(6) *Losses used to reduce taxable income of expanded affiliated group.* Section 1.199–7(b)(4) is applicable for taxable years beginning on or after February 15, 2008. For taxable years beginning on or after October 19, 2006, and before February 15, 2008, see §1.199–7T(b)(4) (see 26 CFR part 1 revised as of April 1, 2007).

(7) *Agricultural and horticultural cooperatives.* Section 1.199–6(c) is applicable for taxable years beginning on or after March 20, 2007. A taxpayer may apply §1.199–(6)(c) to taxable years beginning after December 31, 2004, and before March 20, 2007.

(8) *Qualified film produced by the taxpayer.* Section 1.199–3(k) is applicable to taxable years beginning on or after March 7, 2008. A taxpayer may apply §1.199–3(k) to taxable years beginning after December 31, 2004, and before March 7, 2008. However, for taxable years beginning before June 1, 2006, a taxpayer may rely on §1.199–3(k) only if the taxpayer does not apply Notice 2005–14 (2005–1 CB 498) (see §601.601(d)(2)(ii)(*b*) of this chapter) or REG–105847–05 (2005–2 CB 987) (see §601.601(d)(2)(ii)(*b*) of this chapter) to the taxable year.

(9) *Expanded affiliated groups.* Section 1.199–7(e), *Example 10,* (f)(1), and (g)(3) are applicable to taxable years beginning on or after March 7, 2008. A taxpayer may apply §1.199–7(e), *Example 10,* to taxable years beginning after December 31, 2004, and before March 7, 2008.

[T.D. 9263, 71 FR 31283, June 1, 2006, as amended by T.D. 9293, 71 FR 61680, Oct. 19, 2006; T.D. 9263,72 FR 6, Jan. 3, 2007; T.D. 9317, 72 FR 12973, Mar. 20, 2007; T.D. 9381, 73 FR 8814, Feb. 15, 2008; T.D. 9384, 73 FR 12272, Mar. 7, 2008; T.D. 9381, 73 FR 16519, Mar. 28, 2008]

§ 1.199–9 Application of section 199 to pass-thru entities for taxable years beginning on or before 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)) and regardless of the amount of the partner's share of W-2 wages (as defined in §1.199–2(e)) of the partnership for the taxable year. 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 at the entity level, instead of allocating, in accordance with sections 702 and 704, the partner's share of partnership items (including items of income, gain, loss, and deduction). If a partnership does calculate QPAI at the entity level—

(A) The partner is allocated its share of QPAI and W-2 wages (as defined in §1.199–2(e)), which (subject to the limitations of paragraph (b)(2) of this section and section 199(d)(1)(A)(iii), respectively) are combined with the partner's QPAI and W-2 wages from other sources;

(B) For purposes of computing the partner's QPAI under §§1.199–1 through 1.199–9, 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 that otherwise would be taken into account in computing the partner's section 199 deduction for a taxable year are taken into account in that year only if and to the extent 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 is allowed for a taxable year, a proportionate share of those allowable losses or deductions that are allocated to the partnership's qualified production activities, determined in a manner consistent with sections 465, 469, and 704(d), and any other applicable provision of the Code, is taken into account in computing QPAI and the wage limitation of section 199(d)(1)(A)(iii) for that taxable year. To the extent that any of the disallowed losses or deductions are allowed in a later taxable year, the partner takes into account a proportionate share of those losses or deductions in computing its QPAI for that later taxable year. Losses or deductions of the partnership that are disallowed for taxable years beginning on or before December 31, 2004, are not taken into account in a later taxable year for purposes of computing the partner's QPAI or the wage limitation of section 199(d)(1)(A)(iii) for that taxable year, regardless of whether the losses or deductions are allowed for other purposes.

(3) *Partner's share of W-2 wages*. Under section 199(d)(1)(A)(iii), a partner's share of W-2 wages of a partnership for purposes of determining the partner's section 199(b) wage limitation is the lesser of the partner's allocable share of those wages (without regard to section 199(d)(1)(A)(iii)), or 2 times 3 percent of the QPAI computed by taking into account only the items of the partnership allocated to the partner for the taxable year of the partnership. Except as provided by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter), this QPAI calculation is performed by the partner using the same cost allocation method that the partner uses in calculating the partner's section 199 deduction. The partnership must allocate W-2 wages (prior to the application of the wage limitation) among the partners in the same manner as wage expense. The partner must add the partner's share of the W-2 wages from the partnership, as limited by section 199(d)(1)(A)(iii), to the partner's W-2 wages from other sources, if any. If QPAI, computed by taking into account only the items of the partnership allocated to the partner for the taxable year (as required by the wage limitation of section 199(d)(1)(A)(iii)) is not greater than zero, then the partner may not take into account any W-2 wages of the partnership in applying the wage limitation of §1.199–2 (but the partner will, nevertheless, aggregate its distributive share of partnership items including wage expense with those items not

from the partnership in computing its QPAI when determining its section 199 deduction). See §1.199–2 for the computation of W-2 wages, and paragraph (g) of this section for rules regarding pass-thru entities in a tiered structure.

(4) *Transition percentage rule for W-2 wages*. With regard to partnerships, for purposes of section 199(d)(1)(A)(iii)(II) the transition percentages determined under section 199(a)(2) shall be determined by reference to the partnership's taxable year. Thus, if a partner uses a calendar year taxable year, and owns an interest in a partnership that has a taxable year ending on April 30, the partner's section 199(d)(1)(A)(iii) wage limitation for the partnership's taxable year beginning on May 1, 2006, would be calculated using 3 percent, even though the partner includes the partner's distributive share of partnership items from that taxable year on the partner's 2007 Federal income tax return.

