Members of agricultural cooperatives also include the DPAD for their distributions from the cooperative.

Individual taxpayers claim the deduction as an adjustment to income on line 35 of Form 1040, U.S. Individual Income Tax Return. C corporations claim the DPAD on line 25 of Form 1120, U.S. Corporation Income Tax Return, or line 21 of Form 1120-A, U.S. Corporation Short-Form Income Tax Return. Estates and trusts are eligible for the DPAD if the income is not passed through to beneficiaries.

Computing the DPAD

Because the DPAD is the least of three amounts, all taxpayers have to compute the base figure for those amounts to determine their DPAD.

1. Form 8903 applies the rules by first comparing QPAI with the taxpayer's AGI (taxable income for corporations) and applying the 3% rate (for 2005 and 2006) to the lesser of the two.

2. Form 8903 then compares the above result from 1 above with 50% of the Form W-2 wages and instructs the taxpayer to claim the lesser of these two figures as the DPAD.
3. Form 8903 then adds to the result from 2 above any DPAD passed through to the taxpayer from a cooperative.

To get an overview of the DPAD, the following example presents a set of facts that assumes an understanding of terms and concepts that are used in I.R.C. §199 and the regulations and IRS guidance for I.R.C. §199. Those terms and concepts are explained later in this chapter.

Example 13.1 Form 8903

Joan Juniper operates a sole proprietorship. In 2006 she did not elect to use either of the simplified methods of allocating expenses. From her records, she computed the amounts for the items shown in Figure 13.2.

FIGURE 13.2 Joan's Sole Proprietorship

Item	Amount
Domestic production gross receipts (DPGR)	\$100,000
Expenses allocable to DPGR	
Cost of goods sold	45,000
Direct expenses	15,000
Indirect expenses	10,000
Wages (included in expense listed above)	20,000

Joan was a member of an LLC that is taxed as a partnership. It reported \$35,000 as her share of QPAI and \$2,000 as her share of wages. Joan was also a member of an agricultural cooperative that reported \$600 as her share of the cooperative's DPAD. Joan's adjusted gross income for 2006 was \$70,000. The calculation of her \$2,550 DPAD is shown on Form 8903 in Figure 13.3.

FIGURE 13.3 Form 8903 for Joan Juniper

Form 8903 Department of the Treasury Internal Revenue Service	Domestic Production Activities Deduction ► Attach to your tax return. ► See separate instructions.	OMB No. 1545-1984 2006 Attachment Sequence No. 143
Name(s) as shown on return Joan Juniper		Identifying number 199-01-8903
1 Domestic production gross receipts (DPGR)		100,000
2 Allocable cost of goods sold. If you are using the small business simplified overall method, skip lines 2 and 3		45,000
3 If you are using the section 861 method, enter deductions and losses definitely related to DPGR. Estates and trusts, see instructions. All others, skip line 3		15,000
4 If you are using the section 861 method, enter your pro rata share of deductions and losses not definitely related to DPGR. All others, see instructions		10,000
5 Add lines 2 through 4		70,000
6 Subtract line 5 from line 1		30,000
7 Qualified production activities income from pass-through entities:		35,000
If you are a— Then enter the total qualified production activities income from— a Shareholder Schedule K-1 (Form 1120S), box 12, code Q b Partner Schedule K-1 (Form 1065), box 13, code U c Beneficiary Schedule K-1 (Form 1065-B), box 9, code S2 Schedule K-1 (Form 1041), box 14, code C		
8 Qualified production activities income. Add lines 6 and 7. If zero or less, enter -0- here, skip lines 9 through 15, and enter -0- on line 16		65,000
9 Income limitation (see instructions):		70,000
• Individuals, estates, and trusts. Enter your adjusted gross income figured without the domestic production activities deduction • All others. Enter your taxable income figured without the domestic production activities deduction (tax-exempt organizations, see instructions)		
10 Enter the smaller of line 8 or line 9. If zero or less, enter -0- here, skip lines 11 through 15, and enter -0- on line 16		65,000
11 Enter 3% of line 10		1,950
12 Form W-2 wages (see instructions)		20,000
13 Form W-2 wages from pass-through entities:		2,000
If you are a— Then enter the total Form W-2 wages from— a Shareholder Schedule K-1 (Form 1120S), box 12, code R b Partner Schedule K-1 (Form 1065), box 13, code V c Beneficiary Schedule K-1 (Form 1065-B), box 9, code S3 Schedule K-1 (Form 1041), box 14, code D		
14 Add lines 12 and 13		22,000
15 Form W-2 wage limitation. Enter 50% of line 14		11,000
16 Enter the smaller of line 11 or line 15		1,950
17 Domestic production activities deduction from cooperatives. Enter deduction from Form 1099-PATR, box 6		600
18 Expanded affiliated group allocation (see instructions)		
19 Domestic production activities deduction. Combine lines 16 through 18 and enter the result here and on Form 1040, line 35; Form 1120, line 25; Form 1120-A, line 21; or the applicable line of your return		2,550

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 37712F

Form **8903** (2006)

The following discussion provides details about the meaning of the terms used in the rules for calculating the DPAD.

QPAI

I.R.C. §199(c)(1) defines QPAI as domestic production gross receipts (DPGR) reduced by the following amounts:

1. The cost of goods sold (CGS) allocable to DPGR,
2. Other deductions, expenses, and losses directly allocable to DPGR, and
3. Indirect deductions, expenses, and losses allocable to DPGR.

I.R.C. §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.

Notice 2005-14 required QPAI to be determined on an item-by-item basis, rather than on a division-by-division, a product-line-by-product-line, or a transaction-by-transaction basis. That meant the taxpayer had to allocate gross receipts

and expenses among each item it produced. The taxpayer's QPAI was the sum of the QPAI derived by the taxpayer from each item, and QPAI from each item could be positive or negative. The final regulations omitted this requirement. **Therefore, taxpayers are not required to allocate receipts and expenses among different qualifying items.** If an expense is incurred for more than one qualifying item, that expense can be deducted from the taxpayer's DPGR without allocating it among the qualifying items.



Practitioner Note

Item-by-Item Test Still Applies to DPGR Determination

The final regulations require the test of whether receipts are DPGR to be applied on an item-by-item basis [Treas. Reg. §1.199-3(d)(1)]. An "item" is an identifiable unit, such as a barrel of oil, a toy car, or a television set, that is produced by the taxpayer. When the taxpayer manufactures a component of a finished product, the "item" is the component. When qualifying items produced by the taxpayer are sold in conjunction with other products or services, the DPGR relating to qualifying items must be separated from the gross receipts from nonqualifying items.

DPGR

I.R.C. §199(c)(4)(A) defines DPGR as gross receipts under the taxpayer's usual method of accounting from three sources:

1. Leasing, renting, selling, exchanging, or otherwise disposing of the following:
 - a. Tangible personal property, computer software, or sound recordings, if they are

manufactured, produced, grown, or extracted (MPGE) in whole or significant part in the United States. I.R.C. §199(c)(4) defines this as **qualified production property (QPP)**.

- b. Films that are not sexually explicit, if at least 50% of the total compensation for

production is compensation for specified production services performed in the United States.

- c. Electricity, natural gas, or potable water produced by the taxpayer in the United States.
2. Constructing or substantially renovating real property in the United States, including residential and commercial buildings and infrastructure such as roads, power lines, water systems, and communications facilities.
3. Performing engineering and architectural services in the United States that relate to construction of real property.

Exceptions

I.R.C. §199(c)(4)(B) excludes from DPGR gross receipts from the following activities:

- Sale of food and beverages prepared by the taxpayer at a retail establishment, and
- Transmission or distribution of electricity, natural gas, or potable water.

I.R.C. §199(c)(7) excludes gross receipts from leasing, licensing, or renting property to a related party from DPGR. For purposes of this provision, related parties are defined as

- Corporations that are members of a controlled group,
- Other trades or businesses that are under common control, and
- Members of an affiliated service group.

