

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

which the correction is made, the corrected Forms W-2 are required to be filed by the last day of the second calendar month following the period for which the final return is filed.

(ii) *Corrected return filed to correct a return that was filed within 60 days of the due date.* If a corrected information return (Return B) is filed with SSA on or before the 60th day after the due date (including extensions) of Return B to correct an information return (Return A) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return A) and paragraph (a)(3)(iii) of this section does not apply, then the wage information on Return B must be included in determining W-2 wages. If a corrected information return (Return D) is filed with SSA later than the 60th day after the due date (including extensions) of Return D to correct an information return (Return C) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return C), then if Return D reports an increase (or increases) in wages included in determining W-2 wages from the wage amounts reported on Return C, then such increase (or increases) on Return D shall be disregarded in determining W-2 wages (and only the wage amounts on Return C may be included in determining W-2 wages). If Return D reports a decrease (or decreases) in wages included in determining W-2 wages from the amounts reported on Return C, then, in determining W-2 wages, the wages reported on Return C must be reduced by the decrease (or decreases) reflected on Return D.

(iii) *Corrected return filed to correct a return that was filed later than 60 days after the due date.* If an information return (Return F) is filed to correct an information return (Return E) that was not filed with SSA on or before the 60th day after the due date (including extensions) of Return E, then Return F (and any subsequent information returns filed with respect to Return E) will not be considered filed on or before the 60th day after the due date (including extensions) of Return F (or the subsequent corrected information return). Thus, if a Form W-2c (or corrected

Form W-2) is filed to correct a Form W-2 that was not filed with SSA on or before the 60th day after the due date (including extensions) of the information return including the Form W-2 (or to correct a Form W-2c relating to an information return including a Form W-2 that had not been filed with SSA on or before the 60th day after the due date (including extensions) of the information return including the Form W-2), then the information return including this Form W-2c (or corrected Form W-2) shall not be considered to have been filed with SSA on or before the 60th day after the due date (including extensions) for this information return including the Form W-2c (or corrected Form W-2), regardless of when the information return including the Form W-2c (or corrected Form W-2) is filed.

(4) *Joint return.* An individual and his or her spouse are considered one taxpayer for purposes of determining the amount of W-2 wages for a taxable year, provided that they file a joint return for the taxable year. Thus, an individual filing as part of a joint return may include the wages of employees of his or her spouse in determining W-2 wages, provided the employees are employed in a trade or business of the spouse and the other requirements of this section are met. However, a married taxpayer filing a separate return from his or her spouse for the taxable year may not include the wages of employees of the taxpayer's spouse in determining the taxpayer's W-2 wages for the taxable year.

(b) *Application in the case of a taxpayer with a short taxable year.* In the case of a taxpayer with a short taxable year, subject to the rules of paragraph (a) of this section, the W-2 wages of the taxpayer for the short taxable year shall include only those wages paid during the short taxable year to employees of the taxpayer, only those elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the taxpayer and only compensation actually deferred under section 457 during the short taxable year with respect to employees of the taxpayer. The Secretary shall have the authority to issue published guidance setting forth the

method that is used to calculate W-2 wages in case of a taxpayer with a short taxable year. See paragraph (e)(3) of this section.

(c) *Acquisition or disposition of a trade or business (or major portion).* If a taxpayer (a successor) acquires a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business from another taxpayer (a predecessor), then, for purposes of computing the respective section 199 deduction of the successor and of the predecessor, the W-2 wages paid for that calendar year shall be allocated between the successor and the predecessor based on whether the wages are for employment by the successor or for employment by the predecessor. Thus, in this situation, the W-2 wages are allocated based on whether the wages are for employment for a period during which the employee was employed by the predecessor or for employment for a period during which the employee was employed by the successor, regardless of which permissible method for Form W-2 reporting is used.

(d) *Non-duplication rule.* Amounts that are treated as W-2 wages for a taxable year under any method shall not be treated as W-2 wages of any other taxable year. Also, an amount shall not be treated as W-2 wages by more than one taxpayer.

(e) *Definition of W-2 wages*—(1) *In general.* Under section 199(b)(2), the term *W-2 wages* means, 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. Thus, the term W-2 wages includes the total amount of wages as defined in section 3401(a); the total amount of elective deferrals (within the meaning of section 402(g)(3)); the compensation deferred under section 457; and for taxable years beginning after December 31, 2005, the amount of designated Roth contributions (as defined in section 402A).

(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 paragraph (e)(1) of this section (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

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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 §1.199-5(e)(4) for an example of the application of paragraph (e)(2)(ii) of this section to a trust or estate. The examples read as follows:

*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)
<b>X's taxable income .....</b>	<b>1,380</b>

(ii) *X's QPAI.* X allocates and apportiones 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)
<b>X's QPAI .....</b>	<b>1,395</b>

(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:

Step one wage expense/X's total wage expense for taxable year ending April 30, 2011 × X's paragraph (e)(1) wages  
 $\$625/\$1,800 \times \$3,000 = \$1,042$

(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 the stock of Y and 80% of the total value of the 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
<b>Total wage expense taken into account .....</b>	<b>480</b>

(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: Step one wage expense/Y's total wage expense for taxable year ending April 30, 2011 × Y's paragraph (e)(1) wages

$$\$480/\$1,020 \times \$2,000 = \$941$$

(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 .....