(5) *Partnerships electing out of subchapter K*. For purposes of §§1.199–1 through 1.199–9, 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); that the partnership and each of its partners (whether individual or corporate) are calendar year taxpayers; and that the amount of the partnership's W-2 wages equals wage expense for each taxable year. The examples are 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 50% each. Both X and Y are engaged in a trade or business. PRS 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 PRS's gross income, apportionment of CGS between DPGR and non-DPGR based on gross receipts is appropriate. For 2006, 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 2006, PRS has the following Federal income items:

DPGR	$3,000
Non-DPGR	3,000
CGS (includes $200 of W-2 wages)	3,240
Section 162 selling expenses (includes $300 of W-2 wages)	1,200
Interest expense (not included in CGS)	300

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

Gross income attributable to DPGR ($1,500 (DPGR) − $810 (allocable CGS, includes $50 of W-2 wages))	$690
Gross income attributable to non-DPGR ($1,500 (non-DPGR) − $810 (allocable CGS, includes $50 of W-2 wages))	690
Section 162 selling expenses (includes $150 of W-2 wages)	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, to the extent necessary, its distributive share of PRS's Federal income tax items with all other such items from all other, non-PRS-related activities. For 2006, X does not have any other such items. For 2006, the adjusted basis of

X's non-PRS assets, all of which are investment assets, is $10,000. X's only gross receipts for 2006 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 (including W-2 wages) are definitely related to all of PRS's gross receipts. 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 2006 is $366, as shown below:

DPGR	$1,500
CGS allocable to DPGR (includes $50 of W-2 wages)	(810)
Section 162 selling expenses (includes $75 of W-2 wages) ($600 × $1,500/$3,000)	(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) and X's share of PRS assets ($2,500)))	(24)
X's QPAI	366

(B) *Y's QPAI.* (*1*) For 2006, in addition to the activities of PRS, Y engages in production activities that generate both DPGR and non-DPGR. Y is able to specifically identify CGS allocable to DPGR and to non-DPGR. For 2006, 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, includes $70 of W-2 wages))	$600
Gross income attributable to non-DPGR ($3,000 (other gross receipts) − $1,620 (allocable CGS, includes $150 of W-2 wages))	1,380
Section 162 selling expenses (includes $30 of W-2 wages)	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 (including W-2 wages), 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 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 2006 is $642, as shown below:

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) (includes $120 of W-2 wages)	(1,710)
Section 162 selling expenses (includes $180 of W-2 wages) ($1,140 ($600 from PRS and $540 from non-PRS activities) × ($1,500 PRS DPGR + $1,500 non-PRS DPGR)/($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) and Y's share of PRS DPGR assets ($2,000))/$12,500 (Y's non-PRS assets ($10,000) and Y's share of PRS assets ($2,500)))	(192)
Y's QPAI	642

(iv) *PRS W-2 wages allocated to X and Y under section 199(d)(1)(A)(iii).* Solely for purposes of calculating the PRS W-2 wages that are allocated to them under section 199(d)(1)(A)(iii) for purposes of the wage limitation of section 199(b), X and Y must separately determine QPAI taking into account only the items of PRS allocated to them. X and Y must use the same methods of allocation and apportionment that they use to determine their QPAI in paragraphs (iii)(A) and (B) of this *Example 1*, respectively. Accordingly, X and Y must apportion deductible section 162 selling expenses that include W-2 wage expense on the basis of gross receipts, and must apportion interest expense according to the tax book value method of §1.861–9T(g).

(A) QPAI of X and Y, solely for this purpose, is determined by allocating and apportioning each partner's share of PRS expenses to each partner's share of PRS gross income of $690 attributable to DPGR ($1,500 DPGR − $810 CGS, apportioned based on gross receipts). Thus, QPAI of X and Y solely for this purpose is $270, as shown below:

DPGR	$1,500
CGS allocable to DPGR	(810)
Section 162 selling expenses (including W-2 wages) ($600 × ($1,500/$3,000))	(300)
Interest expense (not included in CGS) ($150 × $2,000 (partner's share of adjusted basis of PRS's DPGR assets)/$2,500 (partner's share of adjusted basis of total PRS assets))	(120)
QPAI	270

(B) X's and Y's shares of PRS's W-2 wages determined under section 199(d)(1)(A)(iii) for purposes of the wage limitation of section 199(b) are $16, the lesser of $250 (partner's allocable share of PRS's W-2 wages ($100 included in total CGS, and $150 included in selling expenses) and $16 (2 × ($270 × .03)).

(v) *Section 199 deduction determination.* (A) X's tentative section 199 deduction is $11 (.03 × $366 (that is, QPAI determined at partner level)) subject to the wage limitation of $8 (50% × $16). Accordingly, X's section 199 deduction for 2006 is $8.

(B) Y's tentative section 199 deduction is $19 (.03 × $642 (that is, QPAI determined at the partner level) subject to the wage limitation of $133 (50% × ($16 from PRS and $250 from non-PRS activities)). Accordingly, Y's section 199 deduction for 2006 is $19.

Example 2. Section 861 method with R&E expense. (i) *Partnership items of income, gain, loss, deduction or credit.* 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 50% each. 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 specifically identify CGS allocable to DPGR and to non-DPGR and, therefore, apportions CGS to DPGR and non-DPGR based on its gross receipts. 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. PRS incurs section 162 selling expenses (that include W–2 wage expense) that are not includible in CGS and are definitely related to all of PRS's gross income. For 2006, 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 (includes $200 of W-2 wages)	2,400

Section 162 selling expenses (includes $100 of W-2 wages)	840
Section 174 R&E–SIC AAA	300
Section 174 R&E–SIC BBB	600

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

Gross income attributable to DPGR ($1,500 (DPGR) − $600 (CGS, includes $50 of W-2 wages))	$900
Gross income attributable to non-DPGR ($1,500 (other gross receipts) − $600 (CGS, includes $50 of W-2 wages))	900
Section 162 selling expenses (includes $50 of W-2 wages)	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, to the extent necessary, its distributive shares of PRS's Federal income tax items with all other such items from all other, non-PRS-related activities. For 2006, X does not have any other such tax items. X's only gross receipts for 2006 are those attributable to the allocation of gross income from PRS. As stated, all of PRS's domestic production activities that generate DPGR are within SIC AAA. X allocates and apportions its deductible items to gross income attributable to DPGR under the section 861 method of §1.199–4(d). In this case, the section 162 selling expenses (including W-2 wages) 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 2006 is $540, as shown below:

