Domestic Production Activities Deduction

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Learning Objectives
After completing this session, participants will be able to perform the following job-related actions:

✔ Identify the various terms associated with the domestic production activities deduction (DPAD)
✔ Calculate the DPAD
✔ Complete Form 8903, Domestic Production Activities Deduction, to report the DPAD
✔ Apply the DPAD to pass-through entities
✔ Identify clients who can benefit from the DPAD
✔ Calculate and claim the DPAD for agricultural and horticultural cooperatives

Introduction
Under I.R.C. § 199, taxpayers can claim a deduction for a percentage of their net income from qualified domestic production activities (the domestic production activities deduction, or DPAD). This tax relief was designed for US manufacturing industries, but it applies to many activities outside the traditional definition of manufacturing. Activities that qualify for the deduction include the design, engineering, renovation, and construction of real property; the production of electricity, natural gas, or potable water; agricultural and mining activities; and film production.

The DPAD is generally calculated as a percentage of a taxpayer’s qualified production activities income (QPAI). QPAI is defined as domestic production gross receipts (DPGR) for a tax year less cost of goods sold and other expenses, losses, or deductions allocable or properly attributable to those receipts.
The deduction is 9% of the lesser of QPAI or taxable income, which is a substantial tax benefit. The Joint Committee on Taxation estimates that the DPAD will result in a $78.2 billion economic benefit to taxpayers for the years 2013 through 2017 [Congress, Joint Committee on Taxation, “Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017” (February 1, 2013)].

This chapter discusses what activities are eligible for the deduction and how to calculate and report the deduction. It also explains how the deduction applies to pass-through entities and cooperatives. Finally, it reviews how the deduction applies to specific industries, which will help the tax practitioner identify clients who can benefit from the DPAD.

**TERMINOLOGY** This section discusses the terminology and definitions used in the DPAD calculation.

The DPAD is effective for tax years after December 31, 2004, and was phased in over several years. The deduction has been 9% since 2010. Figure 7.1 summarizes percentage rates since the deduction was created.

<table>
<thead>
<tr>
<th>Tax Years</th>
<th>Deduction Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005, 2006</td>
<td>3%</td>
</tr>
<tr>
<td>2007, 2008, 2009</td>
<td>6%</td>
</tr>
<tr>
<td>2010 and later</td>
<td>9%</td>
</tr>
</tbody>
</table>

**Observation** Oil and Gas Production Activities

Beginning in 2008, Congress limited the DPAD to 6% for oil and gas production activities.

The DPAD equals the smallest of three amounts:

1. 9% of taxable income derived from QPAI
2. 9% of taxable income (or, in the case of an individual, adjusted gross income) for the tax year calculated without the DPAD
3. 50% of Form W-2, Wage and Tax Statement, wages (attributable to DPGR) paid by the taxpayer during the tax year

The wage limitation eliminates the deduction for many otherwise-qualified Schedule C and F (Form 1040) activities because if there are no wages paid, there is no deduction. The DPAD is allowed for both regular tax and AMT, including adjusted current earnings.

**DPAD Acronyms**

**Figure 7.2** shows the acronyms for terminology related to the DPAD. These terms are defined later in this chapter.

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>COGS</td>
<td>Cost of goods sold</td>
</tr>
<tr>
<td>DPAD</td>
<td>Domestic production activities deduction</td>
</tr>
<tr>
<td>DPGR</td>
<td>Domestic production gross receipts</td>
</tr>
<tr>
<td>EAG</td>
<td>Expanded affiliated group</td>
</tr>
<tr>
<td>MPGE</td>
<td>Manufactured, produced, grown, or extracted</td>
</tr>
<tr>
<td>Non-DPGR</td>
<td>Gross receipts other than DPGR</td>
</tr>
<tr>
<td>QPAI</td>
<td>Qualified production activities income</td>
</tr>
<tr>
<td>QPP</td>
<td>Qualifying production property</td>
</tr>
<tr>
<td>TPP</td>
<td>Tangible personal property</td>
</tr>
</tbody>
</table>

**Qualified Production Activities Income**

To be eligible for the I.R.C. § 199 deduction, taxpayers must have qualified production activities income (QPAI).

QPAI equals domestic production gross receipts (DPGR) less

- cost of goods sold (COGS) allocable to these receipts;
- other deductions, expenses, or losses directly allocable to these receipts; and
a ratable portion of deductions, expenses, and losses not directly allocable to these receipts or another class of income [I.R.C. § 199(c)(1)].

The details of this computation are discussed in the “Computing the Deduction” section later.

Practitioner Note

Net Income Calculation

DPAD is calculated on a net income basis. However, whether gross receipts qualify as DPGR is determined on an item-by-item basis.

Observation

QPAI and Taxable Income

If a taxpayer is engaged exclusively in the production of qualified property in the United States and has no other sources of income, QPAI likely is the same as the taxpayer’s overall taxable income.

Domestic Production Gross Receipts

DPGR include gross receipts from the lease, rental, license, sale, exchange, or other disposition of the following:

1. Qualifying production property (QPP) manufactured, produced, grown, or extracted (MPGE) by the taxpayer, in whole or significant part, in the United States
2. Film production in certain circumstances
3. Electricity, natural gas, or potable water produced by the taxpayer in the United States.

DPGR also include gross receipts from the following:

1. In the case of a taxpayer engaged in the active conduct of a construction trade or business, construction or substantial renovation of real property in the United States (includes residential and commercial property and infrastructure)
2. In the case of a taxpayer engaged in the active conduct of an engineering or architectural services trade or business, engineering and architectural services performed in the United States and relating to the construction of real property
3. Self-constructed property used by the taxpayer in its business before being sold
4. Business interruption insurance proceeds and payments not to produce (if they are substitutes for gross receipts that would qualify as DPGR)

Observation

Exclusion for Leased Property

DPGR does not include gross receipts from the lease, license, or rental of property for use by a related person (unless ultimately subleased to an unrelated person).

Embedded Services

Taxpayers that manufacture and sell an item that includes an embedded service (such as a maintenance agreement, warranty, delivery or installation service, or training) must allocate gross receipts between DPGR and receipts that are not DPGR (non-DPGR), because gross receipts from the performance of services (except for certain construction, engineering, and architectural services) do not qualify as DPGR. However, a taxpayer can include the following embedded services as DPGR if the taxpayer includes the services in the regular product price and does not sell the embedded service without the product:

- Certain warranties
- Deliveries
- Instruction manuals
- Installation
- Computer software maintenance agreements

[Treas. Reg. § 1.199-3(i)(4)(i)(B)]

Example 7.1 Allocation of Gross Receipts for Embedded Services Not Required

Green Corporation manufactures air conditioners, which it sells to retailers. Green charges a delivery fee for delivering the units to the retailers. Green includes the delivery fee as part of the purchase price of the air conditioning units (i.e.,
the fee is not separately stated). Green does not have to allocate its gross receipts between DPGR and non-DPGR.

Example 7.2 Allocation of Gross Receipts for Embedded Services Required
Green Corporation from Example 7.1 separately states on the invoice the delivery fee for delivering the units. The retailers cannot purchase the units without paying the delivery fee. The delivery fee does not qualify as DPGR. Therefore, Green must allocate its gross receipts between DPGR and non-DPGR [Treas. Reg. § 1.199-3(i)(4)(iii), Example 3].

De Minimis Exceptions
Taxpayers with a de minimis amount of gross receipts (less than 5%) from embedded services may include the embedded service income as DPGR. The de minimis exception does not apply if the price of the service is separately stated [Treas. Reg. § 1.199-3(i)(4)(ii)(B)(6)].

Also, taxpayers do not have to allocate gross receipts between DPGR and non-DPGR if less than 5% of total gross receipts are non-DPGR (such as interest income, gains from the sale of property, and dividends). The taxpayer can classify 100% of its gross receipts as DPGR [Treas. Reg. § 1.199-1(d)(3)].

Qualified Production Property
DPGR include gross receipts from the lease, rental, license, sale, exchange, or other disposition of qualifying production property (QPP) that is manufactured, produced, grown, or extracted (MPGE) by the taxpayer in whole, or significant part, in the United States.

QPP is tangible personal property (TPP), computer software, and sound recordings. It is any TPP other than land; buildings (including items that are structural components of a building); qualified film produced by the taxpayer; electricity, natural gas, or potable water produced by the taxpayer; and computer software and sound recordings [Treas. Reg. § 1.199-3(j)(2)(i)].

Manufactured, Produced, Grown, or Extracted
Pursuant to Treas. Reg. § 1.199-3(e), manufactured, produced, grown, or extracted (MPGE) generally includes the following:

1. Activities relating to manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP
2. Making QPP out of scrap, salvage, or junk material; or 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
3. Cultivating soil, raising livestock, fishing, or mining materials
4. Installing QPP if the taxpayer also engages in other MPGE activity with respect to the QPP
5. Storage, handling, or other processing activities connected with certain agricultural products

MPGE generally does not include the following:

- Transportation
- Packaging, repackaging, labeling, or minor assembly of QPP
- Installation of QPP if no other MPGE occurs with respect to the QPP

Example 7.3 Repackaging with Other Activities Is MPGE
Medical Supply Co. provides drugs to seniors in nursing homes and similar facilities. The company purchases drugs in bottles and empties the bottles. It then uses an assembly line to heat plastic; form indentations in the plastic by using a drug-specific mold; place the pills from the bottles into the blister packs; seal the blister packs; and add scannable bar codes identifying the medication, dosage, and expiration date. Because much more than repackaging is involved, the exception to the definition of MPGE for packaging and repackaging does not apply. Medical Supply Co.’s activities constitute MPGE activities [C.C.A. 2012-46-030 (August 9, 2012)].
Example 7.4 Service Is Not MPGE
Photosmart is a pharmacy that does photo-processing and printing for its customers. Photosmart has a photo lab that converts film, negatives, and digital media into photographic products. Photosmart also has kiosks where customers can order and print photos, enlargements, and picture CDs or DVDs. At the kiosk, customers can transfer images provided by customers onto a CD or DVD that Photosmart purchases from a manufacturer. The photo-processing and photo-printing services constitute MPGE of a QPP. However, the process of putting a customer’s files on a CD or a DVD is a service, not a production activity. Photosmart does not change the files or the CDs to a different form, and that activity is not an MPGE activity [F.A.A. 20133302F (July 16, 2013)].

