other deductions) and W–2 wages of $900,000. The consolidated group's section 199 deduction is $378,000, the same as the single corporation. However, for purposes of allocating the section 199 deduction between S and B, the redetermination of S's income as DPGR under §1.1502–13(c)(1)(i) is not taken into account. See §1.199–7(d)(5). Accordingly, the consolidated group's entire section 199 deduction of $378,000 is allocated to B.

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

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

§ 1.199–3 Domestic production gross receipts.

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

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

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

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

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

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

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

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

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

(c) *Definition of gross receipts*. The term *gross receipts* means the taxpayer's receipts for the taxable year that are recognized under the taxpayer's methods of accounting used for Federal income tax purposes for the taxable year. If the gross receipts are recognized in an intercompany transaction within the meaning of §1.1502–13, see also §1.199–7(d). For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of section 103), dividends, rents, royalties, and annuities, regardless of whether the amounts are derived in the ordinary course of the taxpayer's trade of business. Gross receipts are not reduced by cost of goods sold (CGS) or by the cost of property sold if such property is described in section 1221(a)(1), (2), (3), (4), or (5). Gross receipts do not include the amounts received in repayment of a loan or similar instrument (for example, a repayment of the principal amount of a loan held by a commercial lender) and, except to the extent of gain recognized, do not include gross receipts derived from a non-recognition transaction, such as a section 1031 exchange. Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts include the amounts received that are allocable to the payment of such tax.

(d) *Determining domestic production gross receipts*—(1) *In general*. For purposes of §§ 1.199–1 through 1.199–9, a taxpayer determines, using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, whether gross receipts qualify as DPGR on an item-by-item basis (and not, for example, on a division-by-division, product line-by-product line, or transaction-by-transaction basis).

(i) The term *item* means the property offered by the taxpayer in the normal course of the taxpayer's business for lease, rental, license, sale, exchange, or other disposition (for purposes of this paragraph (d), collectively referred to as disposition) to customers, if the gross receipts from the disposition of such property qualify as DPGR; or

(ii) If paragraph (d)(1)(i) of this section does not apply to the property, then any component of the property described in paragraph (d)(1)(i) of this section is treated as the item, provided that the gross receipts from the disposition of the property described in paragraph (d)(1)(i) of this section that are attributable to such component qualify as DPGR. Each component that meets the requirements under this paragraph (d)(1)(ii) must be treated as a separate item and a component that meets the requirements under this paragraph (d)(1)(ii) may not be combined with a component that does not meet these requirements.

(2) *Special rules*. The following special rules apply for purposes of paragraph (d)(1) of this section:

(i) For purposes of paragraph (d)(1)(i) of this section, in no event may a single item consist of two or more properties unless those properties are offered for disposition, in the normal course of the taxpayer's business, as a single item (regardless of how the properties are packaged).

(ii) In the case of property customarily sold by weight or by volume, the item is determined using the custom of the industry (for example, barrels of oil).

(iii) In the case of construction activities and services or engineering and architectural services, a taxpayer may use any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances to determine what construction activities and services or engineering or architectural services constitute an item.

(3) *Exception*. If a taxpayer MPGE QPP within the United States or produces a qualified film or produces utilities in the United States that it disposes of, and the taxpayer leases, rents, licenses, purchases, or otherwise acquires property that contains or may contain the QPP, qualified film, or the utilities (or a portion thereof), and the taxpayer cannot reasonably determine, without undue burden and expense, whether the acquired property contains any of the original QPP, qualified film, or utilities MPGE or produced by the taxpayer, then the taxpayer is not required to determine whether any portion of the acquired property qualifies

as an item for purposes of paragraph (d)(1) of this section. Therefore, the gross receipts derived from the disposition of the acquired property may be treated as non-DPGR. Similarly, the preceding sentences shall apply if the taxpayer can reasonably determine that the acquired property contains QPP, a qualified film, or utilities (or a portion thereof) MPGE or produced by the taxpayer, but cannot reasonably determine, without undue burden or expense, how much, or what type, grade, etc., of the QPP, qualified film, or utilities MPGE or produced by the taxpayer the acquired property contains.

(4) *Examples.* The following examples illustrate the application of paragraph (d) of this section:

Example 1. Q manufactures leather and rubber shoe soles in the United States. Q imports shoe uppers, which are the parts of the shoe above the sole. Q manufactures shoes for sale by sewing or otherwise attaching the soles to the imported uppers. Q offers the shoes for sale to customers in the normal course of Q's business. If the gross receipts derived from the sale of the shoes do not qualify as DPGR under this section, then under paragraph (d)(1)(ii) of this section, Q must treat the sole as the item if the gross receipts derived from the sale of the sole qualify as DPGR under this section.

Example 2. The facts are the same as in *Example 1* except that Q also buys some finished shoes from unrelated persons and resells them to retail shoe stores. Q offers all shoes (manufactured and purchased) for sale to customers, in the normal course of Q's business, in individual pairs, and requires no minimum quantity order. Q ships the shoes in boxes, each box containing as many as 50 pairs of shoes. A full, or partially full, box may contain some shoes that Q manufactured, and some that Q purchased. Under paragraph (d)(2)(i) of this section, Q cannot treat a box of 50 (or fewer) pairs of shoes as an item, because Q offers the shoes for sale in the normal course of Q's business in individual pairs.

Example 3. R manufactures toy cars in the United States. R also purchases cars that were manufactured by unrelated persons. R offers the cars for sale to customers, in the normal course of R's business, in sets of three, and requires no minimum quantity order. R sells the three-car sets to toy stores. A three-car set may contain some cars manufactured by R and some cars purchased by R. If the gross receipts derived from the sale of the three-car sets do not qualify as DPGR under this section, then, under paragraph (d)(1)(ii) of this section, R must treat a toy car in the three-car set as the item, provided the gross receipts derived from the sale of the toy car qualify as DPGR under this section.