DPGR (all from sales of products within SIC AAA)	$1,500
CGS (includes $50 of W-2 wages)	(600)
Section 162 selling expenses (including W-2 wages) ($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 2006, 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 specifically identify CGS allocable to DPGR and to non-DPGR. In this case, because CGS is definitely related under the facts and circumstances to all of Y's non-PRS gross receipts, apportionment of CGS between DPGR and non-DPGR based on Y's non-PRS gross receipts is appropriate. For 2006, 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) (includes $56 of W-2 wages)	750
CGS (allocated to DPGR within SIC BBB) (includes $56 of W-2 wages)	750
CGS (allocated to non-DPGR within SIC BBB) (includes $113 of W-2 wages)	1,500
Section 162 selling expenses (includes $30 of W-2 wages)	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 (including W-2 wages) 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 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 2006 is $1,282, as shown below:

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 (including W–2 wages) ($420 from PRS + $540 from non-PRS activities) x ($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 ($300 from PRS + $450 from non-PRS activities) x ($1,500 DPGR/$6,000 total gross receipts allocated to SIC BBB ($1,500 from PRS and $4,500 from non-PRS activities))	(188)
Y's QPAI	1,282

(iv) *PRS W-2 wages allocated to X and Y under section 199(d)(1)(A)(iii).* Solely for purposes of calculating the PRS W-2 wages that are allocated to X and Y under section 199(d)(1)(A)(iii) for purposes of the wage limitation of section 199(b), X and Y must separately determine QPAI taking into account only the items of PRS allocated to them. X and Y must use the same methods of allocation and apportionment that they use to determine their QPAI in paragraphs (iii)(A) and (B) of this *Example 2*, respectively. Accordingly, X and Y must apportion section 162 selling expenses that include W-2 wage expense on the basis of gross receipts, and apportion section 174 R&E expense under the sales method as described in §1.861–17(c).

(A) QPAI of X and Y, solely for this purpose, is determined by allocating and apportioning each partner's share of PRS expenses to each partner's share of PRS gross income of $900 attributable to DPGR ($1,500 DPGR—$600 CGS, allocated based on PRS's gross receipts). Because all of PRS's SIC AAA sales generate DPGR, all of X's and Y's shares of PRS's section 174 R&E attributable to SIC AAA is taken into account for purposes of determining X's and Y's QPAI. None of PRS's section 174 R&E attributable to SIC BBB is taken into account because PRS has no DPGR within SIC BBB. Thus, X and Y each has QPAI, solely for this purpose, of $540, as shown below:

DPGR (all from sales of products within SIC AAA)	$1,500
CGS (includes $50 of W-2 wages)	(600)
Section 162 selling expenses (including W-2 wages) ($420 × $1,500/$3,000)	(210)
Section 174 R&E–SIC AAA	(150)
QPAI	540

(B) X's and Y's shares of PRS's W-2 wages determined under section 199(d)(1)(A)(iii) for purposes of the wage limitation of section 199(b) are $32, the lesser of $150 (partner's allocable share of PRS's W-2 wages ($100 included in CGS, and $50 included in selling expenses)) and $32 (2 × ($540 × .03)).

(v) *Section 199 deduction determination.* (A) X's tentative section 199 deduction is $16 (.03 × $540 (QPAI determined at partner level)) subject to the wage limitation of $16 (50% × $32). Accordingly, X's section 199 deduction for 2006 is $16.

(B) Y's tentative section 199 deduction is $38 (.03 x $1,282 (QPAI determined at partner level) subject to the wage limitation of $144 (50% x $287 ($32 from PRS + $255 from non-PRS activities)). Accordingly, Y's section 199 deduction for 2006 is $38.

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 (substantial economic effect under section 704(b) is presumed). In the 2006 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 wages 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 2006 taxable year, X has gross receipts attributable to non-partnership trade or business activities of $1,000 and wages of $200. None of X's non-PRS gross receipts is DPGR.

(ii) *Allocation and apportionment of costs.* Under the partnership agreement, X's distributive share of the 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). However, in determining the section 199(d)(1)(A)(iii) wage limitation, QPAI is computed taking into account only the items of PRS allocated to X for the taxable year of PRS. Thus, X apportions $1,350 of deductions to DPGR ($1,800 × ($3,000 DPGR/$4,000 total gross receipts from PRS)). Accordingly, X's QPAI for purposes of the section 199(d)(1)(A)(iii) wage limitation is $0 ($3,000 DPGR × $1,750 CGS × $1,350 of deductions). X's share of PRS's W-2 wages is $0, the lesser of $1,600 (X's 80% allocable share of $2,000 of wage expense for marketing) and $0 (2 × ($0 QPAI × .03)). X's tentative deduction is $2 ($50 QPAI × .03), subject to the section 199(b)(1) wage limitation of $100 (50% × $200 ($0 of PRS-related W-2 wages + $200 of non-PRS W-2 wages)). Accordingly, X's section 199 deduction for the 2006 taxable year is $2.

Example 4. Partnership with no W-2 wages. (i) *Facts.* A, an individual, and B, an individual, 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. In the 2006 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 W-2 wages. A and B each use the small business simplified overall method under §1.199–4(f). A has trade or business activities outside of PRS. With respect to those activities, A has total gross receipts of $1,000 ($500 of which is DPGR), CGS of $400 (including $50 of W-2 wages) and deductions of $200 for the 2006 taxable year. B has no trade or business activities outside of PRS and pays $0 of W-2 wages directly for the 2006 taxable year. A's distributive share of the items of the partnership is $500 DPGR, $500 non-DPGR, $200 CGS, and $400 of deductions.

(ii) *Section 199(d)(1)(A)(iii) wage limitation.* A's CGS and deductions apportioned to DPGR from PRS equal $300 (($200 CGS + $400 of other deductions) × ($500 DPGR/$1,000 total gross receipts)). Accordingly, for purposes of the wage limitation of section 199(d)(1)(A)(iii), A's QPAI is $200 ($500 DPGR × $300 CGS and other deductions). A's share of partnership W-2 wages after application of the section 199(d)(1)(A)(iii) limitation is $0, the lesser of $0 (A's 50% allocable share of PRS's $0 of W-2 wages) or $12 (2 × ($200 QPAI × .03)). B's share of PRS's W-2 wages also is $0.

