60 percent of the business M income ($60,000) and no country X taxes. Assume that allocations of all items other than CFTEs are valid.

(ii) AB has a single CFTE category because all of AB's net income is allocated in the same ratio. See paragraph (b)(4)(viii)(*c*)(*2*). Under paragraph (b)(4)(viii)(*c*)(*3*) of this section, the $40,000 of business M income that is allocated to A is included in the single CFTE category. Under paragraph (b)(4)(viii)(*c*)(*3*)(*ii*) of this section, no portion of the $60,000 allocated to B is included in the single CFTE category. Under paragraph (b)(4)(viii)(*d*) of this section, the $16,000 of taxes is allocated to the single CFTE category.

Therefore, the $16,000 of country X taxes is related to the $40,000 of net income in the single CFTE category that is allocated to A. See paragraph (b)(4)(viii)(*c*)(*1*) of this section. Because AB's partnership agreement allocates the country X taxes in proportion to the distributive share of income to which the taxes relate, AB satisfies the requirement of paragraph (b)(4)(viii) of this section, and the allocation of the country X taxes is deemed to be in accordance with the partners' interests in the partnership.

* * * * *

§ 1.704–1T [Removed]

■ **Par. 3.** Section 1.704–1T is removed.

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

Approved: September 12, 2006.

Eric Solomon,

Acting Deputy Assistant Secretary of the Treasury.

[FR Doc. E6–17307 Filed 10–18–06; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9293]

RIN 1545–BF88

TIPRA Amendments to Section 199

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations concerning the amendments made by the Tax Increase Prevention and Reconciliation Act of 2005 to section 199 of the Internal Revenue Code. The temporary regulations also contain a rule concerning the use of losses incurred by members of an expanded affiliated group. Section 199 provides a deduction for income attributable to domestic production activities. The regulations will affect taxpayers engaged in certain domestic production activities. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: *Effective Date:* These regulations are effective October 19, 2006.

Applicability Date: For dates of applicability, see § 1.199–8T(i)(5) and (6).

FOR FURTHER INFORMATION CONTACT: Concerning §§ 1.199–2T(e)(2) and 1.199–8T(i)(5), Paul Handleman or Lauren Ross Taylor, (202) 622–3040; concerning §§ 1.199–3T(i)(7) and (8), and 1.199–5T, Martin Schaffer, (202) 622–3080; and concerning §§ 1.199–7T(b)(4) and 1.199–8T(i)(6), Ken Cohen, (202) 622–7790 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document provides rules relating to the deduction for income attributable to domestic production activities under section 199 of the Internal Revenue Code (Code). Section 199 was added to the Code by section 102 of the American Jobs Creation Act of 2004 (Pub. L. 108–357, 118 Stat. 1418), and amended by section 403(a) of the Gulf Opportunity Zone Act of 2005 (Pub. L. 109–135, 119 Stat. 25) and section 514 of the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. 109–222, 120 Stat. 345) (TIPRA). On June 1, 2006, the IRS and Treasury Department published final regulations under section 199 (71 FR 31268). The preamble to the final regulations states that the IRS and Treasury Department plan on issuing regulations on the amendments made to section 199 by section 514 of TIPRA.

General Overview

Section 199(a)(1) allows a deduction equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of (A) the qualified production activities income (QPAI) of the taxpayer for the taxable year, or (B) taxable income (determined without regard to section 199) for the taxable year (or, in the case of an individual, adjusted gross income (AGI)).

Section 199(b)(1) limits the deduction for a taxable year to 50 percent of the W–2 wages paid by the taxpayer during the calendar year that ends in such taxable year. For this purpose, section 199(b)(2)(A) defines the term *W–2 wages* to mean, with respect to any person for any taxable year of such person, the sum of the amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Section 514(a) of TIPRA added new section 199(b)(2)(B), which provides that the term *W–2 wages* does not include any amount which is not properly allocable to domestic production gross receipts (DPGR) for purposes of section 199(c)(1). Section 199(b)(2)(C) provides that the term *W–2 wages* does not include any amount that is not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for the return. Section 199(b)(3) provides that the Secretary shall prescribe rules for the application of section 199(b) in the case of an acquisition or disposition of a major portion of either a trade or business or a separate unit of a trade or business during the taxable year.

Pass-Thru Entities

Section 199(d)(1)(A) provides that, in the case of a partnership or S corporation, (i) section 199 shall be applied at the partner or shareholder level, (ii) each partner or shareholder shall take into account such person's allocable share of each item described in section 199(c)(1)(A) or (B) (determined without regard to whether the items described in section 199(c)(1)(A) exceed the items described in section 199(c)(1)(B)), and (iii), as amended by section 514(b) of TIPRA, each partner or shareholder shall be treated for purposes of section 199(b) as having W–2 wages for the taxable year in an amount equal to such person's allocable share of the W–2 wages of the partnership or S corporation for the taxable year (as determined under regulations prescribed by the Secretary).

Section 199(d)(1)(B) provides that, in the case of a trust or estate, (i) the items referred to in section 199(d)(1)(A)(ii) (as determined therein) and the W–2 wages of the trust or estate for the taxable year shall be apportioned between the beneficiaries and the fiduciary (and among the beneficiaries) under regulations prescribed by the Secretary, and (ii) for purposes of section 199(d)(2), AGI of the trust or estate shall be determined as provided in section 67(e) with the adjustments described in such section.

Section 199(d)(1)(C) provides that the Secretary may prescribe rules requiring or restricting the allocation of items and wages under section 199(d)(1) and may prescribe such reporting requirements as the Secretary determines appropriate.

Expanded Affiliated Groups

Section 199(d)(4)(A) provides that all members of an expanded affiliated group (EAG) are treated as a single corporation for purposes of section 199. Section 199(d)(4)(B) provides that an EAG is an affiliated group as defined in section 1504(a), determined by substituting ''more than 50 percent'' for ''at least 80 percent'' each place it appears and without regard to section 1504(b)(2) and (4).

Authority To Prescribe Regulations

Section 199(d)(8) authorizes the Secretary to prescribe such regulations as are necessary to carry out the purposes of section 199, including regulations that prevent more than one taxpayer from being allowed a deduction under section 199 with respect to any activity described in section 199(c)(4)(A)(i).

Explanation of Provisions

W–2 Wages Properly Allocable to Domestic Production Gross Receipts

Section 514(a) of TIPRA amended section 199(b)(2) to provide that the term *W–2 wages* does not include any amount that is not properly allocable to DPGR for purposes of section 199(c)(1). The Secretary is authorized to provide rules for the proper allocation of items (including wages) in determining QPAI. See section 199(d)(8). The temporary regulations provide that for taxable years beginning after May 17, 2006, the term *W–2 wages* includes only amounts described in § 1.199–2(e)(1) (paragraph (e)(1) wages) that are properly allocable to DPGR. The temporary regulations provide that a taxpayer may determine the amount of paragraph (e)(1) wages that is properly allocable to DPGR using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances.

The temporary regulations provide safe harbors for determining the amount of paragraph (e)(1) wages that is properly allocable to DPGR. Under the wage expense safe harbor for taxpayers using either the section 861 method of cost allocation under § 1.199–4(d) or the simplified deduction method under § 1.199–4(e), a taxpayer may determine the amount of paragraph (e)(1) wages that is properly allocable to DPGR by multiplying the amount of paragraph (e)(1) wages by the ratio of the taxpayer's wage expense included in calculating QPAI for the taxable year to the taxpayer's total wage expense used in calculating the taxpayer's taxable income (or AGI, if applicable) for the taxable year. For purposes of determining the amount of wage expense in cost of goods sold (CGS) under this safe harbor, a taxpayer may determine its wage expense included in CGS using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances. For example, a reasonable method would include a taxpayer using direct labor included in CGS as wage expense included in CGS. Additionally, a reasonable method would include a taxpayer using the section 263A labor costs used by the taxpayer in its simplified service cost method with labor-based allocation ratio under § 1.263–1(h)(4)(ii) as wage expense included in CGS. Because CGS frequently includes goods manufactured in prior years, and thus would frequently include paragraph (e)(1) wages from prior years attributable to DPGR, the amount of paragraph (e)(1) wages in CGS that is properly allocable to DPGR may be difficult to determine. The IRS and Treasury Department request comments on appropriate safe harbors for determining the amount of paragraph (e)(1) wages in CGS that are properly allocable to DPGR.

A taxpayer that uses the small business simplified overall method of cost allocation under § 1.199–4(f) may use the small business simplified overall method safe harbor for determining the amount of paragraph (e)(1) wages that is properly allocable to DPGR. Under that safe harbor, the amount of paragraph (e)(1) wages that is properly allocable to DPGR is equal to the same proportion of paragraph (e)(1) wages that the amount of DPGR bears to the taxpayer's total gross receipts.

As a consequence of the amendment to section 199(b)(2) made by TIPRA and its interplay with the rules in § 1.199–7(a) and (b) for the computation of an EAG's section 199 deduction, the section 199 deduction for the members of an EAG may be reduced if one member of an EAG uses employees of another member of the EAG to perform activities attributable to DPGR and does not have paragraph (e)(1) wages. In general, § 1.199–7(a) and (b) provides that each member of an EAG calculates its own taxable income or loss, QPAI, and W–2 wages, which are then aggregated in determining the EAG's section 199 deduction. Therefore, prior to the amendment to section 199(b)(2), in determining the wage limitation under section 199(b)(1) (the W–2 wage limitation), it was irrelevant which member of an EAG had the paragraph (e)(1) wages, because there was no requirement that paragraph (e)(1) wages be properly allocable to DPGR to qualify as W–2 wages, and the W–2 wages of all the members of an EAG are aggregated.

For example, assume that X and Y are members of an EAG and do not join in the filing of a consolidated Federal income tax return. X has paragraph (e)(1) wages incurred in connection with Y's DPGR activities, but X has no DPGR itself. Further assume that Y has no paragraph (e)(1) wages. Prior to the amendment to section 199(b)(2), notwithstanding that X has no DPGR, X would have W–2 wages, because there was no requirement that paragraph (e)(1) wages be properly allocable to DPGR. Thus, the EAG would have W–2 wages, the same as if Y, rather than X, had the paragraph (e)(1) wages. Assuming the EAG had QPAI and taxable income, the EAG would receive a section 199 deduction.

After the amendment to section 199(b)(2), to qualify as W–2 wages within the meaning of § 1.199–2T(e)(2), paragraph (e)(1) wages must be properly allocable to DPGR to qualify as W–2 wages. Because each member of an EAG separately calculates its own items before they are aggregated by the EAG, the member having the paragraph (e)(1) wages must itself have DPGR to which the wages are properly allocable in order to qualify those wages as W–2 wages. Paragraph (e)(1) wages that are not properly allocable to DPGR of the member having the paragraph (e)(1) wages do not qualify as W–2 wages, even if the paragraph (e)(1) wages were paid in connection with another member's DPGR activities. Thus, after the amendment to section 199(b)(2), X's paragraph (e)(1) wages do not qualify as W–2 wages, because X has no DPGR to which the paragraph (e)(1) wages would be properly allocable. Accordingly, as neither X nor Y has W–2 wages, the EAG has no W–2 wages and no section 199 deduction. If Y had the paragraph (e)(1) wages rather than X, the EAG would have W–2 wages and a section 199 deduction.

However, if X and Y join in the filing of a consolidated Federal income tax return, the results may differ. Section 1.1502–13(c)(1)(i) and (c)(4) requires that the separate entity attributes of X's and Y's intercompany items or corresponding items be redetermined to the extent necessary to produce the effect as if X and Y were divisions of a single corporation. Thus, § 1.1502–13(c)(1)(i) and (c)(4) may apply to treat the paragraph (e)(1) wages incurred by X as W–2 wages. The temporary regulations provide examples to demonstrate the described scenarios.

Pass-Thru Entities

Section 514(b) of TIPRA amended section 199(d)(1)(A)(iii) regarding a partner's or shareholder's share of W–2 wages from a partnership or S corporation for taxable years beginning after May 17, 2006. After TIPRA, the section 199(d)(1)(A)(iii) wage limitation for pass-thru entities no longer includes the second prong of a two-prong standard, by which a partner's or shareholder's share of W–2 wages from the partnership or S corporation was limited to the lesser of that person's allocable share of W–2 wages from the entity or a specified percentage of the person's QPAI, computed by taking into account only the items of the entity allocated to that person for the taxable year of the entity.

Section 1.199–5T(b)(3) and (c)(3) provides guidance regarding a partner's or shareholder's share of W–2 wages of a partnership or an S corporation after the effective date of TIPRA. Except as provided by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*)), the partnership or S corporation must allocate its paragraph (e)(1) wages (including any such wages from a lower-tier partnership of which the partnership or S corporation is a partner) among its partners or shareholders in the same manner that wage expense is allocated among those partners or shareholders. The partner or shareholder must add its share of the paragraph (e)(1) wages from the partnership or S corporation to the partner's or shareholder's paragraph (e)(1) wages from other sources, if any. The partner (other than a partner that itself is a partnership or S corporation) or shareholder then must calculate its W–2 wages (as defined in § 1.199–2T(e)(2)) by determining the amount of its paragraph (e)(1) wages properly allocable to DPGR. See § 1.199–2T(e)(2) for the computation of W–2 wages.

Section 1.199–5T(e) requires a non-grantor trust or estate to calculate each beneficiary's share (as well as the trust's or estate's share, if any) of QPAI and W–2 wages from the trust or estate at the trust or estate level. The QPAI of a trust or estate and W–2 wages of the trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust's or estate's distributable net income (DNI), as defined by section 643(a), for the taxable year that is distributed or required to be distributed to the beneficiary or is retained by the trust or estate.

Because the second prong of the wage limitation of section 199(d)(1)(A)(iii) was prospectively repealed by TIPRA, there is no longer any need for a special rule for tiered structures (where a pass-thru entity owns an interest in another pass-thru entity). Accordingly, the rule in § 1.199–9(g) of the final regulations regarding the section 199(d)(1)(A)(iii) wage limitation and tiered structures has not been included in these temporary regulations.

The temporary regulations provide a transition rule for the situation in which a partner (or shareholder) and a partnership (or S corporation) have different taxable years, only one of which begins on or before the effective date of TIPRA. Under § 1.199–5T(b)(4) and (c)(4), the beginning date of the taxable year of the partnership (or S corporation) determines which definition of W–2 wages and which W–2 wage limitation for pass-thru entities apply.