Reasonable Method of Allocation

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 I.R.C. §199(c)(4) based on all of the information available to the taxpayer to substantiate the allocation. Factors the IRS will take into consideration in determining whether a taxpayer's method is reasonable include the following:

1. Whether the taxpayer is using the most accurate information available
2. The relationship between the gross receipts and the base chosen
3. The accuracy of the method chosen as compared with other possible methods
4. Whether the method is used by the taxpayer for internal management or other business purposes
5. Whether the method is used for other federal, state, or foreign income tax purposes
6. The time, burden, and cost of using various methods,
7. Whether the taxpayer applies the method consistently from year to year



Practitioner Note

Information Readily Available

The final regulations do not mandate a single method of determining DPGR. Most taxpayers can use any reasonable method that accurately identifies the source of gross receipts based on the information available to substantiate the allocation. However, a taxpayer who uses a specific identification method for any other purpose or who has information readily available for the use of a specific identification method, generally is required to use that method to determine DPGR.

Example 13.2 Information for Source of Gross Receipts

Widget Manufacturing, Inc. (WMI) has a production plant in Texas. It produces parts for widgets in plants located in the United States and in Mexico. WMI treats each plant as a profit center and therefore accounts for the cost and value of parts produced in each of its plants. Therefore, it must use that same method to allocate its gross receipts between the United States and Mexico for calculating DPGR.

Safe Harbor

A safe harbor permits a taxpayer with less than 5% of total gross receipts from items other than DPGR to treat all gross receipts as DPGR, with no required allocation.



Observation No Allocation of Expenses

By allowing all gross receipts to be treated as DPGR, the safe harbor also allows all expenses to be allocated to DPGR. That eliminates the need to allocate expenses between DPGR and non-DPGR.

Example 13.3 5% Safe Harbor

Paul Producer sells fresh produce to restaurants on credit and charges late fees and interest on overdue payments. The interest and late fees are not DPGR, but they may be treated as DPGR if, together with any other non-DPGR, they are collectively less than 5% of his total gross receipts. He can also treat all of his business expenses as allocable to DPGR.

Similarly, if less than 5% of the taxpayer's gross revenue is from items that are DPGR, the taxpayer can treat all of its gross revenue as being from items that are not DPGR [Treas. Reg. §1.199-1(d)(3)(ii)].

Storing Grain

Receipts from storing grain are DPGR whether or not the taxpayer produced the grain if the taxpayer owned the grain at the time it was stored.

Example 13.4 Storing Grain

A, B, and C are unrelated persons and are not cooperatives under subchapter T of the Internal Revenue Code. B grows agricultural products in the United States and sells them to A, who owns agricultural storage bins in the United States. A stores the agricultural products and has the benefits and burdens of ownership of the agricultural products while they are being stored. A sells the agricultural products to C, who processes them

into refined agricultural products in the United States. The gross receipts from A's, B's, and C's activities are DPGR from the MPGE of QPP [Treas. Reg. §1.199-3(e)(5), Example 1].

Government Payments

Treas. Reg. §1.199-3(i)(1)(iii) states the following:

The proceeds from business interruption insurance, governmental subsidies, and governmental payments not to produce are treated as gross receipts derived from the lease, rental, license, sale, exchange, or other disposition to the extent that they are substitutes for gross receipts that would qualify as DPGR.

Therefore, government payments to farmers that replace sales proceeds from commodities are DPGR.

Example 13.5 Government Payment

Red Durham applied for a loan deficiency payment for his corn crop when the Commodity Credit Corporation loan rate was \$1.83 and the posted county rate was \$1.71. He received a \$12,000 payment (\$0.12 per bushel \times 100,000 bushels). The \$12,000 payment is included in Red's DPGR.

Other government payments to farmers that appear to qualify as DPGR include direct payments under the 2002 Farm Bill, marketing loan gains, and countercyclical payments. Crop and revenue insurance indemnities also qualify as DPGR. However, government cost-sharing payments, stewardship, and incentive payments made under soil, water, and other conservation programs (discussed in Issue 5 in Chapter 11, Agricultural Issues) are not directly related to production and probably do not qualify as DPGR.

Qualified Warranty

Gross receipts from a qualified warranty can be included in DPGR. A qualified warranty must be

provided as part of the sale of qualified property without a separate charge. It cannot be separately offered or bargained for separately. If customers can purchase the property without the warranty, the amount paid for the warranty is not DPGR.

QPP

To qualify as DPGR, receipts must be from the lease, rental, license, sale, exchange, or other disposition of qualified production property. QPP is personal property that is manufactured, produced, grown, or extracted (MPGE) in whole or in significant part in the United States. MPGE includes storage, handling, or other processing activities (other than transportation activities) within the United States related to the sale, exchange, or other disposition of agricultural products, provided the products are consumed in connection with or incorporated into the MPGE of QPP, whether or not by the taxpayer.

Property may be tangible personal property for purposes of I.R.C. §199 even though it is considered a fixture and therefore real property under state law. Property that is in the nature of machinery is tangible personal property even if it is located outside a building.

Significant Part Safe Harbor

Treas. Reg. §1.199-3(g)(3) provides a safe harbor for meeting the requirement that property be MPGE in whole or significant part by the taxpayer in the United States.

A taxpayer is treated as having MPGE its QPP in whole or in significant part within the United States if the taxpayer's direct labor and overhead costs incurred to MPGE the QPP within the United States account for 20% or more of the taxpayer's CGS of the QPP. For a transaction without CGS (for example, a lease, rental, or license) the direct labor and overhead costs must account for 20% or more of the taxpayer's unadjusted depreciable basis in the QPP.

Overhead for taxpayers subject to I.R.C. §263A is all costs required to be capitalized under I.R.C. §263A except direct cost of materials and direct labor costs. For taxpayers not subject to I.R.C. §263A, overhead may be computed using any reasonable method that is satisfactory to the Secretary of the Treasury, based on all of the facts and circumstances, but it may not include any amount that would not be required to be capitalized under I.R.C. §263A if the taxpayer were subject to I.R.C. §263A.

Example 13.6 20% Safe Harbor

Joy Chopper buys luxury cars and makes them into stretch limousines by reinforcing and extending the frame and body. She pays \$80,000 for a car and \$20,000 for labor and overhead to turn it into a stretched automobile. The proceeds from the sale of the car are included in DPGR because 20% of the \$100,000 total cost of the car is attributable to Joy's direct costs of labor and overhead.

ALLOCATING COSTS

To compute QPAI, a taxpayer must subtract CGS and other expenses that are attributable to DPGR from the amount of DPGR. The final regulations provide three methods for making this allocation. Two simplified methods are available only to taxpayers who meet the threshold requirements. The third is a more exact method of allocating each item of CGS and other expenses to DPGR only if that item was incurred for a product that creates DPGR. It can be used by any taxpayer.

1. Small Business Simplified Overall Method

Under this method, CGS and deductions can be ratably apportioned between DPGR and other receipts based on relative gross receipts [Treas. Reg. §1.199-4(f)]. Qualifying taxpayers are as follows:

- A taxpayer that has average annual gross receipts of \$5,000,000 or less

- A taxpayer engaged in the trade or business of farming that is not required to use the accrual method of accounting under I.R.C. §447, and
- A taxpayer that is eligible to use the cash method as provided in Rev. Proc. 2002-28, 2002-1 C.B. 815 (certain taxpayers with average annual gross receipts of \$10,000,000 or less that are not prohibited from using the cash method under I.R.C. §448, including partnerships, S corporations, C corporations, and individuals)

Example 13.7 Small Business Simplified Overall Method

Larry Clean manufactures shower stall inserts and has a crew of workers who install them in homes and rental properties. In addition to the

shower stalls that his crews install, he sells the stalls to other contractors and homeowners who install them.

Because his installation service is sold separately, his gross receipts from installing the inserts is not included in his DPGR. In 2006, he had \$3,000,000 in gross receipts from the sale of shower inserts and \$1,000,000 in gross receipts from the installation of inserts. His CGS for 2006 was \$2,400,000 and his other expenses were \$1,200,000.

Larry qualifies for the small business overall simplified method of allocating CGS and other expenses because his gross revenue is \$5,000,000 or less. Therefore, he can allocate \$1,800,000 of his CGS and \$900,000 of his other expenses to DPGR, as shown in Figure 13.4.