(iii) *Section 199 deduction computation.* A's total CGS and deductions apportioned to DPGR equal $600 (($200 PRS CGS + $400 outside trade or business CGS + $400 PRS deductions + $200 outside trade or business deductions) × ($1,000 total DPGR ($500 from PRS + $500 from outside trade or business)/$2,000 total gross receipts ($1,000 from PRS + $1,000 from outside trade or business)). Accordingly, A's QPAI is $400 ($1,000 DPGR × $600 CGS and deductions). A's tentative deduction is $12 ($400 QPAI × .03), subject to the section 199(b)(1) wage limitation of $25 (50% ×

$50 total W-2 wages). A's section 199 deduction for the 2006 taxable year is $12. B's total section 199 deduction for the 2006 taxable year is $0 because B has no W-2 wages for the 2006 taxable year.

Example 5. Guaranteed payment. (i) *Facts.* The facts are the same as *Example 4* except that in 2006 PRS also makes a guaranteed payment of $200 to A for services, and PRS pays $200 of W-2 wages to PRS employees, which is included within the $400 of CGS. See section 707(c). This guaranteed payment is taxable to A as ordinary income and is properly deducted by PRS under section 162. Pursuant to §1.199–3(p), A may not treat any part of this payment as DPGR. Accordingly, PRS has total gross receipts of $2,000 ($1,000 of which is DPGR), CGS of $400 (including $200 of W-2 wages) and deductions of $1,000 (including the $200 guaranteed payment) for the 2006 taxable year. A's distributive share of the items of the partnership is $500 DPGR, $500 non-DPGR, $200 CGS, and $500 of deductions.

(ii) *Section 199(d)(1)(A)(iii) wage limitation.* A's CGS and deductions apportioned to DPGR from PRS equal $350 (($200 CGS + $500 of other deductions) × ($500 DPGR/$1,000 total gross receipts)). Accordingly, for purposes of the wage limitation of section 199(d)(1)(A)(iii), A's QPAI is $150 ($500 DPGR × $350 CGS and other deductions). A's share of partnership W-2 wages after application of the section 199(d)(1)(A)(iii) limitation is $9, the lesser of $100 (A's 50% allocable share of PRS's $200 of W-2 wages) or $9 (2 × ($150 QPAI × .03)). B's share of PRS's W-2 wages after application of section 199(d)(1)(A)(iii) also is $9.

(iii) *A's section 199 deduction computation.* A's total CGS and deductions apportioned to DPGR equal $591 (($200 PRS CGS + $400 outside trade or business CGS + $500 PRS deductions + $200 outside trade or business deductions) × ($1,000 total DPGR ($500 from PRS + $500 from outside trade or business)/$2,200 total gross receipts ($1,000 from PRS + $200 guaranteed payment + $1,000 from outside trade or business)). Accordingly, A's QPAI is $409 ($1,000 DPGR × $591 CGS and other deductions). A's tentative deduction is $12 ($409 QPAI × .03), subject to the section 199(b)(1) wage limitation of $30 (50% × $59 ($9 PRS W-2 wages $50 + W-2 wages from A's trade or business activities outside of PRS)). A's section 199 deduction for the 2006 taxable year is $12.

(iv) *B's section 199 deduction computation.* B's QPAI is $150 ($500 DPGR × $350 CGS and other deductions). B's tentative deduction is $5 ($150 QPAI × .03), subject to the section 199(b)(1) wage limitation of $5 (50% × $9). Assuming that B engages in no other activities generating DPGR, B's section 199 deduction for the 2006 taxable year is $5.

(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 will have no effect on the 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, and regardless of the amount of the shareholder's share of the W-2 wages of the S corporation for the taxable year. 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 at the entity level, instead of allocating, in accordance with section 1366, the shareholder's pro rata share of S corporation items (including items of income, gain, loss, and deduction). If an S corporation does calculate QPAI at the entity level—

(A) Each shareholder is allocated its share of QPAI and W-2 wages, which (subject to the limitations under paragraph (c)(2) of this section and section 199(d)(1)(A)(iii), respectively) are combined with the shareholder's QPAI and W-2 wages from other sources;

(B) For purposes of computing the shareholder's QPAI under §§1.199–1 through 1.199–9, 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 that otherwise would be taken into account in computing the shareholder's section 199 deduction for a taxable year are taken into account in that year only if and to the extent 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 is allowed for a taxable year, a proportionate share of those allowable losses or deductions that are allocated to the S corporation's qualified production activities, determined in a manner consistent with sections 465, 469, and 1366(d), and any other applicable provision of the Code, is taken into account in computing the QPAI and the wage limitation of section 199(d)(1)(A)(iii) for that taxable year. To the extent that any of the disallowed losses or deductions are allowed in a later taxable year, the shareholder takes into account a proportionate share of those losses or deductions in computing its QPAI for that later taxable year. Losses or deductions of the S corporation that are disallowed for taxable years beginning on or before December 31, 2004, are not taken into account in a later taxable year for purposes of computing the shareholder's QPAI or the wage limitation of section 199(d)(1)(A)(iii) for that taxable year, regardless of whether the losses or deductions are allowed for other purposes.

(3) *Shareholder's share of W-2 wages.* Under section 199(d)(1)(A)(iii), an S corporation shareholder's share of the W-2 wages of the S corporation for purposes of determining the shareholder's section 199(b) limitation is the lesser of the shareholder's allocable share of those wages (without regard to section 199(d)(1)(A)(iii)), or 2 times 3 percent of the QPAI computed by taking into account only the items of the S corporation allocated to the shareholder for the taxable year of the S corporation. Except as provided by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter), this QPAI calculation is performed by the shareholder using the same cost allocation method that the shareholder uses in calculating the shareholder's section 199 deduction. The S corporation must allocate W-2 wages (prior to the application of the wage limitation) among the shareholders in the same manner as wage expense. The shareholder must add the shareholder's share of W-2 wages from the S corporation, as limited by section 199(d)(1)(A)(iii), to the shareholder's W-2 wages from other sources, if any. If QPAI, computed by taking into account only the items of the S corporation allocated to the shareholder for the taxable year (as required by the wage limitation of section 199(d)(1)(A)(iii)), is not greater than zero, then the shareholder may not take into account any W-2 wages of the S corporation in applying the wage limitation of §1.199–2 (but the shareholder will, nevertheless, aggregate its distributive share of S corporation items including wage expense with those items not from the S corporation in computing its QPAI when determining its section 199 deduction). See §1.199–2 for the computation of W-2 wages, and paragraph (g) of this section for rules regarding pass-thru entities in a tiered structure.