Example 7.5 Assembly Process Is MPGE
Houdini, Inc. designs, assembles, and sells gift baskets and gift towers (the towers are a set of decorative boxes that contain different food items). Houdini’s production process changes the form of an article by transforming individual items typically purchased by consumers as ordinary groceries into gifts that are usually given during the holiday season [Treas. Reg. § 1.199-3(e)(1)]. Houdini’s activities are not similar to Treas. Reg. § 1.199-3(e), Example 6, where the taxpayer purchases autos and customizes them by adding spoilers, custom wheels, specialized paint, sunroofs, roof racks, and similar accessories. The taxpayer in Example 6 of the regulations does not change the form or function of the vehicles, and is involved in minor assembly work, which is not an MPGE activity. In contrast, Houdini changes the form and the function of the individual items by creating distinct gifts, which is an MPGE activity [United States v. Dean, 945 F. Supp. 2d 1110 (C.D. Cal. 2013)].

IRS Guidance
The IRS Large Business and International Division (LB&I) has issued guidance on retail activities that do not generally meet MPGE qualifying activities and therefore do not qualify for the DPAD [LB&I-04-0315-001 (March 16, 2015)]. Examples of activities that are generally not MPGE include the following activities performed at a retail level:

- Cutting blank keys to a customer’s specification
- Mixing base paint and a paint coloring agent
- Applying garnishments to cake that is not baked where sold
- Applying gas to agricultural products to slow or expedite fruit ripening
- Storing agricultural products in a controlled environment to extend shelf life
- Maintaining plants and seedlings

Installation Activities
MPGE activities can include the installation of QPP [Treas. Reg. § 1.199-3(e)(3)]. If the taxpayer installs QPP but engages in no other MPGE activities, the installation activity is not an MPGE activity. Conversely, the installation of an item of QPP is an MPGE activity if (1) the taxpayer manufactured, produced, grew, or extracted the QPP; and (2) during the period of installation, the taxpayer had the benefits and burdens of ownership of the QPP, or is treated as satisfying the ownership requirement under the rules for government contracts.
Example 7.6 Installation of Purchased Replacement Parts

Beam Corp. reconstructs and refurbishes TPP belonging to its customers. As part of the reconstruction and refurbishment, Beam installs purchased replacement parts into the customers’ property. Beam’s installation of the purchased parts is not a qualified manufacturing activity because it did not manufacture or produce the replacement parts [Treas. Reg. § 1.199-3(e)(5), Example 3].

Example 7.7 Installation of Manufactured Replacement Parts

The facts are the same as in Example 7.6 except that Beam manufactures the replacement parts. Beam’s manufacture of the replacement parts and its installation of those parts are both treated as an MPGE activity [Treas. Reg. § 1.199-3(e)(5), Example 4].

Example 7.8 Party Bearing the Benefits and Burdens of Ownership

Fast Car contracts with Bob Brown to build a race car to sell to Racing, Inc. While Bob is building the car, Fast Car bears the benefits and burdens of ownership because Fast Car owns the car and is responsible for any damage that occurs while Bob builds the car. Fast Car is the party that qualifies for the I.R.C. § 199 deduction. Bob is providing a service to Fast Car. Because services do not qualify for the deduction, Bob may not claim the I.R.C. § 199 deduction for his work, even though he actually builds the car.

Example 7.9 Party Not Bearing the Benefits and Burdens of Ownership

ADVO, Inc. distributes direct mail ads in the United States. ADVO hired third-party commercial printers to produce some of the ad materials. ADVO provided the printers with designs for the ads as rough art, client-supplied art, or reprints with changes. The printers purchased the paper supply from a broker, and it was shipped directly to the printer. ADVO is not entitled to the I.R.C. § 199 DPAD because it did not bear the benefits and burdens of ownership while the advertising material was printed. The printers are the manufacturers eligible for the deduction [ADVO, Inc. & Subsidiaries v. Commissioner, 141 T.C. 9 (2013); see also C.C.A. 2013-13-020 (November 30, 2011)].

MPGE by the Taxpayer

DPGR include gross receipts derived from QPP that is MPGE in whole or in significant part by the taxpayer. If one taxpayer performs a qualifying activity pursuant to a contract with another taxpayer, the general rule is that the business entitled to claim the deduction is the one bearing the benefits and burdens of ownership of the property while the qualifying production activity occurs. The taxpayer must have the benefits and burdens of ownership of the QPP under federal income tax principles during the period the MPGE activity occurs in order for gross receipts derived from the MPGE of QPP to qualify as DPGR. Who has the benefits and burdens of ownership is determined from all of the facts and circumstances of the transaction [Treas. Reg. §§ 1.199-3(f)(1) and 1.199-3(e)(1)].

Government Contracts

A special rule applies to US government contracts. Gross receipts from the MPGE of QPP are treated as the taxpayer’s activity if the contract is with the US government and the Federal Acquisition Regulations require the taxpayer to transfer title to the government before completion of the property [Treas. Reg. § 1.199-3(f)(2)]. This same rule applies to any subcontractor that is required by a US government contract to transfer title before the subcontractor completes the property [Treas. Reg. § 1.199-3(f)(3)].
MPGE in the United States

DPGR include gross receipts derived from QPP that is MPGE by the taxpayer in whole or in significant part in the United States. Taxpayers must manufacture, produce, grow, or extract QPP in whole or in significant part within the United States. A taxpayer manufactures QPP in significant part if the taxpayer meets one of two tests: a substantial-in-nature test or a safe harbor test [Treas. Reg. § 1.199-3(g)].

Definition of United States

For purposes of the I.R.C. § 199 deduction, the term United States follows the I.R.C. § 7701(a)(9) definition. Therefore, the United States includes the 50 states, the District of Columbia, US territorial waters, and the seabeds and subsoils of any waters adjacent to US territorial waters over which the United States has exclusive exploration and exploitation rights [Treas. Reg. § 1.199-3(h)].

Law Change

Activities in Puerto Rico


Substantial-in-Nature Test

QPP is MPGE in whole or in significant part in the United States if, based on all of the taxpayer’s facts and circumstances, the MPGE activity performed by the taxpayer in the United States is substantial in nature. In some cases a taxpayer imports a partially manufactured item and then finishes the process in the United States. To the extent the taxpayer’s actions, given all of the facts and circumstances, are substantial, the gross receipts from the activity will qualify as DPGR. Likewise, if the taxpayer manufactures a product in the United States and then exports it for further manufacturing while retaining title, all of the gross receipts will be DPGR, regardless of whether the taxpayer imports the property for final disposition [Treas. Reg. § 1.199-3(g)(5), Example 5]. Factors to consider when applying the substantial-in-nature test include the following:

- Relative value added
- Relative cost
- Nature of the activity
- Nature of the property

Example 7.10 Substantial-in-Nature Test

Vintage Model, Inc. operates a classic kit car assembly plant in the United States. It purchases engines, transmissions, and certain other components from Car Supply, Inc., an unrelated non-US manufacturer, and assembles the component parts into autos. On a per-unit basis, Vintage’s selling price and costs are shown in Figure 7.3.

FIGURE 7.3 Vintage Model, Inc.’s Per-Unit Selling Price and Costs

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
</tr>
<tr>
<td>Cost of goods sold:</td>
</tr>
<tr>
<td>Material—acquired from Car Supply</td>
</tr>
<tr>
<td>Direct labor and overhead</td>
</tr>
<tr>
<td>Total cost of goods sold</td>
</tr>
<tr>
<td>Gross profit</td>
</tr>
<tr>
<td>Administrative and selling expenses</td>
</tr>
<tr>
<td>Taxable income</td>
</tr>
</tbody>
</table>

Vintage Model’s direct labor and overhead are less than 20% of each auto’s cost of sales ($2,250 + $12,500 = 18%), and it does not meet the safe harbor test (defined in the next section). However, its activities are substantial in nature, taking into account the nature and the relative value of its activity. Therefore, the autos are manufactured or produced in significant part by Vintage Model in the United States.

Safe Harbor Test

A taxpayer will be treated as having MPGE QPP in whole or in significant part in the United States if, in connection with the QPP, the direct labor and overhead costs of such taxpayer for MPGE of the QPP in the United States accounts for 20% or more of the QPP's COGS; or if, in a transaction

Qualified Production Property
without COGS (such as a lease, rental, or license), the direct labor and overhead total 20% or more of the unadjusted depreciable basis in the QPP. For taxpayers subject to the uniform capitalization (UNICAP) rules, overhead includes all costs that the taxpayer must capitalize under I.R.C. § 263A except for direct materials and direct labor.

**Example 7.12 Safe Harbor Test—US Labor and Overhead**

The facts are the same as in Example 7.10, except that Vintage Model’s direct labor and overhead total $3,000 per unit. Given these facts, Vintage Model’s direct labor and overhead are more than 20% of each auto’s per-unit cost of sales [$3,000 ÷ ($10,250 +$3,000) = 23%], so its activities are conducted in significant part in the United States under the safe harbor rule. Therefore, Vintage Model’s activities qualify under both the substantial-in-nature test and the safe harbor test.

**Example 7.11 Safe Harbor Test—US Fabrication and Assembly**

Green Toys, Inc. makes toy cars. Green Toys buys a small motor and various parts and materials abroad for $75 and incurs $25 in labor costs at its factory in the United States to fabricate a plastic car body and assemble the toy car. It also incurs packaging, selling, and other costs of $2 and sells the toy car for $112. Green Toys has manufactured the toy car in significant part in the United States because its US labor costs are more than 20% of the total costs for the car [$25 ÷ ($25 + $75) = 25%].

**Reasonable Allocation Methods**

Taxpayers without any non-DPGR simply subtract 100% of COGS (the taxpayer does not have to allocate COGS between DPGR and non-DPGR). If a taxpayer has both DPGR and non-DPGR, and the taxpayer cannot specifically identify costs without undue burden, the taxpayer can use any reasonable method to allocate costs. Reasonable methods of allocation may include methods based on gross receipts, number of units sold, number of units produced, or total production costs [Treas. Reg. § 1.199-4(b)(2)]. Consistency is key. If a taxpayer uses a particular
method to allocate gross receipts between DPGR and non-DPGR, then using a different method to allocate COGS will not be reasonable, unless the taxpayer demonstrates that the method is more accurate for allocation of COGS.

Small Business Simplified Overall Method
Taxpayers can use the small business simplified overall method (small business method) to allocate COGS (and other deductions) between DPGR and non-DPGR if the taxpayer

- has average annual gross receipts of $5,000,000 or less for the 3 preceding tax years,
- is a farmer not required to use the accrual method under I.R.C. § 447, or
- has average annual gross receipts of $10,000,000 or less and can use the cash method under Rev. Proc. 2002-28, 2002-18 I.R.B. 815.