Example 4. The facts are the same as *Example 3* except that R offers the toy cars for sale individually to customers in the normal course of R's business, rather than in sets of three. R's customers resell the individual toy cars at three for $10. Frequently, this results in retail customers purchasing three individual cars in one transaction. In determining R's DPGR, under paragraph (d)(2)(i) of this section, each toy car is an item and R cannot treat three individual toy cars as one item, because the individual toy cars are not offered for sale in sets of three by R in the normal course of R's business.

Example 5. The facts are the same as in *Example 3* except that R offers the toy cars for sale to customers in the normal course of R's business both individually and in sets of three. The results are the same as *Example 3* with respect to the three-car sets. The results are the same as in *Example 4* with respect to the individual toy cars that are not included in the three-car sets and offered for sale individually. Thus, R has two items, an individual toy car and a set of three toy cars.

Example 6. S produces television sets in the United States. S also produces the same model of television set outside the United States. In both cases, S packages the sets one to a box. S sells the television sets to large retail consumer electronics stores. S requires that its customers purchase a minimum of 100 television sets per order. With respect to a particular order by a customer of 100 television sets, some were manufactured by S in the United States, and some were manufactured by S outside the United States. Under paragraph (d)(2)(i) of this section, a minimum order of 100 television sets is the item provided that the gross receipts derived from the sale of the 100 television sets qualify as DPGR.

Example 7. T produces in bulk form in the United States the active ingredient for a pharmaceutical product. T sells the active ingredient in bulk form to FX, a foreign corporation. This sale qualifies as DPGR assuming all the other requirements of this section are met. FX uses the active ingredient to produce the finished dosage form drug. FX sells the drug in finished dosage to T, which sells the drug to customers. Assume that T knows how much of the active ingredient is in the finished dosage. Under paragraph (d)(1)(ii) of this section, if T's gross receipts derived from the sale of the finished dosage do not qualify as DPGR under this section, then T must treat the active ingredient component as the item because the gross receipts attributable to the active ingredient qualify as DPGR under this section. The exception in paragraph (d)(3) of this section does not apply because T can reasonably determine without undue burden or expense that the finished dosage contains the active ingredient and the quantity of the active ingredient in the finished dosage.

Example 8. U produces steel within the United States and sells its steel to a variety of customers, including V, an unrelated person, who uses the steel for the manufacture of equipment. V also purchases steel from other steel producers. For its steel operations, U purchases equipment from V that may contain steel produced by U. U sells the equipment after 5 years. If U cannot reasonably determine without undue burden and expense whether the equipment contains any steel produced by U, then, under paragraph (d)(3) of this section, U may treat the gross receipts derived from sale of the equipment as non-DPGR.

Example 9. The facts are the same as in *Example 8* except that U knows that the equipment purchased from V does contain some amount of steel produced by U. If U cannot reasonably determine without undue burden and expense how much steel produced by U the equipment contains, then, under paragraph (d)(3) of this section, U may treat the gross receipts derived from sale of the equipment as non-DPGR.

Example 10. W manufactures sunroofs, stereos, and tires within the United States. W purchases automobiles from unrelated persons and installs the manufactured components in the automobiles. W, in the normal course of W's business, sells the automobiles with the components to customers. If the gross receipts derived from the sale of the automobiles with the components do not qualify as DPGR under this section, then under paragraph (d)(1)(ii) of this section, W must treat each component (sunroofs, stereos, and tires) that it manufactures as a separate item if the gross receipts derived from the sale of each component qualify as DPGR under this section.

Example 11. X manufacturers leather soles within the United States. X purchases shoe uppers, metal eyelets, and laces. X manufactures shoes by sewing or otherwise attaching the soles to the uppers; attaching the metal eyelets to the shoes; and threading the laces through the eyelets. X, in the normal course of X's business, sells the shoes to customers. If the gross receipts derived from the sale of the shoes do not qualify as DPGR under this section, then under paragraph (d)(1)(ii) of this section, X must treat the sole as the item if the gross receipts derived from the sale of the sole qualify as DPGR under this section. X may not treat the shoe upper, metal eyelets or laces as part of the item because under paragraph (d)(1)(ii) of this section the sole is the component that is treated as the item.

Example 12. Y manufactures glass windshields for automobiles within the United States. Y purchases automobiles from unrelated persons and installs the windshields in the automobiles. Y, in the normal course of Y's business, sells the automobiles with the windshields to customers. If the automobiles with the windshields do not meet the requirements for being an item, then, under paragraph (d)(1)(ii) of this section, Y must treat each windshield that it manufactures as an item if the gross receipts derived from the sale of the windshield qualify as DPGR under this section. Y may not treat any other portion of the automobile as part of the item because under paragraph (d)(1)(ii) of this section the windshield is the component.

(e) *Definition of manufactured, produced, grown, or extracted*—(1) *In general.* Except as provided in paragraphs (e)(2) and (3) of this section, the term *MPGE* includes manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP; making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles; cultivating soil, raising livestock, fishing, and mining minerals. The term *MPGE* also includes storage, handling, or other processing activities (other than transportation activities) within the United States related to the sale, exchange, or other disposition of agricultural products, provided the products are consumed in connection with or incorporated into the MPGE of QPP, whether or not by the taxpayer. Pursuant to paragraph (f)(1) of this section, the taxpayer must have the benefits and burdens of ownership of the QPP under Federal income tax principles during the period the MPGE activity occurs in order for gross receipts derived from the MPGE of QPP to qualify as DPGR.

(2) *Packaging, repackaging, labeling, or minor assembly.* If a taxpayer packages, repackages, labels, or performs minor assembly of QPP and the taxpayer engages in no other MPGE activity with respect to that QPP, the taxpayer's packaging, repackaging, labeling, or minor assembly does not qualify as MPGE with respect to that QPP.