(4) *Transition percentage rule for W-2 wages.* With regard to S corporations, for purposes of section 199(d)(1)(A)(iii)(II) the transition percentages determined under section

199(a)(2) shall be determined by reference to the S corporation's taxable year. Thus, if an S corporation shareholder uses a calendar year taxable year, and owns stock in an S corporation that has a taxable year ending on April 30, the shareholder's section 199(d)(1)(A)(iii) wage limitation for the S corporation's taxable year beginning on May 1, 2006, would be calculated using 3 percent, even though the shareholder includes the shareholder's pro rata share of S corporation items from that taxable year on the shareholder's 2007 Federal income tax return.

(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 section 199(b) wage limitation, the owner of the trust takes into account the owner's share of the W-2 wages of the trust that are attributable to the owned portion of the trust. The section 199(d)(1)(A)(iii) wage limitation is not applicable 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 is not permitted to use another cost allocation method to recompute its share of QPAI from the trust or estate or to reallocate the costs of the trust or estate. 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 (subject to the wage limitation as described in paragraph (e)(3) of this section) 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 1.199–9 to determine the taxpayer's total QPAI and W-2 wages from such other sources, does not take into account the items from such trust or estate. Thus, for example, a beneficiary of an estate that receives QPAI from the estate does not take into account the beneficiary's distributive share of the estate's gross receipts, gross income, or deductions when the beneficiary determines whether a threshold or de minimis rule applies or when the beneficiary allocates and apportions deductions in calculating its QPAI from other sources.

(3) *Beneficiary's share of W-2 wages.* The trust or estate must compute each beneficiary's share of W-2 wages from the trust or estate in accordance with section 199(d)(1)(A)(iii), as if the beneficiary were a partner in a partnership. The application of section 199(d)(1)(A)(iii) to each trust and estate therefore means that if QPAI, computed by taking into account only the items of the trust or estate allocated to the beneficiary for the taxable year, is not greater than zero, then the beneficiary may not take into account any W-2 wages of the trust or estate in applying the wage limitation of §1.199–2 (but the beneficiary will, nevertheless, aggregate its QPAI from the trust or estate with its QPAI from other sources when determining the beneficiary's section 199 deduction). See paragraph (g) of this section for rules applicable to pass-thru entities in a tiered structure.

(4) *Transition percentage rule for W-2 wages.* With regard to trusts and estates, for purposes of section 199(d)(1)(A)(iii)(II), the transition percentages determined under section 199(a)(2) shall be determined by reference to the taxable year of the trust or estate.

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

Example. (i) *Computation of DNI and inclusion and deduction amounts.* (A) *Trust's distributive share of partnership items.* Trust, a complex trust, is a partner in PRS, a partnership that engages in activities that generate DPGR and non-DPGR. In 2006, PRS distributes $10,000 cash 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 W-2 wages of $1,000))	$10,000
Gross income attributable to non-DPGR ($5,000 other gross receipts − $0 CGS)	5,000
Selling expenses (includes W-2 wages of $2,000)	3,000
Other expenses (includes W-2 wages of $1,000)	2,000

(B) *Trust's direct activities.* In addition to its cash distribution in 2006 from PRS, Trust also directly has the following items which are properly included in Trust's DNI:

Dividends	$10,000
Tax-exempt interest	10,000
Rents from commercial real property operated by Trust as a business	10,000
Real estate taxes	1,000
Trustee commissions	3,000
State income and personal property taxes	5,000
W-2 wages for rental business	2,000
Other business expenses	1,000

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

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

(D) *Amounts included in taxable income.* For 2006, 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. Next, Trust must identify its other trade or business expenses directly related to non-DPGR trade or business income. In this example, the portion of the trustee commissions not directly attributable to the rental operation ($2,000), as well as the portion of the state income and personal property taxes not directly attributable to either the PRS interests or the rental operation, are not trade or business expenses and, thus, are ignored in computing QPAI. The portion of the state income and personal property taxes that is treated as other trade or business expenses is $3,000 ($5,000 × $30,000 total trade or business gross receipts/$50,000 total gross receipts). Trust then allocates its other trade or business expenses on the basis of its total gross receipts from the conduct of a trade or business ($20,000 from PRS + $10,000 rental income). Trust then combines its non-directly attributable (other) business expenses ($2,000 from PRS + $4,000 ($1,000 of other expenses + $3,000 of income and property taxes) from its own activities) and then apportions this total between DPGR and other receipts on the basis of Trust's total trade or business gross receipts ($6,000 × $15,000 DPGR/$30,000 total trade or business gross receipts = $3,000). Thus, for purposes of computing Trust's and B's section 199 deduction, Trust's QPAI is $4,000 ($7,000 − $3,000). Because the distribution of Trust's DNI to B equals one-half of Trust's DNI, Trust and B each has QPAI from PRS for purposes of the section 199 deduction of $2,000.

(B) *Section 199(d)(1)(A)(iii) wage limitation.* The wage limitation under section 199(d)(1)(A)(iii) must be applied both at the Trust level and at B's level. After applying this limitation to the Trust's share of PRS's W-2 wages, Trust is allocated $330 of W-2 wages from PRS (the lesser of Trust's allocable share of PRS's W-2 wages ($4,000) or 2 × 3% of Trust's QPAI from PRS ($5,500)). Trust's QPAI from PRS for purposes of the section 199(d)(1)(A)(iii) limitation is determined by taking into account only the items of PRS allocated to Trust ($15,000 DPGR − ($5,000 of CGS + $3,000 selling expenses + $1,500 of other expenses)). For this purpose, the $1,500 of other expenses is determined by multiplying $2,000 of other expenses from PRS by $15,000 of DPGR from PRS, divided by $20,000 of total gross receipts from PRS. Trust adds this $330 of W-2 wages to Trust's own $2,000 of W-2 wages (thus, $2,330). Because the $14,000 Trust distribution to B equals one-half of Trust's DNI, Trust and B each has W-2 wages of $1,165. After applying the section 199(d)(1)(A)(iii) wage limitation to B's share of the W-2 wages allocated from Trust, B has W-2 wages of $120 from Trust (lesser of $1,165 (allocable share of W-2 wages) or 2 × .03 × $2,000 (B's share of Trust's QPAI)). B has W-2 wages of $100 from non-Trust activities for a total of $220 of W-2 wages.