Expanded Affiliated Groups

After issuance of the final regulations, it was brought to the attention of the IRS and Treasury Department that the combination of the aggregation rules for determining the taxable income of an EAG in § 1.199–7(b)(1) and the rules of section 172 for net operating loss (NOL) deductions can result in the same loss being used twice in determining the taxable income limitation under section 199(a)(1)(B). That is, in determining the taxable income limitation under section 199(a)(1)(B), a loss sustained by a member of an EAG could be used in the year the loss is sustained to offset the taxable income of another member of the EAG in determining the EAG's taxable income limitation. However, because the EAG is not a separate taxpaying entity that files its own tax return, the member that sustained the loss would still have an NOL carryover or carryback. Thus, the loss could be used again as an NOL deduction of the member that sustained the loss in a previous or subsequent year to offset its own income, either as a member of the same EAG, a different EAG, or on a stand-alone basis. Because the section 199 deduction is a percentage of the lesser of QPAI or taxable income (subject to the W–2 wage limitation), the use of the same loss twice could potentially reduce the section 199 deduction that should be allowable.

For example, assume that corporations X and Y are the only two members of an EAG and that X and Y do not file a consolidated Federal income tax return. In 2010, X and Y each have $100 of QPAI which, under § 1.199–7(b), are aggregated in determining the EAG's QPAI. X has $100 of taxable income and Y has a $100 NOL, which are also aggregated in determining the EAG's taxable income for purposes of the taxable income limitation of section 199(a)(1)(B). Further assume that the EAG has sufficient W–2 wages so that the section 199 deduction is not limited under section 199(b)(1). Thus, although in 2010 the EAG has $200 of QPAI and sufficient W–2 wages so that the section 199 deduction is not limited under section 199(b)(1), as a result of the use of Y's NOL, the EAG has $0 of taxable income and no section 199 deduction. However, because the EAG is not a separate taxpaying entity, Y has an NOL of $100 which is available for carryover or carryback. In 2011, X has $100 of taxable income and Y, before the deduction allowed under section 172, has $300 of taxable income. Under section 172, Y reduces its 2011 taxable income of $300 by its 2010 NOL of $100, thus reducing Y's taxable income to $200. Y's loss was effectively used twice, first in 2010 to reduce the EAG's taxable income for purposes of the taxable income limitation of section 199(a)(1)(B) and then in 2011 to reduce Y's own taxable income, which reduces the EAG's aggregate taxable income for purposes of the taxable income limitation.

This result was not intended. Accordingly, § 1.199–7T(b)(4) has been added to provide that, to the extent that an NOL was used in the year it was sustained in determining any EAG's taxable income for purposes of the taxable income limitation of section 199(a)(1)(B), such NOL is not treated as an NOL carryover or NOL carryback to any taxable year in determining the taxable income limitation under section 199(a)(1)(B). Thus, in the previous example, solely for purposes of determining the EAG's 2011 taxable income limitation under section 199(a)(1)(B), Y would not have an NOL carryover from 2010, because the entire $100 NOL was used in 2010 to reduce the EAG's taxable income. Therefore, for purposes of determining the EAG's taxable income limitation in 2011, Y would have taxable income of $300 and the EAG would have aggregate taxable income of $400. The temporary regulations provide examples to illustrate this provision.

Effective Date

Section 199 applies to taxable years beginning after December 31, 2004. These temporary regulations are applicable for taxable years beginning on or after October 19, 2006. A taxpayer may apply §§ 1.199–2T(e)(2), 1.199–3T(i)(7) and (8), and 1.199–5T to taxable years beginning after May 17, 2006, and before October 19, 2006 regardless of whether the taxpayer otherwise relied upon Notice 2005–14 (2005–1 CB 498) (see § 601.601(d)(2)), the provisions of REG–105847–05 (2005–47 IRB 987) (see § 601.601(d)(2)), or §§ 1.199–1 through

1.199–8. A taxpayer may apply § 1.199–7T(b)(4) to taxable years beginning after December 31, 2004, and before October 19, 2006 regardless of whether the taxpayer otherwise relied upon Notice 2005–14, the provisions of REG–105847–05, or §§ 1.199–1 through 1.199–9. The applicability of these temporary regulations expires on October 19, 2009.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For applicability of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*), refer to the cross-reference notice of proposed rulemaking published elsewhere in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Paul Handleman and Lauren Ross Taylor, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

■ Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

■ **Par. 2.** Section 1.199–0 is amended by adding the following entries for §§ 1.199–7(b)(4) and 1.199–8(i)(5) and (6):

§ 1.199–0 Table of contents.

* * * * *

§ 1.199–7 Expanded affiliated groups.

* * * * *

(b) * * *

(4) Losses used to reduce taxable income of expanded affiliated group. [Reserved].

§ 1.199–8 Other rules.

* * * * *

(i) * * *

(5) Tax Increase Prevention and Reconciliation Act of 2005. [Reserved].

(6) Losses used to reduce taxable income of expanded affiliated group. [Reserved].

* * * * *

■ **Par. 3.** Section 1.199–2 is amended by adding a sentence at the end of paragraph (e)(2) to read as follows:

1.199–2 Wage limitation.

* * * * *

(e) * * *

(2) *Limitation on W–2 wages for taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005.* * * * For further guidance, see § 1.199–2T(e)(2).

* * * * *

■ **Par. 4.** Section 1.199–2T is added to read as follows:

1.199–2T Wage limitation (temporary).

(a) through (d) [Reserved]. For further guidance, see § 1.199–2(a) through (d).

(e) *Definition of W–2 wages—(1) In general.* [Reserved]. For further guidance, see § 1.199–2(e)(1).

(2) *Limitation on W–2 wages for taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005*—(i) *In general.* The term *W–2 wages* includes only amounts described in § 1.199–2(e)(1) (paragraph (e)(1) wages) that are properly allocable to domestic production gross receipts (DPGR) (as defined in § 1.199–3) for purposes of section 199(c)(1). A taxpayer may determine the amount of paragraph (e)(1) wages that is properly allocable to DPGR using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances.

(ii) *Wage expense safe harbor*—(A) *In general.* A taxpayer using either the section 861 method of cost allocation under § 1.199–4(d) or the simplified deduction method under § 1.199–4(e) may determine the amount of paragraph (e)(1) wages that is properly allocable to DPGR for a taxable year by multiplying the amount of paragraph (e)(1) wages for the taxable year by the ratio of the taxpayer's wage expense included in calculating qualified production activities income (QPAI) (as defined in § 1.199–1(c)) for the taxable year to the taxpayer's total wage expense used in calculating the taxpayer's taxable income (or adjusted gross income, if applicable) for the taxable year, without regard to any wage expense disallowed by section 465, 469, 704(d), or 1366(d). A taxpayer that uses the section 861 method of cost allocation under § 1.199–4(d) or the simplified deduction method under § 1.199–4(e) to determine QPAI must use the same expense allocation and apportionment methods that it uses to determine QPAI to allocate and apportion wage expense for purposes of this safe harbor. For purposes of this paragraph (e)(2)(ii), the term *wage expense* means wages (that is, compensation paid by the employer in the active conduct of a trade or business to its employees) that are properly taken into account under the taxpayer's method of accounting.

(B) *Wage expense included in cost of goods sold.* For purposes of paragraph (e)(2)(ii)(A) of this section, a taxpayer may determine its wage expense included in cost of goods sold (CGS) using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, such as using the amount of direct labor included in CGS or using section 263A labor costs (as defined in § 1.263A–1(h)(4)(ii)) included in CGS.

(iii) *Small business simplified overall method safe harbor.* A taxpayer that uses the small business simplified overall method under § 1.199–4(f) may use the small business simplified overall method safe harbor for determining the amount of paragraph (e)(1) wages that is properly allocable to DPGR. Under this safe harbor, the amount of paragraph (e)(1) wages that is properly allocable to DPGR is equal to the same proportion of paragraph (e)(1) wages that the amount of DPGR bears to the taxpayer's total gross receipts.

(iv) *Examples.* The following examples illustrate the application of this paragraph (e)(2). See § 1.199–5T for an example of the application of paragraph (e)(2)(ii) of this section to a trust or estate.

Example 1. Section 861 method and no EAG. (i) *Facts.* X, a United States corporation that is not a member of an expanded affiliated group (EAG) (as defined in § 1.199–7) or an affiliated group as defined in the regulations under section 861, engages in activities that generate both DPGR and non-DPGR. X's taxable year ends on April 30, 2011. For X's taxable year ending April 30, 2011, X has $3,000 of paragraph (e)(1) wages reported on 2010 Forms W–2. All of X's production activities that generate DPGR are within Standard Industrial Classification (SIC) Industry Group AAA (SIC AAA). All of X's production activities that generate non-DPGR are within SIC Industry Group BBB (SIC BBB). X is able to specifically identify CGS allocable to DPGR and to non-DPGR. X incurs $900 of research and experimentation expenses (R&E) that are deductible under section 174, $300 of which are performed with respect to SIC AAA and $600 of which are performed with respect to SIC BBB. None of the R&E is legally mandated R&E as described in § 1.861–17(a)(4) and none of the R&E is included in CGS. X incurs section 162 selling expenses that are not includible in CGS and are definitely related to all of X's gross income. For X's taxable year ending April 30, 2011, the adjusted basis of X's assets is $50,000, $40,000 of which generate gross income attributable to DPGR and $10,000 of which generate gross income attributable to non-DPGR. For X's taxable year ending April 30, 2011, the total square footage of X's headquarters is 8,000 square feet, of which 2,000 square feet is set aside for domestic production activities. For its taxable year ending April 30, 2011, X's taxable income is $1,380 based on the following Federal income tax items:

DPGR (all from sales of products within SIC AAA)	$3,000
Non-DPGR (all from sales of products within SIC BBB)	3,000
CGS allocable to DPGR (includes $200 of wage expense)	(600)
CGS allocable to non-DPGR (includes $600 of wage expense)	(1,800)
Section 162 selling expenses (includes $600 of wage expense)	(840)
Section 174 R&E–SIC AAA (includes $100 of wage expense)	(300)
Section 174 R&E–SIC BBB (includes $200 of wage expense)	(600)
Interest expense (not included in CGS)	(300)
Headquarters overhead expense (includes $100 of wage expense)	(180)
X's taxable income	1,380

(ii) *X's QPAI.* X allocates and apportions its deductions to gross income attributable to DPGR under the section 861 method in § 1.199–4(d). In this case, the section 162 selling expenses and overhead expense are definitely related to all of X's gross income. Based on the facts and circumstances of this specific case, apportionment of the section 162 selling expenses between DPGR and non-DPGR on the basis of X's gross receipts is appropriate. In addition, based on the facts and circumstances of this specific case, apportionment of the headquarters overhead expense between DPGR and non-DPGR on the basis of the square footage of X's headquarters is appropriate. For purposes of apportioning R&E, X elects to use the sales method as described in § 1.861–17(c). X elects to apportion interest expense under the tax book value method of § 1.861–9T(g). X has $2,400 of gross income attributable to DPGR (DPGR of $3,000—CGS of $600 allocated based on X's books and records). X's QPAI for its taxable year ending April 30, 2011, is $1,395, as shown in the following table:

DPGR (all from sales of products within SIC AAA)	$3,000
CGS allocable to DPGR	(600)
Section 162 selling expenses ($840 × ($3,000 DPGR/$6,000 total gross receipts))	(420)
Section 174 R&E–SIC AAA	(300)
Interest expense (not included in CGS) ($300 × ($40,000 (X's DPGR assets)/$50,000 (X's total assets)))	(240)
Headquarters overhead expense ($180 × (2,000 square feet attributable to DPGR activity/total 8,000 square feet))	(45)
X's QPAI	1,395

(iii) *W–2 wages.* X chooses to use the wage expense safe harbor under paragraph (e)(2)(ii) of this section to determine its W–2 wages, as shown in the following steps:

(A) *Step one.* X determines that $625 of wage expense were taken into account in determining its QPAI in paragraph (ii) of this *Example 1,* as shown in the following table:

CGS wage expense	$200
Section 162 selling expenses wage expense ($600 × ($3,000 DPGR/$6,000 total gross receipts))	300
Section 174 R&E–SIC AAA wage expense	100
Headquarters overhead wage expense ($100 × (2,000 square feet attributable to DPGR activity/8,000 total square feet))	25
Total wage expense taken into account	625

(B) *Step two.* X determines that $1,042 of the $3,000 in paragraph (e)(1) wages are properly allocable to DPGR, and are therefore W–2 wages, as shown in the following calculation:

$$\frac{\text{Step one wage expense}}{\text{X's total wage expense for taxable year ending April 30, 2011}} \times \text{X's paragraph (e)(1) wages}$$

$$\frac{\$625}{\$1{,}800} \times \$3{,}000 = \$1{,}042$$

(iv) *Section 199 deduction determination.* X's tentative deduction under § 1.199–1(a) (section 199 deduction) is $124 (.09 × (lesser of QPAI of $1,395 or taxable income of $1,380)) subject to the wage limitation under section 199(b)(1) (W–2 wage limitation) of $521 (50% × $1,042). Accordingly, X's section 199 deduction for its taxable year ending April 30, 2011, is $124.

Example 2. Section 861 method and EAG. (i) *Facts.* The facts are the same as in *Example 1* except that X owns stock in Y, a United States corporation, equal to 75% of the total voting power of stock of Y and 80% of the total value of stock of Y. X and Y are not members of an affiliated group as defined in section 1504(a). Accordingly, the rules of § 1.861–14T do not apply to X's and Y's selling expenses, R&E, and charitable contributions. X and Y are, however, members of an affiliated group for purposes of allocating and apportioning interest expense (see § 1.861–11T(d)(6)) and are also members of an EAG. Y's taxable year ends April 30, 2011. For Y's taxable year ending April 30, 2011, Y has $2,000 of paragraph (e)(1) wages reported on 2010 Forms W–2.