(3) *Installing.* If a taxpayer installs QPP and engages in no other MPGE activity with respect to the QPP, the taxpayer's installing activity does not

qualify as an MPGE activity. Notwithstanding paragraph (i)(4)(i)(B)(*4*) of this section, if the taxpayer installs QPP MPGE by the taxpayer and, except as provided in paragraph (f)(2) of this section, the taxpayer has the benefits and burdens of ownership of the QPP under Federal income tax principles during the period the installing activity occurs, then the portion of the installing activity that relates to the QPP is an MPGE activity.

(4) *Consistency with section 263A.* A taxpayer that has MPGE QPP for the taxable year should treat itself as a producer under section 263A with respect to the QPP unless the taxpayer is not subject to section 263A. A taxpayer that currently is not properly accounting for its production activities under section 263A, and wishes to change its method of accounting to comply with the producer requirements of section 263A, must follow the applicable administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 97–27 (1997–1 C.B. 680), or Rev. Proc. 2002–9 (2002–1 C.B. 327), whichever applies (see §601.601(d)(2) of this chapter)).

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

Example 1. A, B, and C are unrelated persons and are not cooperatives to which Part I of subchapter T of the Code applies. B grows agricultural products in the United States and sells them to A, who owns agricultural storage bins in the United States. A stores the agricultural products and has the benefits and burdens of ownership under Federal income tax principles of the agricultural products while they are being stored. A sells the agricultural products to C, who processes them into refined agricultural products in the United States. The gross receipts from A's, B's, and C's activities are DPGR from the MPGE of QPP.

Example 2. The facts are the same as in *Example 1* except that B grows the agricultural products outside the United States and C processes them into refined agricultural products outside the United States. Pursuant to paragraph (e)(1) of this section, the gross receipts derived by A from its sale of the agricultural products to C are DPGR from the MPGE of QPP within the United States. B's and C's respective MPGE activities occur outside the United States and, therefore, their respective gross receipts are non-DPGR.

Example 3. Y is hired to reconstruct and refurbish unrelated customers' tangible personal property. As part of the reconstruction and refurbishment, Y installs purchased replacement parts that constitute QPP in the customers' property. Y's installation of purchased replacement parts does not qualify as MPGE pursuant to paragraph (e)(3) of this section because Y did not MPGE the replacement parts.

Example 4. The facts are the same as in *Example 3* except that Y manufactures the replacement parts it uses for the reconstruction and refurbishment of customers' tangible personal property. Y has the benefits and burdens of ownership under Federal income tax principles of the replacement parts during the reconstruction and refurbishment activity and while installing the parts. Y's gross receipts derived from the MPGE of the replacement parts and Y's gross receipts derived from the installation of the replacement parts, which is an MPGE activity pursuant to paragraph (e)(3) of this section, are DPGR (assuming all the other requirements of this section are met).

Example 5. Z MPGE QPP within the United States. The following activities are performed by Z as part of the MPGE of the QPP while Z has the benefits and burdens of ownership under Federal income tax principles: materials analysis and selection, subcontractor inspections and qualifications, testing of component parts, assisting customers in their review and approval of the QPP, routine production inspections, product documentation, diagnosis and correction of system failure, and packaging for shipment to customers. Because Z MPGE the QPP, these activities performed by Z are part of the MPGE of the QPP.

Example 6. X purchases automobiles from unrelated persons and customizes them by adding ground effects, spoilers, custom wheels, specialized paint and decals, sunroofs, roof racks, and similar accessories. X does not manufacture any of the accessories. X's activity is minor assembly under paragraph (e)(2) of this section which is not an MPGE activity.

Example 7. Y manufactures furniture in the United States that it sells to unrelated persons. Y also engraves customers' names on pens and pencils purchased from unrelated persons and sells the pens and pencils to such customers. Although Y's sales of furniture qualify as DPGR if all the other requirements of this section are met, Y must determine whether its gross receipts derived from the sale of the pens and pencils qualify as DPGR. Y's status as a manufacturer of furniture in the United States does not carry over to its other activities.

Example 8. X produces computer software within the United States. In 2007, X enters into an agreement with Y, an unrelated person, under which X will manage Y's networks using computer software that X produced. Pursuant to the terms of the agreement, X also provides to Y for Y's use on Y's own hardware computer software that X produced (additional computer software). Assume that, based on all of the facts and circumstances, the transaction between X and Y relating to the additional computer software is a lease or sale of the additional computer software. Y pays X monthly fees of $100 under the agreement during 2007. No separate charge for the additional computer software is stated in the agreement or in the monthly invoices that X provides to Y. The portion of X's gross receipts that is derived from the lease or sale of the additional computer software is DPGR (assuming all the other requirements of this section are met).

(f) *Definition of by the taxpayer*—(1) *In general*. With the exception of the rules applicable to an expanded affiliated group (EAG) under §1.199–7, qualifying in-kind partnerships under paragraph (i)(7) of this section and §1.199–9(i), EAG partnerships under paragraph (i)(8) of this section and §1.199–9(j), and government contracts under paragraph (f)(2) of this section, only one taxpayer may claim the deduction under §1.199–1(a) with respect to any qualifying activity under paragraphs (e)(1), (k)(1), and (l)(1) of this section performed in connection with the same QPP, or the production of a qualified film or utilities. If one taxpayer performs a qualifying activity under paragraph (e)(1), (k)(1), or (l)(1) of this section pursuant to a contract with another party, then only the taxpayer that has the benefits and burdens of ownership of the QPP, qualified film, or utilities under Federal income tax principles during the period in which the qualifying activity occurs is treated as engaging in the qualifying activity.