FIGURE 13.4 Small Business Overall Simplified Method

Ratio of DPGR to total gross receipts	$\$3,000,000 \div \$4,000,000$	0.75
CGS allocated to DPGR	$\$2,400,000 \times 0.75$	\$1,800,000
Other expenses allocated to DPGR	$\$1,200,000 \times 0.75$	\$ 900,000



Observation Effect of Small Business Simplified Overall Method

Note that the impact of this allocation method is that a portion of Larry's CGS is allocated away from DPGR. Accordingly, his QPAI is higher than if he were required to allocate all of his CGS to his product.

- A taxpayer that has average annual gross receipts of \$100,000,000 or less
- A taxpayer that has assets that are \$10,000,000 or less

2. Simplified Deduction Method

Deductions (but not CGS) can be ratably apportioned between DPGR and other receipts based on relative gross receipts [Treas. Reg. §1.199-4(e)]. Qualifying taxpayers are as follows:

3. Other Methods

Treas. Reg. §1.199-4(b)(2)(i) allows taxpayers to use **any reasonable method of allocating CGS** between DPGR and other gross receipts. Any taxpayer can use this method.

Treas. Reg. §1.199-4(c)(1) requires taxpayers who do not qualify for the small business simplified overall method or the simplified deduction method to **allocate other expenses using the method set out in I.R.C. §861**. I.R.C. §861 is primarily used by taxpayers with international operations to allocate income between United States and other sources. Any taxpayer can choose to use this method for allocating expenses to DPGR under I.R.C. §199.

FORM W-2 WAGES

For some taxpayers, the 50%-of-wages-paid limitation is a significant limit on the DPAD. I.R.C. §199(b)(2)(A) defines W-2 wages as amounts paid by the taxpayer during the year that are any of the following:

- Wages subject to income tax withholding [I.R.C. §3401(a)]
- Elective deferrals such as employer contributions to 401(k) plans, SEPs, 403(b) plans, or SIMPLEs [I.R.C. §402(g)(3)]
- Compensation deferred under I.R.C. §457
- For taxable years beginning after December 31, 2005, the amount of designated Roth contributions [I.R.C. §402A]

I.R.C. §199(b)(2)(C) adds a requirement that wage amounts be reported to the Social Security Administration on or before 60 days after the due date of Form W-2 to qualify for the DPAD.



Practitioner Note Fiscal-Year Taxpayers

The wage limit is computed using the wages reported on Forms W-2 for the calendar year ending on December 31 during the taxpayer's fiscal year [I.R.C. §199(b)(2)(A)].



Law Change Wages Must Be Allocable to DPGR

For tax years beginning after May 17, 2006, only the wages allocable to DPGR are qualified wages for the 50%-of-wages limitation.

Methods for Computing W-2 Wages

Because no single box on Form W-2 satisfies the definition of W-2 wages under I.R.C. §199(b)(2), Rev. Proc. 2006-22, 2006-22 IRB 1033, provides three options for calculating W-2 wages only for purposes of I.R.C. §199. The first option is a sim-

plified calculation, whereas the other two provide greater accuracy.

1. Unmodified Box Method

An employer may use the lesser of the total entries in box 1 or in box 5 of all Forms W-2 filed with the Social Security Administration.

2. Modified Box 1 Method

An employer may modify the amounts reported in box 1 of the Forms W-2 as follows:

- By subtracting both amounts that are not subject to federal income tax withholding and amounts that are treated as wages under I.R.C. §3402(o). Amounts treated as wages under I.R.C. §3402(o) include the following:
 - * Supplemental unemployment compensation benefits paid under a plan because of the employee's involuntary separation from employment due to a reduction in workforce or other similar condition
 - * Pension or annuity payments for which a withholding request is in effect
 - * Sick-pay benefits paid while a withholding request is in effect, under a plan to which the employer is a party, in lieu of remuneration for any period the employee is temporarily absent from work on account of sickness or personal injury, and
- By adding elective deferrals under I.R.C. §402(g)(3) and compensation deferred under I.R.C. §457, which are reported in box 12 of Form W-2 with codes D [an I.R.C. §401(k) arrangement], E [an I.R.C. §403(b) arrangement], F [an I.R.C. §408(k)(6) salary reduction SEP], G [an I.R.C. §457(b) arrangement], and S [an I.R.C. §408(p) SIMPLE]

3. Tracking-Wages Method

An employer may track the actual amount of wages subject to federal income tax withholding and then modify it as follows:

- By subtracting supplemental unemployment compensation benefits paid under a plan because of the employee's involuntary separation

ration from employment due to a reduction in workforce or other similar condition, and

- By adding elective deferrals under I.R.C. §402(g)(3) and compensation deferred under I.R.C. §457, which are reported in box 12 of Form W-2 with codes D [an I.R.C. §401(k) arrangement], E [an I.R.C. §403(b) arrangement], F [an I.R.C. §408(k)(6) salary reduction SEP], G [an I.R.C. §457(b) arrangement], and S [an I.R.C. §408(p) SIMPLE]

Other Wage Rules

Joint Returns

Married individuals who file a joint return are treated as one taxpayer for purposes of determining the Form W-2 wages they paid [Treas. Reg. §1.199-2(a)(4)]. Therefore, an individual filing as part of a joint return may take qualifying wages paid to employees of his or her spouse into account in determining the amount of Form W-2 wages. The wages must be paid in a trade or business of the spouse and they must meet the other requirements of the final regulations. But if the taxpayer and spouse file separate returns, the taxpayer may not use wages paid by his or her spouse in determining a DPAD because the couple then are not considered one taxpayer.

Domestic Employees

Payments to employees for domestic services in the taxpayer's private home are not attributable to the actual conduct of a trade or business of the tax-

payer. Accordingly, they are not included in Form W-2 wages for purposes of I.R.C. §199(b)(2).

Wages Paid by Other Entities

A taxpayer may take into account wages paid and reported by other entities to the taxpayer's employees for employment by the taxpayer. This rule lets a taxpayer take into account wages paid by agents acting on behalf of the taxpayer that are included on Forms W-2 issued by the agent.

Wages Paid by Predecessor

If a taxpayer (the successor employer) 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 employer), the successor **may not** take into account wages paid to the predecessor employer's common-law employees for services rendered to the predecessor employer, even if those wages are reported on Forms W-2 furnished by the successor.

Nonduplication Rule

A nonduplication rule provides that amounts that are treated as Form W-2 wages for any tax year may not be treated as Form W-2 wages for any other tax year. Thus, an amount of nonqualified deferred compensation that is treated as Form W-2 wages under the Unmodified Box Method for one year may not be treated as Form W-2 wages in any other tax year.

SELECTED PRODUCTION ACTIVITIES

Production of Tangible Personal Property

Taxable income derived from the manufacture, production, growth, or extraction of tangible personal property is determined by subtracting the allocable costs and deductions from the taxpayer's gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of tan-

gible personal property manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States.

Property is treated as manufactured by the taxpayer in significant part in the United States if, based on all facts and circumstances, either of the following is true:

1. The activity performed by the taxpayer in the United States is substantial in nature.

2. The labor and overhead costs incurred in the United States for MPGE of the property are at least 20% of the taxpayer's total cost for the property.

Packaging, repackaging, labeling, and minor assembly operations are not taken into account for purposes of the significant part test. A taxpayer cannot qualify for the DPAD if the only activities in the United States are packaging and labeling property produced outside the United States.

Design and development activities also do not constitute manufacturing activities for the significant part test for tangible personal property because they produce an intangible asset (the design) rather than tangible personal property.



Practitioner Note I.R.C. §263A Capitalization

Treas. Reg. §1.199-3(e)(4) requires a taxpayer to be consistent in its application of the I.R.C. §199 rules and the I.R.C. §263A rules that require pre-production expenses to be capitalized. That means a taxpayer cannot claim to be a producer for purposes of the DPAD but not a producer for purposes of the I.R.C. §263A capitalization rules [Treas. Reg. §1.199-3(e)(4)].

Example 13.8 Percentage Test Met

Manny Factor purchases toy car parts and materials (including a motor) for \$75 and incurs \$25 in labor costs at his factory in the United States to fabricate a plastic car body and assemble a toy car. He also incurs packaging, selling, and other costs of \$2. The toy sells for \$112 in 2006.