For Y's taxable year ending April 30, 2011, the adjusted basis of Y's assets is $50,000, $20,000 of which generate gross income attributable to DPGR and $30,000 of which generate gross income attributable to non-DPGR. All of Y's activities that generate DPGR are within SIC Industry Group AAA (SIC AAA). All of Y's activities that generate non-DPGR are within SIC Industry Group BBB (SIC BBB). None of X's and Y's sales are to each other. Y is not able to specifically identify CGS allocable to DPGR and non-DPGR. In this case, because CGS is definitely related under the facts and circumstances to all of Y's gross receipts, apportionment of CGS between DPGR and non-DPGR based on gross receipts is appropriate. For Y's taxable year ending April 30, 2011, the total square footage of Y's headquarters is 8,000 square feet, of which, 2,000 square feet is set aside for domestic production activities. Y incurs section 162 selling expenses that are not includible in CGS and are definitely related to all of Y's gross income. For Y's taxable year ending April 30, 2011, Y's taxable income is $1,710 based on the following Federal income tax items:

DPGR (all from sales of products within SIC AAA)	$3,000
Non-DPGR (all from sales of products within SIC BBB)	3,000
CGS allocated to DPGR (includes $300 of wage expense)	(1,200)
CGS allocated to non-DPGR (includes $300 of wage expense)	(1,200)
Section 162 selling expenses (includes $300 of wage expense)	(840)
Section 174 R&E–SIC AAA (includes $20 of wage expense)	(100)
Section 174 R&E–SIC BBB (includes $60 of wage expense)	(200)
Interest expense (not included in CGS and not subject to § 1.861–10T)	(500)
Charitable contributions	(50)
Headquarters overhead expense (includes $40 of wage expense)	(200)
Y's taxable income	1,710

(ii) *QPAI.* (A) *X's QPAI.* Determination of X's QPAI is the same as in *Example 1* except that interest is apportioned to gross income attributable to DPGR based on the combined adjusted bases of X's and Y's assets. See § 1.861–11T(c). Accordingly, X's QPAI for its taxable year ending April 30, 2011, is $1,455, as shown in the following table:

DPGR (all from sales of products within SIC AAA)	$3,000
CGS allocated to DPGR	(600)
Section 162 selling expenses ($840 × ($3,000 DPGR/$6,000 total gross receipts))	(420)
Section 174 R&E–SIC AAA	(300)
Interest expense (not included in CGS and not subject to § 1.861–10T) ($300 × ($60,000 (tax book value of X's and Y's DPGR assets)/$100,000 (tax book value of X's and Y's total assets)))	(180)
Headquarters overhead expense ($180 × (2,000 square feet attributable to DPGR activity/total 8,000 square feet))	(45)
X's QPAI	1,455

(B) *Y's QPAI.* Y makes the same elections under the section 861 method as does X. Y has $1,800 of gross income attributable to DPGR (DPGR of $3,000—CGS of $1,200 allocated based on Y's gross receipts). Y's QPAI for its taxable year ending April 30, 2011, is $905, as shown in the following table:

DPGR (all from sales of products within SIC AAA)	$3,000
CGS allocated to DPGR	(1,200)
Section 162 selling expenses ($840 × ($3,000 DPGR/$6,000 total gross receipts))	(420)
Section 174 R&E–SIC AAA	(100)
Interest expense (not included in CGS and not subject to § 1.861–10T) ($500 × ($60,000 (tax book value of X's and Y's DPGR assets)/$100,000 (tax book value of X's and Y's total assets)))	(300)
Charitable contributions (not included in CGS) ($50 × ($1,800 gross income attributable to DPGR/$3,600 total gross income))	(25)
Headquarters overhead expense ($200 × (2,000 square feet attributable to DPGR activity/total 8,000 square feet))	(50)
Y's QPAI	905

(iii) *W–2 wages.* (A) *X's W–2 wages.* X's W–2 wages are $1,042, the same as in Example 1.

(B) *Y's W–2 wages.* Y chooses to use the wage expense safe harbor under paragraph (e)(2)(ii) of this section to determine its W–2 wages, as shown in the following steps:

(*1*) *Step one.* Y determines that $480 of wage expense were taken into account in determining its QPAI in paragraph (ii)(B) of this *Example 2,* as shown in the following table:

CGS wage expense	$300
Section 162 selling expenses wage expense ($300 × ($3,000 DPGR/$6,000 total gross receipts))	150
Section 174 R&E–SIC AAA wage expense	20
Headquarters overhead wage expense ($40 × (2,000 square feet attributable to DPGR activity/8,000 total square feet))	10
Total wage expense taken into account	480

(*2*) *Step two.* Y determines that $941 of the $2,000 paragraph (e)(1) wages are properly allocable to DPGR, and are therefore W–2 wages, as shown in the following calculation:

$$\frac{\text{Step one wage expense}}{\text{Y's total wage expense for taxable year ending April 30, 2011}} \times \text{Y's paragraph (e)(1) wages}$$

$$\frac{\$480}{\$1{,}020} \times \$2{,}000 = \$941$$

(iv) *Section 199 deduction determination.* The section 199 deduction of the X and Y EAG is determined by aggregating the separately determined taxable income, QPAI, and W–2 wages of X and Y. See § 1.199–7(b). Accordingly, the X and Y EAG's tentative section 199 deduction is $212 (.09 × (lesser of combined QPAI of X and Y of $2,360 (X's QPAI of $1,455 plus Y's QPAI of $905) or combined taxable incomes of X and Y of $3,090 (X's taxable income of $1,380 plus Y's taxable income of $1,710)) subject to the combined W–2 wage limitation of X and Y of $992 (50% × ($1,042 (X's W–2 wages) + $941 (Y's W–2 wages)))). Accordingly, the X and Y EAG's section 199 deduction is $212. The $212 is allocated to X and Y in proportion to their QPAI. See § 1.199–7(c).

Example 3. Simplified deduction method. (i) *Facts.* Z, a corporation that is not a member of an EAG, engages in activities that generate both DPGR and non-DPGR. Z is able to specifically identify CGS allocable to DPGR and to non-DPGR. Z's taxable year ends on April 30, 2011. For Z's taxable year ending April 30, 2011, Z has $3,000 of paragraph (e)(1) wages reported on 2010 Forms W–2, and Z's taxable income is $1,380 based on the following Federal income tax items:

DPGR	$3,000
Non-DPGR	3,000
CGS allocable to DPGR (includes $200 of wage expense)	(600)
CGS allocable to non-DPGR (includes $600 of wage expense)	(1,800)
Expenses, losses, or deductions (deductions) (includes $1,000 of wage expense)	(2,220)
Z's taxable income	1,380

(ii) *Z's QPAI.* Z uses the simplified deduction method under § 1.199–4(e) to apportion deductions between DPGR and non-DPGR. Z's QPAI for its taxable year ending April 30, 2011, is $1,290, as shown in the following table:

DPGR	$3,000
CGS allocable to DPGR	(600)
Deductions apportioned to DPGR ($2,220 × ($3,000 DPGR/$6,000 total gross receipts))	(1,110)
Z's QPAI	1,290

(iii) *W–2 wages.* Z chooses to use the wage expense safe harbor under paragraph (e)(2)(ii) of this section to determine its W–2 wages, as shown in the following steps:

(A) *Step one.* Z determines that $700 of wage expense were taken into account in determining its QPAI in paragraph (ii) of this *Example 3,* as shown in the following table:

Wage expense included in CGS allocable to DPGR	$200
Wage expense included in deductions ($1,000 in wage expense × ($3,000 DPGR/$6,000 total gross receipts))	500
Wage expense allocable to DPGR	700

(B) *Step two.* Z determines that $1,167 of the $3,000 paragraph (e)(1) wages are properly allocable to DPGR, and are therefore W–2 wages, as shown in the following calculation:

$$\frac{\text{Step one wage expense}}{\text{Z's total wage expense for taxable year ending April 30, 2011}} \times \text{Z's paragraph (e)(1) wages}$$

$$\frac{\$700}{\$1{,}800} \times \$3{,}000 = \$1{,}167$$

(iv) *Section 199 deduction determination.* Z's tentative section 199 deduction is $116 (.09 × (lesser of QPAI of $1,290 or taxable income of $1,380)) subject to the W–2 wage limitation of $584 (50% × $1,167). Accordingly, Z's section 199 deduction for its taxable year ending April 30, 2011, is $116.

Example 4. Small business simplified overall method. (i) *Facts.* Z, a corporation that is not a member of an EAG, engages in activities that generate both DPGR and non-DPGR. Z's taxable year ends on April 30, 2011. For Z's taxable year ending April 30, 2011, Z has $3,000 of paragraph (e)(1) wages reported on 2010 Forms W–2, and Z's taxable income is $1,380 based on the following Federal income tax items:

DPGR	$3,000
Non-DPGR	3,000
CGS and deductions	(4,620)
Z's taxable income	1,380

(ii) *Z's QPAI.* Z uses the small business simplified overall method under § 1.199–4(f) to apportion CGS and deductions between DPGR and non-DPGR. Z's QPAI for its taxable year ending April 30, 2011, is $690, as shown in the following table:

DPGR	$3,000
CGS and deductions apportioned to DPGR ($4,620 × ($3,000 DPGR/$6,000 total gross receipts))	(2,310)
Z's QPAI	690

(iii) *W–2 wages.* Z's W–2 wages under paragraph (e)(2)(iii) of this section are $1,500, as shown in the following calculation:

$3,000 in paragraph (e)(1) wages × ($3,000 DPGR/$6,000 total gross receipts)—$1,500

(iv) *Section 199 deduction determination.* Z's tentative section 199 deduction is $62 (.09 × (lesser of QPAI of $690 or taxable income of $1,380)) subject to the W–2 wage limitation of $750 (50% × $1,500). Accordingly, Z's section 199 deduction for its taxable year ending April 30, 2011, is $62.

Example 5. Corporation uses employees of non-consolidated EAG member. (i) *Facts.* Corporations S and B are members of the same EAG but are not members of a consolidated group. S and B are both calendar year taxpayers. All the activities described in this example take place during the same taxable year and they are the only activities of S and B. S and B each use the section 861 method described in § 1.199–4(d) for allocating and apportioning their deductions. B is a manufacturer but has only three employees of its own. S employs the remainder of the personnel who perform the manufacturing activities for B. S's only receipts are from supplying employees to B. In 2010, B manufactures qualifying production property (QPP) (as defined in § 1.199–3(j)(1)), using its three employees and S's employees, and sells the QPP for $10,000,000. B's total CGS and other deductions are $6,000,000, including $1,000,000 paid to S for the use of S's employees and $100,000 paid to its own employees. B reports the $100,000 paid to its employees on the 2010 Forms W–2 issued to its employees. S pays its employees $800,000 that is reported on the 2010 Forms W–2 issued to the employees.

(ii) *B's W–2 wages.* In determining its W–2 wages, B utilizes the wage expense safe harbor described in paragraph (e)(2)(ii) of this section. The entire $100,000 paid by B to its employees is included in B's wage expense included in calculating its QPAI and is the only wage expense used in calculating B's taxable income. Thus, under the wage expense safe harbor described in paragraph (e)(2)(ii) of this section, B's W–2 wages are $100,000 ($100,000 (paragraph (e)(1) wages) x ($100,000 (wage expense used in calculating B's QPAI)/$100,000 (wage expense used in calculating B's taxable income))).

(iii) *S's W–2 wages.* In determining its W–2 wages, S utilizes the wage expense safe harbor described in paragraph (e)(2)(ii) of this section. Because S's $1,000,000 in receipts from B do not qualify as DPGR and are S's only gross receipts, none of the $800,000 paid by S to its employees is included in S's wage expense included in calculating its QPAI. However, the entire $800,000 is included in calculating S's taxable income. Thus, under the wage expense safe harbor described in paragraph (e)(2)(ii)(A) of this section, S's W–2 wages are $0 ($800,000 (paragraph (e)(1) wages) × ($0 (wage expense used in calculating S's QPAI)/$800,000 (wage expense used in calculating S's taxable income))).

(iv) *Determination of EAG's section 199 deduction.* The section 199 deduction of the S and B EAG is determined by aggregating the separately determined taxable income or loss, QPAI, and W–2 wages of S and B. See § 1.199–7(b). B's taxable income and QPAI are each $4,000,000 ($10,000,000 DPGR − $6,000,000 CGS and other deductions). S's taxable income is $200,000 ($1,000,000 gross receipts − $800,000 total deductions). S's QPAI is $0 ($0 DPGR − $0 CGS and other deductions). B's W–2 wages (as calculated in paragraph (ii) of this *Example 5*) are $100,000 and S's W–2 wages (as calculated in paragraph (iii) of this *Example 5*) are $0. The EAG's tentative section 199 deduction is $360,000 (.09 × (lesser of combined QPAI of $4,000,000 (B's QPAI of $4,000,000 + S's QPAI of $0) or combined taxable income of $4,200,000 (B's taxable income of $4,000,000 + S's taxable income of $200,000)) subject to the W–2 wage limitation of $50,000 (50% × ($100,000 (B's W–2 wages) + $0 (S's W–2 wages))). Accordingly, the S and B EAG's section 199 deduction for 2010 is $50,000. The $50,000 is allocated to S and B in proportion to their QPAI. See § 1.199–7(c). Because S has no QPAI, the entire $50,000 is allocated to B.

Example 6. Corporation using employees of consolidated EAG member. The facts are the same as in *Example 5* except that B and S are members of the same consolidated group. Ordinarily, as demonstrated in *Example 5*, S's $1,000,000 of receipts would not be DPGR and its $800,000 paid to its employees would not be W–2 wages (because the $800,000 would not be properly allocable to DPGR). However, because S and B are members of the same consolidated group, § 1.1502–13(c)(1)(i) provides that the separate entity attributes of S's intercompany items or B's corresponding items, or both, may be redetermined in order to produce the same effect as if S and B were divisions of a single corporation. If S and B were divisions of a single corporation, S and B would have QPAI and taxable income of $4,200,000 ($10,000,000 DPGR received from the sale of the QPP—$5,800,000 CGS and other deductions) and, under the wage expense safe harbor described in paragraph (e)(2)(ii) of this section, would have $900,000 of W–2 wages ($900,000 combined paragraph (e)(1) wages of S and B) × ($900,000 (wage expense used in calculating QPAI)/$900,000 (wage expense used in calculating taxable income)). The single corporation would have a tentative section 199 deduction equal to 9% of $4,200,000, or $378,000, subject to the W–2 wage limitation of 50% of $900,000, or $450,000. Thus, the single corporation would have a section 199 deduction of $378,000. To obtain this same result for the consolidated group, S's $1,000,000 of receipts from the intercompany transaction are redetermined as DPGR. Thus, S's $800,000 paid to its employees are costs properly allocable to DPGR and S's W–2 wages are $800,000. Accordingly, the consolidated group has QPAI and taxable income of $4,200,000 ($11,000,000 DPGR (from the sale of the QPP and the redetermined intercompany transaction)—$6,800,000 CGS and other deductions) and W–2 wages of $900,000. The consolidated group's section 199 deduction is $378,000, the same as the single corporation. However, for purposes of allocating the section 199 deduction between S and B, the redetermination of S's income as DPGR under § 1.1502–13(c)(1)(i) is not taken into account. See § 1.199–7(d)(5). Accordingly, the consolidated group's entire section 199 deduction of $378,000 is allocated to B.