(2) *Special rule for certain government contracts*. Gross receipts derived from the MPGE of QPP in whole or in significant part within the United States will be treated as gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP MPGE by the taxpayer in whole or in significant part within the United States notwithstanding the requirements of paragraph (f)(1) of this section if—

(i) The QPP is MPGE by the taxpayer within the United States pursuant to a contract with the Federal government; and

(ii) The Federal Acquisition Regulation (Title 48, Code of Federal Regulations) requires that title or risk of loss with respect to the QPP be transferred to the Federal government before the MPGE of the QPP is completed.

(3) *Subcontractor*. If a taxpayer (subcontractor) enters into a contract or agreement to MPGE QPP on behalf of a taxpayer to which paragraph (f)(2) of this section applies, and the QPP under the contract or agreement is subject to paragraph (f)(2)(ii) of this section, then, notwithstanding the requirements of paragraph (f)(1) of this section, the subcontractor's gross receipts derived from the MPGE of the QPP in whole or in significant part within the United States will be treated as gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP MPGE by the subcontractor in whole or in significant part within the United States.

(4) *Examples*. The following examples illustrate the application of this paragraph (f):

Example 1. X designs machines that it uses in its trade or business. X contracts with Y, an unrelated person, for the manufacture of the machines. The contract between X and Y is a fixed-price contract. The contract specifies that the machines will be manufactured in the United States using X's design. X owns the intellectual property attributable to the design and provides it to Y with a restriction that Y may only use it during the manufacturing process and has no right to exploit the intellectual property. The contract specifies that Y controls the details of the manufacturing process while the machines are being produced; Y bears the risk of loss or damage during manufacturing of the machines; and Y has the economic loss or gain upon the sale of the machines based on the difference between Y's costs and the fixed price. Y has legal title during the manufacturing process and legal title to the machines is not transferred to X until final manufacturing of the machines has been completed. Based on all of the facts and circumstances, pursuant to paragraph (f)(1) of this section Y has the benefits and burdens of ownership of the machines under Federal income tax principles during the period the manufacturing occurs and, as a result, Y is treated as the manufacturer of the machines.

Example 2. X designs and engineers machines that it sells to customers. X contracts with Y, an unrelated person, for the manufacture of the machines. The contract between X and Y is a cost-reimbursable type contract. Assume that X has the benefits and burdens of ownership of the machines under Federal income tax principles during the period the manufacturing occurs except that legal title to the machines is not transferred to X until final manufacturing of the machines is completed. Based on all of the facts and circumstances, X is treated as the manufacturer of the machines under paragraph (f)(1) of this section.

Example 3. X manufactures machines within the United States pursuant to a contract with the Federal government and the Federal Acquisition Regulation requires that the title or risk of loss with respect to the machines be transferred to the Federal government before X completes manufacture of the machines. X subcontracts with Y, an unrelated person, for the manufacture of components for the machines that Y manufactures within the United States. Assume that the machines manufactured by X, and the components for the machines manufactured by Y, are QPP. Both the machines and components are subject to the Federal Acquisition Regulation that requires title or risk of loss with respect to the machines and components be transferred to the Federal government before manufacturing of the machines and components are complete. Under paragraph (f)(2) of this section, the gross receipts derived by X from the manufacture within the United States of the machines for the Federal government are treated as having been derived from the lease, rental, license, sale, exchange, or other disposition of the machines manufactured by X in whole or in significant part within the United States. Under paragraph (f)(3) of this section, the gross receipts derived by Y from the manufacture within the United States of the components for X are also treated as having been derived from the lease, rental, license, sale, exchange, or other disposition of the components manufactured by Y in whole or in significant part within the United States.

(g) *Definition of in whole or in significant part*—(1) *In general.* QPP must be MPGE in whole or in significant part by the taxpayer and in whole or in significant part within the United States to qualify under section 199(c)(4)(A)(i)(I). If a taxpayer enters into a contract with an unrelated person for the unrelated person to MPGE QPP for the taxpayer and the taxpayer has the benefits and burdens of ownership of the QPP under applicable Federal income tax principles during the period the MPGE activity occurs, then, pursuant to paragraph (f)(1) of this section, the taxpayer is considered to MPGE the QPP under this section. The unrelated person must perform the MPGE activity on behalf of the taxpayer in whole or in significant part within the United States in order for the taxpayer to satisfy the requirements of this paragraph (g)(1).

(2) *Substantial in nature.* QPP will be treated as MPGE in significant part by the taxpayer within the United States for purposes of paragraph (g)(1) of this section if the MPGE of the QPP by the taxpayer within the United States is substantial in nature taking into account all of the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer's MPGE activity within the United States, the nature of the QPP, and the nature of the MPGE activity that the taxpayer performs within the United States. The MPGE of a key component of QPP does not, in itself, meet the substantial-in-nature requirement with respect to the QPP under this paragraph (g)(2). In the case of tangible personal property (as defined in paragraph (j)(2) of this section), research and experimental activities under section 174 and the creation of intangible assets are not taken into account in determining whether the MPGE of QPP is substantial in nature for any QPP other than computer software (as defined in paragraph (j)(3) of this section) and sound recordings (as defined in paragraph (j)(4) of this section). Thus, for example, a taxpayer may take into account its design and development activities when determining whether its MPGE of computer software is substantial in nature.

(3) *Safe harbor*—(i) *In general.* A taxpayer will be treated as having MPGE QPP in whole or in significant part within the United States for purposes of paragraph (g)(1) of this section if, in connection with the QPP, the direct labor and overhead of such taxpayer to MPGE the QPP within the United States account for 20 percent or more of the taxpayer's CGS of the QPP, or in a transaction without CGS (for example, a lease, rental, or license) account for 20 percent or more of the taxpayer's *unadjusted depreciable basis* (as defined in paragraph (g)(3)(ii) of this section) in the QPP. For taxpayers subject to

section 263A, overhead is all costs required to be capitalized under section 263A except direct materials and direct labor. For taxpayers not subject to section 263A, overhead may be computed using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, but may not include any cost, or amount of any cost, that would not be required to be capitalized under section 263A if the taxpayer were subject to section 263A. Research and experimental expenditures under section 174 and the costs of creating intangible assets are not taken into account in determining direct labor or overhead for any tangible personal property. However, for a special rule regarding computer software and sound recordings, see paragraph (g)(3)(iii) of this section. In the case of tangible personal property (as defined in paragraph (j)(2) of this section), research and experimental expenditures under section 174 and any other costs incurred in the creation of intangible assets may be excluded from CGS or unadjusted depreciable basis for purposes of determining whether the taxpayer meets the safe harbor under this paragraph (g)(3).