(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). 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 $90 (.03 × $3,000), but it is limited under section 199(b) to $110 (50% × $220 W-2 wages). Accordingly, B's section 199 deduction for 2006 is $90.

(*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). Trust's tentative deduction is $60 (.03 × $2,000 QPAI), but it is limited under section 199(b) to $583 (50% × $1,165 W-2 wages). Accordingly, Trust's section 199 deduction for 2006 is $60.

(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 for 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 paragraph (i) of this section.

(g) *Section 199(d)(1)(A)(iii) wage limitation and tiered structures*—(1) *In general.* If a pass-thru entity owns an interest, directly or indirectly, in one or more pass-thru entities, then the wage limitation of section 199(d)(1)(A)(iii) must be applied at each tier (that is, separately for each entity). For purposes of this wage limitation, references to pass-thru entities includes partnerships, S corporations, trusts (to the extent not described in paragraph (d) of this section) and estates. Thus, at each tier, the owner of a pass-thru entity (or the entity on behalf of the owner) calculates the amounts described in sections 199(d)(1)(A)(iii)(I) (owner's allocable share) and 199(d)(1)(A)(iii)(II) (twice the applicable percentage of the owner's QPAI from that entity) separately with regard to its interest in that pass-thru entity.

(2) *Share of W-2 wages.* For purposes of section 199(d)(1)(A)(iii) and section 199(b), the W-2 wages of the owner of an interest in a pass-thru entity (upper-tier entity) that owns an interest in one or more pass-thru entities (lower-tier entities) are equal to the sum of the owner's allocable share of W-2 wages of the upper-tier entity, as limited in accordance with section 199(d)(1)(A)(iii), and the owner's own W-2 wages. The upper-tier entity's W-2 wages are equal to the sum of the upper-tier entity's allocable share of W-2 wages of the next lower-tier entity, as limited in accordance with section 199(d)(1)(A)(iii), and the upper-tier entity's own W-2 wages. The W-2 wages of each lower-tier entity in a tiered structure, in turn, is computed as described in the preceding sentence. Except as provided by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter)—

(i) An upper-tier entity may compute its share of QPAI attributable to items from a lower-tier entity solely for purposes of section 199(d)(1)(A)(iii)(II) by applying either the section 861 method described in §1.199–4(d) or the simplified deduction method described in

§ 1.199–4(e), provided the upper tier entity would otherwise qualify to use such method.

(ii) Alternatively, the upper-tier entity (other than a trust or estate described in paragraph (e) of this section) may compute its share of QPAI attributable to items from a lower-tier entity solely for purposes of section 199(d)(1)(A)(iii)(II) by applying the small business simplified overall method described in § 1.199–4(f), regardless of whether such upper-tier entity would otherwise qualify to use the small business simplified overall method.

(3) *Example*. The following example illustrates the application of this paragraph (g). Assume that each partnership and each partner (whether or not an individual) is a calendar year taxpayer.

Example. (i) In 2006, A, an individual, owns a 50% interest in a partnership, UTP, which in turn owns a 50% interest in another partnership, LTP. All partnership items are allocated in proportion to these ownership percentages. LTP has $900 DPGR, $450 CGS (which includes W-2 wages of $100), and $50 other deductions. Before taking into account its share of items from LTP, UTP has $500 DPGR, $500 CGS (which includes W-2 wages of $200), and $500 other deductions. UTP chooses to compute its share of QPAI attributable to items from LTP for purposes of section 199(d)(1)(A)(iii)(II) by applying the small business simplified overall method described in § 1.199–4(f). For purposes of the wage limitation of section 199(d)(1)(A)(iii), UTP's distributive share of LTP's QPAI is $200 ($450 DPGR − $250 CGS and other deductions).

(ii) UTP's share of LTP's W-2 wages for purposes of the section 199(d)(1)(A)(iii) limitation is $12, the lesser of $50 (UTP's 50% allocable share of LTP's $100 of W-2 wages) or $12 (2 × ($200 QPAI × .03)). After taking into account its share of items from LTP, UTP has $950 DPGR, $725 CGS, and $525 other deductions. A is eligible for and uses the simplified deduction method described in § 1.199–4(e). For purposes of the wage limitation of section 199(d)(1)(A)(iii), A's distributive share of UTP's QPAI is ($151) ($475 DPGR − $363 CGS − $263 other deductions). A's wage limitation under section 199(d)(1)(A)(iii) with respect to A's interest in UTP is $0, the lesser of $106 (A's 50% allocable share of UTP's $212 of W-2 wages) or $0 (because A's share of UTP's QPAI ($151), is less than zero).

(h) *No attribution of qualified activities*. Except as provided in paragraph (i) of this section regarding qualifying in-kind partnerships and paragraph (j) of this section 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 MPGE 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 MPGE or other production, 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 MPGE 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 MPGE or other production, 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.

(i) *Qualifying in-kind partnership*—(1) *In general*. If a partnership is a qualifying in-kind partnership described in paragraph (i)(2) of this section, then each partner is treated as MPGE or producing the property MPGE or produced by the partnership that is distributed to that partner. If a partner of a qualifying in-kind partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of the property that was MPGE or produced by the qualifying in-kind partnership, then, provided such partner is a partner of the qualifying in-kind partnership at the time the partner disposes of the property, the partner is treated as conducting the MPGE or production activities previously conducted by the qualifying in-kind partnership with respect to that property. With respect to a lease, rental, or license, the partner is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts derived from the lease, rental, or license under its methods of accounting. With respect to a sale, exchange, or other disposition, the partner is treated as having disposed of the property on the date on which it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account.

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

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

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

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

(3) *Special rules for distributions*. If a qualifying in-kind partnership distributes property to a partner, then, solely for purposes of section 199(d)(1)(A)(iii)(II), the partnership is treated as having gross receipts in the taxable year of the distribution equal to the fair market value of the distributed property at the time of distribution to the partner and the deemed gross receipts are allocated to that partner, provided that the partner derives gross receipts from the distributed property (and takes into account such receipts under its method of accounting) during the taxable year of the partner with or within which the partnership's taxable year (in which the distribution occurs) ends. For rules for taking costs into account (such as costs included in the adjusted basis of the distributed property), *see* §1.199–4.