■ **Par. 5.** Section 1.199–3 is amended by adding a sentence at the end of each of paragraphs (i)(7) and (8) to read as follows:

§ 1.199–3 Domestic production gross receipts.

* * * * *

(i) * * *

(7) *Qualifying in-kind partnership for taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005.* * * * For further guidance, see § 1.199–3T(i)(7).

(8) *Partnerships owned by members of a single expanded affiliated group for taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005.* * * * For further guidance, see § 1.199–3T(i)(8).

* * * * *

■ **Par. 6.** Section 1.199–3T is amended by adding paragraphs (i)(7) and (8) to read as follows:

§ 1.199–3T Domestic production gross receipts (temporary).

* * * * *

(i) * * *

(7) *Qualifying in-kind partnership for taxable years beginning after May 17,*

2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005—(i) *In general.* If a partnership is a qualifying in-kind partnership described in paragraph (i)(7)(ii) of this section, then each partner is treated as having manufactured, produced, grown, or extracted (MPGE) (as defined in § 1.199–3(e)) or produced the property MPGE or produced by the partnership that is distributed to that partner. If a partner of a qualifying in-kind partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of the property that was MPGE or produced by the qualifying in-kind partnership and distributed to that partner, then, provided such partner is a partner of the qualifying in-kind partnership at the time the partner disposes of the property, the partner is treated as conducting the MPGE or production activities previously conducted by the qualifying in-kind partnership with respect to that property. With respect to a lease, rental, or license, the partner is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts derived from the lease, rental, or license under its method of accounting. With respect to a sale, exchange, or other disposition, the partner is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account.

(ii) *Definition of qualifying in-kind partnership.* For purposes of this paragraph (i)(7), a qualifying in-kind partnership is a partnership engaged solely in—

(A) The extraction, refining, or processing of oil, natural gas (as described in § 1.199–3(l)(2)), petrochemicals, or products derived from oil, natural gas, or petrochemicals in whole or in significant part within the United States;

(B) The production or generation of electricity in the United States; or

(C) An activity or industry designated by the Secretary by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(iii) *Other rules.* Except as provided in this paragraph (i)(7), a qualifying in-kind partnership is treated the same as other partnerships for purposes of section 199. Accordingly, a qualifying in-kind partnership is subject to the rules of this section regarding the application of section 199 to pass-thru entities, including application of the section 199(d)(1)(A)(iii) wage limitation under § 1.199–5T(b)(3). In determining whether a qualifying in-kind partnership or its partners MPGE qualifying production property (QPP) (as defined in § 1.199–3(j)) in whole or in significant part within the United States (as defined in § 1.199–3(h)), see § 1.199–3(g)(2) and (3).

(iv) *Example.* The following example illustrates the application of this paragraph (i)(7). Assume that PRS and X are calendar year taxpayers.

Example. X, Y and Z are partners in PRS, a qualifying in-kind partnership described in paragraph (i)(7)(ii) of this section. X, Y, and Z are corporations. In 2007, PRS distributes oil to X that PRS derived from its oil extraction. PRS incurred $600 of CGS extracting the oil distributed to X, and X's adjusted basis in the distributed oil is $600. X incurs $200 of CGS in refining the oil within the United States. In 2007, X, while it is a partner in PRS, sells the oil to a customer for $1,500. X is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes. Under paragraph (i)(7)(i) of this section, X is treated as having extracted the oil. The extraction and refining of the oil qualify as an MPGE activity under § 1.199–3(e)(1). Therefore, X's $1,500 of gross receipts qualify as DPGR. X subtracts from the $1,500 of DPGR the $600 of CGS incurred by PRS and the $200 of refining costs it incurred. Thus, X's QPAI is $700 for 2007.

(8) *Partnerships owned by members of a single expanded affiliated group for taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005*—(i) *In general.* For purposes of this section, if all of the interests in the capital and profits of a partnership are owned by members of a single expanded affiliated group (EAG) at all times during the taxable year of the partnership (EAG partnership), then the EAG partnership and all members of that EAG are treated as a single taxpayer for purposes of section 199(c)(4) during that taxable year.

(ii) *Attribution of activities*—(A) *In general.* If a member of an EAG (disposing member) derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE or produced by an EAG partnership, all the partners of which are members of the same EAG to which the disposing member belongs at the time that the disposing member disposes of such property, then the disposing member is treated as conducting the MPGE or production activities previously conducted by the EAG partnership with respect to that property. The previous sentence applies only for those taxable years in which the disposing member is a member of the EAG of which all the partners of the EAG partnership are members for the entire taxable year of the EAG partnership. With respect to a lease, rental, or license, the disposing member is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts from the lease, rental, or license under its method of accounting. With respect to a sale, exchange, or other disposition, the disposing member is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account. Likewise, if an EAG partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE or produced by a member (or members) of the same EAG (the producing member) to which all the partners of the EAG partnership belong at the time that the EAG partnership disposes of such property, then the EAG partnership is treated as conducting the MPGE or production activities previously conducted by the producing member with respect to that property. The previous sentence applies only for those taxable years in which the producing member is a member of the EAG of which all the partners of the EAG partnership are members for the entire taxable year of the EAG partnership. With respect to a lease, rental, or license, the EAG partnership is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts derived from the lease, rental, or license under its method of accounting. With respect to a sale, exchange, or other disposition, the EAG partnership is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account. See paragraph (i)(8)(iv) *Example 3* of this section.

(B) *Attribution between EAG partnerships.* If an EAG partnership (disposing partnership) derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE or produced by another EAG partnership (producing partnership), then the disposing partnership is treated as conducting the MPGE or production activities previously conducted by the producing partnership with respect to that property, provided that each of these partnerships (the producing partnership and the disposing partnership) is owned for its entire taxable year in which the disposing partnership disposes of such property by members of the same EAG. With respect to a lease, rental, or license, the disposing partnership is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts from the lease, rental, or license under its method of accounting. With respect to a sale, exchange, or other disposition, the disposing partnership is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account.

(C) *Exceptions to attribution.* Attribution of activities does not apply for purposes of the construction of real property under § 1.199–3(m)(1) and the performance of engineering and architectural services under § 1.199–3(n)(2) and (3), respectively.

(iii) *Other rules.* Except as provided in this paragraph (i)(8), an EAG partnership is treated the same as other partnerships for purposes of section 199. Accordingly, an EAG partnership is subject to the rules of this section regarding the application of section 199 to pass-thru entities, including the section 199(d)(1)(A)(iii) wage limitation under § 1.199–5T(b)(3). In determining whether a member of an EAG or an EAG partnership MPGE QPP in whole or in significant part within the United States or produced a qualified film or produced utilities within the United States, see § 1.199–3(g)(2) and (3) and *Example 5* of paragraph (i)(8)(iv) of this section.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (i)(8). Assume that PRS, X, Y, and Z all are calendar year taxpayers.

Example 1. Contribution. X and Y are the only partners in PRS, a partnership, for PRS's entire 2007 taxable year. X and Y are both members of a single EAG for the entire 2007 year. In 2007, X MPGE QPP within the United States and contributes the QPP to PRS. In 2007, PRS sells the QPP for $1,000. Under this paragraph (i)(8), PRS is treated as having MPGE the QPP within the United States, and PRS's $1,000 gross receipts constitute DPGR. PRS, X, and Y must apply the rules of this section regarding the application of section 199 to pass-thru entities with respect to the activity of PRS, including the section 199(d)(1)(A)(iii) wage limitation under § 1.199–5T(b)(3).

Example 2. Sale. X, Y, and Z are the only members of a single EAG for the entire 2007 year. X and Y each own 50% of the capital and profits interests in PRS, a partnership, for PRS's entire 2007 taxable year. In 2007, PRS MPGE QPP within the United States and then sells the QPP to X for $6,000, its fair market value at the time of the sale. PRS's gross receipts of $6,000 qualify as DPGR. In 2007, X sells the QPP to customers for $10,000, incurring selling expenses of $2,000. Under paragraph (i)(8)(ii)(A) of this section, X is treated as having MPGE the QPP within the United States, and X's $10,000 of gross receipts qualify as DPGR. PRS, X and Y must apply the rules of this section regarding the application of section 199 to pass-thru entities with respect to the activity of PRS, including application of the section 199(d)(1)(A)(iii) wage limitation under § 1.199–5T(b)(3). The results would be the same if PRS sold the QPP to Z rather than to X. However, if PRS did sell the QPP to Z, and Z was not a member of the EAG for PRS's entire taxable year, the activities previously conducted by PRS with respect to the QPP would not be attributed to Z, and none of Z's $10,000 of gross receipts would qualify as DPGR.

Example 3. Lease. X, Y, and Z are the only members of a single EAG for the entire 2007 year. X and Y each own 50% of the capital and profits interests in PRS, a partnership, for PRS's entire 2007 taxable year. In 2007, PRS MPGE QPP within the United States and then sells the QPP to X for $6,000, its fair market value at the time of the sale. PRS's gross receipts of $6,000 qualify as DPGR. In 2007, X rents the QPP it acquired from PRS to customers unrelated to X. X takes the gross receipts attributable to the rental of the QPP into account under its method of accounting in 2007 and 2008. On July 1, 2008, X ceases to be a member of the same EAG to which Y, the other partner in PRS, belongs. For 2007, X is treated as having MPGE the QPP within the United States under paragraph (i)(8)(ii)(A) of this section, and its gross receipts derived from the rental of the QPP qualify as DPGR. For 2008, however, because X and Y, partners in PRS, are no longer members of the same EAG for the entire year, the gross rental receipts X takes into account in 2008 do not qualify as DPGR.

Example 4. Distribution. X and Y are the only partners in PRS, a partnership, for PRS's entire 2007 taxable year. X and Y are both members of a single EAG for the entire 2007 year. In 2007, PRS MPGE QPP within the United States, incurring $600 of CGS, and then distributes the QPP to X. X's adjusted basis in the QPP is $600. X incurs $200 of directly allocable costs to further MPGE the QPP within the United States. In 2007, X sells the QPP for $1,500 to an unrelated customer. X is treated as having disposed of the QPP on the date it ceases to own the QPP for Federal income tax purposes. Under paragraph (i)(8)(ii)(A) of this section, X is treated as having MPGE the QPP within the United States, and X's $1,500 of gross receipts qualify as DPGR.

Example 5. Multiple sales. (i) *Facts.* X and Y are the only partners in PRS, a partnership, for PRS's entire 2007 taxable year. X and Y are both non-consolidated members of a single EAG for the entire 2007 year. PRS produces in bulk form in the United States the active ingredient for a drug. Assume that PRS's own MPGE activity with respect to the active ingredient is not substantial in nature, taking into account all of the facts and circumstances, and PRS's direct labor and overhead to MPGE the active ingredient within the United States are $15 and account for 15% of PRS's $100 CGS of the active ingredient. In 2007, PRS sells the active ingredient in bulk form to X. X uses the active ingredient to produce the finished dosage form drug. Assume that X's own MPGE activity with respect to the drug is not substantial in nature, taking into account all of the facts and circumstances, and X's direct labor and overhead to MPGE the drug within the United States are $12 and account for 10% of X's $120 CGS of the drug. In 2007, X sells the drug in finished dosage to Y and Y sells the drug to customers. Assume that Y's own MPGE activity with respect to the drug is not substantial in nature, taking into account all of the facts and circumstances, and Y incurs $2 of direct labor and overhead and Y's CGS in selling the drug to customers is $130.

(ii) *Analysis.* PRS's gross receipts from the sale of the active ingredient to X are non-DPGR because PRS's MPGE activity is not substantial in nature and PRS does not satisfy the safe harbor described in § 1.199–3(g)(3) because PRS's direct labor and overhead account for less than 20% of PRS's CGS of the active ingredient. X's gross receipts from the sale of the drug to Y are DPGR because X is considered to have MPGE the drug in significant part in the United States pursuant to the safe harbor described in § 1.199–3(g)(3) because the $27 ($15 + $12) of direct labor and overhead incurred by PRS and X equals or exceeds 20% of X's total CGS ($120) of the drug at the time X disposes of the drug to Y. Similarly, Y's gross receipts from the sale of the drug to customers are DPGR because Y is considered to have MPGE the drug in significant part in the United States pursuant to the safe harbor described in § 1.199–3(g)(3) because the $29 ($15 + $12 + $2) of direct labor and overhead incurred by PRS, X, and Y equals or exceeds 20% of Y's total CGS ($130) of the drug at the time Y disposes of the drug to Y's customers.

■ **Par. 7.** Section 1.199–5 is amended by adding a sentence at the end to read as follows:

§ 1.199–5 Application of section 199 to pass-thru entities for taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005.

* * * For further guidance, see § 1.199–5T.

■ **Par. 8.** Section 1.199–5T is added to read as follows:

§ 1.199–5T Application of section 199 to pass-thru entities for taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005 (temporary).

(a) *In general.* The provisions of this section apply solely for purposes of section 199 of the Internal Revenue Code (Code).

