[T.D. 9263, 71 FR 31283, June 1, 2006, as amended by T.D. 9293, 71 FR 61665, Oct. 19, 2006; T.D. 9317, 72 FR 12971, Mar. 20, 2007; T.D. 9381, 73 FR 8800, Feb. 15, 2008; 73 FR 12270, Mar. 7, 2008]

§ 1.199–1 Income attributable to domestic production activities.

(a) *In general.* A taxpayer may deduct an amount 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 the taxpayer's qualified production activities income (QPAI) (as defined in paragraph (c) of this section) for the taxable year, or the taxpayer's taxable income for the taxable year (or, in the case of an individual, adjusted gross income). The amount of the deduction allowable under this paragraph (a) for any taxable year cannot exceed 50 percent of the W-2 wages of the employer for the taxable year (as determined under §1.199–2). The provisions of this section apply solely for purposes of section 199 of the Internal Revenue Code.

(b) *Taxable income and adjusted gross income*—(1) *In general.* For purposes of paragraph (a) of this section, the definition of taxable income under section 63 applies, except that taxable income (or alternative minimum taxable income, if applicable) is determined without regard to section 199 and without regard to any amount excluded from gross income pursuant to section 114 or pursuant to section 101(d) of the American Jobs Creation Act of 2004, Public Law 108–357 (118 Stat. 1418) (Act). In the case of individuals, adjusted gross income for the taxable year is determined after applying sections 86, 135, 137, 219, 221, 222, and 469, and without regard to section 199 and without regard to any amount excluded from gross income pursuant to section 114 or pursuant to section 101(d) of the Act. For purposes of determining the tax imposed by section 511, paragraph (a) of this section is applied using unrelated business taxable income. Except as provided in §1.199–7(c)(2), the deduction under section 199 is not taken into account in computing any net operating loss or the amount of any net operating loss carryback or carryover.

(2) *Examples.* The following examples illustrate the application of this paragraph (b):

Example 1. X, a corporation that is not part of an expanded affiliated group (EAG) (as defined in §1.199–7), engages in production activities that generate QPAI and taxable income (without taking into account the deduction under this section and an NOL deduction) of $600 in 2010. During 2010, X incurs W-2 wages as defined in §1.199–2(e) of $300. X has an NOL carryover to 2010 of $500. X's deduction under this section for 2010 is $9 (.09 × (lesser of QPAI of $600 and taxable income of $100 ($600 taxable income—$500 NOL)). Because the wage limitation is $150 (50% × $300), X's deduction is not limited.

Example 2. (i) *Facts.* X, a corporation that is not part of an EAG, engages in production activities that generate QPAI and taxable income (without taking into account the deduction under this section and an NOL deduction) of $100 in 2010. X has an NOL carryover to 2010 of $500 that reduces its taxable income for 2010 to $0. X's deduction under this section for 2010 is $0 (.09 × (lesser of QPAI of $100 and taxable income of $0)).

(ii) *Carryover to 2011.* X's taxable income for purposes of determining its NOL carryover to 2011 is $100. Accordingly, X's NOL carryover to 2011 is $400 ($500 NOL carryover to 2010—$100 NOL used in 2010).

(c) *Qualified production activities income.* QPAI for any taxable year is an amount equal to the excess (if any) of the taxpayer's domestic production gross receipts (DPGR) (as defined in §1.199–3) over the sum of—

(1) The cost of goods sold (CGS) that is allocable to such receipts; and

(2) Other expenses, losses, or deductions (other than the deduction allowed under this section) that are properly allocable to such receipts. See §§1.199–3 and 1.199–4.

(d) *Allocation of gross receipts*—(1) *In general.* A taxpayer must determine the portion of its gross receipts for the taxable year that is DPGR and the portion of its gross receipts that is non-DPGR. Applicable Federal income tax principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition the gross receipts of which may constitute DPGR (assuming all the other requirements of §1.199–3 are met), whether it is a service the gross receipts of which may constitute non-DPGR, or some combination thereof. For example, if a taxpayer leases qualifying production property (QPP) (as defined in §1.199–3(j)(1)) and in connection with that lease, also provides services, the taxpayer must allocate its gross receipts from the transaction using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances and that accurately identifies the gross receipts that constitute DPGR and non-DPGR.