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

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

Example. X, Y and Z are partners in PRS, a qualifying in-kind partnership described in paragraph (i)(2) of this section. X, Y, and Z are corporations. In 2006, PRS distributes oil to X that PRS derived from its oil extraction. PRS incurred $600 of CGS, including $500 of W-2 wages (as defined in §1.199–2(e)), extracting the oil distributed to X, and X's adjusted basis in the distributed oil is $600. The fair market value of the oil at the time of the distribution to X is $1,000. X incurs $200 of CGS, including $100 of W-2 wages, in refining the oil within the United States. In 2006, X, while it is a partner in PRS, sells the oil to a customer for $1,500, taking the gross receipts into account under its method of accounting in the same taxable year. Under paragraph (i)(1) of this section, X is treated as having extracted the oil. The extraction and refining of the oil qualify as an MPGE activity under §1.199–3(e)(1). Therefore, X's $1,500 of gross receipts qualify as DPGR. X subtracts from the $1,500 of DPGR the $600 of CGS incurred by PRS and the $200 of refining costs incurred by X. Thus, X's QPAI is $700 for 2006. In addition, PRS is treated as having $1,000 of DPGR solely for purposes of applying the wage limitation in section 199(d)(1)(A)(iii) based on the applicable percentage of QPAI. Accordingly, X's share of PRS's W-2 wages determined under section 199(d)(1)(A)(iii) is $24, the lesser of $500 (X's allocable share of PRS's W-2 wages included in CGS) and $24 (2 × ($400 ($1,000 deemed DPGR less $600 of CGS) × .03)). X adds the $24 of PRS W-2 wages to its $100 of W-2 wages incurred in refining the oil for purposes of section 199(b).

(j) *Partnerships owned by members of a single expanded affiliated group*—(1) *In general*. For purposes of this section, if all of the interests in the capital and profits of a partnership are owned by members of a single EAG at all times during the taxable year of the partnership (EAG partnership), then the EAG partnership and all members of that EAG are treated as a single taxpayer for purposes of section 199(c)(4) during that taxable year.

(2) *Attribution of activities*—(i) *In general.* If a member of an EAG (disposing member) derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE or produced by an EAG partnership, all the partners of which are members of the same EAG to which the disposing member belongs at the time that the disposing member disposes of such property, then the disposing member is treated as conducting the MPGE or production activities previously conducted by the EAG partnership with respect to that property. The previous sentence applies only for those taxable years in which the disposing member is a member of the EAG of which all the partners of the EAG partnership are members for the entire taxable year of the EAG partnership. With respect to a lease, rental, or license, the disposing member is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts from the lease, rental, or license under its methods of accounting. With respect to a sale, exchange, or other disposition, the disposing member is treated as having disposed of the property on the date on which it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account. Likewise, if an EAG partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE or produced by a member (or members) of the same EAG (the producing member) to which all the partners of the EAG partnership belong at the time that the EAG partnership disposes of such property, then the EAG partnership is treated as conducting the MPGE or production activities previously conducted by the producing member with respect to that property. The previous sentence applies only for those taxable years in which the producing member is a member of the EAG of which all the partners of the EAG partnership are members for the entire taxable year of the EAG partnership. With respect to a lease, rental, or license, the EAG partnership is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts derived from the lease, rental, or license under its methods of accounting. With respect to a sale, exchange, or other disposition, the EAG partnership is treated as having disposed of the property on the date on which it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account. See paragraph (j)(5) *Example 3* of this section.

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

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

(3) *Special rules for distributions.* If an EAG partnership distributes property to a partner, then, solely for purposes of section 199(d)(1)(A)(iii)(II), the EAG partnership is treated as having gross receipts in the taxable year of the distribution equal to the fair market value of the property at the time of

distribution to the partner and the deemed gross receipts are allocated to that partner, provided that the partner derives gross receipts from the distributed property (and takes such receipts into account under its methods of accounting) during the taxable year of the partner with or within which the partnership's taxable year (in which the distribution occurs) ends. For rules for taking costs into account (such as costs included in the adjusted basis of the distributed property), *see* §1.199–4.

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

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

Example 1. Contribution. X and Y are the only partners in PRS, a partnership, for PRS's entire 2006 taxable year. X and Y are both members of a single EAG for the entire 2006 year. In 2006, X MPGE QPP within the United States and contributes the property to PRS. In 2006, PRS sells the QPP for $1,000. Under this paragraph (j), PRS is treated as having MPGE the QPP within the United States, and PRS's $1,000 gross receipts constitute DPGR. PRS, X, and Y must apply the rules of this section regarding the application of section 199 to pass-thru entities with respect to the activity of PRS, including application of the section 199(d)(1)(A)(iii) wage limitation under paragraph (b)(3) of this section.

Example 2. Sale. X, Y, and Z are the only members of a single EAG for the entire 2006 year. X and Y each own 50% of the capital and profits interests in PRS, a partnership, for PRS's entire 2006 taxable year. In 2006, PRS MPGE QPP within the United States and then sells the property to X for $6,000, its fair market value at the time of the sale. PRS's gross receipts of $6,000 qualify as DPGR. In 2006, X sells the QPP to customers for $10,000, incurring selling expenses of $2,000. Under this paragraph (j), X is treated as having MPGE the QPP within the United States, and X's $10,000 of gross receipts qualify as DPGR. PRS, X and Y must apply the rules of this section regarding the application of section 199 to pass-thru entities with respect to the activity of PRS, including application of the section 199(d)(1)(A)(iii) wage limitation under paragraph (b)(3) of this section. The results would be the same if PRS sold the property to Z rather than to X.

Example 3. Lease. X, Y, and Z are the only members of a single EAG for the entire 2005 year. X and Y each own 50% of the capital and profits interests in PRS, a partnership, for PRS's entire 2005 taxable year. In 2005, PRS MPGE QPP within the United States and then sells the property to X for $6,000, its fair market value at the time of the sale. PRS's gross receipts of $6,000 qualify as DPGR. In 2005, X rents the QPP it acquired from PRS to customers unrelated to X. X takes the gross receipts attributable to the rental of the QPP into account under its methods of accounting in 2005 and 2006. On July 1, 2006, X ceases to be a member of the same EAG to which Y, the other partner in PRS, belongs. For 2005, X is treated as having MPGE the QPP in the United States, and its gross receipts derived from the rental of the QPP qualify as DPGR. For 2006, however, because X and Y, partners in PRS, are no longer members of the same EAG for the entire year, the gross rental receipts X takes into account in 2006 do not qualify as DPGR.