(b) *Partnerships*—(1) *In general*—(i) *Determination at partner level.* The deduction with respect to the qualified production activities of the partnership allowable under § 1.199–1(a) (section 199 deduction) is determined at the partner level. As a result, each partner must compute its deduction separately. The section 199 deduction has no effect on the adjusted basis of the partner's interest in the partnership. Except as provided by publication pursuant to paragraph (b)(1)(ii) of this section, for purposes of this section, each partner is allocated, in accordance with sections 702 and 704, its share of partnership items (including items of income, gain, loss, and deduction), cost of goods sold (CGS) allocated to such items of income, and gross receipts that are included in such items of income, even if the partner's share of CGS and other deductions and losses exceeds domestic production gross receipts (DPGR) (as defined in § 1.199–3(a)). A partnership may specially allocate items of income, gain, loss, or deduction to its partners, subject to the rules of section 704(b) and the supporting regulations. Guaranteed payments under section 707(c) are not considered allocations of partnership income for purposes of this section. Guaranteed payments under section 707(c) are deductions by the partnership that must be taken into account under the rules of § 1.199–4. See § 1.199–3(p) and paragraph (b)(6) *Example 5* of this section. Except as provided in paragraph (b)(1)(ii) of this section, to determine its section 199 deduction for the taxable year, a partner aggregates its distributive share of such items, to the extent they are not otherwise disallowed by the Code, with those items it incurs outside the partnership (whether directly or indirectly) for purposes of allocating and apportioning deductions to DPGR and computing its qualified production activities income (QPAI) (as defined in § 1.199–1(c)).

(ii) *Determination at entity level.* The Secretary may, by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), permit a partnership to calculate a partner's share of QPAI and W–2 wages as defined in § 1.199–2T(e)(2) (W–2 wages) at the entity level, instead of allocating to the partner, in accordance with sections 702 and 704, the partner's share of partnership items (including items of income, gain, loss, and deduction) and amounts described in § 1.199–2(e)(1) (paragraph (e)(1) wages). If a partnership does calculate QPAI at the entity level—

(A) Each partner is allocated its share of QPAI (subject to the limitations of paragraph (b)(2) of this section) and W–2 wages from the partnership, which are combined with the partner's QPAI and W–2 wages from other sources, if any;

(B) For purposes of computing QPAI under §§ 1.199–1 through 1.199–8, a partner does not take into account the items from the partnership (for example, a partner does not take into account items from the partnership in determining whether a threshold or de minimis rule applies or in allocating and apportioning deductions in calculating its QPAI from other sources);

(C) A partner generally does not recompute its share of QPAI from the partnership using another method; however, the partner might have to adjust its share of QPAI from the partnership to take into account certain disallowed losses or deductions, or the allowance of suspended losses or deductions; and

(D) A partner's distributive share of QPAI from a partnership may be less than zero.

(2) *Disallowed losses or deductions.* Except as provided by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), losses or deductions of a partnership are taken into account in computing the partner's section 199 deduction for a taxable year only if, and to the extent that, the partner's distributive share of those losses or deductions from all of the partnership's activities is not disallowed by section 465, 469, or 704(d), or any other provision of the Code. If only a portion of the partner's distributive share of the losses or deductions from a partnership is allowed for a taxable year, a proportionate share of those allowable losses or deductions that are allocated to the partnership's qualified production activities, determined in a manner consistent with sections 465, 469, and 704(d), and any other applicable provision of the Code, is taken into account in computing QPAI for that taxable year. To the extent that any of the disallowed losses or deductions are allowed in a later taxable year under section 465, 469, or 704(d), or any other provision of the Code, the partner takes into account a proportionate share of those allowed losses or deductions that are allocated to the partnership's qualified production activities in computing the partner's QPAI for that later taxable year. Losses or deductions of the partnership that are disallowed for taxable years beginning on or before December 31, 2004, are not taken into account in a later taxable year for purposes of computing the partner's QPAI for that later taxable year, whether or not the losses or deductions are allowed for other purposes.

(3) *Partner's share of paragraph (e)(1) wages.* Under section 199(d)(1)(A)(iii), a partner's share of paragraph (e)(1) wages of a partnership for purposes of determining the partner's wage limitation under section 199(b)(1) (W–2 wage limitation) equals the partner's allocable share of those wages. Except as provided by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), the partnership must allocate the amount of paragraph (e)(1) wages among the partners in the same manner it allocates wage expense among those partners. The partner must add its share of the paragraph (e)(1) wages from the partnership to the partner's paragraph (e)(1) wages from other sources, if any. The partner (other than a partner that itself is a partnership or S corporation) then must calculate its W–2 wages by determining the amount of the partner's total paragraph (e)(1) wages properly allocable to DPGR. If the partner is a partnership or S corporation, the partner must allocate its paragraph (e)(1) wages (including the paragraph (e)(1) wages from a lower-tier partnership) among its partners or shareholders in the same manner it allocates wage expense among those partners or shareholders. See § 1.199–2T(e)(2) for the computation of W–2 wages and for the proper allocation of any such wages to DPGR.

(4) *Transition rule for definition of W–2 wages and for W–2 wage limitation.* If a partnership and any partner in that partnership have different taxable years, only one of which begins on or before May 17, 2006, the definition of W–2 wages of the partnership and the section 199(d)(1)(A)(iii) limitation on W–2 wages from that partnership is determined under the law applicable to partnerships based on the beginning date of the partnership's taxable year. Thus, for example, for the taxable year of a partnership beginning on or before May 17, 2006, a partner's share of W–2 wages from the partnership is determined under section 199(d)(1)(A)(iii) as in effect for taxable years beginning on or before May 17, 2006, even if the taxable year of that partner in which those wages are taken into account begins after May 17, 2006.

(5) *Partnerships electing out of subchapter K.* For purposes of §§ 1.199–1 through 1.199–8, the rules of paragraph (b) of this section apply to all partnerships, including those partnerships electing under section 761(a) to be excluded, in whole or in part, from the application of subchapter K of chapter 1 of the Code.

(6) *Examples.* The following examples illustrate the application of this paragraph (b). Assume that each partner has sufficient adjusted gross income or taxable income so that the section 199 deduction is not limited under section 199(a)(1)(B). Assume also that the partnership and each of its partners (whether individual or corporate) are calendar year taxpayers.

Example 1. Section 861 method with interest expense. (i) *Partnership Federal income tax items.* X and Y, unrelated United States corporations, are each 50% partners in

PRS, a partnership that engages in production activities that generate both DPGR and non-DPGR. X and Y share all items of income, gain, loss, deduction, and credit equally. Both X and Y are engaged in a trade or business. PRS is not able to identify from its books and records CGS allocable to DPGR and non-DPGR. In this case, because CGS is definitely related under the facts and circumstances to all of PRS's gross receipts, apportionment of CGS between DPGR and non-DPGR based on gross receipts is appropriate. For 2010, the adjusted basis of PRS's business assets is $5,000, $4,000 of which generate gross income attributable to DPGR and $1,000 of which generate gross income attributable to non-DPGR. For 2010, PRS has the following Federal income tax items:

DPGR	$3,000
Non-DPGR	3,000
CGS	3,240
Section 162 selling expenses	1,200
Interest expense (not included in CGS)	300

(ii) *Allocation of PRS's Federal income tax items.* X and Y each receive the following distributive share of PRS's Federal income tax items, as determined under the principles of § 1.704–1(b)(1)(vii):

Gross income attributable to DPGR ($1,500 (DPGR)—$810 (allocable CGS))	$690
Gross income attributable to non-DPGR ($1,500 (non-DPGR)—$810 (allocable CGS))	690
Section 162 selling expenses	600
Interest expense (not included in CGS)	150

(iii) *Determination of QPAI.* (A) *X's QPAI.* Because the section 199 deduction is determined at the partner level, X determines its QPAI by aggregating its distributive share of PRS's Federal income tax items with all other such items from all other, non-PRS-related activities. For 2010, X does not have any other such items. For 2010, the adjusted basis of X's non-PRS assets, all of which are investment assets, is $10,000. X's only gross receipts for 2010 are those attributable to the allocation of gross income from PRS. X allocates and apportions its deductible items to gross income attributable to DPGR under the section 861 method of § 1.199–4(d). In this case, the section 162 selling expenses are not included in CGS and are definitely related to all of PRS's gross income. Based on the facts and circumstances of this specific case, apportionment of those expenses between DPGR and non-DPGR on the basis of PRS's gross receipts is appropriate. X elects to apportion its distributive share of interest expense under the tax book value method of § 1.861–9T(g). X's QPAI for 2010 is $366, as shown in the following table:

DPGR	$1,500
CGS allocable to DPGR	(810)
Section 162 selling expenses ($600 × ($1,500 DPGR/$3,000 total gross receipts))	(300)
Interest expense (not included in CGS) ($150 × ($2,000 (X's share of PRS's DPGR assets)/$12,500 (X's non-PRS assets ($10,000) + X's share of PRS assets ($2,500))))	(24)
X's QPAI	366

(B) *Y's QPAI.* (*1*) For 2010, in addition to the activities of PRS, Y engages in production activities that generate both DPGR and non-DPGR. Y is able to identify from its books and records CGS allocable to DPGR and to non-DPGR. For 2010, the adjusted basis of Y's non-PRS assets attributable to its production activities that generate DPGR is $8,000 and to other production activities that generate non-DPGR is $2,000. Y has no other assets. Y has the following Federal income tax items relating to its non-PRS activities:

Gross income attributable to DPGR ($1,500 (DPGR)—$900 (allocableCGS))	$600
Gross income attributable to non-DPGR ($3,000 (other gross receipts)—$1,620 (allocable CGS))	1,380
Section 162 selling expenses	540
Interest expense (not included in CGS)	90

(*2*) Y determines its QPAI in the same general manner as X. However, because Y has other trade or business activities outside of PRS, Y must aggregate its distributive share of PRS's Federal income tax items with its own such items. Y allocates and apportions its deductible items to gross income attributable to DPGR under the section 861 method of § 1.199–4(d). In this case, Y's distributive share of PRS's section 162 selling expenses, as well as those selling expenses from Y's non-PRS activities, are definitely related to all of its gross income. Based on the facts and circumstances of this specific case, apportionment of those expenses between DPGR and non-DPGR on the basis of Y's gross receipts (including Y's share of PRS's gross receipts) is appropriate. Y elects to apportion its distributive share of interest expense under the tax book value method of § 1.861–9T(g). Y has $1,290 of gross income attributable to DPGR ($3,000 DPGR ($1,500 from PRS and $1,500 from non-PRS activities)—$1,710 CGS ($810 from PRS and $900 from non-PRS activities)). Y's QPAI for 2010 is $642, as shown in the following table:

DPGR ($1,500 from PRS and $1,500 from non-PRS activities)	$3,000
CGS allocable to DPGR ($810 from PRS and $900 from non-PRS activities)	(1,710)

Section 162 selling expenses ($1,140 ($600 from PRS and $540 from non-PRS activities) × $3,000 ($1,500 PRS DPGR + $1,500 non-PRS DPGR)/ $7,500 ($3,000 PRS total gross receipts + $4,500 non-PRS total gross receipts))	(456)
Interest expense (not included in CGS) ($240 ($150 from PRS and $90 from non-PRS activities) × $10,000 (Y's non-PRS DPGR assets ($8,000) + Y's share of PRS DPGR assets ($2,000))/$12,500 (Y's non-PRS assets ($10,000) + Y's share of PRS assets ($2,500)))	(192)
Y's QPAI	642

(iv) *Determination of section 199 deduction.* X's tentative section 199 deduction is $33 (.09 x $366, that is, QPAI determined at the partner level) subject to the W–2 wage limitation (50% of W–2 wages). Y's tentative section 199 deduction is $58 (.09 x $642) subject to the W–2 wage limitation.

Example 2. Section 861 method with R&E expense. (i) *Partnership Federal income tax items.* X and Y, unrelated United States corporations each of which is engaged in a trade or business, are partners in PRS, a partnership that engages in production activities that generate both DPGR and non-DPGR. Neither X nor Y is a member of an affiliated group. X and Y share all items of income, gain, loss, deduction, and credit equally. All of PRS's domestic production activities that generate DPGR are within Standard Industrial Classification (SIC) Industry Group AAA (SIC AAA). All of PRS's production activities that generate non-DPGR are within SIC Industry Group BBB (SIC BBB). PRS is not able to identify from its books and records CGS allocable to DPGR and to non-DPGR. In this case, because CGS is definitely related under the facts and circumstances to all of PRS's gross receipts, apportionment of CGS between DPGR and non-DPGR based on gross receipts is appropriate. PRS incurs $900 of research and experimentation expenses (R&E) that are deductible under section 174, $300 of which are performed with respect to SIC AAA and $600 of which are performed with respect to SIC BBB. None of the R&E is legally mandated R&E as described in § 1.861–17(a)(4) and none is included in CGS. For 2010, PRS has the following Federal income tax items:

DPGR (all from sales of products within SIC AAA)	$3,000
Non-DPGR (all from sales of products within SIC BBB)	3,000
CGS	2,400
Section 162 selling expenses	840
Section 174 R&E–SIC AAA	300
Section 174 R&E–SIC BBB	600

(ii) *Allocation of PRS's Federal income tax items.* X and Y each receive the following distributive share of PRS's Federal income tax items, as determined under the principles of § 1.704–1(b)(1)(vii):

Gross income attributable to DPGR ($1,500 (DPGR)—$600 (CGS))	$900
Gross income attributable to non-DPGR ($1,500 (other gross receipts)—$600 (CGS))	900
Section 162 selling expenses	420
Section 174 R&E–SIC AAA	150
Section 174 R&E–SIC BBB	300

(iii) *Determination of QPAI.* (A) *X's QPAI.* Because the section 199 deduction is determined at the partner level, X determines its QPAI by aggregating its distributive share of PRS's Federal income tax items with all other such items from all other, non-PRS-related activities. For 2010, X does not have any other such tax items. X's only gross receipts for 2010 are those attributable to the allocation of gross income from PRS. As stated, all of PRS's domestic production activities that generate DPGR are within SIC AAA. X allocates and apportions its deductible items to gross income attributable to DPGR under the section 861 method of § 1.199–4(d). In this case, the section 162 selling expenses are definitely related to all of PRS's gross income. Based on the facts and circumstances of this specific case, apportionment of those expenses between DPGR and non-DPGR on the basis of PRS's gross receipts is appropriate. For purposes of apportioning R&E, X elects to use the sales method as described in § 1.861–17(c). Because X has no direct sales of products, and because all of PRS's SIC AAA sales attributable to X's share of PRS's gross income generate DPGR, all of X's share of PRS's section 174 R&E attributable to SIC AAA is taken into account for purposes of determining X's QPAI. Thus, X's total QPAI for 2010 is $540, as shown in the following table:

DPGR (all from sales of products within SIC AAA)	$1,500
CGS	(600)
Section 162 selling expenses ($420 × ($1,500 DPGR/$3,000 total gross receipts))	(210)
Section 174 R&E–SIC AAA	(150)
X's QPAI	540

(B) *Y's QPAI.* (*1*) For 2010, in addition to the activities of PRS, Y engages in domestic production activities that generate both DPGR and non-DPGR. With respect to those non-PRS activities, Y is not able to identify from its books and records CGS allocable to DPGR and to non-DPGR. In this case, because non-PRS CGS is definitely related under the facts and circumstances to all of Y's non-PRS gross receipts, apportionment of non-PRS CGS between DPGR and non-DPGR based on Y's non-PRS gross receipts is appropriate. For 2010, Y has the following non-PRS Federal income tax items:

DPGR (from sales of products within SIC AAA)	$1,500
DPGR (from sales of products within SIC BBB)	1,500
Non-DPGR (from sales of products within SIC BBB)	3,000
CGS (allocated to DPGR within SIC AAA)	750

CGS (allocated to DPGR within SIC BBB)	750
CGS (allocated to non-DPGR within SIC BBB)	1,500
Section 162 selling expenses	540
Section 174 R&E–SIC AAA	300
Section 174 R&E–SIC BBB	450

(*2*) Because Y has DPGR as a result of activities outside PRS, Y must aggregate its distributive share of PRS's Federal income tax items with such items from all its other, non-PRS-related activities. Y allocates and apportions its deductible items to gross income attributable to DPGR under the section 861 method of § 1.199–4(d). In this case, the section 162 selling expenses are definitely related to all of Y's gross income. Based on the facts and circumstances of the specific case, apportionment of such expenses between DPGR and non-DPGR on the basis of Y's gross receipts (including Y's share of PRS's gross receipts) is appropriate. For purposes of apportioning R&E, Y elects to use the sales method as described in § 1.861–17(c).