[Treas. Reg. § 1.199-4(f)]

Under the small business method, COGS allocable to DPGR equals: \[ \text{COGS} \times \left( \frac{\text{DPGR}}{\text{total gross receipts}} \right) \]

Example 7.13 Small Business Method
Weighted Keyboards builds custom pianos and provides piano tuning and repair services. Weighted Keyboards must allocate its income and deductions between its DPGR (piano manufacturing) and non-DPGR (piano service). Weighted Keyboards’s average gross receipts for the 3 preceding tax years are less than $5,000,000, so it qualifies to use the small business method. Figure 7.4 shows Weighted Keyboards’s gross receipts and COGS for 2016.

Using the small business method, Weighted Keyboards allocates $2,065,722 of its COGS to its qualifying manufacturing activity \([($3,500,000 ÷ $3,880,000) \times $2,290,000]\). Weighted Keyboards’s QPAI is $1,434,278 \((\$3,500,000 - \$2,065,722)\).

Had Weighted Keyboards used the specific-identification method, its QPAI would be $1,400,000 \((\$3,500,000 - \$2,100,000)\). By using the simplified method, Weighted Keyboards has more QPAI, and thus a larger deduction.

FIGURE 7.4 Gross Receipts and COGS for 2016

<table>
<thead>
<tr>
<th></th>
<th>Manufacturing</th>
<th>Services</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross receipts</td>
<td>$3,500,000</td>
<td>$380,000</td>
<td>$3,880,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>$2,100,000</td>
<td>$190,000</td>
<td>$2,290,000</td>
</tr>
</tbody>
</table>

Other Deductions and Costs Allocable to DPGR
To determine its QPAI for a tax year, a taxpayer must subtract from DPGR the COGS allocable to DPGR and also the other expenses, losses, or deductions that are properly allocable to DPGR. The taxpayer can allocate other deductions and costs between DPGR and non-DPGR using (1) the I.R.C. § 861 method (the section 861 method), (2) the small business simplified overall method, or (3) the simplified deduction method.

1. Section 861 Method
Under the section 861 method, if a cost is not directly allocable to DPGR or non-DPGR, the taxpayer apportions the cost between DPGR and non-DPGR. This can be a costly and burdensome calculation. While the resulting QPAI is more accurate than under the other two allocation methods, the offsetting costs and complexity of computing QPAI and the recordkeeping requirements for using this method may exceed any benefit derived from using this method.
2. Small Business Method
Taxpayers can use the small business method (described earlier) to allocate COGS and other deductions between DPGR and non-DPGR. Under this method, the other deductions allocable to DPGR equal: other deductions × (DPGR ÷ total gross receipts).

3. Simplified Deduction Method
Taxpayers with average annual gross receipts of $100,000,000 or less in the 3 preceding tax years, or total assets of $10,000,000 or less at the end of the current tax year, can use the simplified deduction method [Treas. Reg. § 1.199-4(e)]. Whether the owner of a pass-through entity may use the simplified deduction method is determined at the owner level. The simplified deduction method is illustrated in Example 7.21 later.

Observation Purpose of the Simplified Method
Even though the simplified deduction method works mechanically the same as the small business method, the taxpayer cannot use the simplified deduction method to allocate COGS. Therefore, all the simplified deduction method does is extend the availability of the small business method to allocate other deductions to taxpayers with average annual gross receipts between $5,000,000 and $100,000,000.

Taxpayers using the simplified deduction method or the small business method must use that method for all deductions. Taxpayers eligible to use the small business method may choose at any time to use that method, the simplified deduction method, or the section 861 method for a tax year. Taxpayers eligible to use the simplified deduction method may choose at any time to use that method or the section 861 method for a tax year [Treas. Reg. § 1.199-4(c)].

Using Statistical Sampling to Make Allocations
The calculation of allocable expenses and QPAI can be burdensome, particularly where large amounts of data are involved. To provide some relief, taxpayers can use statistical sampling to
1. allocate gross receipts between DPGR and non-DPGR sources,
2. allocate COGS between DPGR and non-DPGR, and
3. allocate various deductions between DPGR and non-DPGR.

Whether statistical sampling is appropriate is based on the facts and circumstances, including the time required to analyze large volumes of data, the cost of that analysis, the existence of verifiable information relevant to the taxpayer’s I.R.C. § 199 calculation, and the availability of more accurate information. The taxpayer typically can use statistical sampling if the taxpayer can show a compelling reason to use it [Rev. Proc. 2007-35].

Other Losses Allocable to DPGR
To calculate QPAI for a tax year, the taxpayer subtracts from its DPGR the COGS allocable to DPGR, other expenses or deductions allocable to such receipts, and other losses allocable to DPGR. Taxpayers with I.R.C. § 165 losses deduct those losses from DPGR if the property sale proceeds are, or would have been, included in DPGR. The property sale proceeds are included in DPGR if the underlying property is QPP.
Example 7.14 Deducting I.R.C. § 165 Loss from DPGR

Omega Corporation constructed a factory in the United States that was later struck by a tornado. The adjusted basis in the factory before the casualty was $600,000. The FMV of the factory declined $500,000 because of the tornado damage. Omega received insurance proceeds totaling $450,000. Omega’s deduction under I.R.C. § 165 for the casualty loss was $50,000 ($500,000 decrease in FMV – $450,000 insurance proceeds).

If Omega had sold the factory, the sale proceeds would be included in DPGR because Omega constructed the factory in the United States. Therefore, Omega must deduct the I.R.C. § 165 loss from DPGR to calculate its QPAI. If Omega had purchased the factory rather than constructing it, Omega would not deduct the loss from DPGR.

Taxpayers do not deduct net operating loss (NOL) deductions under I.R.C. § 172 from DPGR to calculate QPAI, even if the taxpayer’s manufacturing activities generated the losses [Treas. Reg. § 1.199-4(c)(2)]. An NOL carryforward or carryback to a year with domestic production activities may reduce or eliminate the DPAD because of taxable income limitations. In addition, taxpayers must determine the amount of their NOL carryforward or carryback under I.R.C. § 172(b)(2) using taxable income without the DPAD [Treas. Reg. § 1.199-1(b); I.R.C. § 172(d)(7)]. The DPAD cannot create or increase an NOL carryback or carryover [Treas. Reg. 1.199-1(b)(2), Example 2].

Example 7.15 Effect of $100,000 NOL on DPAD

Smith Corporation has $200,000 QPAI and taxable income for the current year before deducting the DPAD or its NOL. Smith has a $100,000 NOL carryforward from prior years. Smith does not reduce its QPAI for the current year by the NOL carryforward from the prior years when computing its tentative DPAD (before considering the 50%–of–W-2 wage limitation). However, Smith must use the lesser of its QPAI ($200,000) or taxable income ($200,000 – $100,000 NOL = $100,000) to compute its tentative DPAD.

Example 7.16 Effect of $200,000 NOL on DPAD

Smith Corporation from Example 7.15 has a $200,000 NOL carryforward from prior years. Smith does not reduce its QPAI for the current year by the NOL carryforward from the prior years when computing its tentative DPAD. However, Smith’s tentative DPAD for the year is $0 because it must use the lesser of its QPAI ($200,000) or taxable income ($200,000 – $200,000 NOL = $0) to compute its tentative DPAD.

Rules for an Expanded Affiliated Group

An expanded affiliated group (EAG) is treated as a single corporation for computing the DPAD. The starting point for the definition of an EAG is I.R.C. § 1504(a). However, for I.R.C. § 199 purposes, the “at-least-80% test” is replaced with a “more-than-50% test.” Thus, to the extent there is more-than-50% ownership of a group of corporations, the group is an EAG, and all of the corporations within that group are treated as one taxpayer.

To compute the DPAD for an EAG, the EAG must aggregate each member’s taxable income or loss, QPAI, and W-2 wages, and remove gross receipts from related entities. This can be a complicated and time-consuming process. On the other hand, the activities of one member are attributed to another member (except for construction, architecture, and engineering activities, which are not attributed to another member). So if one member manufactures QPP in the United States and sells it to another member that sells it to an unrelated party, both members’ manufacturing costs are counted in the computation of the deduction, and (assuming the other tests are met) the gross receipts from the sale to the third party qualify as DPGR. However, there is an antiavoidance rule that prohibits structuring transactions specifically for the purpose of qualifying for or increasing the DPAD.

Membership in an EAG is determined on a daily basis. Thus, the EAG member’s QPAI and W-2 wages must be allocated between the portion of the tax year the member was and was not a member of the EAG.
If a corporation is a member of an EAG for only part of the year, its deduction for the year is the sum of (1) the deduction for the part of the year it was not a member of the EAG and (2) its allocated DPAD deduction from the EAG.

If an EAG includes a consolidated group, the EAG must use the consolidated group’s taxable income, not the income of the individual consolidated group members, to compute the deduction. As with a regular member of an EAG, the deduction allocated to a consolidated group member must be based on the member’s proportional share of consolidated group QPAI. If a member has negative QPAI, the QPAI is zero.

**LIMITATIONS ON THE DEDUCTION AMOUNT**

This section discusses two limitations on the amount of the DPAD.

The DPAD amount that a taxpayer can claim is limited by the amount of wages paid by the taxpayer (the wage limitation) and the taxable income of the taxpayer (the taxable income limitation). The rules for the DPAD deduction in computing alternative minimum taxable income are slightly different.

**Wage Limitation**

The DPAD for any year may not exceed 50% of the Form W-2 wages paid by the taxpayer for that year [I.R.C. § 199(b)(1)]. The wages must be properly allocable to a qualifying production activity of the taxpayer [I.R.C. § 199(b)(2)(B)]. Wages of the taxpayer are those subject to FICA and properly reported on a Form W-2. The taxpayer can calculate wages for the 50% limitation under any one of three methods, pursuant to Rev. Proc. 2006-47, 2006-45 I.R.B. 869.

**Example 7.17 Creating Wages to Claim the DPAD**

In 2016, Frank, a sole proprietor, reported $80,000 of net farm income. He had no W-2 wage expenses for the year. His DPAD could be $7,200 (9% × $80,000), but due to the wage limitation, his DPAD is $0. However, if Frank paid a $15,000 wage to his spouse for bona fide services that she provided to the farming operation, the wage limitation on his DPAD would be $7,500 (50% × $15,000). The $15,000 wage will trigger FICA payroll taxes but will save a corresponding amount of self-employment (SE) tax by reducing Frank’s net farm income from $80,000 to $65,000. The wage reduces net farm income, and reduces the DPAD to $5,850 (9% × $65,000), which is less than the $7,500 wage limitation.
Observation  
Additional Medicare Tax

Individuals must also pay an additional 0.9% Medicare tax on earned income above certain thresholds. The employee portion of the Medicare tax increases from 1.45% to 2.35% on wages or SE income that the taxpayer receives in a calendar year in excess of $200,000 ($250,000 for married couples filing jointly; $125,000 for married filing separately) [I.R.C. § 3101(b)]. The taxpayer must take this additional 0.9% Medicare tax into account when considering creating wages for DPAD purposes.