(ii) *Unadjusted depreciable basis.* The term *unadjusted depreciable basis* means the basis of property for purposes of section 1011 without regard to any adjustments described in section 1016(a)(2) and (3). This basis does not reflect the reduction in basis for—

(A) Any portion of the basis the taxpayer properly elects to treat as an expense under section 179 or 179C; or

(B) Any adjustments to basis provided by other provisions of the Code and the regulations under the Code (for example, a reduction in basis by the amount of the disabled access credit pursuant to section 44(d)(7)).

(iii) *Computer software and sound recordings.* In determining direct labor and overhead under paragraph (g)(3)(i) of this section, the costs of direct labor and overhead for developing computer software as described in Rev. Proc. 2000–50 (2000–1 C.B. 601) (see §601.601(d)(2) of this chapter), research and experimental expenditures under section 174, and any other costs of creating intangible assets for computer software and sound recordings are treated as direct labor and overhead. These costs must be included in the taxpayer's CGS or unadjusted depreciable basis of computer software and sound recordings for purposes of determining whether the taxpayer meets the safe harbor under paragraph (g)(3)(i) of this section. If the taxpayer expects to lease, rent, license, sell, exchange, or otherwise dispose of computer software or sound recordings over more than one taxable year, the costs of developing computer software as described in Rev. Proc. 2000–50 (2000–1 C.B. 601), research and experimental expenditures under section 174, and any other costs of creating intangible assets for computer software and sound recordings must be allocated over the estimated number of units that the taxpayer expects to lease, rent, license, sell, exchange, or otherwise dispose of.

(4) *Special rules*—(i) *Contract with an unrelated person.* If a taxpayer enters into a contract with an unrelated person for the unrelated person to MPGE QPP within the United States for the taxpayer, and the taxpayer is considered to MPGE the QPP pursuant to paragraph (f)(1) of this section, then, for purposes of the substantial-in-nature requirement under paragraph (g)(2) of this section and the safe harbor under paragraph (g)(3)(i) of this section, the taxpayer's MPGE or production activities or direct labor and overhead shall include both the taxpayer's MPGE or production activities or direct labor and overhead to MPGE the QPP within the United States as well as the MPGE or production activities or direct labor and overhead of the unrelated person to MPGE the QPP within the United States under the contract.

(ii) *Aggregation.* In determining whether the substantial-in-nature requirement under paragraph (g)(2) of this section or the safe harbor under paragraph (g)(3)(i) of this section is met at the time the taxpayer disposes of an item of QPP—

(A) An EAG member must take into account all of the previous MPGE or production activities or direct labor and overhead of the other members of the EAG;

(B) An EAG partnership (as defined in paragraph (i)(8) of this section and

§1.199–9(j)) must take into account all of the previous MPGE or production activities or direct labor and overhead of all members of the EAG in which the partners of the EAG partnership are members (as well as the previous MPGE or production activities of any other EAG partnerships owned by members of the same EAG);

(C) A member of an EAG in which the partners of an EAG partnership are members must take into account all of the previous MPGE or production activities or direct labor and overhead of the EAG partnership (as well as those of any other members of the EAG and any previous MPGE or production activities of any other EAG partnerships owned by members of the same EAG); and

(D) A partner of a qualifying in-kind partnership (as defined in paragraph (i)(7) of this section and §1.199–9(i)) must take into account all of the previous MPGE or production activities or direct labor and overhead of the qualifying in-kind partnership.

(5) *Examples.* The following examples illustrate the application of this paragraph (g):

Example 1. X purchases from Y, an unrelated person, unrefined oil extracted outside the United States. X refines the oil in the United States. The refining of the oil by X is an MPGE activity that is substantial in nature.

Example 2. X purchases gemstones and precious metal from outside the United States and then uses these materials to produce jewelry within the United States by cutting and polishing the gemstones, melting and shaping the metal, and combining the finished materials. X's MPGE activities are substantial in nature under paragraph (g)(2) of this section. Therefore, X has MPGE the jewelry in significant part within the United States.

Example 3. (i) *Facts.* X operates an automobile assembly plant in the United States. In connection with such activity, X purchases assembled engines, transmissions, and certain other components from Y, an unrelated person, and X assembles all of the component parts into an automobile. X also conducts stamping, machining, and subassembly operations, and X uses tools, jigs, welding equipment, and other machinery and equipment in the assembly of automobiles. On a per-unit basis, X 's selling price and costs of such automobiles are as follows:

Selling price: $ 2,500
Cost of goods sold:
Material—Acquired from Y: $ 1,475
Direct labor and overhead: $325
Total cost of goods sold: $1,800
Gross profit: $700
Administrative and selling expenses: $300
Taxable income: $400

(ii) *Analysis.* Although X's direct labor and overhead are less than 20% of total CGS ($325/$1,800, or 18%) and X is not within the safe harbor under paragraph (g)(3)(i) of this section, the activities conducted by X in connection with the assembly of an automobile are substantial in nature under paragraph (g)(2) of this section taking into account the nature of X's activity and the relative value of X's activity. Therefore, X's automobiles will be treated as MPGE in significant part by X within the United States for purposes of paragraph (g)(1) of this section.