The toy is treated as manufactured by Manny because his labor costs (\$25) are more than 20% of his \$100 total cost for the toy car (\$75 + \$25). The \$2 cost incurred for packaging, selling, and other costs is excluded from the DPAD calculation. His profit on the car is \$10 [\$112 minus (\$100 + \$2)]. This is his qualified production activities income (QPAI) for the car.

Manny's I.R.C. §199 DPAD for each of the toys is 3% of the \$10 QPAI from the toy car, or 30¢ per car.

If one taxpayer performs manufacturing activities for another (custom or contract manufacturing), only the one who has the **benefits and burdens of ownership** during the manufacturing process is treated as the manufacturer [Treas. Reg. §1.199-3(e)(1)]. As a result, only one of them is entitled to the deduction for the same manufacture of tangible personal property. 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 I.R.C. §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.

Construction Activities

Qualifying construction activities include construction and substantial renovation of real property, including residential and commercial buildings and infrastructure such as roads, power lines, water systems, and communications facilities.



Practitioner Note Ownership Not Required for Construction Activities

Gross receipts for construction activities are not required to be derived from a lease, rental, license, sale, exchange, or other disposition of the property. As a result, a taxpayer engaged in construction activities may qualify for the DPAD even if he or she does not have the benefits and burdens of ownership of the property being constructed [Treas. Reg. §1.199-3(f)].

More than one taxpayer may be regarded as constructing real property with respect to the same activity and the same construction project. A general contractor and a subcontractor may both be engaged in construction activities for installation of a roof on a new building. Each taxpayer's DPAD is a percentage of its profit on its work.

Example 13.9 More Than One Construction Contractor

Rose Petal hired Clarence Carpenter to build a shed. Clarence hired Eddie Electrician to do the electrical work. The amount that Clarence receives from Rose is DPGR but he has to subtract the payments he makes to Eddie when he computes his QPAI. The amount that Eddie receives from Clarence is DPGR. Neither Clarence nor Eddie must own the building to have DPGR because they are providing a qualifying service rather than producing qualified property.

Treas. Reg. §1.199-3(m)(3) defines real property to mean buildings (including items that are structural components of such buildings), inherently permanent structures [as defined in Treas. Reg. §1.263A-8(c)(3)] other than machinery [as defined in Treas. Reg. §1.263A-8(c)(4), including items that are structural components of such inherently permanent structures], inherently permanent land improvements, oil and gas wells, and infrastructure [as defined in Treas. Reg. §1.199-3(m)(4)]. However, gross receipts from the sale of land are not included in DPGR because the land is not MPGE. Therefore, taxpayers must separate their gross receipts arising from the sale of improvements from their gross receipts arising from the sale of the land on which the improvements are located.

Safe Harbor for Land

A safe harbor allows taxpayers to allocate gross receipts to real property other than land using a formula if the land has been held for no more than 15 years [Treas. Reg. §1.199-3(m)(6)(iv)(A)]. The formula starts with the gross receipts from the sale of the land and improvements and reduces it by the cost of the land plus an additional percentage based on the holding period. The result is the amount of gross receipts that is allocated to the real property other than land.

The additional percentage of the cost of land that must be subtracted is 5% if the land was held not more than 60 months, 10% for land held more than 60 months but not more than 120 months, and 15% for land held more than 120 months but not more than 180 months. Land held by a taxpayer for more than 180 months is not eligible for the safe harbor. Taxpayers must separately value land that is not eligible for the safe harbor (or for

which the safe harbor is not elected) for purposes of allocating the gross receipts.

Generally, if another provision of the Internal Revenue Code or Treasury regulations tacks on the prior owner's holding period to the taxpayer's holding period, the expanded holding period also applies for purposes of the land safe harbor.

Example 13.10 Land Safe Harbor

Brenda Builder paid \$60,000 for a residential lot in 2005. In 2006 she built a home on the lot and sold it for \$300,000. Under the safe harbor, Brenda can allocate the gross proceeds to DPGR by subtracting her \$60,000 cost of the lot and another 5% of that cost (\$3,000) from the \$300,000 gross revenue. Therefore, her DPGR from building the house is \$237,000 (\$300,000 – \$60,000 – \$3,000).

Rental of Constructed Real Property

Gross receipts derived from rental of real property that the taxpayer constructs are not derived from construction but rather are income for the use of the property. As a result, rental income from the real property is not eligible for the deduction. Gain on a later sale of the property may qualify for the deduction if all other requirements are satisfied.

Preparation of Food and Beverages

Food and beverages prepared at a retail establishment do not qualify for the DPAD. A retail establishment generally includes any real property used in the trade or business of selling food or beverages to the public if retail sales occur at the facility. This includes a restaurant at which food and beverages are prepared, sold, and served to customers.

However, some retail establishments are mixed-use facilities, preparing food and beverages for both wholesale and retail sales. If a taxpayer's facility is a mixed-use facility, the food or beverages that are sold at wholesale are not considered prepared at a retail establishment. The taxable income related to the wholesale transactions is eligible for the DPAD.

Computer Software

In general, income from a lease, rental, license, sale, exchange, or other disposition of software developed in the United States qualifies for the DPAD, whether the customer purchases the software off the shelf or downloads it from the Internet. Computer software includes video game software. However, income that is attributable to the provision of a service is not derived from a lease, rental, license, sale, exchange, or other disposition of the software. Thus, the following income does not qualify for the deduction:

1. Fees for online use of software
2. Fees for customer support with respect to computer software

3. Online services
4. Fees for telephone services provided in part through use of software
5. Fees for playing computer games online
6. Provider-controlled online access services

PARTNERSHIPS AND S CORPORATIONS

The DPAD attributable to the qualifying production activities of a partnership or S corporation is determined at the partner or shareholder level. As a result, each partner or shareholder must compute the deduction separately, based on all qualifying activities.

In general, a pass-through entity will allocate to each partner or shareholder a share of the items of income, gain, loss, and deduction attributable to qualifying production activities, along with any other items of income, gain, loss, deduction, or credit. The partner or shareholder then must aggregate the pass-through items with items attributable to any other qualified production activities to determine the DPAD.

QPAI from Flow-Through Entity

The effect of a flow-through entity's gross receipts, DPGR, and expenses on its owners' QPAI depends on the method the owner uses to allocate CGS and other expenses in computing QPAI. The three possible methods were explained earlier in this chapter in the Allocating Costs section. This section illustrates the use of each method by a partner or shareholder.

Small Business Simplified Overall Method

If an owner of an entity uses the small business simplified overall method to allocate CGS and other expenses, the owner must combine his or her share of the entity's DPGR and other gross receipts with his or her DPGR and gross receipts from other sources to determine the ratio of DPGR to total gross receipts. That ratio is used to allocate the owner's total CGS and other expenses from the flow-through entity and other sources. The CGS and other expenses allocated to DPGR are then subtracted from the owner's total DPGR to compute the owner's QPAI.

Example 13.11 QPAI Using Small Business Simplified Overall Method

Pete Bogg owns one-third of Latte, LLC, which is taxed as a partnership. He also has DPGR, non-DPGR, and expenses from a sole proprietorship. Figure 13.5 shows Latte's DPGR, total gross receipts, CGS, and other expenses for 2006, Pete's share of those items, and Pete's DPGR, total gross receipts, CGS, and other expenses from his sole proprietorship.

FIGURE 13.5 Pete's 2006 Information

Item	Latte, LLC	Pete's Share	Pete's Sole	Pete's Total
			Proprietorship	
DPGR	\$ 90,000	\$30,000	\$20,000	\$50,000
Total Gross Receipts	120,000	40,000	35,000	75,000
CGS	30,000	10,000	5,000	15,000
Other Expenses	60,000	20,000	13,000	33,000

Pete qualifies for the small business simplified overall method of allocating CGS and other expenses, and his tax preparer chose to use that

method. Under that method, Pete's QPAI is \$18,000, as shown in Figure 13.6.