(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)
<b>Z's QPAI .....</b>	<b>1,290</b>

(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
<b>Wage expense allocable to DPGR .....</b>	<b>700</b>

(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: *Step one wage expense / Z's total wage expense for taxable year ending April 30, 2011 × Z's paragraph (e)(1) wages*

$$\$700 / \$1,800 \times \$3,000 = \$1,167$$

(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 .....

(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 ( $\$4,620 \times (\$3,000 \text{ DPGR} / \$6,000 \text{ total gross receipts})$ ) .....	(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 $\times$ ( $\$3,000 \text{ DPGR} / \$6,000 \text{ total gross receipts}$ ) .....	\$1,500
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(iv) *Section 199 deduction determination.* Z's tentative section 199 deduction is \$62 ( $.09 \times$  (lesser of QPAI of \$690 or taxable income of \$1,380)) subject to the W-2 wage limitation of \$750 ( $50\% \times \$1,500$ ). 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 the only members of a single EAG but are not members of a consolidated group. S and B are both calendar year taxpayers. All the activities described in this *Example 5* 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 ( $\$100,000 \text{ (paragraph (e)(1) wages)} \times (\$100,000 \text{ (wage expense used in calculating B's QPAI)} / \$100,000 \text{ (wage expense used in calculating B's taxable income)})$ ).

(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 ( $\$800,000 \text{ (paragraph (e)(1) wages)} \times (\$0 \text{ (wage expense used in calculating S's QPAI)} / \$800,000 \text{ (wage expense used in calculating S's taxable income)})$ ).

(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 ( $\$10,000,000 \text{ DPGR} - \$6,000,000 \text{ CGS and other deductions}$ ). S's taxable income is \$200,000 ( $\$1,000,000 \text{ gross receipts} - \$800,000 \text{ total deductions}$ ). S's QPAI is \$0 ( $\$0 \text{ DPGR} - \$0 \text{ CGS and other deductions}$ ). 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 ( $.09 \times$  (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 ( $50\% \times (\$100,000 \text{ (B's W-2 wages)} + \$0 \text{ (S's W-2 wages)})$ ). 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 ( $\$10,000,000 \text{ DPGR received from the sale of the QPP} - \$5,800,000 \text{ CGS and other deductions}$ ) and, under the wage expense safe harbor described in paragraph (e)(2)(ii) of this section, would have \$900,000 of W-2 wages ( $\$900,000 \text{ (combined paragraph (e)(1) wages of S and B)} \times (\$900,000 \text{ (wage expense used in calculating QPAI)} / \$900,000 \text{ (wage expense used in calculating taxable income)})$ ).

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.

(3) *Methods for calculating W-2 wages.* The Secretary may provide by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter) for methods to be used in calculating W-2 wages, including W-2 wages for short taxable years. For example, see Rev. Proc. 2006-22 (2006-23 I.R.B. 1033). (see § 601.601(d)(2) of this chapter).

[T.D. 9263, 71 FR 31283, June 1, 2006, as amended by T.D. 9293, 71 FR 61665, Oct. 19, 2006; T.D. 9263, 72 FR 5, Jan. 3, 2007; T.D. 9381, 73 FR 8801, Feb. 15, 2008]

### § 1.199-3 Domestic production gross receipts.

(a) *In general.* The provisions of this section apply solely for purposes of section 199 of the Internal Revenue Code (Code). Domestic production gross receipts (DPGR) are the gross receipts (as defined in paragraph (c) of this section) of the taxpayer that are—

(1) Derived from any lease, rental, license, sale, exchange, or other disposition (as defined in paragraph (i) of this section) of—

(i) Qualifying production property (QPP) (as defined in paragraph (j)(1) of this section) that is manufactured, produced, grown, or extracted (MPGE) (as defined in paragraph (e) of this section) by the taxpayer (as defined in paragraph (f) of this section) in whole or in significant part (as defined in paragraph (g) of this section) within the

United States (as defined in paragraph (h) of this section);

(ii) Any qualified film (as defined in paragraph (k) of this section) produced by the taxpayer; or

(iii) Electricity, natural gas, or potable water (as defined in paragraph (l) of this section) (collectively, utilities) produced by the taxpayer in the United States;

(2) Derived from, in the case of a taxpayer engaged in the active conduct of a construction trade or business, construction of real property (as defined in paragraph (m) of this section) performed in the United States by the taxpayer in the ordinary course of such trade or business; or

(3) Derived from, in the case of a taxpayer engaged in the active conduct of an engineering or architectural services trade or business, engineering or architectural services (as defined in paragraph (n) of this section) performed in the United States by the taxpayer in the ordinary course of such trade or business with respect to the construction of real property in the United States.

(b) *Related persons*—(1) *In general.* DPGR does not include any gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person. A person is treated as related to another person if both persons are treated as a single employer under either section 52(a) or (b) (without regard to section 1563(b)), or section 414(m) or (o). Any other person is an unrelated person for purposes of §§ 1.199-1 through 1.199-9.

(2) *Exceptions.* Notwithstanding paragraph (b)(1) of this section, gross receipts derived from any QPP or qualified film leased or rented by the taxpayer to a related person may qualify as DPGR if the QPP or qualified film is held for sublease or rent, or is subleased or rented, by the related person to an unrelated person for the ultimate use of the unrelated person. Similarly, notwithstanding paragraph (b)(1) of this section, gross receipts derived from the license of QPP or a qualified film to a related person for reproduction and sale, exchange, lease, rental, or sublicense to an unrelated person for