Example 4. X imports into the United States QPP that is partially manufactured. Assume that X completes the manufacture of the QPP within the United States and X's completion of the manufacturing of the QPP within the United States satisfies the in-whole-or-in-significant-part requirement under paragraph (g)(1) of this section. Therefore, X's gross receipts from the lease, rental, license, sale, exchange, or other disposition of the QPP qualify as DPGR if all other applicable requirements under this section are met.

Example 5. X manufactures QPP in significant part within the United States and exports the QPP for further manufacture outside the United States. X retains title to the QPP while the QPP is being further manufactured outside the United States. Assuming X meets all the requirements under this section for the QPP after the further manufacturing, X's gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the QPP will be considered DPGR, regardless of whether the QPP is imported back into the United States prior to the lease, rental, license, sale, exchange, or other disposition of the QPP.

Example 6. X is a retailer within the United States that sells cigars and pipe tobacco that X purchases from an unrelated person. While being displayed and offered for sale by X, the cigars and pipe tobacco age on X's shelves in a room with controlled temperature and humidity. Although X's cigars and pipe tobacco may become more valuable as they age, the gross receipts derived by X from the sale of the cigars and pipe tobacco are non-DPGR because the aging of the cigars and pipe tobacco while being displayed and offered for sale by X does not qualify as an MPGE activity that is substantial in nature.

Example 7. X incurs $1,000,000 in computer software development costs in direct labor and overhead to develop computer software. X begins producing the computer software and expects to license one million copies of the computer software. In determining its direct labor and overhead for the computer software under paragraph (g)(3)(i) of this section, X must allocate under paragraph (g)(3)(iii) of this section the $1,000,000 to the computer software X expects to produce. Thus, for each copy of the computer software produced by X, $1 ($1,000,000 in computer software development costs/one million estimated number of units to be licensed) in computer software development costs are treated as direct labor and overhead.

Example 8. X creates computer software for microwave ovens. X also manufactures the electric motors used in the ovens. X purchases the other components of the microwave ovens from unrelated persons. X sells each microwave oven individually to customers. Assume that X's assembly of the finished microwave ovens is not minor assembly. To determine whether the manufacture of the microwave ovens satisfies the safe harbor under paragraph (g)(3)(i) of this section, X's direct labor and overhead include X's direct labor and overhead for creating the computer software, manufacturing the electric motors, and assembling the finished microwave ovens that are offered for sale.

Example 9. X designs shirts within the United States, but X cuts and sews the shirts outside of the United States. Because X's design activity is the creation of an intangible, its design activity is not taken into account in determining whether the manufacture of the shirts is substantial in nature under paragraph (g)(2) of this section, and the costs X incurs in creating the design of the shirts are not direct labor or overhead under paragraph (g)(3)(i) of this section. Therefore, X has not MPGE the shirts in significant part within the United States.

Example 10. X manufactures computer chips within the United States. X installs the computer chips that it manufactures in computers that X purchases from unrelated persons and sells the finished computers individually to customers. The computer chips are key components of the computers and the computers will not operate without them. The manufacture of the computer chips is not, in itself, substantial in nature with respect to the finished computers. Therefore, the taxpayer's MPGE activities must meet either the substantial-in-nature requirement under paragraph (g)(2) of this section, or the safe harbor under paragraph (g)(3) of this section, in order to qualify with respect to the finished computers.

(h) *Definition of United States.* For purposes of this section, the term *United States* includes the 50 states, the District of Columbia, the territorial waters of the United States, and the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. The term *United States* does not include possessions and territories of the United States or the airspace or space over the United States and these areas.

(i) *Derived from the lease, rental, license, sale, exchange, or other disposition*—(1) *In general*—(i) *Definition.* The term *derived from the lease, rental, license, sale, exchange, or other disposition* is defined as, and limited to, the gross receipts directly derived from the lease, rental, license, sale, exchange, or other disposition of QPP, a qualified film, or utilities, even if the taxpayer has already recognized gross receipts from a previous lease, rental, license, sale, exchange, or other disposition of the same QPP, qualified film, or utilities. Applicable Federal income tax principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition, whether it is a service, or whether it is some combination thereof.

(ii) *Lease income.* The financing and interest components of a lease of QPP or a qualified film are considered to be derived from the lease of such QPP or qualified film. However, any portion of the lease income that is attributable to services or non-qualified property as defined in paragraph (i)(4) of this section is not derived from the lease of QPP or a qualified film.

(iii) *Income substitutes.* The proceeds from business interruption insurance, governmental subsidies, and governmental payments not to produce are treated as gross receipts derived from the lease, rental, license, sale, exchange, or other disposition to the extent that they are substitutes for gross receipts that would qualify as DPGR.

(iv) *Exchange of property*—(A) *Taxable exchanges.* Except as provided in paragraph (i)(1)(iv)(B) of this section, the value of property received by a taxpayer in a taxable exchange of QPP MPGE in whole or in significant part by the taxpayer within the United States, a qualified film produced by the taxpayer, or utilities produced by the taxpayer within the United States is DPGR for the taxpayer (assuming all the other requirements of this section are met). However, unless the taxpayer meets all of the requirements under this section with respect to any further MPGE by the taxpayer of the QPP or any further production by the taxpayer of the film or utilities received in the taxable exchange, any gross receipts derived from the sale by the taxpayer of the property received in the taxable exchange are non-DPGR, because the taxpayer did not MPGE or produce such property, even if the property was QPP, a qualified film, or utilities in the hands of the other party to the transaction.