(*3*) With respect to sales that generate DPGR, Y has gross income of $2,400 ($4,500 DPGR ($1,500 from PRS and $3,000 from non-PRS activities) − $2,100 CGS ($600 from sales of products by PRS and $1,500 from non-PRS activities)). Because all of the sales in SIC AAA generate DPGR, all of Y's share of PRS's section 174 R&E attributable to SIC AAA and the section 174 R&E attributable to SIC AAA that Y incurs in its non-PRS activities are taken into account for purposes of determining Y's QPAI. Because only a portion of the sales within SIC BBB generate DPGR, only a portion of the section 174 R&E attributable to SIC BBB is taken into account in determining Y's QPAI. Thus, Y's QPAI for 2010 is $1,282, as shown in the following table:

DPGR ($4,500 DPGR ($1,500 from PRS and $3,000 from non-PRS activities))	$4,500
CGS ($600 from sales of products by PRS and $1,500 from non-PRS activities)	(2,100)
Section 162 selling expenses ($960 ($420 from PRS + $540 from non-PRS activities) × ($4,500 DPGR/$9,000 total gross receipts))	(480)
Section 174 R&E SIC AAA ($150 from PRS and $300 from non-PRS activities)	(450)
Section 174 R&E–SIC BBB ($750 ($300 from PRS + $450 from non-PRS activities) × ($1,500 DPGR/$6,000 total gross receipts allocated to SIC BBB ($1,500 from PRS + $4,500 from non-PRS activities)))	(188)
Y's QPAI	1,282

(iv) *Determination of section 199 deduction.* X's tentative section 199 deduction is $49 (.09 × $540, that is, QPAI determined at the partner level) subject to the W–2 wage limitation (50% of W–2 wages). Y's tentative section 199 deduction is $115 (.09 × $1,282) subject to the W–2 wage limitation.

Example 3. Partnership with special allocations. (i) *In general.* X and Y are unrelated corporate partners in PRS and each is engaged in a trade or business. PRS is a partnership that engages in a domestic production activity and other activities. In general, X and Y share all partnership items of income, gain, loss, deduction, and credit equally, except that 80% of the wage expense of PRS and 20% of PRS's other expenses are specially allocated to X. Under all the facts and circumstances, these special allocations have substantial economic effect under section 704(b). In the 2010 taxable year, PRS's only wage expense is $2,000 for marketing, which is not included in CGS. PRS has $8,000 of gross receipts ($6,000 of which is DPGR), $4,000 of CGS ($3,500 of which is allocable to DPGR), and $3,000 of deductions (comprised of $2,000 of wage expense for marketing and $1,000 of other expenses). X qualifies for and uses the simplified deduction method under § 1.199–4(e). Y does not qualify to use that method and, therefore, must use the section 861 method under § 1.199–4(d). In the 2010 taxable year, X has gross receipts attributable to non-partnership trade or business activities of $1,000 and wage expense of $200. None of X's non-PRS gross receipts is DPGR. For purposes of this example, with regard to both X and PRS, paragraph (e)(1) wages equal wage expense for the 2010 taxable year.

(ii) *Allocation and apportionment of costs.* Under the partnership agreement, X's distributive share of the Federal income tax items of PRS is $1,250 of gross income attributable to DPGR ($3,000 DPGR − $1,750 allocable CGS), $750 of gross income attributable to non-DPGR ($1,000 non-DPGR − $250 allocable CGS), and $1,800 of deductions (comprised of X's special allocations of $1,600 of wage expense ($2,000 × 80%) for marketing and $200 of other expenses ($1,000 × 20%)). Under the simplified deduction method, X apportions $1,200 of other deductions to DPGR ($2,000 ($1,800 from the partnership and $200 from non-partnership activities) × ($3,000 DPGR/ $5,000 total gross receipts)). Accordingly, X's QPAI is $50 ($3,000 DPGR − $1,750 CGS − $1,200 of deductions). X has $1,800 of paragraph (e)(1) wages ($1,600 (X's 80% share) from PRS + $200 (X's own non-PRS paragraph (e)(1) wages)). To calculate its W–2 wages, X must determine how much of this $1,800 is properly allocable under § 1.199–2T(e)(2) to X's total DPGR (including X's share of DPGR from PRS). Thus, X's tentative section 199 deduction for the 2010 taxable year is $5 (.09 × $50), subject to the W–2 wage limitation (50% of X's W–2 wages).

Example 4. Partnership with no paragraph (e)(1) wages. (i) *Facts.* A and B, both individuals, are partners in PRS. PRS is a partnership that engages in manufacturing activities that generate both DPGR and non-DPGR. A and B share all items of income, gain, loss, deduction, and credit equally. For the 2010 taxable year, PRS has total gross receipts of $2,000 ($1,000 of which is DPGR), CGS of $400 and deductions of $800. PRS has no paragraph (e)(1) wages. Each partner's distributive share of PRS's Federal income tax items is $500 DPGR, $500 non-DPGR, $200 CGS, and $400 of deductions. A has trade or business activities outside of PRS (non-PRS activities). With respect to those activities, A has total gross receipts of $1,000 ($500 of which is DPGR), CGS of $400 (including $50 of paragraph (e)(1) wages), and deductions of $200 for the 2010 taxable year. B has no trade or business activities outside of PRS. A and B each use the small business simplified overall method under § 1.199–4(f).

(ii) *A's QPAI.* A's total CGS and deductions apportioned to DPGR equal $600 (($1,200 ($200 PRS CGS + $400 non-PRS CGS + $400 PRS deductions + $200 non-PRS trade or business deductions)) × ($1,000 total DPGR ($500 from PRS + $500 from non-PRS activities)/$2,000 total gross receipts ($1,000 from PRS + $1,000 from non-PRS activities))). Accordingly, A's QPAI is $400 ($1,000 DPGR ($500 from PRS + $500 from non-PRS activities) − $600 CGS and deductions).

(iii) *A's W–2 wages and section 199 deduction.* A has $50 of paragraph (e)(1) wages ($0 from PRS + $50 from A's non-PRS activities). To calculate A's W–2 wages, A determines, under a reasonable method satisfactory to the Secretary, that $40 of this $50 is properly allocable under § 1.199–2T(e)(2) to A's DPGR from PRS and non-PRS activities. A's tentative section 199 deduction is $36 (.09 × $400), subject to the W–2 wage limitation of $20 (50% of W–2 wages of $40). Thus, A's section 199 deduction is $20.

(iv) *B's QPAI and section 199 deduction.* B's CGS and deductions apportioned to DPGR equal $300 (($200 PRS CGS + $400 PRS deductions) × ($500 DPGR from PRS /$1,000 total gross receipts from PRS)). Accordingly, B's QPAI is $200 ($500 DPGR − $300 CGS and deductions). B's tentative section 199 deduction is $18 (.09 × $200), subject to the W–2 wage limitation. In this case, however, the limitation is $0, because B has no paragraph (e)(1) wages. Thus, B's section 199 deduction is $0.

Example 5. Guaranteed payment. (i) *Facts.* The facts are the same as in *Example 4*, except that in 2010 PRS also makes a guaranteed payment of $200 to A for services rendered by A (see section 707(c)), and PRS incurs $200 of wage expense for employees' salary, which is included within the $400 of CGS (in this case the wage expense of $200 equals PRS's paragraph (e)(1) wages). The guaranteed payment is taxable to A as ordinary income and is properly deducted by PRS under section 162. Pursuant to § 1.199–3(p), A may not treat any part of this payment as DPGR. Accordingly, PRS has total gross receipts of $2,000 ($1,000 of which is DPGR), CGS of $400 (including $200 of wage expense) and deductions of $1,000 (including the $200 guaranteed payment) for the 2010 taxable year. Each partner's distributive share of the items of the partnership is $500 DPGR, $500 non-DPGR, $200 CGS (including $100 of wage expense), and $500 of deductions.

(ii) *A's QPAI and W–2 wages.* A's total CGS and deductions apportioned to DPGR equal $591 ($1,300 ($200 PRS CGS + $400 non-PRS CGS + $500 PRS deductions + $200 non-PRS trade or business deductions) × ($1,000 total DPGR ($500 from PRS + $500 from non-PRS activities)/$2,200 total gross receipts ($1,000 from PRS + $200 guaranteed payment + $1,000 from non-PRS activities))). Accordingly, A's QPAI is $409 ($1,000 DPGR − $591 CGS and other deductions). A's total paragraph (e)(1) wages are $150 ($100 from PRS + $50 from non-PRS activities). To calculate its W–2 wages, A must determine how much of this $150 is properly allocable under § 1.199–2T(e)(2) to A's total DPGR from PRS and non-PRS activities. A's tentative section 199 deduction is $37 (.09 x $409), subject to the W–2 wage limitation (50% of W–2 wages).

(iii) *B's QPAI and W–2 wages.* B's QPAI is $150 ($500 DPGR − $350 CGS and other deductions). B has $100 of paragraph (e)(1) wages (all from PRS). To calculate its W–2 wages, B must determine how much of this $100 is properly allocable under § 1.199–2T(e)(2) to B's total DPGR. B's tentative section 199 deduction is $14 (.09 × $150), subject to the W–2 wage limitation (50% of B's W–2 wages).

(c) *S corporations*—(1) *In general*—(i) *Determination at shareholder level.* The section 199 deduction with respect to the qualified production activities of an S corporation is determined at the shareholder level. As a result, each shareholder must compute its deduction separately. The section 199 deduction has no effect on the adjusted basis of a shareholder's stock in an S corporation. Except as provided by publication pursuant to paragraph (c)(1)(ii) of this section, for purposes of this section, each shareholder is allocated, in accordance with section 1366, its pro rata share of S corporation items (including items of income, gain, loss, and deduction), CGS allocated to such items of income, and gross receipts included in such items of income, even if the shareholder's share of CGS and other deductions and losses exceeds DPGR. Except as provided by publication under paragraph (c)(1)(ii) of this section, to determine its section 199 deduction for the taxable year, the shareholder aggregates its pro rata share of such items, to the extent they are not otherwise disallowed by the Code, with those items it incurs outside the S corporation (whether directly or indirectly) for purposes of allocating and apportioning deductions to DPGR and computing its QPAI.

(ii) *Determination at entity level.* The Secretary may, by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), permit an S corporation to calculate a shareholder's share of QPAI and W–2 wages at the entity level, instead of allocating to the shareholder, in accordance with section 1366, the shareholder's pro rata share of S corporation items (including items of income, gain, loss, and deduction) and paragraph (e)(1) wages. If an S corporation does calculate QPAI at the entity level—

(A) Each shareholder is allocated its share of QPAI (subject to the limitations of paragraph (c)(2) of this section) and W–2 wages from the S corporation, which are combined with the shareholder's QPAI and W–2 wages from other sources, if any;

(B) For purposes of computing QPAI under §§ 1.199–1 through 1.199–8, a shareholder does not take into account the items from the S corporation (for example, a shareholder does not take into account items from the S corporation in determining whether a threshold or *de minimis* rule applies or in allocating and apportioning deductions in calculating its QPAI from other sources);

(C) A shareholder generally does not recompute its share of QPAI from the S corporation using another method; however, the shareholder might have to adjust its share of QPAI from the S corporation to take into account certain disallowed losses or deductions, or the allowance of suspended losses or deductions; and

(D) A shareholder's share of QPAI from an S corporation may be less than zero.

(2) *Disallowed losses or deductions.* Except as provided by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), losses or deductions of the S corporation are taken into account in computing the shareholder's section 199 deduction for a taxable year only if, and to the extent that, the shareholder's pro rata share of the losses or deductions from all of the S corporation's activities is not disallowed by section 465, 469, or 1366(d), or any other provision of the Code. If only a portion of the shareholder's share of the losses or deductions from an S corporation is allowed for a taxable year, a proportionate share of those allowable losses or deductions that are allocated to the S corporation's qualified production activities, determined in a manner consistent with sections 465, 469, and 1366(d), and any other applicable provision of the Code, is taken into account in computing QPAI for that taxable year. To the extent that any of the disallowed losses or deductions are allowed in a later taxable year under section 465, 469, or 704(d), or any other provision of the Code, the shareholder takes into account a proportionate share of those allowed losses or deductions that are allocated to the S corporation's qualified production activities in computing the shareholder's QPAI for that later taxable year. Losses or deductions of the S corporation that are disallowed for taxable years beginning on or before December 31, 2004, are not taken into account in a later taxable year for purposes of computing the shareholder's QPAI for that later taxable year, whether or not the losses or deductions are allowed for other purposes.