(2) *Reasonable method of allocation.* Factors taken into consideration in determining whether the taxpayer's method of allocating gross receipts between DPGR and non-DPGR is reasonable include whether the taxpayer uses the most accurate information available; the relationship between the gross receipts and the method used; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the taxpayer for internal management or other business purposes; whether the method is used for other Federal or state income tax purposes; the time, burden, and cost of using alternative methods; and whether the taxpayer applies the method consistently from year to year. Thus, if a taxpayer has the information readily available and can, without undue burden or expense, specifically identify whether the gross receipts derived from an item are DPGR, then the taxpayer must use that specific identification to determine DPGR. If a taxpayer does not have information readily available to

specifically identify whether the gross receipts derived from an item are DPGR or cannot, without undue burden or expense, specifically identify whether the gross receipts derived from an item are DPGR, then the taxpayer is not required to use a method that specifically identifies whether the gross receipts derived from an item are DPGR.

(3) *De minimis rules*—(i) *DPGR.* All of a taxpayer's gross receipts may be treated as DPGR if less than 5 percent of the taxpayer's total gross receipts are non-DPGR (after application of the exceptions provided in §1.199–3(i)(4)(i)(B), (l)(4)(iv)(A), (m)(1)(iii)(A), (n)(6)(i), and (o)(2) that may result in gross receipts being treated as DPGR). If the amount of the taxpayer's gross receipts that are non-DPGR equals or exceeds 5 percent of the taxpayer's total gross receipts, then, except as provided in paragraph (d)(3)(ii) of this section, the taxpayer is required to allocate all gross receipts between DPGR and non-DPGR in accordance with paragraph (d)(1) of this section. If a corporation is a member of an EAG, but is not a member of a consolidated group, then the determination of whether less than 5 percent of the taxpayer's total gross receipts are non-DPGR is made at the corporation level. If a corporation is a member of a consolidated group, then the determination of whether less than 5 percent of the taxpayer's total gross receipts are non-DPGR is made at the consolidated group level. In the case of an S corporation, partnership, trust (to the extent not described in §1.199–5(d) or §1.199–9(d)) or estate, or other pass-thru entity, the determination of whether less than 5 percent of the pass-thru entity's total gross receipts are non-DPGR is made at the pass-thru entity level. In the case of an owner of a pass-thru entity, the determination of whether less than 5 percent of the owner's total gross receipts are non-DPGR is made at the owner level, taking into account all gross receipts of the owner from its other trade or business activities and the owner's share of the gross receipts of the pass-thru entity.

(ii) *Non-DPGR.* All of a taxpayer's gross receipts may be treated as non-DPGR if less than 5 percent of the taxpayer's total gross receipts are DPGR (after application of the exceptions provided in §1.199–3(i)(4)(ii), (l)(4)(iv)(B), (m)(1)(iii)(B), and (n)(6)(ii) that may result in gross receipts being treated as non-DPGR). If a corporation is a member of an EAG, but is not a member of a consolidated group, then the determination of whether less than 5 percent of the taxpayer's total gross receipts are DPGR is made at the corporation level. If a corporation is a member of a consolidated group, then the determination of whether less than 5 percent of the taxpayer's total gross receipts are DPGR is made at the consolidated group level. In the case of an S corporation, partnership, trust (to the extent not described in §1.199–5(d) or §1.199–9(d)) or estate, or other pass-thru entity, the determination of whether less than 5 percent of the pass-thru entity's total gross receipts are DPGR is made at the pass-thru entity level. In the case of an owner of a pass-thru entity, the determination of whether less than 5 percent of the owner's total gross receipts are DPGR is made at the owner level, taking into account all gross receipts of the owner from its other trade or business activities and the owner's share of the gross receipts of the pass-thru entity.