(B) *Safe harbor*. For purposes of paragraph (i)(1)(iv)(A) of this section, the gross receipts derived by the taxpayer from the sale of eligible property (as defined in paragraph (i)(1)(iv)(C) of this section) received in a taxable exchange, net of any adjustments between the parties involved in the taxable exchange to account for differences in the eligible property exchanged (for example, location differentials and product differentials), may be treated as the value of the eligible property received by the taxpayer in the taxable exchange. For purposes of the preceding sentence, the taxable exchange is deemed to occur on the date of the sale of the eligible property received in the taxable exchange by the taxpayer, to the extent the sale occurs no later than the last day of the month following the month in which the exchanged eligible property is received by the taxpayer. In addition, if the taxpayer engages in any further MPGE or production activity with respect to the eligible property received in the taxable exchange, then, unless the taxpayer meets the in-whole-or-in-significant-part requirement under paragraph (g)(1) of this section with respect to the property sold, for purposes of this paragraph (i)(1)(iv)(B), the taxpayer must also value the property sold without taking into account the gross receipts attributable to the further MPGE or production activity.

(C) *Eligible property*. For purposes of paragraph (i)(1)(iv)(B) of this section, eligible property is—

(*1*) Oil, natural gas (as described in paragraph (l)(2) of this section), or petrochemicals, or products derived from oil, natural gas, or petrochemicals; or

(*2*) Any other property or product designated by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(2) *Examples*. The following examples illustrate the application of paragraph (i)(1) of this section:

Example 1. X MPGE QPP in whole or in significant part within the United States and uses the QPP in its business. After several years X sells the QPP that it MPGE to Y. The gross receipts derived from the sale of the QPP to Y are DPGR (assuming all the other requirements of this section are met).

Example 2. X MPGE QPP within the United States and sells the QPP to Y, an unrelated person. Y leases the QPP for 3 years to Z, a taxpayer unrelated to both X and Y, and shortly after Y enters into the lease with Z, X repurchases the QPP from Y subject to the lease. At the end of the lease term, Z purchases the QPP from X. X's proceeds derived from the sale of the QPP to Y, from the lease to Z (including any financing and interest components of the lease), and from the sale of the QPP to Z all qualify as DPGR (assuming all the other requirements of this section are met).

Example 3. X MPGE QPP within the United States and sells the QPP to Y, an unrelated person, for $25,000. X finances Y's purchase of the QPP and receives total payments of $35,000, of which $10,000 relates to interest and finance charges. The $25,000 qualifies as DPGR, but the $10,000 in interest and finance charges do not qualify as DPGR because the $10,000 is not derived from the MPGE of QPP within the United States, but rather from X's lending activity.

Example 4. Cable company X charges subscribers $15 a month for its basic cable television. Y, an unrelated person, produces a qualified film within the meaning of paragraph (k)(1) of this section that it licenses to X for $.10 per subscriber per month. The gross receipts derived by Y are derived from the license of a qualified film produced by Y and are DPGR (assuming all the other requirements of this section are met).

Example 5. X manufactures cars within the United States. X also manufactures replacement parts within the United States. The replacement parts are QPP under paragraph (j)(1) of this section. X offers extended warranties to its customers. X sells a car to Y. Y purchases an extended warranty and brings the car to X's service department for maintenance. X repairs the car and replaces damaged parts with replacement parts that X manufactured within the United States. The portion of X's gross receipts derived from the sale of the extended warranty relating to the manufactured parts are DPGR.

(3) *Hedging transactions*—(i) *In general.* For purposes of this section, provided that the risk being hedged relates to QPP described in section 1221(a)(1) or relates to property described in section 1221(a)(8) consumed in an activity giving rise to DPGR, and provided that the transaction is a hedging transaction within the meaning of section 1221(b)(2)(A) and §1.1221–2(b) and is properly identified as a hedging transaction in accordance with §1.1221–2(f), then—

(A) In the case of a hedge of purchases of property described in section 1221(a)(1), gain or loss on the hedging transaction must be taken into account in determining CGS;

(B) In the case of a hedge of sales of property described in section 1221(a)(1), gain or loss on the hedging transaction must be taken into account in determining DPGR; and

(C) In the case of a hedge of purchases of property described in section 1221(a)(8), gain or loss on the hedging transaction must be taken into account in determining DPGR.

(ii) *Currency fluctuations.* For purposes of this section, in the case of a transaction that manages the risk of currency fluctuations, the determination of whether the transaction is a hedging transaction within the meaning of §1.1221–2(b) is made without regard to whether the transaction is a section 988 transaction. See §1.1221–2(a)(4). The preceding sentence applies only to the extent that §1.988–5(b) does not apply.

(iii) *Effect of identification and nonidentification.* If a taxpayer does not make an identification that satisfies all of the requirements of §1.1221–2(f) but the taxpayer has no reasonable grounds for treating the transaction as other than a hedging transaction, then a loss from the transaction is taken into account under this paragraph (i)(3). If the inadvertent identification rule of §1.1221–2(g)(1)(ii) or the inadvertent error rule of §1.1221–2(g)(2)(ii) applies, then the taxpayer is treated as not having identified the transaction as a hedging transaction or as having identified the transaction as a hedging transaction, as the case may be. If a taxpayer identifies a transaction as a hedging transaction in accordance with §1.1221–2(f)(1), then—

(A) That identification is binding with respect to loss for purposes of this paragraph (i)(3), whether or not all of the requirements of §1.1221–2(f) are satisfied and whether or not the transaction is in fact a hedging transaction within the meaning of section 1221(b)(2)(A) and §1.1221–2(b), and

(B) This paragraph (i)(3) does not apply to require gain to be taken into account in determining CGS or DPGR, if the transaction is not in fact a hedging transaction within the meaning of section 1221(b)(2)(A) and §1.1221–2(b).

(iv) *Other rules.* See §1.1221–2(e) for rules applicable to hedging by members of a consolidated group and §1.446–4 for rules regarding the timing of income, deductions, gains, or losses with respect to hedging transactions.

