

be annualized by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in the short period.

(2) *Members of an expanded affiliated group.* To compute the average annual gross receipts of an EAG, the gross receipts, for the entire taxable year, of each corporation that is a member of the EAG at the end of its taxable year that ends with or within the taxable year of the computing member are aggregated. For purposes of this paragraph, a consolidated group is treated as one member of the EAG.

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**§ 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.**

(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 § 1.199-2(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 the partner's 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 QPAI 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 allowed 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, however, 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 § 1.199-2(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 after May 17, 2006, the definition of W-2 wages of the partnership and the section 199(d)(1)(A)(iii) rule for determining a partner's share of 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 this paragraph (b) 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. The examples read as follows:

*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 (allocable CGS)) .....	\$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 × \$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 × \$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
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(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 apportion 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 3*, 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 §1.199-2(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 ( $(\$1,200 (\$200 \text{ PRS CGS} + \$400 \text{ non-PRS CGS} + \$400 \text{ PRS deductions} + \$200 \text{ non-PRS trade or business deductions}) \times (\$1,000 \text{ total DPGR} (\$500 \text{ from PRS} + \$500 \text{ from non-PRS activities})) / \$2,000 \text{ total gross receipts} (\$1,000 \text{ from PRS} + \$1,000 \text{ from non-PRS activities}))$ ). Accordingly, A's QPAI is \$400 ( $\$1,000 \text{ DPGR} (\$500 \text{ from PRS} + \$500 \text{ from non-PRS activities}) - \$600 \text{ CGS and deductions}$ ).

(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 § 1.199-2(e)(2) to A's DPGR from PRS and non-PRS activities. A's tentative section 199 deduction is \$36 ( $.09 \times \$400$ ), 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 ( $(\$200 \text{ PRS CGS} + \$400 \text{ PRS deductions}) \times (\$500 \text{ DPGR from PRS} / \$1,000 \text{ total gross receipts from PRS})$ ). Accordingly, B's QPAI is \$200 ( $\$500 \text{ DPGR} - \$300 \text{ CGS and deductions}$ ). B's tentative section 199 deduction is \$18 ( $.09 \times \$200$ ), 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 in-

come 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 ( $\$1,300 (\$200 \text{ PRS CGS} + \$400 \text{ non-PRS CGS} + \$500 \text{ PRS deductions} + \$200 \text{ non-PRS trade or business deductions}) \times (\$1,000 \text{ total DPGR} (\$500 \text{ from PRS} + \$500 \text{ from non-PRS activities})) / \$2,200 \text{ total gross receipts} (\$1,000 \text{ from PRS} + \$200 \text{ guaranteed payment} + \$1,000 \text{ from non-PRS activities}))$ ). Accordingly, A's QPAI is \$409 ( $\$1,000 \text{ DPGR} - \$591 \text{ CGS and other deductions}$ ). A's total paragraph (e)(1) wages are \$150 ( $\$100 \text{ from PRS} + \$50 \text{ from non-PRS activities}$ ). To calculate its W-2 wages, A must determine how much of this \$150 is properly allocable under § 1.199-2(e)(2) to A's total DPGR from PRS and non-PRS activities. A's tentative section 199 deduction is \$37 ( $.09 \times \$409$ ), 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 ( $\$500 \text{ DPGR} - \$350 \text{ CGS and other deductions}$ ). 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 § 1.199-2(e)(2) to B's total DPGR. B's tentative section 199 deduction is \$14 ( $.09 \times \$150$ ), 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 the shareholder's 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 QPAI 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 allowed 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 1366(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, however, 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 § 1.199-2(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 after May 17, 2006, the definition of W-2 wages of the S corporation and the section 199(d)(1)(A)(iii) rule for determining a shareholder's share of 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 re-allocate 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. For this purpose, the trust or estate's DNI is determined with regard to the separate share rule of section 663(c), but without regard to section 199. 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 apports 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) rule for determining the respective shares of 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. The example reads as follows:

*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.* In addition to its cash distribution in 2010 from PRS, Trust 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 (direct paragraph (e)(1) wages)	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 ( $\$8,000 \times (\$10,000 \text{ tax exempt interest} / \$36,000 \text{ gross receipts net of direct expenses})$ ), 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) is 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 is not a trade or business expense and, thus, is not taken into account in computing QPAI. The portion of the state income and personal property taxes

that is treated as an other trade or business expense 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 (\$15,000 DPGR - \$5,000 CGS - \$3,000 selling expenses) - \$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 § 1.199-2(e)(2)(ii) to determine its W-2 wages. For its taxable year ending December 31, 2010, Trust has \$5,000 (\$3,000 from PRS + \$2,000 of Trust) 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 × (\$15,000 DPGR/\$30,000 total trade or business gross receipts) .....	500
	<hr/>
Wage expense allocable to DPGR ...	3,500
W-2 wages ((\$3,500 of wage expense allocable to DPGR/\$6,000 of total wage expense) × \$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 trade or business activities outside of Trust and attributable to DPGR (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 1.199-3(i)(7).

(g) *No attribution of qualified activities.* Except as provided in § 1.199-3(i)(7) regarding qualifying in-kind partnerships and § 1.199-3(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. This rule applies to all partnerships, including partnerships that have elected out of subchapter K under section 761(a). Accordingly, 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.

[ T.D. 9381, 73 FR 8806, Feb. 15, 2008 ]

#### § 1.199-6 Agricultural and horticultural cooperatives.

(a) *In general.* A patron who receives a qualified payment (as defined in paragraph (e) of this section) from a specified agricultural or horticultural cooperative (cooperative) (as defined in paragraph (f) of this section) is allowed a deduction under § 1.199-1(a) (section 199 deduction) for the taxable year the qualified payment is received for the portion of the cooperative's section 199 deduction passed through to the patron and identified by the cooperative in a written notice mailed to the person during the payment period described in section 1382(d). The provisions of this