(4) *Example.* The following example illustrates the application of this paragraph (d):

Example. X derives its gross receipts from the sale of gasoline refined by X within the United States and the sale of refined gasoline that X acquired by purchase from an unrelated person. If at least 5% of X's gross receipts are derived from gasoline refined by X within the United States (that qualify as DPGR if all the other requirements of §1.199–3 are met) and at least 5% of X's gross receipts are derived from the resale of the acquired gasoline (that do not qualify as DPGR), then X does not qualify for the *de minimis* rules under paragraphs (d)(3)(i) and (ii) of this section, and X must allocate its gross receipts between the gross receipts derived from the sale of gasoline refined by X within the United States and the gross receipts derived from the resale of the acquired gasoline. If less than 5% of X's gross receipts are derived from the resale of the acquired gasoline, then, X may either allocate its gross receipts between the gross receipts derived from the gasoline refined by X within the United States and the gross receipts derived from the resale of the acquired gasoline, or, pursuant to paragraph (d)(3)(i) of this section, X may treat all of its gross receipts derived from the sale of the refined gasoline as DPGR. If X's gross receipts attributable to the gasoline refined by X within the United States constitute less than 5% of X's total gross receipts, then, X may either allocate its gross receipts between the gross receipts derived from the gasoline refined by X within the United States and the gross receipts derived from the resale of the acquired gasoline, or, pursuant to paragraph (d)(3)(ii) of this section, X may treat all of its gross receipts derived from the sale of the refined gasoline as non-DPGR.

(e) *Certain multiple-year transactions*—(1) *Use of historical data.* If a taxpayer recognizes and reports gross receipts from advance payments or other similar payments on a Federal income tax return for a taxable year, then the taxpayer's use of historical data in making an allocation of gross receipts from the transaction between DPGR and non-DPGR may constitute a reasonable method. If a taxpayer makes allocations using historical data, and subsequently updates the data, then the taxpayer must use the more recent or updated data, starting in the taxable year in which the update is made.

(2) *Percentage of completion method.* A taxpayer using a percentage of completion method under section 460 must determine the ratio of DPGR and non-DPGR using a reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances that accurately identifies the gross receipts that constitute DPGR. See paragraph (d)(2) of this section for the factors taken into consideration in determining whether the taxpayer's method is reasonable.

(3) *Examples.* The following examples illustrate the application of this paragraph (e):

Example 1. On December 1, 2007, X, a calendar year accrual method taxpayer, sells for $100 a one-year computer software maintenance agreement that provides for (i) computer software updates that X expects to produce in the United States, and (ii) customer support services. At the end of 2007, X uses a reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances to allocate 60% of the gross receipts ($60) to the computer software updates and 40% ($40) to the customer support services. X treats the $60 as DPGR in 2007. At the expiration of the one-year agreement on November 30, 2008, no computer software updates are provided by X. Pursuant to paragraph (e)(1) of this section, because X used a reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances to identify gross receipts as DPGR, X is not required to make any adjustments to its 2007 Federal income tax return (for example, by amended return) or in 2008 for the $60 that was properly treated as DPGR in 2007, even though no computer software updates were provided under the contract.

Example 2. X manufactures automobiles within the United States and sells 5-year extended warranties to customers. The sales price of the warranty is based on historical data that determines what repairs and services are performed on an automobile during the 5-year period. X sells the 5-year warranty to Y for $1,000 in 2007. Under X's method of accounting, X recognizes warranty revenue when received. Using historical data, X concludes that 60% of the gross receipts attributable to a 5-year warranty will be derived from the sale of parts (QPP) that X manufactures within the United States, and 40% will be derived from the sale of purchased parts X did not manufacture and non-qualifying services. X's method of allocating its gross receipts with respect to the 5-year warranty between DPGR and non-DPGR is a reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances. Therefore, X properly treats $600 as DPGR in 2007.

Example 3. The facts are the same as in *Example 2* except that in 2009 X updates its historical data. The updated historical data show that 50% of the gross receipts attributable to a 5-year warranty will be derived from the sale of parts (QPP) that X manufactures within the United States and 50% will be derived from the sale of purchased parts X did not manufacture and non-qualifying services. In 2009, X sells a 5-year warranty for $1,000 to Z. Under all of the facts and circumstances, X's method of allocation is still a reasonable method. Relying on its updated historical data, X properly treats $500 as DPGR in 2009.