All qualifying wages of a partnership or S corporation pass through to the individual owner (see the discussion of pass-through entities infra) [I.R.C. § 199(d)(1)(A)(iii)]. Therefore, if a sole proprietor conducting a qualifying farm or nonfarm activity without wages [or a Schedule C or F (Form 1040) taxpayer who is limited by the I.R.C. § 199 wage limitation] owns an interest in a partnership or S corporation that pays wages in a qualifying production activity, the sole proprietor can use the pass-through wages from the qualifying pass-through activity to claim the DPAD for the Schedule C or F (Form 1040) proprietorship activity. Partners are considered self-employed individuals; therefore, they cannot draw wages from a partnership in which they own an interest. However, as shown in Example 7.18, a partnership can allocate to the partners wages attributable to the production activity that are paid to nonpartners.

Example 7.18 Use of Pass-Through Wages to Claim the DPAD

Susan, a farmer, annually reports approximately $150,000 of net Schedule F (Form 1040) income, but has no Schedule F wage expense. Susan is also a 10% partner in a hog-farrowing facility that annually allocates approximately $15,000 of net income to her.

The partnership can allocate wages attributable to its production activity to Susan. If the wages allocable to Susan for her 10% share in the farrowing activity are $30,000, Susan can take a DPAD for all of her eligible production income of $165,000 ($150,000 from Schedule F + $15,000 from the hog-farrowing pass-through entity). Susan’s DPAD will be $14,850 ($165,000 × 9%).

Her total wages of $30,000 (all applicable to the partnership) multiplied by 50% equal $15,000, which is greater than the DPAD.

Taxable Income Limitation

The DPAD is limited by the taxable income of the entity. Thus, the amount of the deduction is limited to 9% of the lesser of

- qualified production activities income (QPAI) of the taxpayer, or
- the taxable income for the taxable year of the taxpayer determined without the DPAD.

The DPAD also applies to individual taxpayers. Under I.R.C. § 199(d)(2), the deduction is limited based on adjusted gross income (without the DPAD) after application of the following:

1. I.R.C. § 86 (social security and tier 1 railroad retirement benefits)
2. I.R.C. § 135 (income from US savings bonds used to pay higher-education tuition and fees)
3. I.R.C. § 137 (adoption assistance programs)
4. I.R.C. § 219 (retirement savings)
5. I.R.C. § 221 (interest on education loans)
6. I.R.C. § 222 (qualified tuition and related expenses)
7. I.R.C. § 469 (passive activity losses)

Alternative Minimum Tax

The taxpayer may deduct the DPAD when computing alternative minimum taxable income (AMTI) [I.R.C. § 199(d)(6)]. When computing AMTI, the taxpayer determines the DPAD by using the lesser of the QPAI (as determined for the regular tax) or AMTI, regardless of the DPAD. When computing AMTI, the taxpayer determines QPAI without any adjustments under I.R.C. §§ 56 through 59. The taxpayer cannot use the deduction to determine the alternative tax NOL deduction.
REPORTING THE DEDUCTION ON FORM 8903  This section explains how to use Form 8903 to calculate and report the DPAD.

Individuals, corporations, cooperatives, estates, and trusts use Form 8903, Domestic Production Activities Deduction, to calculate their allowable DPAD from certain trade or business activities. Shareholders of S corporations and partners use information provided by the S corporation or partnership to determine their allowable DPAD. Beneficiaries of an estate or trust use information provided by the estate or trust to calculate their allowable deduction. Certain agricultural or horticultural cooperatives may allocate a share of the cooperative’s DPAD to their patrons.

Example 7.19 Completed Form 8903
Elvis Green operates a manufacturing sole proprietorship. In 2016, he does not elect to use either of the simplified methods of allocating expenses. Elvis uses the amounts listed in Figure 7.5 to compute his DPAD. Elvis is a member of an LLC that is taxed as a partnership. The partnership reported $3,000 as Elvis’s share of QPAI and $1,000 as his share of wages. Elvis was also a member of an agricultural cooperative that reported $850 as his share of the cooperative’s DPAD on Form 1099-PATR, box 6. Elvis’s adjusted gross income for 2016 was $65,000; the calculation of his $5,170 DPAD is shown on Form 8903 in Figure 7.6.

FIGURE 7.5 Elvis’s Sole-Proprietorship DPGR

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic production gross receipts (DPGR)</td>
<td>$100,000</td>
</tr>
<tr>
<td>Expenses allocable to DPGR:</td>
<td></td>
</tr>
<tr>
<td>COGS</td>
<td>$ 35,000</td>
</tr>
<tr>
<td>Direct expenses</td>
<td>15,000</td>
</tr>
<tr>
<td>Indirect expenses</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Total expenses allocable to DPGR</td>
<td>$ 55,000</td>
</tr>
<tr>
<td>Form W-2 wages included in expenses allocable to DPGR</td>
<td>$ 21,000</td>
</tr>
</tbody>
</table>

Observation  Most Recent Version
Form 8903 is not specific to a year (the most recent revision is December 2010), but the IRS usually updates the instructions for Form 8903 annually on a stand-alone basis.

Practitioner Note  MFJ Taxpayers
MFJ taxpayers calculate the DPAD on one Form 8903 using the applicable items of both spouses.

 Unless a taxpayer was allocated a share of a cooperative’s DPAD or the taxpayer is a member of an expanded affiliated group (EAG), the taxpayer cannot claim a DPAD unless all three of the following are positive amounts on Form 8903:

1. QPAI
2. AGI for an individual, estate, or trust (taxable income for all other taxpayers)
3. Form W-2 wages paid to employees

226  REPORTING THE DEDUCTION ON FORM 8903
## Reporting the Deduction on Form 8903

**Domestic Production Activities Deduction**

- **Attachment Sequence No. 143**
- **Name(s) as shown on return**: ELVIS GREEN
- **Identifying number**: 111-22-3333

### Form 8903 (Rev. December 2010)

### Department of the Treasury

### Internal Revenue Service

#### Note. Do not complete column (a), unless you have oil-related production activities. Enter amounts for all activities in column (b), including oil-related production activities.

<table>
<thead>
<tr>
<th></th>
<th>Oil-related production activities</th>
<th>All activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Domestic production gross receipts (DPGR)</td>
<td>100,000</td>
</tr>
<tr>
<td>2</td>
<td>Allocable cost of goods sold. If you are using the small business simplified overall method, skip lines 2 and 3</td>
<td>35,000</td>
</tr>
<tr>
<td>3</td>
<td>Enter deductions and losses allocable to DPGR (see instructions)</td>
<td>15,000</td>
</tr>
<tr>
<td>4</td>
<td>If you are using the small business simplified overall method, enter the amount of cost of goods sold and other deductions or losses you ratably apportion to DPGR. All others, skip line 4</td>
<td>5,000</td>
</tr>
<tr>
<td>5</td>
<td>Add lines 2 through 4</td>
<td>55,000</td>
</tr>
<tr>
<td>6</td>
<td>Subtract line 5 from line 1</td>
<td>45,000</td>
</tr>
<tr>
<td>7</td>
<td>Qualified production activities income from estates, trusts, and certain partnerships and S corporations (see instructions)</td>
<td>3,000</td>
</tr>
<tr>
<td>8</td>
<td>Add lines 6 and 7. Estates and trusts, go to line 9, all others, skip line 9 and go to line 10</td>
<td>46,000</td>
</tr>
<tr>
<td>9</td>
<td>Amount allocated to beneficiaries of the estate or trust (see instructions)</td>
<td>46,000</td>
</tr>
</tbody>
</table>

#### 10a Oil-related qualified production activities income. Estates and trusts, subtract line 9, column (a), from line 8, column (a), all others, enter amount from line 8, column (a). If zero or less, enter -0- here.

- 10a

#### 10b Qualified production activities income. Estates and trusts, subtract line 9, column (b), from line 8, column (b), all others, enter amount from line 8, column (b). If zero or less, enter -0- here, skip lines 11 through 21, and enter -0- on line 22.

- 10b

#### 11 Income limitation (see instructions):

- All others. Enter your taxable income figured without the domestic production activities deduction (tax-exempt organizations, see instructions)

<table>
<thead>
<tr>
<th></th>
<th>11</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>65,000</td>
</tr>
</tbody>
</table>

#### 12 Enter the smaller of line 10b or line 11. If zero or less, enter -0- here, skip lines 13 through 21, and enter -0- on line 22.

<table>
<thead>
<tr>
<th></th>
<th>12</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>48,000</td>
</tr>
</tbody>
</table>

#### 13 Enter 9% of line 12

<table>
<thead>
<tr>
<th></th>
<th>13</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>4,320</td>
</tr>
</tbody>
</table>

#### 14 Enter the smaller of line 10a or line 12

<table>
<thead>
<tr>
<th></th>
<th>14a</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1,000</td>
</tr>
</tbody>
</table>

#### 14b Reduction for oil-related qualified production activities income. Multiply line 14a by 3%

<table>
<thead>
<tr>
<th></th>
<th>14b</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1,000</td>
</tr>
</tbody>
</table>

#### 15 Subtract line 14b from line 13

<table>
<thead>
<tr>
<th></th>
<th>15</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>4,320</td>
</tr>
</tbody>
</table>

#### 16 Form W-2 wages (see instructions)

<table>
<thead>
<tr>
<th></th>
<th>16</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>21,000</td>
</tr>
</tbody>
</table>

#### 17 Form W-2 wages from estates, trusts, and certain partnerships and S corporations (see instructions)

<table>
<thead>
<tr>
<th></th>
<th>17</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1,000</td>
</tr>
</tbody>
</table>

#### 18 Add lines 16 and 17. Estates and trusts, go to line 19, all others, skip line 19 and go to line 20

<table>
<thead>
<tr>
<th></th>
<th>18</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>22,000</td>
</tr>
</tbody>
</table>

#### 19 Amount allocated to beneficiaries of the estate or trust (see instructions)

<table>
<thead>
<tr>
<th></th>
<th>19</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1,000</td>
</tr>
</tbody>
</table>

#### 20 Estates and trusts, subtract line 19 from line 18, all others, enter amount from line 18

<table>
<thead>
<tr>
<th></th>
<th>20</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>22,000</td>
</tr>
</tbody>
</table>

#### 21 Form W-2 wage limitation. Enter 50% of line 20

<table>
<thead>
<tr>
<th></th>
<th>21</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>11,000</td>
</tr>
</tbody>
</table>

#### 22 Enter the smaller of line 15 or line 21

<table>
<thead>
<tr>
<th></th>
<th>22</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>4,320</td>
</tr>
</tbody>
</table>

#### 23 Domestic production activities deduction from cooperatives. Enter deduction from Form 1099-PATR, box 6

<table>
<thead>
<tr>
<th></th>
<th>23</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>850</td>
</tr>
</tbody>
</table>

#### 24 Expanded affiliated group allocation (see instructions)

<table>
<thead>
<tr>
<th></th>
<th>24</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1,000</td>
</tr>
</tbody>
</table>

#### 25 Domestic production activities deduction. Combine lines 22 through 24 and enter the result here and on Form 1040, line 35; Form 1120, line 25; or the applicable line of your return

<table>
<thead>
<tr>
<th></th>
<th>25</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>5,170</td>
</tr>
</tbody>
</table>

---

For Paperwork Reduction Act Notice, see separate instructions.
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 as a deduction on line 25 of Form 1120, U.S. Corporation Income Tax Return. Trusts or estates claim the deduction (if the trust or estate does not allocate distributable net income to the beneficiaries) on line 15c of Form 1041, U.S. Income Tax Return for Estates and Trusts.