(3) *Shareholder's share of paragraph (e)(1) wages.* Under section 199(d)(1)(A)(iii), an S corporation shareholder's share of the paragraph (e)(1) wages of the S corporation for purposes of determining the shareholder's W–2 wage limitation equals the shareholder's allocable share of those wages. Except as provided by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), the S corporation must allocate the paragraph (e)(1) wages among the shareholders in the same manner it allocates wage expense among those shareholders. The shareholder then must add its share of the paragraph (e)(1) wages from the S corporation to the shareholder's paragraph (e)(1) wages from other sources, if any, and then must determine the portion of those total paragraph (e)(1) wages allocable to DPGR to compute the shareholder's W–2 wages. See § 1.199–2T(e)(2) for the computation of W–2 wages and for the proper allocation of such wages to DPGR.

(4) *Transition rule for definition of W–2 wages and for W–2 wage limitation.* If an S corporation and any of its shareholders have different taxable years, only one of which begins on or before May 17, 2006, the definition of W–2 wages of the S corporation and the section 199(d)(1)(A)(iii) limitation on W–2 wages from that S corporation is determined under the law applicable to

S corporations based on the beginning date of the S corporation's taxable year. Thus, for example, for the short taxable year of an S corporation beginning after May 17, 2006, and ending in 2006, a shareholder's share of W–2 wages from the S corporation is determined under section 199(d)(1)(A)(iii) for taxable years beginning after May 17, 2006, even if that shareholder's taxable year began on or before May 17, 2006.

(d) *Grantor trusts.* To the extent that the grantor or another person is treated as owning all or part (the owned portion) of a trust under sections 671 through 679, such person (owner) computes its QPAI with respect to the owned portion of the trust as if that QPAI had been generated by activities performed directly by the owner. Similarly, for purposes of the W–2 wage limitation, the owner of the trust takes into account the owner's share of the paragraph (e)(1) wages of the trust that are attributable to the owned portion of the trust. The provisions of paragraph (e) of this section do not apply to the owned portion of a trust.

(e) *Non-grantor trusts and estates*—(1) *Allocation of costs.* The trust or estate calculates each beneficiary's share (as well as the trust's or estate's own share, if any) of QPAI and W–2 wages from the trust or estate at the trust or estate level. The beneficiary of a trust or estate may not recompute its share of QPAI or W–2 wages from the trust or estate by using another method to reallocate the trust's or estate's qualified production costs or paragraph (e)(1) wages, or otherwise. Except as provided in paragraph (d) of this section, the QPAI of a trust or estate must be computed by allocating expenses described in section 199(d)(5) in one of two ways, depending on the classification of those expenses under § 1.652(b)–3. Specifically, directly attributable expenses within the meaning of § 1.652(b)–3 are allocated pursuant to § 1.652(b)–3, and expenses not directly attributable within the meaning of § 1.652(b)–3 (other expenses) are allocated under the simplified deduction method of § 1.199–4(e) (unless the trust or estate does not qualify to use the simplified deduction method, in which case it must use the section 861 method of § 1.199–4(d) with respect to such other expenses). For this purpose, depletion and depreciation deductions described in section 642(e) and amortization deductions described in section 642(f) are treated as other expenses described in section 199(d)(5). Also for this purpose, the trust's or estate's share of other expenses from a lower-tier pass-thru entity is not directly attributable to any class of income (whether or not those other expenses are directly attributable to the aggregate pass-thru gross income as a class for purposes other than section 199). A trust or estate may not use the small business simplified overall method for computing its QPAI. See § 1.199–4(f)(5).

(2) *Allocation among trust or estate and beneficiaries*—(i) *In general.* The QPAI of a trust or estate (which will be less than zero if the CGS and deductions allocated and apportioned to DPGR exceed the trust's or estate's DPGR) and W–2 wages of a trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust's or estate's distributable net income (DNI), as defined by section 643(a), for the taxable year that is distributed or required to be distributed to the beneficiary or is retained by the trust or estate. To the extent that the trust or estate has no DNI for the taxable year, any QPAI and W–2 wages are allocated entirely to the trust or estate. A trust or estate is allowed the section 199 deduction in computing its taxable income to the extent that QPAI and W–2 wages are allocated to the trust or estate. A beneficiary of a trust or estate is allowed the section 199 deduction in computing its taxable income based on its share of QPAI and W–2 wages from the trust or estate, which are aggregated with the beneficiary's QPAI and W–2 wages from other sources, if any.

(ii) *Treatment of items from a trust or estate reporting qualified production activities income.* When, pursuant to this paragraph (e), a taxpayer must combine QPAI and W–2 wages from a trust or estate with the taxpayer's total QPAI and W–2 wages from other sources, the taxpayer, when applying §§ 1.199–1 through 1.199–8 to determine the taxpayer's total QPAI and W–2 wages from such other sources, does not take into account the items from such trust or estate. Thus, for example, a beneficiary of an estate that receives QPAI from the estate does not take into account the beneficiary's distributive share of the estate's gross receipts, gross income, or deductions when the beneficiary determines whether a threshold or *de minimis* rule applies or when the beneficiary allocates and apportions deductions in calculating its QPAI from other sources. Similarly, in determining the portion of the beneficiary's paragraph (e)(1) wages from other sources that is attributable to DPGR (thus, the W–2 wages from other sources), the beneficiary does not take into account DPGR and non-DPGR from the trust or estate.

(3) *Transition rule for definition of W–2 wages and for W–2 wage limitation.* The definition of W–2 wages of a trust or estate and the section 199(d)(1)(A)(iii) limitation on W–2 wages from that trust or estate, and thus the beneficiary's share of W–2 wages from that trust or estate, is determined under the law applicable to pass-thru entities based on the beginning date of the taxable year of the trust or estate, regardless of the beginning date of the taxable year of the beneficiary.

(4) *Example.* The following example illustrates the application of this paragraph (e). Assume that the partnership, trust, and trust beneficiary all are calendar year taxpayers.

Example. (i) *Computation of DNI and inclusion and deduction amounts.* (A) *Trust's distributive share of partnership items.* Trust, a complex trust, is a partner in PRS, a partnership that engages in activities that generate DPGR and non-DPGR. In 2010, PRS distributes $10,000 cash to Trust. PRS properly allocates (in the same manner as wage expense) paragraph (e)(1) wages of $3,000 to Trust. Trust's distributive share of PRS items, which are properly included in Trust's DNI, is as follows:

Gross income attributable to DPGR ($15,000 DPGR—$5,000 CGS (including wage expense of $1,000))	$10,000
Gross income attributable to non-DPGR ($5,000 other gross receipts—$0 CGS)	5,000
Selling expenses attributable to DPGR (includes wage expense of $2,000)	3,000
Other expenses (includes wage expense of $1,000)	2,000

(B) *Trust's direct activities.* Trust has direct paragraph (e)(1) wages of $2,000 for the 2010 taxable year. In addition to its cash distribution in 2010 from PRS, Trust also directly has the following items which are properly included in Trust's DNI:

Dividends	$10,000
Tax-exempt interest	10,000
Rents from commercial real property operated by Trust as a business	10,000
Real estate taxes	1,000

Trustee commissions	3,000
State income and personal property taxes	5,000
Wage expense for rental business	2,000
Other business expenses	1,000

(C) *Allocation of deductions under § 1.652(b)–3.* (*1*) *Directly attributable expenses.* In computing Trust's DNI for the taxable year, the distributive share of expenses of PRS are directly attributable under § 1.652(b)–3(a) to the distributive share of income of PRS. Accordingly, the $5,000 of CGS, $3,000 of selling expenses, and $2,000 of other expenses are subtracted from the gross receipts from PRS ($20,000), resulting in net income from PRS of $10,000. With respect to the Trust's direct expenses, $1,000 of the trustee commissions, the $1,000 of real estate taxes, and the $2,000 of wage expense are directly attributable under § 1.652(b)–3(a) to the rental income.

(*2*) *Non-directly attributable expenses.* Under § 1.652(b)–3(b), the trustee must allocate a portion of the sum of the balance of the trustee commissions ($2,000), state income and personal property taxes ($5,000), and the other business expenses ($1,000) to the $10,000 of tax-exempt interest. The portion to be attributed to tax-exempt interest is $2,222 ($8,000 × ($10,000 tax exempt interest/$36,000 gross receipts net of direct expenses)), resulting in $7,778 ($10,000—$2,222) of net tax-exempt interest. Pursuant to its authority recognized under § 1.652(b)–3(b), the trustee allocates the entire amount of the remaining $5,778 of trustee commissions, state income and personal property taxes, and other business expenses to the $6,000 of net rental income, resulting in $222 ($6,000—$5,778) of net rental income.

(D) *Amounts included in taxable income.* For 2010, Trust has DNI of $28,000 (net dividend income of $10,000 + net PRS income of $10,000 + net rental income of $222 + net tax-exempt income of $7,778). Pursuant to Trust's governing instrument, Trustee distributes 50%, or $14,000, of that DNI to B, an individual who is a discretionary beneficiary of Trust. Assume that there are no separate shares under Trust, and no distributions are made to any other beneficiary that year. Consequently, with respect to the $14,000 distribution B receives from Trust, B properly includes in B's gross income $5,000 of income from PRS, $111 of rents, and $5,000 of dividends, and properly excludes from B's gross income $3,889 of tax-exempt interest. Trust includes $20,222 in its adjusted total income and deducts $10,111 under section 661(a) in computing its taxable income.

(ii) *Section 199 deduction.* (A) *Simplified deduction method.* For purposes of computing the section 199 deduction for the taxable year, assume Trust qualifies for the simplified deduction method under § 1.199–4(e). The determination of Trust's QPAI under the simplified deduction method requires multiple steps to allocate costs. First, the Trust's expenses directly attributable to DPGR under § 1.652(b)–3(a) are subtracted from the Trust's DPGR. In this step, the directly attributable $5,000 of CGS and selling expenses of $3,000 are subtracted from the $15,000 of DPGR from PRS. Second, the Trust's expenses directly attributable under § 1.652(b)–3(a) to non-DPGR from a trade or business are subtracted from the Trust's trade or business non-DPGR. In this step, $4,000 of Trust expenses directly allocable to the real property rental activity ($1,000 of real estate taxes, $1,000 of Trustee commissions, and $2,000 of wages) are subtracted from the $10,000 of rental income. Third, Trust must identify the portion of its other expenses that is attributable to Trust's trade or business activities, if any, because expenses not attributable to trade or business activities are not taken into account in computing QPAI. In this step, in this example, the portion of the trustee commissions not directly attributable to the rental operation ($2,000) are directly attributable to non-trade or business activities. In addition, the state income and personal property taxes are not directly attributable under § 1.652(b)–3(a) to either trade or business or non-trade or business activities, so the portion of those taxes not attributable to either the PRS interests or the rental operation are not trade or business expenses and, thus, are not taken into account in computing QPAI. The portion of the state income and personal property taxes that is treated as other trade or business expenses is $3,000 ($5,000 × $30,000 total trade or business gross receipts/$50,000 total gross receipts). Fourth, Trust then allocates its other trade or business expenses (not directly attributable under § 1.652(b)–3(a)) between DPGR and non-DPGR on the basis of its total gross receipts from the conduct of a trade or business ($20,000 from PRS + $10,000 rental income). Thus, Trust combines its non-directly attributable (other) business expenses ($2,000 from PRS + $4,000 ($1,000 of other business expenses + $3,000 of income and property taxes allocated to a trade or business) from its own activities) and then apportions this total ($6,000) between DPGR and other receipts on the basis of Trust's total trade or business gross receipts ($6,000 of such expenses × $15,000 DPGR/$30,000 total trade or business gross receipts = $3,000). Thus, for purposes of computing Trust's and B's section 199 deduction, Trust's QPAI is $4,000 ($7,000—$3,000). Because the distribution of Trust's DNI to B equals one-half of Trust's DNI, Trust and B each has QPAI from PRS for purposes of the section 199 deduction of $2,000. B has $1,000 of QPAI from non-Trust activities that is added to the $2,000 QPAI from Trust for a total of $3,000 of QPAI.

(B) *W–2 wages.* For the 2010 taxable year, Trust chooses to use the wage expense safe harbor under § 1.199–2T(e)(2)(ii) to determine its W–2 wages. For its taxable year ending December 31, 2010, Trust has $5,000 of paragraph (e)(1) wages reported on 2010 Forms W–2. Trust's W–2 wages are $2,917, as shown in the following table:

Wage expense included in CGS directly attributable to DPGR	$1,000
Wage expense included in selling expense directly attributable to DPGR	2,000
Wage expense included in non-directly attributable deductions ($1,000 in wage expense x ($15,000 DPGR/$30,000 total trade or business gross receipts))	500
Wage expense allocable to DPGR	3,500
W–2 wages (($3,500 of wage expense allocable to DPGR/$6,000 of total wage expense) x $5,000 in paragraph (e)(1) wages)	$2,917

(C) *Section 199 deduction computation.* (*1*) *B's computation.* B is eligible to use the small business simplified overall method. Assume that B has sufficient adjusted gross income so that the section 199 deduction is not limited under section 199(a)(1)(B). Because the $14,000 Trust distribution to B equals one-half of Trust's DNI, B has W–2 wages from Trust of $1,459 (50% × $2,917). B has W–2 wages of $100 from non-Trust trade or business activities (computed without regard to B's interest in Trust pursuant to § 1.199–2(e)) for a total of $1,559 of W–2 wages. B has $1,000 of QPAI from non-Trust activities that is added to the $2,000 QPAI from Trust for a total of $3,000 of QPAI. B's tentative deduction is $270 (.09 × $3,000), limited under the W–2 wage limitation to $780 (50% × $1,559 W–2 wages). Accordingly, B's section 199 deduction for 2010 is $270.

(*2*) *Trust's computation.* Trust has sufficient adjusted gross income so that the section 199 deduction is not limited under section 199(a)(1)(B). Because the $14,000 Trust distribution to B equals one-half of Trust's DNI, Trust has W–2 wages of $1,459 (50% × $2,917). Trust's tentative deduction is $180 (.09 × $2,000 QPAI), limited under the W–2 wage limitation to $730 (50% × $1,459 W–2 wages). Accordingly, Trust's section 199 deduction for 2010 is $180.