FIGURE 13.6 Pete's QPAI

DPGR		\$ 50,000
Ratio of DPGR to Total Gross Receipts	$\$50,000 \div \$75,000 = 0.6667$	
CGS Allocated to DPGR	$\$15,000 \times 0.6667$	(10,000)
Other Expenses Allocated to DPGR	$\$33,000 \times 0.6667$	(22,000)
Pete's QPAI		<u>\$ 18,000</u>

Simplified Deduction Method

If an owner of an entity uses the simplified deduction method, the owner must combine DPGR and other gross receipts from the entity with DPGR and other gross receipts from other sources to compute the ratio of DPGR to total gross receipts. That ratio is used to allocate other expenses. CGS is allocated by assigning each item of CGS to DPGR or non-DPGR, according to the use of that item.

Example 13.12 QPAI Using Simplified Deduction Method

Paige Turner is another one-third member of Latte, LLC. She has the same outside DPGR, other revenue, CGS, and other expenses as Pete from the previous example. However, her tax preparer chose to use the simplified deduction method and, based on information from Latte's and Paige's records, determined that \$9,000 of Latte's CGS are attributed to Latte's DPGR, and \$1,000 of Paige's outside CGS is allocable to DPGR. As in the previous example, Paige's other expenses are allocated using the ratio of her total DPGR to her total other expenses. Paige's QPAI is \$24,000, as shown in Figure 13.7.

FIGURE 13.7 Paige's QPAI

DPGR		\$ 50,000
Ratio of DPGR to Total Gross Receipts	$\$50,000 \div \$75,000 = 0.6667$	
CGS Attributed to DPGR	$(\$9,000 \times 1/3) + \$1,000$	(4,000)
Other Expenses Allocated to DPGR	$\$33,000 \times 0.6667$	(22,000)
Paige's QPAI		<u>\$ 24,000</u>

Other Methods

If an owner does not qualify for either of the simplified methods of allocating CGS and other expenses to DPGR or chooses not to use those methods, then CGS and other expenses are allocated by assigning each item of CGS or other expenses to DPGR or non-DPGR, according to the use of that item.

Example 13.13 QPAI Using Other Methods

Sally Forth is the final one-third member of Latte, LLC. She has the same outside DPGR, other revenue, CGS, and other expenses as Pete and Paige

from the previous examples. However, her tax preparer chose to not use either of the simplified methods and, based on information from Latte's and Paige's records, determined that (as in the previous example) \$9,000 of Latte's CGS are attributed to Latte's DPGR and \$1,000 of Sally's outside CGS is allocable to DPGR. Her tax preparer also determined that \$24,000 of Latte's other expenses and \$2,000 of Sally's outside other expenses are attributed to her DPGR under the I.R.C. §861 method of allocation. Sally's QPAI is \$36,000, as shown in Figure 13.8.

FIGURE 13.8 Sally's QPAI

DPGR		\$ 50,000
CGS Attributed to DPGR	$(\$9,000 \times 1/3) + \$1,000$	(4,000)
Other Expenses Attributed to DPGR	$(\$24,000 \times 1/3) + \$2,000$	(10,000)
Sally's QPAI		<u>\$ 36,000</u>



Observation More Exact Methods Could Reduce QPAI

In these examples, the more exact methods of allocating CGS and other expenses resulted in a greater QPAI because the more exact methods allocated less CGS and other expenses to DPGR. In other cases, the more exact methods could allocate more expenses to DPGR than the simplified methods, which would result in a smaller QPAI.



Observation Guaranteed Payments and Wages Reduce QPAI

A distribution of profits to partners, members, or shareholders does not reduce QPAI. In contrast, a guaranteed payment to a partner or a payment of wages to a shareholder reduces the net QPAI of all the owners of a flow-through entity. Depending on the distribution of guaranteed payments or wages among the owners and on the method the owners use to allocate CGS and other expenses, the QPAI of some owners may increase. However, the decrease in QPAI of other owners will always exceed the increase in QPAI for the owners that realize an increase. If the guaranteed payments and wages are proportional to the sharing of profits, an increase in guaranteed payments or wages will decrease QPAI for all of the owners.

Payments to Owners

A guaranteed payment to a partner of a partnership or to a member of an LLC that is taxed as a partnership is an expense that must be deducted from DPGR to compute QPAI to the extent it is allocable to DPGR [Treas. Reg. §1.199-9(b)(1)(i)]. However, the guaranteed payment is not DPGR for the partner or member that received it [Treas. Reg. §1.199-3(p)]. Similarly, wages paid to an S corporation shareholder are deducted from the corporation's DPGR to the extent they are allocable to DPGR, but they are not DPGR for the shareholder.

Example 13.14 Guaranteed Payment to One Owner

The facts are the same as in the previous three examples, except that Latte, LLC made a \$9,000 guaranteed payment to Pete. The guaranteed payment is an LLC expense that must be allo-

cated between DPGR and non-DPGR. It is also adds to Pete's gross receipts from sources outside the LLC. Pete's DPGR, other gross receipts, CGS, and other expenses are shown in Figure 13.9.

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FIGURE 13.9 Pete's 2006 Information

Item	Latte, LLC	Pete's Share	Pete's Sole Proprietorship	Pete's Total
DPGR	\$ 90,000	\$30,000	\$20,000	\$50,000
Total Gross Receipts	120,000	40,000	44,000	84,000
CGS	30,000	10,000	5,000	15,000
Other Expenses	69,000	23,000	13,000	36,000

If all of the partners use the small business simplified overall method of allocating expenses, the guaranteed payment increases the amount of expenses each partner allocates to DPGR. It also affects Pete's ratio of DPGR to total receipts because the \$9,000 guaranteed payment is addi-

tional gross revenue for him. Pete's QPAI after the \$9,000 guaranteed payment is \$19,645, as shown in Figure 13.10. This is a \$1,645 (\$19,645 - \$18,000) increase in his QPAI as a result of the \$9,000 guaranteed payment.

FIGURE 13.10 Pete's QPAI

DPGR		\$ 50,000
Ratio of DPGR to Total Gross Receipts	$\$50,000 \div \$84,000 = 0.5952$	
CGS Allocated to DPGR	$\$15,000 \times 0.5952$	(8,928)
Other Expenses Allocated to DPGR	$\$36,000 \times 0.5952$	(21,427)
Pete's QPAI		<u>\$ 19,645</u>

The only effect the guaranteed payment has on Paige's and Sally's QPAI calculations is a \$3,000 increase in the other expenses allocated to each of them from the LLC, which increases each of their total other expenses to \$36,000. If they use the small business simplified overall method

of allocating expenses, each would have QPAI of \$18,000 without the guaranteed payment (see the calculation for Pete in Example 13.11). The guaranteed payment reduces the QPAI to \$16,000, as shown in Figure 13.11.

FIGURE 13.11 Paige's and Sally's QPAI

DPGR		\$ 50,000
Ratio of DPGR to Total Gross Receipts	$\$50,000 \div \$75,000 = 0.6667$	
CGS Allocated to DPGR	$\$15,000 \times 0.6667$	(10,000)
Other Expenses Allocated to DPGR	$\$36,000 \times 0.6667$	(24,000)
Paige's and Sally's QPAI		<u>\$ 16,000</u>

Note that the sum of the QPAI for the three members of Latte, LLC was decreased from \$54,000 (\$18,000 + \$18,000 + \$18,000) to \$51,645 (\$19,645 + \$16,000 + \$16,000) as a result of the guaranteed payment. That \$2,355 net decrease is much less than the \$9,000 guaranteed payment for two reasons:

1. Paige's and Sally's QPAI was reduced by only two-thirds of the \$3,000 increase in their shares of expenses from Latte because their ratio of DPGR to total gross revenue is 0.6667.
2. The reduction in Pete's ratio of DPGR to total gross receipts from 0.6667 to 0.5952 caused some of Pete's outside expenses to be allocated away from his DPGR.

Without the guaranteed payment, the three members shared equally in the \$30,000 of LLC profit. The guaranteed payment reduced the profits that were shared equally to \$21,000, so that Paige and Sally each get \$7,000 and Pete gets \$16,000 when his guaranteed payment is included.