PASS-THROUGH ENTITIES  This section examines how partnerships and S corporations calculate, allocate, and report income and wages for the DPAD.

Generally, partnerships and S corporations pass through to the partner or shareholder the owner’s share of income, gain, loss, and deduction, and the owner calculates the DPAD at the individual level. However, some partnerships and S corporations can calculate QPAI and Form W-2 wages at the entity level. The entity then allocates and reports those items to the owners, who then use the reported amounts to claim the DPAD at the individual level.

I.R.C. § 199 Pass-Through Rules

The DPAD for partnership qualified production activities is determined at the partner level. As a result, each partner computes its deduction separately [Treas. Reg. § 1.199-5(b)(1)]. The partnership allocates to each partner its share of partnership items (including income, gain, loss, and deduction), the COGS allocated to these income items, and gross receipts that are included in the income items. Items are allocated pursuant to the I.R.C. § 702 rules for determining partners’ income and the I.R.C. § 704 rules for determining partners’ distributive shares of partnership items. Guaranteed payments are not considered allocations of partnership income under the I.R.C. § 199 rules. However, they must be taken into account as partnership deductions when determining deductions allocable to DPGR under Treas. Reg. § 1.199-4.

When allocating and apportioning deductions to DPGR and computing QPAI, the partner generally aggregates its distributive share of partnership items with the items it incurs outside the partnership (either directly or indirectly). The partner takes partnership deductions into account in computing the partner’s DPAD only to the extent the partner’s distributive share of those deductions is not disallowed under I.R.C. § 704(d), the I.R.C. § 465 at-risk rules, the I.R.C. § 469 passive activity loss rules, or any other Internal Revenue Code provision. If only part of the partner’s distributive share of the losses or deductions is allowed for the year, then, to compute the DPAD, the taxpayer takes into account a proportionate share of those allowable losses or deductions that are allocated to the partnership’s qualified production activities. If any of the disallowed amounts are allowed in a later year, the partner takes into account a proportionate share of those losses or deductions in computing QPAI for that later year [Treas. Reg. § 1.199-5(b)(2)].

The DPAD for S corporation qualified production activities is determined at the shareholder level. As a result, each shareholder computes the deduction separately [Treas. Reg. § 1.199-5(c)]. The S corporation allocates to each shareholder, under the regular I.R.C. § 1366 pass-through rules, his or her pro rata share of items (income, gain, loss, and deduction), COGS allocated to these income items, and gross receipts included in the income items. This allocation applies even if the shareholder’s share of COGS and other deductions and losses exceeds DPGR.

Each S corporation shareholder aggregates his or her pro rata share of S corporation items, to the extent they are not otherwise disallowed, with items incurred outside the S corporation (whether directly or indirectly) for purposes of allocating and apportioning deductions to DPGR and computing QPAI.

S corporation deductions that otherwise would be taken into account in computing the shareholder’s deduction are only taken into account if and to the extent the shareholder’s pro rata share of the losses or deductions from all of
Determination at the Entity Level

Under Treas. Reg. § 1.199-5(c)(1)(ii), an S corporation can calculate a shareholder’s share of QPAI and W-2 wages at the entity level. Similarly, under Treas. Reg. § 1.199-5(b)(1)(ii), a partnership can calculate the partner’s share of QPAI and W-2 wages at the entity level. If the S corporation or partnership calculates QPAI at the S corporation or partnership level, the entity allocates to each shareholder or partner his or her share of QPAI and W-2 wages from the entity. The shareholder or partner then combines the allocated QPAI and W-2 wages with any QPAI and W-2 wages from other sources.

Shareholders or partners receiving an allocation of QPAI and W-2 wages cannot recalculate their share of QPAI or W-2 wages from the entity using another cost allocation method (although they must adjust QPAI for certain disallowed losses or deductions, and for the allowance of suspended losses or deductions).

Rev. Proc. 2007-34, 2007-23 I.R.B. 1345, explains when an eligible entity can choose to calculate QPAI and W-2 wages at the entity level and the rules for making the calculation. Under Rev. Proc. 2007-34, the following entities can calculate QPAI and W-2 wages at the entity level:

1. Eligible I.R.C. § 861 partnership: The determination of whether a partnership is an eligible I.R.C. § 861 partnership (a section 861 partnership) is made each tax year. An eligible section 861 partnership has at least 100 partners on any day in the tax year; and is owned at least 70% by qualifying partners at all times during the year. A qualifying partner is a partner that on any day of the partnership’s current tax year is not a managing partner, does not materially participate in the partnership activities, and does not hold 5% or more of the partnership’s profits or capital. A partner that is not an individual materially participates if its owners, directors, officers, employees, or fiduciaries are treated as materially participating in the partnership’s activities. Qualifying in-kind partnerships [under Treas. Reg. § 1.199-3(i)(7)] and expanded affiliated group (EAG) partnerships (under Treas. Reg. § 1.199-7) cannot be qualifying partners.

2. Eligible widely held pass-through entity: An eligible widely held pass-through entity must be an S corporation or a partnership that is an eligible taxpayer under Treas. Reg. § 1.199-4(e)(2)—that is, it must have average annual gross receipts of $100,000,000 or less in the 3 preceding tax years or must have total assets of $10,000,000 or less at the end of the current year. Additionally, the entity must have DPGR, must have COGS and deductions of $10,000,000 or less, and must be comprised on every day of its current tax year of partners or S corporation shareholders that are individuals, estates, or trusts described in I.R.C. § 1361(c)(2) [a qualified subchapter S trust (QSST)]. For a partnership, no partner can have a profits or capital interest exceeding 10% [determined after aggregating the interests of any related persons as determined in I.R.C. §§ 267(b) or 707(b), disregarding I.R.C. §§ 267(e)(1) and (f)(1)(A)] on any day of the current tax year. For an S corporation, no shareholder can own shares exceeding 10% (determined after aggregating the interests of any related persons) of the total shares of the S corporation during the current tax year.

3. Eligible small pass-through entity: An eligible small pass-through entity is a partnership or S corporation that meets the requirements of Treas. Reg. § 1.199-4(f)(2) to use the small business simplified overall method; has total costs of $5,000,000 or less; has DPGR; and, if the entity is a partnership, does not have a qualifying ineligible partner [under Treas. Reg. § 1.199-3(i)(7)] or an EAG partnership as a partner.
8. The entity must take into account an increase or decrease in the basis of partnership assets pursuant to I.R.C. § 743.

9. The partnership must exclude any entity items allocated by an eligible I.R.C. § 861 partnership to a partner that is not a qualifying partner [including items allocated to such partner pursuant to I.R.C. § 704(c)] for purposes of calculating the QPAI and Form W-2 wages to be allocated to its qualifying partners.

10. The QPAI computed at the entity level and allocated to each partner or shareholder will be less than zero if the entity’s DPGR does not exceed the sum of the entity’s items to be deducted in computing QPAI.

Cost Allocation Methods

An eligible I.R.C. § 861 entity that chooses to calculate QPAI and W-2 wages at the entity level must use the section 861 method to calculate QPAI. An eligible widely held pass-through entity that chooses to calculate QPAI and W-2 wages at the entity level must use the simplified deduction method. An eligible small pass-through entity that chooses to calculate QPAI and W-2 wages at the entity level must use the small business method to calculate QPAI. (See the earlier “Computing the Deduction” section for a discussion of these methods.)

According to Rev. Proc. 2007-34, a change in an eligible entity’s method for calculating QPAI at the entity level, or a change from calculating QPAI and W-2 wages at the entity level to calculating such amounts at the member level (or vice versa), is not a change in accounting method.

Example 7.20 Small Business Method

Al Armstrong and Bob Buckley each own 50% of Bobal Partners, a calendar-year partnership that engages in activities that generate DPGR and non-DPGR. Al and Bob share partnership items equally. Bobal has $2,000 of total gross receipts ($1,000 of which is DPGR), $900 of COGS (including $400 of W-2 wages), and $800 of other deductions.

Eligibility to use the small business simplified overall method is determined at the partnership level, and the method is applied at the partnership level. Bobal uses the small business method. Under this method, Bobal’s COGS and
Calculating W-2 Wages and QPAI at the Entity Level

Example 7.21 Simplified Deduction Method
Cindy Crawley and Diana Dunston are 50% partners in Happy Partners, which uses a calendar tax year. In general, they share partnership items equally, except that 80% of the wage expense and 20% of other expenses are specially allocated to Cindy [the allocation has substantial economic effect under I.R.C. §704(b)]. In the current year, Happy Partners’s only wage expense is $2,000 for marketing, which is not included in COGS. Happy Partners has $8,000 of gross receipts ($6,000 of which is DPGR), $4,000 of COGS ($3,500 of which is allocable to DPGR), and $3,000 of other deductions ($2,000 of wages for marketing and $1,000 of other expenses).

Eligibility for the simplified deduction method is determined at the partner level, and the method is applied at the partner level. Assume that Cindy qualifies for and uses this method. In the current year, she has $1,000 of gross receipts attributable to nonpartnership activities and $200 of wages.