Example 4. Distribution. X and Y are the only partners in PRS, a partnership, for PRS's entire 2006 taxable year. X and Y are both members of a single EAG for the entire 2006 year. In 2006, PRS MPGE QPP within the United States, incurring $600 of CGS, including $500 of W-2 wages (as defined in §1.199–2(e)), and then distributes the QPP to X. X's adjusted basis in the QPP is $600. At the time of the distribution, the fair market value of the QPP is $1,000. X incurs $200 of CGS, including $100 of W-2 wages, to further MPGE the QPP within the United States. In 2006, X sells the QPP for $1,500 to an unrelated customer and takes the gross receipts into account under its method of accounting in the same taxable year. Under paragraph (j)(1) of this section, X is treated as having MPGE the QPP within the United States, and X's $1,500 of gross receipts qualify as DPGR. In addition, PRS is treated as having DPGR of $1,000 solely for purposes of applying the wage limitation in section 199(d)(1)(A)(iii) based on the applicable percentage of QPAI.

Example 5. Multiple sales. (i) *Facts.* X and Y are the only partners in PRS, a partnership, for PRS's entire 2006 taxable year. X and Y are both non-consolidated members of a single EAG for the entire 2006 year. PRS produces in bulk form in the United States the active ingredient for a pharmaceutical product. Assume that PRS's own MPGE activity with respect to the active ingredient is not substantial in nature, taking into account all of the facts and circumstances, and PRS's direct labor and overhead to MPGE the active ingredient within the United States are $15 and account for 15% of PRS's $100 CGS of the active ingredient. In 2006, PRS sells the active ingredient in bulk form to X. X uses the active ingredient to produce the finished dosage form drug. Assume that X's own MPGE activity with respect to the finished dosage form drug is not substantial in nature, taking into account all of the facts and circumstances, and X's direct labor and overhead to MPGE the finished dosage form drug within the United States are $12 and account for 10% of X's $120 CGS of the finished dosage form drug. In 2006, X sells the finished dosage form drug in finished dosage to Y and Y sells the finished dosage form drug to customers. Assume that Y's own MPGE activity with respect to the finished dosage form drug is not substantial in nature, taking into account all of the facts and circumstances, and Y incurs $2 of direct labor and overhead and Y's CGS in selling the finished dosage form drug to customers is $130.

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

(k) *Effective dates*. Section 199 applies to taxable years beginning after December 31, 2004. In determining the deduction under section 199, items arising from a taxable year of a partnership, S corporation, estate, or trust beginning before January 1, 2005, shall not be taken into account for purposes of section 199(d)(1). Section 1.199–9 does not apply to taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005 (Public Law 109–222, 120 Stat. 345). For taxable years beginning on or before May 17, 2006, a taxpayer must apply §1.199–9 if the taxpayer applies §§1.199–1 through 1.199–8 to that taxable year. Notwithstanding the preceding sentence, a partnership or S corporation that is a qualifying small taxpayer under §1.199–4(f) of REG–105847–05 (2005–47 I.R.B. 987) (see §601.601(d)(2) of this chapter) may use the small business simplified overall method to apportion CGS and deductions between DPGR and non-DPGR at the entity level under §1.199–4(f) of REG–105847–05 for taxable years beginning on or before May 17, 2006. If a taxpayer chooses not to rely on §§1.199–1 through 1.199–9 (as provided in §1.199–8(i)) for a taxable year beginning before June 1, 2006, the guidance under section 199 that applies to taxable years beginning before June 1, 2006, is contained in Notice 2005–14 (2005–1 C.B. 498) (see §601.601(d)(2) of this chapter). In addition, a taxpayer also may rely on the provisions of REG-105847–05 for taxable years beginning before June 1, 2006. If Notice 2005–14 and REG–105847–05 include different rules for the same particular issue, then a taxpayer may rely on either the rule set forth in Notice 2005–14 or the rule set forth in REG–105847–05. However, if REG–105847–05 includes a rule that was not included in Notice 2005–14, then a taxpayer is not permitted to rely on the absence of a rule in Notice 2005–14 to apply a rule contrary to REG–105847–05. For taxable years beginning after May 17, 2006, and before June 1, 2006, a taxpayer may not apply Notice 2005–14, REG–105847–05, or any other guidance under section 199 in a manner inconsistent with amendments made to section 199 by section 514 of the Tax Increase Prevention and Reconciliation Act of 2005.

[T.D. 9263, 71 FR 31283, Jun 1, 2006; 72 FR 6, Jan. 3, 2007; as amended by T.D. 9381, 73 FR 8814, Feb. 15, 2008]

ADDITIONAL ITEMIZED DEDUCTIONS FOR INDIVIDUALS

§ 1.211–1 Allowance of deductions.

In computing taxable income under section 63(a), the deductions provided by sections 212, 213, 214, 215, 216, and 217 shall be allowed subject to the exceptions provided in Part IX, Subchapter B, Chapter 1 of the Code (section 261 and following, relating to items not deductible).

[T.D. 6796, 30 FR 1037, Feb. 2, 1965]

§ 1.212–1 Nontrade or nonbusiness expenses.

(a) An expense may be deducted under section 212 only if:

(1) It has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income, or (iii) in connection with the determination, collection, or refund of any tax; and

(2) It is an ordinary and necessary expense for any of the purposes stated in subparagraph (1) of this paragraph.

(b) The term *income* for the purpose of section 212 includes not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter paid or incurred in connection with such bonds are deductible. Similarly, ordinary and necessary expenses paid or incurred in the management, conservation, or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be deductible under section 212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto.

(c) In the case of taxable years beginning before January 1, 1970, expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses. The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case. For example, consideration will be given to the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer. For provisions relating to activities not engaged in for profit applicable to taxable years beginning after December 31, 1969, see section 183 and the regulations thereunder.

(d) Expenses, to be deductible under section 212, must be ''ordinary and necessary''. Thus, such expenses must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

(e) A deduction under section 212 is subject to the restrictions and limitations in part IX (section 261 and following), subchapter B, chapter 1 of the Code, relating to items not deductible. Thus, no deduction is allowable under