Planning Pointer Special Allocation of Profits

Instead of making a guaranteed payment to Pete, the members of Latte, LLC could accomplish the same distribution of Latte's net revenue without reducing QPAI by making a special allocation of profits. For example, near the end of the tax year, when the members could see that there would be \$30,000 of net income to share, they could agree that Pete would get 53.33% ($\$16,000 \div \$30,000$) of the profits and Paige and Sally would each get 23.33% ($\$7,000 \div \$30,000$) of the profits. In order to be recognized for income tax purposes, the special allocation must have substantial economic effect. (See page 248 in the Business Entities chapter of this book and pages 569 through 571 in the Business Entities chapter of the *2004 National Income Tax Workbook* for a discussion of the requirements of substantial economic effect.) Therefore, Pete's capital account must reflect the extra \$9,000 of profits that are allocated to him. If the members want to maintain equal ownership, Pete could withdraw \$9,000 from his capital account to bring them back into balance.

Example 13.15 Wages Paid to One Shareholder

If Latte, LLC from the previous example is an S corporation (or an LLC taxed as an S corporation) instead of an LLC taxed as a partnership, and it paid \$9,000 of wages to Pete, the effect on the shareholders' QPAI is the same as that of the guaranteed payment illustrated in the previous example. However, S corporation shareholders cannot make a special allocation to Pete to avoid the reduction of QPAI because an S corporation can have only one class of stock. An S corporation shareholder must be compensated in wages for the fair market value of services he or she provides to the corporation.

Wages from Flow-Through Entity

QPAI is only one of the three factors that a taxpayer must compute to calculate the DPAD. The DPAD is also limited by the taxpayer's AGI (taxable income for a corporate taxpayer) and the qualified wages paid by the taxpayer.

Wage Limitation

For 2005 and 2006, an owner of a flow-through entity generally cannot use the entity's Form W-2 wages to increase a DPAD based on other sources of QPAI. A partner or shareholder's share of Form W-2 wages is limited to the smaller of the following:

1. The otherwise allocable share of the wages
2. Twice the applicable percentage of the partner or shareholder's portion of the entity's QPAI

Because the applicable percentage for 2005 and 2006 is 3%, the wage allocation cannot exceed 6% of the flow-through entity's QPAI.



Observation No Wage Allocation If No QPAI

If the partner or shareholder is not allocated positive QPAI, none of the entity's Form W-2 wages can be taken into account for purposes of computing the partner or shareholder's wage limitation for the DPAD in 2005 and 2006.

To compute the limit on wages allocable to owners from an entity, the entity must compute its QPAI even if the owners are using a simplified method of allocating expenses and are using the entity's DPGR, total gross receipts, CGS, and other expenses to calculate their QPAI [see Example 4 in Treas. Reg. §1.199-9(b)(6)]. Consequently, for 2005 and 2006, an owner may have an allocation of QPAI from an entity for purposes of the wage limitation that is different from the owner's QPAI for computing the tentative DPAD.

Example 13.16 Different QPAIs

The facts are the same as in Example 13.11, but the \$20,000 of other expenses for Latte, LLC includes \$3,000 of wages, and Pete has \$400 of wages included in his other expenses from outside sources. The limit on Pete's share of the LLC's wages is computed by applying the ratio of his \$30,000 DPGR from the LLC to his \$40,000 share of the LLC's gross receipts to his share of the LLC's CGS and other expenses.

In contrast, the QPAI he received from the LLC to compute his tentative DPAD was computed by using the ratio of his \$50,000 total DPGR (including his \$20,000 outside DPGR) to his \$75,000 total gross revenue (including his \$35,000 outside gross revenue).

Thus, Pete's QPAI from the LLC to compute the limit on his wages from the LLC is \$7,500, while his QPAI from the LLC to compute his DPAD is \$10,000, as shown in Figure 13.12.

FIGURE 13.12 Pete's QPAI from Latte, LLC for Wage Limit and for DPAD

	QPAI for Wage Limit		QPAI for DPAD	
DPGR		\$ 30,000		\$ 30,000
Ratio of DPGR to Total Gross Receipts	$\$30,000 \div \$40,000 = 0.75$		$\$50,000 \div \$75,000 = 0.6667$	
CGS Allocated to DPGR	$\$10,000 \times 0.75$	(7,500)	$\$10,000 \times 0.6667$	(6,667)
Other Expenses Allocated to DPGR	$\$20,000 \times 0.75$	(15,000)	$\$20,000 \times 0.6667$	(13,333)
Pete's QPAI		<u>\$ 7,500</u>		<u>\$ 10,000</u>
Limit on Wages for Pete	$\$7,500 \text{ of QPAI} \times 6\%$	\$ 450		

Limiting the wages from Latte, LLC that Pete can take into account reduces Pete's DPAD in this example by \$115 as shown in Figure 13.13.

FIGURE 13.13 Reduction in Pete's DPAD

	With QPAI Wage Limit		Without QPAI Wage Limit	
1. Tentative DPAD	$\$18,000 \text{ of QPAI} \times 3\%$	\$540	$\$18,000 \text{ of QPAI} \times 3\%$	\$540
2. Wage Limit				
3. Proprietorship Wages		400		400
4. Wages from Latte	$\$7,500 \text{ of QPAI} \times 6\%$	450	$\$3,000 \div 3$	1,000
5. Total Wages		<u>\$850</u>		<u>\$1,400</u>
6. Wage Limit on DPAD	$\$850 \times 50\%$	\$425	$\$1,400 \times 50\%$	\$700
7. DPAD (lesser of line 1 or line 6)		\$425		\$540
8. Reduction in DPAD			$\$540 - \425	\$115



Observation Effect of Wage Limitation

The ceiling on wages that flow to an owner in 2005 and 2006 effectively limits the DPAD an owner can claim as a result of the entity's domestic production activities to 3% of the owner's QPAI as calculated for the wage limit. In the previous example, Pete's DPAD from Latte, LLC is effectively limited to 50% of 6% of the \$7,500 QPAI calculated for purposes of the wage limit, which is the same as 3% of that \$7,500.

Two New Rules for Wages

For tax years that start after May 17, 2006, two rules related to calculating wages for the 50% of wage limitation on DPAD are changed. The first change allows taxpayers to claim a bigger deduction in some cases, and the second change reduces the deduction in some cases.

Limit on Wages from an Entity

The first change is the repeal of the QPAI limit on wages that flow from an entity to an owner [I.R.C. §199(d)(1)(A)(iii), as amended by §514(b)(1) of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA)]. This change means that a QPAI for the entity wage limit will no longer have to be computed.

Example 13.17 No QPAI Limit on Wages

The facts are the same as in Example 13.16, except that they are for 2007 rather than 2006. There is no limit on the qualifying wages from Latte that Pete can take into account for the 50% wage limitation. If all of the wages are qualifying wages, Pete can use his one-third of the \$3,000 of LLC wages to compute his wage limit. Because the qualified percentage for calculating the DPAD increases to 6% in 2007, the tentative DPAD increases to \$1,080. Pete could claim a \$700 DPAD, as shown in Figure 13.14.

FIGURE 13.14 Pete's 2007 DPAD Using All Wages

Tentative DPAD: \$18,000 of QPAI \times 6%	\$1,080
Wage Limit on DPAD	
Proprietorship Wages	400
Wages from Latte	1,000
Total Wages	<u>\$1,400</u>
Wage Limit on DPAD: \$1,400 \times 50%	\$ 700
DPAD (Lesser of Tentative DPAD or Wage Limit on DPAD)	\$ 700

Qualifying Wages

The second change is a new requirement for wages to qualify for the 50%-of-wage limitation on DPAD. I.R.C. §199(B)(2)(b), as amended by §514(a) of TIPRA, requires wages to be allocable to DPGR in order to be included in wages for purposes of the 50%-of-wage limitation.

**Observation** All Taxpayers Affected by This Change

This change in the definition of wages for purposes of the 50%-of-wage limitation on DPAD affects all taxpayers—not just owners of a flow-through entity.

Example 13.18 Wages Allocable to DPGR

Example 13.17 assumed that all of the wages were qualifying wages and therefore all of them contributed to the wage limitation. However, because Pete used the small business simplified overall method of allocating expenses to DPGR, he must use that same method to allocate wages to DPGR. In Pete's case, only 0.6667 of both outside wages and wages from Latte are allocated to determine the wage limit. Therefore his QPAD for 2007 is limited to \$467, as shown in Figure 13.15.