Under the partnership agreement, Cindy’s distributive share of partnership items is

■ $1,250 of gross income attributable to DPGR [(6,000 DPGR × 50% = $3,000) – (3,500 allocable to DPGR × 50% = $1,750 allocable COGS)],

■ $750 of gross income attributable to non-DPGR [(2,000 non-DPGR receipts × 50% = $1,000 non-DPGR) – (500 non-DPGR COGS × 50% = $250 non-DPGR COGS)],

and

$1,800 of deductions [Cindy’s special allocations of $1,600 ($2,000 × 80%) wage expense for marketing + $200 ($1,000 × 20%) of other expenses].

Cindy apportions $1,200 of other deductions to DPGR calculated as follows:

■ $1,800 from the partnership + $200 from nonpartnership activities = $2,000 other deductions

■ [$3,000 DPGR ÷ ($4,000 gross receipts from the partnership + $1,000 gross receipts from the nonpartnership = $5,000 total gross receipts)] = 60%

■ 60% × $2,000 = $1,200

Accordingly, Cindy’s QPAI for the year is $50 ($3,000 DPGR − $1,750 COGS − $1,200 deductions). Cindy’s tentative deduction is $4.50 ($50 QPAI × 9%, subject to the I.R.C. §199(b)(1) wage limitation). Cindy has $1,080 total wages allocable to DPGR [60% × ($1,600 partnership W-2 wages + $200 nonpartnership W-2 wages)]. Her wage limitation is $540 ($1,080 × 50%). Accordingly, her I.R.C. §199 deduction for the year is $4.50.

Safe Harbors to Calculate W-2 Wages
A partnership or S corporation using the small business method may use the small business method safe harbor to calculate W-2 wages at the entity level. Eligible I.R.C. §861 partnerships and widely held pass-through entities may use the wage expense safe harbor method to calculate W-2 wages at the entity level.

Small Business Method Safe Harbor
Under Treas. Reg. §1.199-2(e)(2)(iii), a taxpayer that uses the small business method under Treas. Reg. §1.199-4(f) may use the small business simplified overall method safe harbor (the small business method safe harbor) to determine the amount of wages properly allocable to DPGR. The amount of wages that is properly allocable to DPGR is equal to the same proportion of wages that the amount of DPGR bears to the taxpayer’s total gross receipts.
**Wage Expense Safe Harbor**

Under Treas. Reg. § 1.199-2(e)(2)(ii), a taxpayer that uses the section 861 method of cost allocation or the simplified deduction method may determine the amount of wages that is properly allocable to DPGR for a tax year under the wage expense safe harbor. The taxpayer multiplies the amount of wages for the tax year by the ratio of the taxpayer’s wage expense included in calculating QPAI for the tax year to the taxpayer’s total wage expense used in calculating the taxpayer’s taxable income (or adjusted gross income, if applicable) for the tax year, without regard to any wage expense disallowed by I.R.C. § 465, 469, 704(d), or 1366(d).

**Allocating QPAI and W-2 Wages**

A pass-through entity that calculates QPAI at the entity level must allocate its QPAI and W-2 wages for that tax year among the owners. Generally, the entity allocates QPAI in the same proportion that the entity allocates gross income to the owners for the year. If the entity has no gross income for the year, it allocates QPAI among the owners in proportion to its partners’ profit interests, or to its shareholders’ ownership interests.

An entity that calculates QPAI at the entity level also allocates its W-2 wages among the owners. First, the entity determines the amount of wages that are properly allocable to DPGR for purposes of I.R.C. § 199(c)(1). The entity then allocates its W-2 wages among its partners or shareholders in the same manner that it allocates wage expense among its partners or shareholders for that tax year.

**Reporting the Deduction**

The partnership reports each partner’s share of the partnership’s QPAI and W-2 wages for the year on the partner’s Schedule K-1 (Form 1065), Partner’s Share of Income, Deductions, Credits, etc., line 13, codes T through V. The partner uses the QPAI and W-2 information to calculate the DPAD on the partner’s Form 8903. Figure 7.7 shows the Schedule K-1 line 13, code descriptions.

**FIGURE 7.7 Schedule K-1 Line 13 Codes for Partnerships**

<table>
<thead>
<tr>
<th>Schedule K-1 Line 13 Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Code T. Domestic production activities information</td>
<td>Provides the partner with a statement that includes information used to figure the DPAD</td>
</tr>
<tr>
<td>Code U. Qualified production activities income (QPAI)</td>
<td>Provides the partnership’s allocation of QPAI to the partner that the partner reports in the applicable line 7 column of Form 8903</td>
</tr>
<tr>
<td>Code V. Employer’s Form W-2 wages</td>
<td>Provides the partnership’s allocation of Form W-2 wages to the partner that the partner reports on line 17 of Form 8903</td>
</tr>
</tbody>
</table>

Similarly, S corporations report the shareholder’s share of the partnership’s QPAI and W-2 wages for the year on the shareholder’s Schedule K-1 (Form 1120S), Shareholder’s Share of Income, Deductions, Credits, etc., line 12, codes P through R. The shareholder uses the information to calculate the DPAD on Form 8903. Figure 7.8 shows the Schedule K-1, line 12, code descriptions.
Agricultural and Horticultural Cooperatives

Specified agricultural or horticultural cooperatives can claim the DPAD if they manufacture, produce, grow, or extract (MPGE) agricultural or horticultural products. A cooperative can also claim the DPAD for such products that the cooperative markets.

A specified agricultural or horticultural cooperative that is engaged in the marketing of agricultural or horticultural products is treated as having MPGE in whole or significant part in the United States from any qualifying production property (QPP) that the cooperative markets if its patrons MPGE the QPP. Even nonpooling cooperatives that lack captive marketing agreements can claim the DPAD [Ltr. Rul. 2010-02-009 (October 1, 2009)].

Nonexempt subchapter T cooperatives can exclude or deduct eligible distributions to their patrons as patronage dividends or per-unit retain allocations. Under I.R.C. § 1388(f), this includes any per-unit retain paid in money (PURPIM) to a producer for products the cooperative markets.

An agricultural cooperative can pass through to its patrons all or any portion of its DPAD. Amounts passed through appear on Form 1099-PATR, Taxable Distributions Received From Cooperatives, and the patron can claim the deduction on the patron’s corporate or individual tax return. If the patron is a pass-through entity (partnership or S corporation), the DPAD retains its status as a separately stated item on Schedule K-1 even if the pass-through entity has a loss or basis limitation [Treas. Reg. § 1.199-5(b)(1) and (c)(1)]. Also, the 50%-of-gross-wages limitation does not apply to any DPAD passed through by a cooperative.

For purposes of the preceding rules, agricultural or horticultural products include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are MPGE.

### FIGURE 7.8 Schedule K-1 Line 12 Codes for S Corporations

<table>
<thead>
<tr>
<th>Schedule K-1 Line 12 Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Code P. Domestic production activities information</td>
<td>Provides the shareholder with a statement that includes information used to figure the DPAD</td>
</tr>
<tr>
<td>Code Q. Qualified production activities income (QPAI)</td>
<td>Provides the S corporation’s allocation of QPAI to the shareholder that the shareholder reports in the applicable line 7 column of Form 8903</td>
</tr>
<tr>
<td>Code R. Employer’s Form W-2 wages</td>
<td>Provides the S corporation’s allocation of Form W-2 wages to the shareholder that the shareholder reports on line 17 of Form 8903</td>
</tr>
</tbody>
</table>

### Practitioner Note

Few estates or trusts will have QPAI since most are not engaged in a trade or business and do not pay W-2 wages. However, the trust or estate must allocate any QPAI and Form W-2 wages among the trust or estate (line 15a of Form 1041, U.S. Income Tax Return for Estates and Trusts) and its beneficiaries on Schedule K-1 (Form 1041), line 14. If the estate or trust has no distributable net income (DNI) for the tax year, QPAI and W-2 wages are allocated entirely to the estate or trust. Treas. Reg. § 1.199-9(d) and (e) details the QPAI rules applicable to estates and trusts.
Agricultural and Horticultural Cooperatives

Example 7.22 Cooperative Receipts Are DPGR

Co-op Black, a specified agricultural or horticultural cooperative, markets corn grown by its patrons in the United States for sale to retail grocers. All of Co-op Black’s gross receipts are derived from the sale of corn grown by its patrons in the United States. Co-op Black is treated as having grown the corn that it markets, even though its patrons grew the corn. The cooperative’s gross receipts from its sales of the corn are gross receipts from the sale of corn grown by the cooperative in the United States, and thus qualify as DPGR [Treas. Reg. § 1.199-6(m), Example 1].

Treas. Reg. § 1.199-6(m), Example 1, supra has been interpreted to state that the cooperative’s payment for its members’ corn is a per-unit retain allocation paid in money as defined in I.R.C. §§ 1382(b)(3) and 1388(f) (i.e., a qualified payment). But the IRS says that the example does not identify the cooperative’s payment for its members’ corn as a per-unit retain allocation and is not intended to illustrate how QPAI is computed when a cooperative’s payments to its patrons are per-unit retain allocations. Prop. Treas. Reg. § 1.199-6(m), Example 4 (described infra), shows how QPAI is computed when a cooperative’s payments to its patrons are per-unit retain allocations paid in money under I.R.C. § 1388(f).

Example 7.23 Calculation of QPAI for Co-op

The facts are the same as in Example 7.22. Co-op Black has $1,500,000 of gross receipts, all derived from the sale of corn grown by its patrons in the United States; it pays $370,000 for its patrons’ corn, and it pays $130,000 of W-2 wages. All of Co-op Black’s gross receipts qualify as DPGR. Co-op Black’s payments of $370,000 for its patrons’ corn qualify as per-unit retain allocations paid in money within the meaning of I.R.C. § 1388(f), and Co-op Black reports the per-unit retain allocations paid in money on Form 1099-PATR. Under Treas. Reg. § 1.199-6(c), in computing QPAI, the per-unit retain allocations paid in money are disregarded, and Co-op Black’s QPAI is $1,370,000 ($1,500,000 gross receipts − $130,000 W-2 wages) [Prop. Treas. Reg. § 1.199-6(m), Example 4].

Example 7.24 Calculation of Patronage Dividend by Co-op

For the 2016 tax year, Co-op White, a specified agricultural or horticultural cooperative, had $1,000,000 taxable income, before taking into account its $60,000 DPAD. In 2016, the cooperative declared a patronage dividend of $1,000,000, and passed through the entire DPAD to its members. The cooperative may deduct the amount of the patronage dividend, reduced by the amount of the passed-through DPAD. Therefore, Co-op White is entitled to a patronage dividend deduction of $940,000 ($1,000,000 patronage dividend − $60,000 passed-through DPAD). It is also entitled to the DPAD of $60,000. Therefore, its
taxable income for the year is $0 ($1,000,000 — $940,000 patronage dividend deduction — $60,000 DPAD).