Example 4. The facts are the same as in *Example 2* except that Y pays for the 5-year warranty over time ($200 a year for 5 years). Under X's method of accounting, X recognizes each $200 payment as it is received. In 2009, X updates its historical data and the updated historical data show that 50% of the gross receipts attributable to a 5-year warranty will be derived from the sale of QPP that X manufactures within the United States and 50% will be derived from the sale of purchased parts X did not manufacture and non-qualifying services. Under all of the facts and circumstances, X's method of allocation is still a reasonable method. When Y makes its $200 payment for 2009, X, relying on its updated historical data, properly treats $100 as DPGR in 2009.

[T.D. 9263, 71 FR 31283, June 1, 2006; 72 FR 5, Jan. 3, 2007, as amended by T.D. 9381, 73 FR 8801, Feb. 15, 2008]

§ 1.199–2 Wage limitation.

(a) *Rules of application*—(1) *In general.* The provisions of this section apply solely for purposes of section 199 of the Internal Revenue Code. The amount of the deduction allowable under §1.199–1(a) (section 199 deduction) to a taxpayer for any taxable year shall not exceed 50 percent of the W-2 wages (as defined in paragraph (e) of this section) of the taxpayer. For this purpose, except as provided in paragraph (a)(3) of this section and paragraph (b) of this section, the Forms W-2, ''Wage and Tax Statement,'' used in determining the amount of W-2 wages are those issued for the calendar year ending during the taxpayer's taxable year for wages paid to employees (or former employees) of the taxpayer for employment by the taxpayer. For purposes of this section, employees of the taxpayer are limited to employees of the taxpayer as defined in section 3121(d)(1) and (2) (that is, officers of a corporate taxpayer and employees of the taxpayer under the common law rules). See paragraph (a)(3) of this section for the requirement that W-2 wages must have been included in a return filed with the Social Security Administration (SSA) within 60 days after the due date (including extensions) of the return.

(2) *Wages paid by entity other than common law employer.* In determining W-2 wages, a taxpayer may take into account any wages paid by another entity and reported by the other entity on Forms W-2 with the other entity as the employer listed in Box c of the Forms W-2, provided that the wages were paid to employees of the taxpayer for employment by the taxpayer. If the taxpayer is treated as an employer described in section 3401(d)(1) because of control of the payment of wages (that is, the taxpayer is not the common law employer of the payee of the wages), the payment of wages may not be included in determining W-2 wages of the taxpayer. If the taxpayer is paying wages as an agent of another entity to individuals who are not employees of the taxpayer, the wages may not be included in determining the W-2 wages of the taxpayer.

(3) *Requirement that wages must be reported on return filed with the Social Security Administration*—(i) *In general.* The term *W-2 wages* shall not include any amount that is not properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return. Under §31.6051–2 of this chapter, each Form W-2 and the transmittal Form W–3, ''Transmittal of Wage and Tax Statements,'' together constitute an information return to be filed with SSA. Similarly, each Form W-2c, ''Corrected Wage and Tax Statement,'' and the transmittal Form W–3 or W–3c, ''Transmittal of Corrected Wage and Tax Statements,'' together constitute an information return to be filed with SSA. In determining whether any amount has been properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return, each Form W-2 together with its accompanying Form W–3 shall be considered a separate information return and each Form W-2c together with its accompanying Form W–3 or Form W–3c shall be considered a separate information return. Section 31.6071(a)–1(a)(3) of this chapter provides that each information return in respect of wages as defined in the Federal Insurance Contributions Act or of income tax withheld from wages which is required to be made under §31.6051–2 of this chapter shall be filed on or before the last day of February (March 31 if filed electronically) of the year following the calendar year for which it is made, except that if a tax return under §31.6011(a)–5(a) of this chapter is filed as a final return for a period ending prior to December 31, the information statement shall be filed on or before the last day of the second calendar month following the period for which the tax return is filed. Corrected Forms W-2 are required to be filed with SSA on or before the last day of February (March 31 if filed electronically) of the year following the year in which the correction is made, except that if a tax return under §31.6011(a)–5(a) is filed as a final return for a period ending prior to December 31 for the period in