FIGURE 13.15 Pete's 2007 DPAD with Qualified Wage Limitation

Tentative DPAD: \$18,000 of QPAI \times 6%	\$1,080
Wage Limit on DPAD	
Proprietorship Wages Allocated to DPGR: \$400 \times 0.6667	267
Wages from Latte Allocated to DPGR: \$1,000 \times 0.6667	667
Total Wages	<u>\$934</u>
Wage Limit on DPAD: \$934 \times 50%	\$ 467
DPAD (Lesser of Tentative DPAD or Wage Limit on DPAD)	\$ 467



Observation LLC Wages Can Increase DPAD from Outside Activities

For tax years that begin after May 17, 2006, wages from an entity can contribute more to an owner's wage limit than QPAI from the entity contributes to the owner's tentative DPAD. Therefore, wages from the entity can allow an owner to use outside QPAI that would otherwise not add to the owner's DPAD.

Example 13.19 LLC Wages Increase Outside DPAD

The facts are the same as in the previous example, except that Latte's wages were \$6,000 instead of \$3,000. Pete's \$2,000 ($\$6,000 \div 3$) of wages from Latte, LLC results in \$1,333 ($\$2,000 \times 0.6667$) of wages allocated to DPGR, which contributes \$667 ($\$1,333 \times 50\%$) to the wage limit for his DPAD. However, Pete's \$30,000 share of Latte's DPGR and \$20,000 ($\$10,000 \text{ CGS} + \$20,000 \text{ other expenses} = \$30,000 \times 0.6667 =$

\$20,000) share of CGS and other expenses allocated to DPGR increased his QPAI by \$10,000 ($\$30,000 - \$20,000$), which added only \$600 ($\$10,000 \times 6\%$) to his tentative DPAD. The \$67 excess contribution to the wage limit allows Pete to deduct more of the tentative DPAD from his outside activities, because it would otherwise be limited by his outside wages.

Pete's \$20,000 outside DPGR and \$12,000 ($\$5,000 \text{ CGS} + \$13,000 \text{ other expenses} = \$18,000 \times 0.6667 = \$12,000$) share of CGS and other expenses allocated to DPGR increased his QPAI by \$8,000 ($\$20,000 - \$12,000$), which increased his tentative DPAD by \$480 ($\$8,000 \times 6\%$). However, his \$267 ($\400×0.6667) of outside wages allocated to DPGR contributed only \$133 ($\$267 \times 50\%$) to his wage limitation. The \$67 excess contribution to the wage limit by LLC wages allows him to deduct \$67 of the \$347 ($\$480 - \133) DPAD from his outside activity that would otherwise be lost because of the outside wage limitation. The remaining \$280 of tentative DPAD is still lost. Pete's 2007 DPAD is calculated in Figure 13.16.

FIGURE 13.16 Pete's 2007 DPAD with Additional Wages

Tentative DPAD: $\$18,000 \text{ of QPAI} \times 6\%$	\$1,080
Wage Limit	
Proprietorship Wages Allocated to DPGR: $\$400 \times 0.6667$	267
Wages from Latte Allocated to DPGR: $\$2,000 \times 0.6667$	1,333
Total Wages	<u>\$1,600</u>
Wage Limit on DPAD: $\$1,600 \times 50\%$	\$800
DPAD (lesser of Tentative DPAD or Wage Limit on DPAD)	\$800

Entity Reporting to Owner

The preceding discussion and examples assume that the entity reports each owner's share of DPGR, other receipts, and expenses to each of the owners. That is consistent with the rules in Treas. Reg. §1.199-9(b)(1)(i) and (c)(1)(i), which require partners and S corporation shareholders to calculate their DPAD with respect to a partnership or an S corporation at the owner level.

However, under Treas. Reg. §1.199-9(b)(1)(ii) and (c)(1)(ii), the Secretary of the Treasury may permit partnerships and S corporations to compute QPAI (rather than receipts and expenses) at the entity level. If an entity reports the owners' shares of QPAI under that authority, the owners generally do not recompute their shares of QPAI [Treas. Reg. §1.199-9(b)(1)(ii)(C) and (c)(1)(ii)(C)]. Instead, the owners add their reported shares of QPAI and wages from the entity with their QPAI

and wages from other sources to compute their DPAD.

Treas. Reg. §1.199-9 is effective for tax years beginning before May 17, 2006. Treasury has not yet issued regulations regarding pass-through entities for tax years beginning after May 16, 2006.



Observation QPAI Calculated at Entity Level

If the owners are required to add their shares of QPAI from the entity to their other QPAI, they cannot take advantage of the simplified methods to shift CGS and other expenses away from DPGR to increase their DPAD.

Schedule K-1 Instructions

If a partnership uses the small business simplified overall method of allocating CGS and other expenses, the 2005 Schedule K-1 (Form 1065) instructions require the partnership to report the partner's share of the partnership's QPAI and wages on line 13d of the Schedule K-1 (Form 1065), using codes U and V respectively. If the partnership does not use the small business sim-

plified overall method, the 2005 Schedule K-1 (Form 1065) instructions require the partnership to use code T on line 13d of Schedule K-1 (Form 1065) and to attach a statement with the following information:

- DPGR
- Gross receipts from all sources
- CGS allocable to DPGR
- CGS from all sources
- Total deductions, expenses, and losses directly allocable to DPGR
- Total deductions, expenses, and losses directly allocable to a non-DPGR class of income
- Other deductions, expenses, and losses not directly allocable to DPGR or another class of income
- Form W-2 wages

The 2005 instructions for Schedule K-1 (Form 1120S) require the same reporting by S corporations that use the small business simplified overall method, except that the information is reported on line 12d of Schedule K-1 (Form 1120S) and the codes are P, Q, and R.

SHARE-RENT ARRANGEMENTS

There is no guidance on whether crop or live-stock share-rent landowners have DPGR to qualify them for the domestic activities production deduction.

Arguments for Inclusion in DPGR

Landowners could argue that their receipts are from the sale of commodities that they produced in a trade or business and not from rent for real property. They could argue that the commodities are qualified production property and that proceeds from sale of those commodities are included in DPGR. They could distinguish their facts from landowners who receive cash rent by saying they face the risks of crop production and

price fluctuations. They pay production expenses and own the commodity at the time it is grown.

They could also argue that they are considered to be in the "business of farming" for purposes of I.R.C. §175 (soil and water conservation) and I.R.C. §1301 (farm income averaging) and should be treated as being in the "business of farming" (producing) for purposes of the DPAD.

Landowners who materially participate in the production and therefore report their income and expenses on Schedule F (Form 1040) have a stronger argument that they are in a trade or business, but they still face the hurdle of showing that their income is not from renting real estate.

Arguments for Exclusion from DPGR

The IRS could take the position that the landowner's receipts are rents from real property and therefore not included in DPGR. The IRS could argue that while landowners are not required to report production shares on page 1 of Schedule E (Form 1040), which includes income from rental real estate, the tax law still treats their income as rental income. For example, the material participation rules that determine whether their net income is subject to self-employment tax under I.R.C. §1402(a)(1) are a part of the exception to the rule that rentals from real estate are not subject to self-employment taxes. Therefore, the rules imply that the income from share leases is rental income from real estate even if it is subject to self-employment taxes.

Treas. Reg. §1.61-4(a) distinguishes between commodities acquired by landowners from a share-rent arrangement and commodities produced by a taxpayer in a farming business. Share-

rent landowners receive their commodities as rent and therefore have income from the commodities when they are reduced to money or the equivalent of money. Under that authority, the court in *Tatum v. Commissioner*, 400 F. 2d 242 (5th Cir. 1968), held that crop shares are potential income assets, not property, and that a landlord may not avoid taxation by assigning his rights to such income prior to its reduction to money or a money equivalent. By contrast, a taxpayer who produced commodities in his or her own farming business owns assets that can be given away without triggering recognition of income.



Observation Wages Limitation

As a practical matter, very few share-rent landowners will have the Form W-2 wages needed to satisfy the 50% of wage limitation for the DPAD.

LAND OWNED BY AN LLC

Some families have set up a separate entity, such as a limited liability company (LLC), to own the real property that is used in the family business. The landowner entity rents the land to an operating entity that may be a sole proprietorship, corporation, partnership, or another LLC. Because the landowner LLC is not directly engaged in the business, it does not qualify for the DPAD. The rent paid to the landholding LLC reduces the QPAI for the entity engaged in farming, and it does not increase the DPAD of the landholding entity.