To the extent a cooperative treats payments to patrons as PURPIM, the amount is not deducted in computing its QPAI, resulting in its I.R.C. § 199 deduction being markedly higher because most cost of sales are ignored. A cooperative is required to notify patrons of the PURPIM amount used in its I.R.C. § 199 calculation. The patron cannot treat those sales as DPGR on the patron’s return [Treas. Reg. § 1.199-6(k)]. The patron must use one of the allocation methods to allocate deductions between DPGR and non-DPGR and calculate his or her QPAI.

**SPECIFIC INDUSTRIES**  This section explains how the DPAD applies in specific industries.

The DPAD was intended for taxpayers in the manufacturing industry, but it can apply to taxpayers who produce computer software, farmers, taxpayers in the construction industry, architects and engineers, food and beverage producers, taxpayers who produce utilities, taxpayers in the oil and gas industry, and agricultural cooperatives.

**Computer Software**

Income from the lease, rental, license, sale, exchange, or other disposition of computer software manufactured, produced, grown, or extracted (MPGE) in the United States qualifies for the DPAD, regardless of whether the customer purchases the software off the shelf or takes delivery of the software by downloading it from the Internet [Treas. Reg. § 1.199-3(i)(6)].

The term computer software means any program, routine, or sequence of machine-readable coding that a taxpayer designs to make a computer perform a desired function [Treas. Reg. § 1.199-3(j)(3)]. Computer software also includes video game software and the rights to use the software. Computer software does not include tangible property on which the taxpayer places the program or machine-readable coding, because these items are tangible personal property (TPP) for I.R.C. § 199 purposes. However, the taxpayer may treat the tangible medium (e.g., a diskette) as software if it produces the software and adds the software to the tangible medium, and it does not consider any of its I.R.C. § 174 costs (research and experimental expenditures) when determining whether its production activity attributable to the tangible medium is substantial in nature [Treas. Reg. § 1.199-3(j)(5)].

**Example 7.25 Computer Software and TPP Created in United States**

Red, Inc. developed a software program at its US location for a video game that it reproduces and sells on a compact disc. Therefore, the sale of the compact disc involves both computer software (the program) and TPP (the compact disc). Red may treat the income from the sale of the computer software and the compact disc as DPGR because both were developed and produced in the United States.

**Example 7.26 Computer Software and TPP outside the United States**

Blue, Inc. develops video game software outside the United States and licenses the rights to manufacture and distribute the software to Red. Red
manufactures the compact discs (encoded with the software) at its US location and sells the video games to retailers. Red derives its gross receipts in part from the sale of the computer software and in part from the sale of the compact disc. Red will have to allocate its gross receipts between these two items because only the gross receipts from the sale of the compact disc qualify as DPGR. The portion of Red’s receipts from the sale of the software does not qualify as DPGR because Blue developed the software outside the United States.

Gross receipts from customer and technical support, telephone and other telecommunication services, online services (such as Internet access services; online banking services; or providing access to online electronic books, newspapers, and journals), and similar services do not constitute DPGR. However, the following exceptions under Treas. Reg. § 1.199-3(i)(6)(iv)(B) treat gross receipts from providing computer software for customers’ direct use while connected to the Internet as DPGR (if the taxpayer meets the other requirements of I.R.C. § 199):

1. The taxpayer derives, on a regular basis, gross receipts from the lease, rental, license, sale, etc., to unrelated persons of computer software that has only minor or immaterial differences from the online software, and has been provided to customers on a tangible medium (e.g., a disk or DVD) or by electronic download from the Internet.

2. An unrelated person derives, on a regular basis, gross receipts from the lease, rental, license, sale, etc., of software that is substantially identical to the taxpayer’s online software, and delivers that software on a tangible medium or by electronic download from the Internet.

Example 7.27 Sale of Online Software Is DPGR
Periodic Payroll produces payroll management software in Texas. For a fee, Periodic Payroll provides customers access to the payroll management computer software for use while connected to the Internet. A competitor, Davis Payroll Services, sells substantially identical payroll management software that can be affixed to a compact disc or downloaded from the Internet. Periodic Payroll’s gross receipts from providing access to its payroll management online software qualify as DPGR under Treas. Reg. § 1.199-3(i)(6)(iii)(B), assuming that the company meets all other requirements.

Example 7.28 Sale of Online Software Is Not DPGR
The facts are the same as in Example 7.27 except that Periodic Payroll produces inventory control software. Davis Payroll Services’s software is not substantially identical to Periodic Payroll’s software from the customers’ perspective because it does not have the same functional result as Periodic Payroll’s software and it does not have a significant overlap of features or purpose with Periodic Payroll’s software. Assuming that no other person provides substantially identical software to customers affixed to a compact disc or by download, Periodic Payroll’s gross receipts from providing access to its payroll management online software do not qualify as DPGR.

When determining whether software is substantially identical, all computer software games are deemed to be substantially identical software. As a result, computer software sports games and card games are treated as substantially identical [Treas. Reg. § 1.199-3(i)(6)(iv)(B)].

Pursuant to Generic Legal Advice Memorandum 2014-008 (November 21, 2014), a taxpayer derives no DPGR from the disposition of a computer software application when it allows its customers to download the application free of charge and the application only enables the customers to access the taxpayer’s online fee-based services. In order to realize DPGR, a taxpayer must dispose of computer software and derive gross receipts from that disposition. According to Treas. Reg. § 1.199-3(i)(6)(i) and (ii), offering customers access to online software is not a qualifying disposition of computer software.

For the substantial-in-nature and safe harbor tests, taxpayers generally must disregard research and experimental expenditures leading to the creation of TPP because these activities create an intangible asset. However, in the case of computer software and sound recordings, the taxpayer does not disregard these activities in applying these two tests [Treas. Reg. § 1.199-3(j)(5)].
Farming Activities

Qualifying production for DPAD purposes includes producing and growing activities. The regulations expand the growing definition to include cultivating soil, raising livestock, fishing, and mining. Eligible activities also include the storage, handling, or other processing activities (other than transportation activities) in the United States related to the sale, exchange, or other disposition of agricultural products [Treas. Reg. § 1.199-3(e)(1)]. The taxpayer must have the benefits and burdens of ownership of the property while the producing or growing activity takes place for the gross receipts to qualify for the DPAD.

Example 7.29 DPAD Deduction for Farming Activities

Mike Miller owns and operates an incorporated farm that generated $500,000 from the sale of raised grain in 2016. The corporation also had $50,000 of USDA farm subsidies, some of which included payments for not producing crops; $40,000 of insurance proceeds for hail damage to crops; and $10,000 of revenue for custom combining services that Mike performed for other farmers.

Proceeds from business interruption insurance, governmental subsidies, and governmental payments not to produce are treated as gross receipts for DPAD purposes to the extent they are substitutes for gross receipts that would otherwise qualify [Treas. Reg. § 1.199-3(i)(1)(iii)].

Therefore, the $500,000 of grain sales, the $50,000 of USDA payments, and the $40,000 of hail insurance all represent qualifying DPGR for the DPAD. The $10,000 for custom combining is not DPGR because Mike and his corporation did not own the agricultural products involved in the activity. However, the $10,000 is less than 5% ($10,000 ÷ $600,000 = 1.67%) of the gross receipts of $600,000. Accordingly, the corporation can treat all of the gross receipts as qualifying DPGR because the de minimis provision in Treas. Reg. § 1.199-1(d)(3) applies. This provision states that a taxpayer can treat all of a taxpayer’s gross receipts as DPGR if less than 5% of its total gross receipts are non-DPGR. See Treas. Reg. § 1.199-3 for certain exceptions to this rule.

Construction Activities

DPGR from the construction of real property performed in the United States include proceeds from the sale, exchange, or other disposition of real property constructed by the taxpayer, including buildings, inherently permanent structures and land improvements, oil and gas wells, and infrastructure. Services such as grading, demolition, clearing, and excavating land are considered construction only if the taxpayer performs these services in connection with other activities that constitute the erection or substantial renovation of real property. Administrative support services performed in connection with construction are also construction activities. The taxpayer must be engaged in a construction trade or business (but not necessarily as its primary, or only, trade or business) under the North American Industry Classification System (NAICS code 23) on a regular and ongoing basis [Treas. Reg. § 1.199-3(m)(1)(i)]. Other construction activities also qualify if they are for the construction of real property (e.g., NAICS code 213111—drilling oil and gas wells). [See Treas. Reg. § 1.199-3(m).]

A taxpayer is engaged in a construction trade or business on a regular and ongoing basis if the taxpayer derives gross receipts from an unrelated person by selling or exchanging constructed real property within 60 months of the date on which construction is complete (for example, on the date a certificate of occupancy is issued for the property) [Treas. Reg. § 1.199-3(m)(1)(ii)]. In the case of a newly formed trade or business or a taxpayer in its first tax year, the taxpayer is engaged in a trade or business on a regular and ongoing basis if the taxpayer reasonably expects that it will engage in a trade or business on a regular and ongoing basis.

To construct real property means to erect or substantially renovate the property. Improving land (e.g., grading and landscaping) and painting qualify as construction only if connected with other activities that constitute the erection or substantial renovation of real property. A substantial renovation must increase the value of the property, prolong the property’s useful life, or adapt the property to a new or different use [Treas. Reg. § 1.199-3(m)(5); also see Gibson & Associates, Inc. v. Commissioner, 136 T.C. 195 (2011)]. Construction does not include services such as hauling.
trash and delivering materials unless the taxpayer performs these services in connection with (along with) its construction activities [Treas. Reg. § 1.199-3(m)(2)].

A corporation engaged in construction activities may qualify for the DPAD even if it does not have the benefits and burdens of ownership of the property it constructed. Therefore, more than one taxpayer can construct real property when working on the same construction project.

Example 7.30 Gross Receipts from Construction Activities

Rebecca Brown owns an apartment building in New York. She hired Andrew Steel (a general contractor) to oversee a substantial renovation of the building. Andrew Steel hired Air Repair (a subcontractor) to install a new air conditioning system in the building as part of the renovation. The amounts that Andrew Steel receives from Rebecca and the amounts that Air Repair receives from Andrew Steel qualify as DPGR. If Rebecca later sells the building, the proceeds she receives will not qualify as DPGR because Rebecca did not engage in a construction activity [Treas. Reg. § 1.199-3(m)(6)(v), Example 1].

Example 7.31 DPAD from a Small Construction Company with AMT

TRS Construction, Inc., a calendar-year C corporation, is a small contractor reporting revenue from long-term construction contracts. The amounts on its 2016 tax return are shown in Figure 7.9.