(f) *Gain or loss from the disposition of an interest in a pass-thru entity.* DPGR generally does not include gain or loss recognized on the sale, exchange, or other disposition of an interest in a pass-thru entity. However, with respect to a partnership, if section 751(a) or (b) applies, then gain or loss attributable to assets of the partnership giving rise to ordinary income under section 751(a) or (b), the sale, exchange, or other disposition of which would give rise to DPGR, is taken into account in computing the partner's section 199 deduction. Accordingly, to the extent that cash or property received by a partner in a sale or exchange of all or part of its partnership interest is attributable to unrealized receivables or inventory items within the meaning of section 751(c) or (d), respectively, and the sale or exchange of the unrealized receivable or inventory items would give rise to DPGR if sold, exchanged, or otherwise disposed of by the partnership, the cash or property received by the partner is taken into account by the partner in determining its DPGR for the taxable year. Likewise, to the extent that a distribution of property to a partner is treated under section 751(b) as a sale or exchange of property between the partnership and the distributee partner, and any property deemed sold or exchanged would give rise to DPGR if sold, exchanged, or otherwise disposed of by the partnership, the deemed sale or exchange of the property must be taken into account in determining the partnership's and distributee partner's DPGR to the extent not taken into account under the qualifying in-kind partnership rules. See §§ 1.751–1(b) and 1.199–3T(i)(7).

(g) *No attribution of qualified activities.* Except as provided in § 1.199–3T(i)(7) regarding qualifying in-kind partnerships and § 1.199–3T(i)(8) regarding EAG partnerships, an owner of a pass-thru entity is not treated as conducting the qualified production activities of the pass-thru entity, and vice versa. For example, if a partnership manufactures QPP within the United States, or produces a qualified film or produces utilities in the United States, and distributes or leases, rents, licenses, sells, exchanges, or otherwise disposes of such property to a partner who then, without performing its own qualifying activity, leases, rents, licenses, sells, exchanges, or otherwise disposes of such property, then the partner's gross receipts from this latter lease, rental, license, sale, exchange, or other disposition are treated as non-DPGR. In addition, if a partner manufactures QPP within the United States, or produces a qualified film or produces utilities in the United States, and contributes or leases, rents, licenses, sells, exchanges, or otherwise disposes of such property to a partnership which then, without performing its own qualifying activity, leases, rents, licenses, sells, exchanges, or otherwise disposes of such property, then the partnership's gross receipts from this latter disposition are treated as non-DPGR.

■ **Par. 9.** Section 1.199–7 is amended by adding new paragraph (b)(4) to read as follows:

§ 1.199–7 Expanded affiliated groups.

* * * * *

(b) * * *

(4) *Losses used to reduce taxable income of expanded affiliated group.* [Reserved]. For further guidance, see § 1.199–7T(b)(4).

* * * * *

■ **Par. 10.** Section 1.199–7T is added to read as follows:

§ 1.199–7T Expanded affiliated groups (temporary).

(a) [Reserved]. For further guidance, see § 1.199–7(a).

(b) *Computation of expanded affiliated group's section 199 deduction.* (1) through (3) [Reserved]. For further guidance, see § 1.199–7(b)(1) through (3).

(4) *Losses used to reduce taxable income of expanded affiliated group*—(i) *In general.* The amount of a net operating loss (NOL) sustained by any member of an expanded affiliated group (EAG) (as defined in § 1.199–7) that is used in the year sustained in determining an EAG's taxable income limitation under section 199(a)(1)(B) is not treated as an NOL carryover or NOL carryback to any taxable year in determining the taxable income limitation under section 199(a)(1)(B). For purposes of this paragraph (b)(4), an NOL is considered to be used if it reduces an EAG's aggregate taxable income, regardless of whether the use of the NOL actually reduces the amount of the deduction under § 1.199–1(a) (section 199 deduction) that the EAG would otherwise derive. An NOL is not considered to be used to the extent that it reduces an EAG's aggregate taxable income to an amount less than zero. If more than one member of an EAG has an NOL used in the same taxable year to reduce the EAG's taxable income, the members' respective NOLs are deemed used in proportion to the amount of their NOLs.

(ii) *Examples.* The following examples illustrate the application of this paragraph (b)(4). For purposes of these examples, assume that all relevant parties have sufficient W–2 wages so that the section 199 deduction is not limited under section 199(b)(1).

Example 1. (i) *Facts.* Corporations A and B are the only two members of an EAG. A and B are both calendar year taxpayers and they do not join in the filing of a consolidated Federal income tax return. Neither A nor B had taxable income or loss prior to 2010. In 2010, A has qualified production activities income (QPAI) (as defined in § 1.199–1(c)) and taxable income of $1,000 and B has QPAI of $1,000 and an NOL of $1,500. In 2011, A has QPAI of $2,000 and taxable income of $1,000 and B has QPAI of $2,000 and taxable income prior to the NOL deduction allowed under section 172 of $2,000.

(ii) *Section 199 deduction for 2010.* In determining the EAG's section 199 deduction for 2010, A's $1,000 of QPAI and B's $1,000 of QPAI are aggregated, as are A's $1,000 of taxable income and B's $1,500 NOL. Thus, for 2010, the EAG has QPAI of $2,000 and taxable income of ($500). The EAG's section 199 deduction for 2010 is 9% of the lesser of its QPAI or its taxable income. Because the EAG has a taxable loss in 2010, the EAG's section 199 deduction is $0.

(iii) *Section 199 deduction for 2011.* In determining the EAG's section 199 deduction for 2011, A's $2,000 of QPAI and B's $2,000 of QPAI are aggregated, giving the EAG QPAI of $4,000. Also, $1,000 of B's NOL from 2010 was used in 2010 to reduce the EAG's taxable income to $0. The remaining $500 of B's 2010 NOL is not considered to have been used in 2010 because it reduced the EAG's taxable income below $0. Accordingly, for purposes of determining the EAG's taxable income limitation under section 199(a)(1)(B) in 2011, B is deemed to have only a $500 NOL carryover from 2010 to offset a portion of its 2011 taxable income. Thus, B's taxable income in 2011 is $1,500 which is aggregated with A's $1,000 of taxable income. The EAG's taxable income limitation in 2011 is $2,500. The EAG's section 199 deduction is 9% of the lesser of its QPAI of $4,000 or its taxable income of $2,500. Thus, the EAG's section 199 deduction in 2011 is 9% of $2,500, or $225. The results would be the same if neither A nor B had QPAI in 2010.

Example 2. The facts are the same as in *Example 1* except that in 2010 B was not a member of the same EAG as A, but instead was a member of an EAG with Corporation X, which had QPAI and taxable income of $1,000 in 2010, and had neither taxable income nor loss in any other year. There were no other members of the EAG in 2010 besides B and X, and B and X did not file a consolidated Federal income tax return. As $1,000 of B's NOL was used in 2010 to reduce the B and X EAG's taxable income to $0, B is considered to have only a $500 NOL carryover from 2010 to offset a portion of its 2011 taxable income for purposes of the taxable income limitation under section 199(a)(1)(B), just as in *Example 1.* Accordingly, the results for the A and B EAG in 2011 are the same as in *Example 1.*

Example 3. The facts are the same as in *Example 1* except that B is not a member of any EAG in 2011. Because $1,000 of B's NOL was used in 2010 to reduce the EAG's taxable income to $0, B is considered to have only a $500 NOL carryover from 2010 to offset a portion of its 2011 taxable income for purposes of the taxable income limitation under section 199(a)(1)(B), just as in *Example 1*. Thus, for purposes of determining B's taxable income limitation in 2011, B is considered to have taxable income of $1,500, and B has a section 199 deduction of 9% of $1,500, or $135.

Example 4. Corporations A, B, and C are the only members of an EAG. A, B, and C are all calendar year taxpayers and they do not join in the filing of a consolidated Federal income tax return. None of the EAG members (A, B, or C) had taxable income or loss prior to 2010. In 2010, A has QPAI of $2,000 and taxable income of $1,000, B has QPAI of $1,000 and an NOL of $1,000, and C has QPAI of $1,000 and an NOL of $3,000. In 2011, prior to the NOL deduction allowed under section 172, A and B each has taxable income of $200 and C has taxable income of $5,000. In determining the EAG's section 199 deduction for 2010, A's QPAI of $2,000, B's QPAI of $1,000, and C's QPAI of $1,000 are aggregated, as are A's taxable income of $1,000, B's NOL of $1,000, and C's NOL of $3,000. Thus, for 2010, the EAG has QPAI of $4,000 and taxable income of ($3,000). In determining the EAG's taxable income limitation under section 199(a)(1)(B) in 2011, $1,000 of B's and C's aggregate NOLs in 2010 of $4,000 are considered to have been used in 2010 to reduce the EAG's taxable income to $0, in proportion to their NOLs. Thus, $250 of B's NOL from 2010 ($1,000 x $1,000/$4,000) and $750 of C's NOL from 2010 ($1,000 x $3,000/$4,000) are deemed to have been used in 2010. The remaining $750 of B's NOL and the remaining $2,250 of C's NOL are not deemed to have been used because so doing would have reduced the EAG's taxable income in 2010 below $0. Accordingly, for purposes of determining the EAG's taxable income limitation in 2011, B is deemed to have a $750 NOL carryover from 2010 and C is deemed to have a $2,250 NOL carryover from 2010. Thus, for purposes of determining the EAG's taxable income limitation, B's taxable income in 2011 is $0 and C's taxable income in 2011 is $2,750, which are aggregated with A's $200 taxable income. B's unused NOL carryover from 2010 cannot be used to reduce either A's or C's 2011 taxable income. Thus, the EAG's taxable income limitation in 2011 is $2,950, A's taxable income of $200 plus B's taxable income of $0 plus C's taxable income of $2,750.

■ **Par. 11.** Section 1.199–8 is amended by adding new paragraphs (i)(5) and (6) to read as follows:

§ 1.199–8 Other rules.

* * * * *

(i) * * *

(5) *Tax Increase Prevention and Reconciliation Act of 2005.* [Reserved]. For further guidance, see § 1.199–8T(i)(5).

(6) *Losses used to reduce taxable income of expanded affiliated group.* [Reserved]. For further guidance, see § 1.199–8T(i)(6).

■ **Par. 12.** Section 1.199–8T is amended by adding new paragraphs (i)(5) and (6) to read as follows:

§ 1.199–8T Other rules (temporary).

* * * * *

(i) * * *

(5) *Tax Increase Prevention and Reconciliation Act of 2005.* Sections 1.199–2T(e)(2), 1.199–3T(i)(7) and (8), and 1.199–5T are applicable for taxable years beginning on or after October 19, 2006. A taxpayer may apply §§ 1.199–2T(e)(2), 1.199–3T(i)(7) and (8), and 1.199–5T to taxable years beginning after May 17, 2006, and before October 19, 2006 regardless of whether the taxpayer otherwise relied upon Notice 2005–14 (2005–1 CB 498) (see § 601.601(d)(2) of this chapter), the provisions of REG–105847–05 (2005–47 IRB 987) (see § 601.601(d)(2) of this chapter), or §§ 1.199–1 through 1.199–8. The applicability of §§ 1.199–2T(e)(2), 1.199–3T(i)(7) and (8), and 1.199–5T expires on October 19, 2009.

(6) *Losses used to reduce taxable income of expanded affiliated group.* Section 1.199–7T(b)(4) is applicable for taxable years beginning on or after October 19, 2006. A taxpayer may apply § 1.199–7T(b)(4) to taxable years beginning after December 31, 2004, and before October 19, 2006 regardless of whether the taxpayer otherwise relied upon Notice 2005–14 (2005–1 CB 498) (see § 601.601(d)(2) of this chapter), the provisions of REG–105847–05 (2005–47 IRB 987) (see § 601.601(d)(2) of this chapter), or §§ 1.199–1 through 1.199–9. The applicability of § 1.199–7T(b)(4) expires on October 19, 2009.

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

Approved: October 12, 2006.

Eric Solomon,

Acting Deputy Assistant Secretary of the Treasury.

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DEPARTMENT OF THE INTERIOR

Office of Surface Mining Reclamation and Enforcement

30 CFR Part 931

[NM–045–FOR]

New Mexico Regulatory Program

AGENCY: Office of Surface Mining Reclamation and Enforcement, Interior.

ACTION: Final rule; approval of amendment.

SUMMARY: We are approving an amendment to the New Mexico regulatory program (the ''New Mexico program'') under the Surface Mining Control and Reclamation Act of 1977 (SMCRA or the Act). New Mexico proposed revisions to and additions of rules and revisions to statutes concerning the administrative appeals process and revisions to statutes concerning an extension of time for the authority of the Coal Surface Mining Commission (Commission). New Mexico revised its program to be consistent with SMCRA and the corresponding Federal regulations, streamline and clarify the administrative and judicial appeals process and ensure continuing authority for the New Mexico program.

EFFECTIVE DATE: October 19, 2006.

FOR FURTHER INFORMATION CONTACT: Willis Gainer, Telephone: (505) 248–5096, E-mail address: *wgainer@osmre.gov.*

SUPPLEMENTARY INFORMATION:

I. Background on the New Mexico Program

Section 503(a) of the Act permits a State to assume primacy for the regulation of surface coal mining and reclamation operations on non-Federal and non-Indian lands within its borders by demonstrating that its State program includes, among other things, ''a State law which provides for the regulation of surface coal mining and reclamation operations in accordance with the requirements of this Act * * *; and rules and regulations consistent with regulations issued by the Secretary pursuant to this Act.'' See 30 U.S.C. 1253(a)(1) and (7). On the basis of these criteria, the Secretary conditionally approved the New Mexico program on December 31, 1980. You can find background information on the New Mexico program, including the Secretary's findings, the disposition of comments, and conditions of approval in the December 31, 1980, **Federal Register** (45 FR 86459). You can also find later actions concerning New Mexico's program and program amendments at 30 CFR 931.10, 931.11, 931.13, 931.15, 931.16, and 931.30.

II. Submission of the Proposed Amendment

By letter dated November 18, 2005, New Mexico sent us an amendment to its program (Administrative Record No. 874) under SMCRA (30 U.S.C. 1201 *et seq.*). New Mexico sent the amendment to include the changes made at its own