Example 13.20 Rent Paid to an LLC

Paul Smith is the sole owner of a C corporation that operates a manufacturing business. The corporation rents a building from an LLC owned solely by Paul. In 2006, the corporation paid \$80,000 of rent to the LLC. It also paid \$45,000 of

wages. The corporation has \$400,000 of DPGR and \$340,000 of expenses, including the rent and wages.

The corporation's QPAI for 2006 is \$60,000 (\$400,000 - \$340,000), which results in an \$1,800 (\$60,000 × 0.03) DPAD. The \$80,000 of rent is not DPGR for the LLC, so Paul does not get any DPAD from that rent.

If the corporation owned the building, its DPAD for 2006 would increase by 3% of the difference between the \$80,000 rent and the expenses of owning the building, such as depreciation, taxes, insurance, repairs, and interest. In other words, the increase in QPAI at the corporate level would be equal to the net rental profit that would otherwise be in the LLC.

PATRONS OF COOPERATIVES

Patrons of cooperatives that are engaged in a qualifying activity can claim a DPAD for their share of the cooperative's QPAI that would be deductible under I.R.C. §199 if the cooperative were allowed to claim its own DPAD.

A cooperative engaged in marketing agricultural and horticultural products is treated as having produced in significant part any products that are produced by its patrons and marketed by the cooperative. In determining the pass-through DPAD, the cooperative's taxable income is computed without taking into account any deductions for patronage dividends, per-unit retain allocations, and nonpatronage distributions under I.R.C. §1382(b) and (c). The deduction claimed by the patron does not reduce the cooperative's taxable income.

Qualifying cooperatives are those that

- Have a significant role in the production of agricultural or horticultural products, or
- Market agricultural or horticultural products.

For this purpose, agricultural or horticultural products include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are produced or extracted by the cooperative.

The patron's deduction is the deductible QPAI of the cooperative that is allocable to the following:

- Patronage dividends paid to the patron, or
- Per-unit retain allocations that are paid to the patron in qualified per-unit retain certificates

In order for a member to qualify for the deduction, I.R.C. §199(d)(3)(A)(ii) requires the cooperative to designate the patron's portion of the income allocable to QPAI in a written notice mailed by the cooperative to the patron no later than the 15th day of the ninth month following the close of the tax year.

Example 13.21 DPAD from a Cooperative

Ruraltown Farmers' Cooperative is a marketing cooperative that had \$5,000,000 in gross receipts in 2006 from the sale of corn that it purchased from its members, who are farmers that produced the corn. Ruraltown had \$4,500,000 of expenses, which included \$120,000 of wages. It paid \$400,000 in patronage refunds and retained \$100,000 to build its equity for a future expansion.

Because Ruraltown marketed grain produced by its members, all of its receipts are DPGR. Consequently all of its expenses are allocable to DPGR, and its QPAI is \$500,000 (\$5,000,000 - \$4,500,000). Ruraltown can allocate its \$15,000 (\$500,000 × 3%) DPAD among its members in proportion to the patronage refunds it paid to each member.

Joe Corngrower, a member of Ruraltown, marketed 50,000 bushels of corn through Ruraltown in 2006, which was 2% of all the grain Ruraltown marketed that year. Joe received an \$8,000 patronage refund from Ruraltown and is allocated 2% of Ruraltown's \$15,000 QPAD. Joe reports that \$300 DPAD on line 17 of Form 8903.

ALTERNATIVE MINIMUM TAX

The DPAD is allowed for purposes of the AMT, except that the deduction is equal to the applicable percentage of the lesser of the following:

1. The taxpayer's QPAI, determined without regard to the AMT adjustments (I.R.C. §56), preferences (I.R.C. §57), disallowance of farm and passive activity losses (I.R.C. §58), and other rules under I.R.C. §59



Law Change Gulf Opportunity Zone Act of 2005

Prior to the change in this provision by the GOZA, QPAI was determined without regard to the income tax credits. The GOZA change is effective for tax years beginning after December 31, 2004.

2. The taxpayer's AGI, determined without regard to I.R.C. §199. For a corporation, alternative minimum taxable income (AMTI) is substituted for AGI.



Observation Effect on Individual's AMT

For individuals, the DPAD is the same for the AMT as it is for regular income tax. Most taxpayers who would owe AMT without the DPAD will find that the DPAD reduces the tentative minimum tax by more than it reduces the regular tax because the tentative minimum tax rate is higher than the regular income tax rate. Because the AMT is the difference between the tentative minimum tax and the regular tax, for most taxpayers, the DPAD will reduce the AMT.

Example 13.22 AMT Reduced by DPAD

Guy Wire has a \$1,000 DPAD for 2006 from his construction business. The joint return income, deductions, and tax liability for Guy and his wife, Barb, are shown in Figure 13.17. The DPAD reduces their regular tax liability by \$150, but it decreases their tentative minimum tax (and therefore their total tax) by \$260. The AMT is reduced by the \$110 difference between the \$260 tentative minimum tax decrease and the \$150 regular tax decrease.

FIGURE 13.17 Effect of DPAD on AMT

Item	Without DPAD	With DPAD	Difference
Wages	\$ 70,000	\$ 70,000	
Farm Income	45,870	45,870	
Total Income	\$ 115,870	\$ 115,870	
DPAD		(1,000)	\$(1,000)
Other Adjustments to Income	(13,512)	(13,512)	
Adjusted Gross Income	\$ 102,358	\$ 101,358	\$(1,000)
Taxes	(8,988)	(8,988)	
Interest	(3,500)	(3,500)	
Total Itemized Deductions	(12,488)	(12,488)	
Exemptions Deduction ($\$3,300 \times 10$)	(33,000)	(33,000)	
Taxable Income	\$ 56,870	\$ 55,870	\$(1,000)
Regular Tax	\$ 7,776	\$ 7,626	\$(150)
Tentative Minimum Tax	\$ 10,350	\$ 10,090	\$(260)
Alternative Minimum Tax	\$ 2,574	\$ 2,464	\$(110)
SE Tax	\$ 6,481	\$ 6,481	
Total Tax	\$ 16,831	\$ 16,571	\$(260)

NET OPERATING LOSSES

Except for members of an expanded affiliated group, the DPAD is not taken into account in computing any net operating loss (NOL) or the amount of any NOL carryback or carryover.



Observation No NOL If There Is a DPAD

Because the DPAD is limited to 3% of a taxpayer's AGI (taxable income for a corporation), a taxpayer cannot have an NOL if he or she has a DPAD because AGI (taxable income for a corporation) has to be above zero.

However, an NOL carried to the tax year is considered in the computation of the DPAD. For example, to the extent an NOL carryforward or carryback reduces AGI, it will reduce the 50% of AGI limit on the DPAD.

Example 13.23 DPAD with NOL Deduction

Fran Smith is a sole proprietor who had a \$20,000 NOL from her manufacturing business in 2005 that she elected to carry forward to 2006. In 2006, her net income from the business and her QPAI was \$50,000. She paid \$10,000 of wages, and her adjusted gross income was \$55,000 before deducting the NOL. Fran must deduct the \$20,000 NOL to compute her AGI for purposes of the DPAD calculation. Therefore, her AGI is \$35,000 (\$55,000 – \$20,000).

Fran's DPAD for 2006 is \$1,050, which is the least of the following:

1. 3% of her \$50,000 QPAI = \$1,500
2. 3% of her \$35,000 AGI = \$1,050
3. 50% of her \$10,000 of wages = \$5,000

Conclusion

I.R.C. §199 and the regulations that implement it create a complex set of rules that practitioners must apply to determine if a taxpayer is eligible for the DPAD and to compute the DPAD for eligible taxpayers. Several safe harbors in the rules simplify the calculations for many taxpayers.

The benefit of the DPAD doubles from 2006 to 2007 (from 3% to 6%) and increases to 9% beginning in 2010. Therefore, it becomes more important for practitioners to help their clients understand how to maximize the benefit of the deduction by organizing their business activities in a way that increases QPAI and provides enough wages to take advantage of the full tentative DPAD. Practitioners should also instruct their clients on the proper recordkeeping to document the deduction.

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