The only non-DPRG is the $500 interest income, and that amount is less than 5% of the total gross receipts, so all gross receipts are considered DPGR. TRS Construction’s QPAI of $150,500 is the same as taxable income.

TRS Construction calculates its $13,545 I.R.C. § 199 deduction as the least of the following three amounts:

1. 9% of QPAI: $150,500 \times 9\% = $13,545
2. Taxable income before deduction: $150,500
3. 50% of W-2 wages: $350,000 \times 50\% = $175,000

Form 8903 for TRS Construction is shown in Figure 7.10.
| Note. Do not complete column (a), unless you have oil-related production activities. Enter amounts for all activities in column (b), including oil-related production activities. |
| Domestic production gross receipts (DPGR) | 1 | 1,400,500 |
| Allocable cost of goods sold. If you are using the small business simplified overall method, skip lines 2 and 3 | 2 | 800,000 |
| Enter deductions and losses allocable to DPGR (see instructions) | 3 | 450,000 |
| If you are using the small business simplified overall method, enter the amount of cost of goods sold and other deductions or losses you ratably apportion to DPGR. All others, skip line 4 | 4 |  |
| Add lines 2 through 4 | 5 | 1,250,000 |
| Subtract line 5 from line 1 | 6 | 150,500 |
| Qualified production activities income from estates, trusts, and certain partnerships and S corporations (see instructions) | 7 |  |
| Add lines 6 and 7. Estates and trusts, go to line 9, all others, skip line 9 and go to line 10 | 8 | 150,500 |
| Amount allocated to beneficiaries of the estate or trust (see instructions) | 9 |  |
| Oil-related qualified production activities income. Estates and trusts, subtract line 9, column (a), from line 8, column (a), all others, enter amount from line 8, column (a). If zero or less, enter 0 here. | 10a |  |
| Qualified production activities income. Estates and trusts, subtract line 9, column (b), from line 8, column (b), all others, enter amount from line 8, column (b). If zero or less, enter 0 here, skip lines 11 through 21, and enter 0 on line 22 | 10b | 150,500 |
| Income limitation (see instructions): | 11 |  |
| 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) | 11 | 150,500 |
| Enter the smaller of line 10b or line 11. If zero or less, enter 0 here, skip lines 13 through 21, and enter 0 on line 22 | 12 | 150,500 |
| Enter 9% of line 12 | 13 | 13,545 |
| Enter the smaller of line 10a or line 12 | 14a |  |
| Reduction for oil-related qualified production activities income. Multiply line 14a by 3% | 14b |  |
| Subtract line 14b from line 13 | 15 | 13,545 |
| Form W-2 wages (see instructions) | 16 | 350,000 |
| Form W-2 wages from estates, trusts, and certain partnerships and S corporations (see instructions) | 17 |  |
| Add lines 16 and 17. Estates and trusts, go to line 19, all others, skip line 19 and go to line 20 | 18 | 350,000 |
| Amount allocated to beneficiaries of the estate or trust (see instructions) | 19 |  |
| Estates and trusts, subtract line 19 from line 18, all others, enter amount from line 18 | 20 | 350,000 |
| Form W-2 wage limitation. Enter 50% of line 20 | 21 | 175,000 |
| Enter the smaller of line 15 or line 21 | 22 | 13,545 |
| Domestic production activities deduction from cooperatives. Enter deduction from Form 1099-PATR, box 6 | 23 |  |
| Expanded affiliated group allocation (see instructions) | 24 |  |
| Domestic production activities deduction. Combine lines 22 through 24 and enter the result here and on Form 1040, line 35; Form 1120, line 25; or the applicable line of your return | 25 | 13,545 |
DPGR will not prevent the taxpayer from treating the receipts as non-DPGR.

Food or Beverage Sales

Food and beverages prepared and sold at a retail establishment do not qualify for the DPAD. A retail establishment is real property and personal property (e.g., a food cart) used in the trade or business of selling food or beverages to the public if retail sales occur at the facility. A restaurant at which food and beverages are prepared, sold, and served to customers is a retail establishment. In addition, a facility at which a taxpayer prepares food or beverages for take-out or delivery is also a retail establishment (e.g., a caterer).

However, some retail establishments prepare food and beverages for both wholesale and retail sale. Wholesale sales are defined as food and beverages held for resale by the purchaser. If a taxpayer’s facility is a retail establishment, then the taxpayer may allocate its gross receipts between the gross receipts derived from the retail sale of the food and beverages prepared and sold at the retail establishment (that are non-DPGR) and gross receipts derived from the wholesale sale of the food and beverages prepared and sold at the retail establishment (that are DPGR assuming the
taxpayer meets the other requirements of I.R.C. § 199) [Treas. Reg. § 1.199-3(o)]. Therefore, the gross receipts related to the wholesale transactions are eligible for the DPAD.

Example 7.32 Food or Beverage Sales
Sue’s Coffee, Inc. buys, roasts, and sells coffee beans. It also sells prepared coffee and other food that customers can either take out or consume in the store. The company engages in two activities for I.R.C. § 199 purposes. Income from buying, roasting, and selling the coffee beans qualifies as a production activity eligible for the DPAD because Sue’s Coffee manufactured (roasted) the coffee beans. The sale of prepared coffee (e.g., a caffe latte) and food at the coffee shop does not qualify for the DPAD [I.R.C. § 199(c)(4)(B); Treas. Reg. § 1.199-3(o)(3), Example 1].

A taxpayer does not have to treat its facility at which food or beverages are prepared as a retail establishment if less than 5% of the gross receipts at that facility are from the sale of food or beverages [Treas. Reg. § 1.199-3(o)(2)].

Electricity, Natural Gas, and Potable Water

Income from the lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by a taxpayer in the United States qualifies as DPGR [Treas. Reg. § 1.199-3(l)]. However, gross receipts from the transmission of electricity from the power plant to a point of local distribution and gross receipts from the distribution of electricity to the final customer are not DPGR [Treas. Reg. § 1.199-3(l)(4)].

A taxpayer that produces and delivers electricity, natural gas, or potable water must allocate its gross receipts between the production and the distribution and transmission of these items. If less than 5% of the taxpayer’s gross receipts are attributable to transmission and distribution activities, the taxpayer may treat all gross receipts as DPGR.

The taxpayer must extract natural gas from a natural deposit; thus, methane gas extracted from a landfill, for example, does not qualify [Treas. Reg. § 1.199-3(l)(2)]. Production of natural gas includes all activities involved in extracting the natural gas from the ground and processing it into pipeline-quality gas. Gross receipts for the transmission of pipeline-quality gas from a natural gas field or processing plant to a local distributor, or from a local gas distribution company to the local customer, are not DPGR.

Production activities for potable water include the acquisition, collection, and storage of untreated water; transportation of the raw water to a treatment facility; and treatment of the water at the facility. The taxpayer must conduct all of these production activities in the United States [Treas. Reg. § 1.199-3(l)(3)]. DPGR do not include gross receipts derived from the storage of the water after its treatment, or delivery of the potable water to customers. The taxpayer must allocate gross receipts between the production activities and the delivery activities.

DPGR from the Oil and Gas Industry

I.R.C. § 199 (c)(4)(A)(i)(I) states that DPGR may be derived from qualifying production property (QPP) that was extracted by the taxpayer in whole or in significant part in the United States. I.R.C. § 199(c)(4)(A)(i)(III) lists natural gas as something produced by the taxpayer that gives rise to DPGR. Specifically, Treas. Reg. § 1.199-3(l)(2) states that production activities include all activities involved in extracting natural gas from the ground and processing the gas into pipeline-quality gas. This same reasoning should apply to oil and all products derived from oil. Treas. Reg. § 1.199-3(m)(2)(iii) clarifies that construction activities include activities related to drilling an oil or gas well and include any activities that generate intangible drilling and development costs (IDC) within the meaning of Treas. Reg. § 1.612-4. Therefore, both the extraction process and sale of the extracted product give rise to DPGR.

Treas. Reg. § 1.199-3(m)(1)(i) states that activities coded under NAICS code 213111 (drilling oil and gas wells) and NAICS code 213112 (support activities for oil and gas operations) give rise to DPGR from the construction of real property. NAICS 213112 support activities include oil and gas field services, not elsewhere classified, performed on a contract or fee basis. Such services include excavating slush pits and cellars; grading and building of foundations at well locations; well
surveying; running, cutting, and pulling casings, tubes, and rods; cementing wells; shooting wells; perforating well casings; acidizing and chemically treating wells; and cleaning out, bailing, and swabbing wells. They also include geophysical, geological, and other exploration services for oil and gas on a contract or fee basis.

Applicable crude oil refiners may exclude 75% of their oil transportation costs (such as pipeline tariffs, rail costs, and tanker fees) when computing their DPAD. Specifically, in computing their oil-related QPAI, refiners will have to reduce the amount of their DPGR by only 25% of their oil transportation expenses allocable to those receipts, which will increase their QPAI and the amount of their (initial) DPAD. But the provision also results in an increase in the amount of a taxpayer’s oil-related QPAI, which could increase the amount of the required DPAD reduction under I.R.C. § 199(d)(9). The overall result would still be an increase in the taxpayer’s final DPAD.

Example 7.33 Independent Oil Refinery
Bleecker Mining Co., an independent oil refiner, has $400,000 in DPGR for the year, $300,000 of which are oil-related. Bleecker Mining has $100,000 in costs allocable to DPGR: $25,000 to non-oil-related DPGR, and $75,000 to oil-related DRGR ($50,000 for oil transportation costs). Assume that the taxable income/AGI and the 50%-of-W-2-wages limits do not apply; that Bleecker Mining’s DPAD is based on its QPAI; and that, under I.R.C. § 199(d)(9), Bleecker Mining must reduce its DPAD by 3% of its oil-related QPI.

Under pre-2016 law, Bleecker Mining’s QPAI for the year is $300,000 ( $400,000 in DPGR – $100,000 in allocable costs). Bleecker Mining’s initial DPAD deduction is $27,000 (9% × $300,000). The $27,000 DPAD is decreased under I.R.C. § 199(d)(9) by $6,750 [3% × ($300,000 of oil-related QPAI – $75,000 of oil-related allocable costs)], for a final DPAD of $20,250 ($27,000 – $6,750).
The provision is intended to reduce the potential damage to domestic refiners resulting from the lift of the ban on most oil exports. The ban did not apply to exports of refined petroleum products (e.g., gasoline and diesel fuel), and US exports of those products have more than doubled since 2007. Some US refineries opposed lifting the ban because of concerns that the export of crude oil to be refined abroad would hurt their businesses and require that they pass along higher costs (e.g., for gasoline) to consumers.