(4) *Allocation of gross receipts*—(i) *Embedded services and non-qualified property*—(A) *In general.* Except as otherwise provided in paragraph (i)(4)(i)(B), paragraph (m) (relating to construction), and paragraph (n) (relating to engineering and architectural services) of this section, gross receipts derived from the performance of services do not qualify as DPGR. In the case of an embedded service, that is, a service the price of which, in the normal course of the taxpayer's business, is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of QPP, a qualified film, or utilities, DPGR include only the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP, a qualified film, or utilities (assuming all the other requirements of this section are met) and not any receipts attributable to the embedded service. In addition, DPGR does not include the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of property that does not meet all of the requirements under this section (non-qualified property). The allocation of the gross receipts attributable to the embedded services or non-qualified property will be deemed to be reasonable if the allocation reflects the fair market value of the embedded services or non-qualified property. For

example, gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of a replacement part that is non-qualified property does not qualify as DPGR. In addition, see §1.199–1(e) for other instances when an allocation of gross receipts attributable to embedded services or non-qualified property will be deemed reasonable.

(B) *Exceptions.* There are six exceptions to the rules under paragraph (i)(4)(i)(A) of this section regarding embedded services and non-qualified property. A taxpayer may include in DPGR, if all the other requirements of this section are met with respect to the underlying item of QPP, qualified films, or utilities to which the embedded services or non-qualified property relate, the gross receipts derived from—

(*1*) A qualified warranty, that is, a warranty (other than a computer software maintenance agreement described in paragraph (i)(4)(i)(B)(*5*) of this section) that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of QPP, a qualified film, or utilities if, in the normal course of the taxpayer's business—

(*i*) The price for the warranty is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the QPP, qualified film, or utilities; and

(*ii*) The warranty is neither separately offered by the taxpayer nor separately bargained for with customers (that is, a customer cannot purchase the QPP, qualified film, or utilities without the warranty);

(*2*) A qualified delivery, that is, a delivery or distribution service that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of QPP if, in the normal course of the taxpayer's business—

(*i*) The price for the delivery or distribution service is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the QPP; and

(*ii*) The delivery or distribution service is neither separately offered by the taxpayer nor separately bargained for with customers (that is, a customer cannot purchase the QPP without the delivery or distribution service);

(*3*) A qualified operating manual, that is, a manual of instructions (including electronic instructions) that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of QPP, a qualified film or utilities if, in the normal course of the taxpayer's business—

(*i*) The price for the manual is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the QPP, qualified film, or utilities;

(*ii*) The manual is neither separately offered by the taxpayer nor separately bargained for with customers (that is, a customer cannot purchase the QPP, qualified film, or utilities without the manual); and

(*iii*) The manual is not provided in connection with a training course for customers;

(*4*) A qualified installation, that is, an installation service (including minor assembly) for tangible personal property that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of the tangible personal property if, in the normal course of the taxpayer's business—

(*i*) The price for the installation service is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the tangible personal property; and

(*ii*) The installation is neither separately offered by the taxpayer nor separately bargained for with customers (that is, a customer cannot purchase the tangible personal property without the installation service);

(*5*) Services performed pursuant to a qualified computer software maintenance agreement. A qualified computer software maintenance agreement is an agreement provided in connection with the lease, rental, license, sale, exchange, or other disposition of the computer software that entitles the customer to receive future updates, cyclical releases, rewrites of the underlying software, or customer support services for the computer software if, in the normal course of the taxpayer's business—

(*i*) The price for the agreement is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the computer software; and

(*ii*) The agreement is neither separately offered by the taxpayer nor separately bargained for with customers (that is, a customer cannot purchase the computer software without the agreement); and

(*6*) A de minimis amount of gross receipts from embedded services and non-qualified property for each item of QPP, qualified films, or utilities. For purposes of the preceding sentence, a de minimis amount of gross receipts from embedded services and non-qualified property is less than 5 percent of the total gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of each item of QPP, qualified films, or utilities. In the case of gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP, a qualified film, or utilities that are received over a period of time (for example, a multi-year lease or installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from the lease, rental, license, sale, exchange, or other disposition of the item of QPP, qualified films, or utilities. For purposes of the preceding sentence, if a taxpayer treats gross receipts as DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as DPGR. The gross receipts that the taxpayer treats as DPGR under paragraphs (i)(4)(i)(B)(*1*), (*2*), (*3*), (*4*), and (*5*) and (l)(4)(iv)(A) of this section are treated as DPGR for purposes of applying this de minimis exception. This de minimis exception does not apply if the price of a service or non-qualified property is separately stated by the taxpayer, or if the service or non-qualified property is separately offered or separately bargained for with the customer (that is, the customer can purchase the QPP, qualified film, or utilities without the service or non-qualified property).

(ii) *Non-DPGR.* All of a taxpayer's gross receipts derived from the lease, rental, license, sale, exchange or other disposition of an item of QPP, qualified films, or utilities may be treated as non-DPGR if less than 5 percent of the taxpayer's total gross receipts derived from the lease, rental, license, sale, exchange or other disposition of that item are DPGR. In the case of gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP, a qualified film, and utilities that are received over a period of time (for example, a multi-year lease or installment sale), this paragraph (i)(4)(ii) is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from the lease, rental, license, sale, exchange, or other disposition of the item of QPP, qualified films, or utilities. For purposes of the preceding sentence, if a taxpayer treats gross receipts as non-DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as non-DPGR.

(iii) *Examples.* The following examples illustrate the application of this paragraph (i)(4):

Example 1. X MPGE QPP within the United States. As part of the sale of the QPP to Z, X trains Z's employees on how to use and operate the QPP. No other services or property are provided to Z in connection with the sale of the QPP to Z. In the normal course of X's business, the QPP and training services are separately stated in the sales contract. Because, in the normal course of the X's business, the training services are separately stated, the training services are not treated as embedded services under the de minimis exception in paragraph (i)(4)(i)(B)(*6*) of this section.

Example 2. The facts are the same as in *Example 1* except that, in the normal course of X's business, the training services are not separately stated in the sales contract and the customer cannot purchase the QPP without the training services. If the gross receipts for the embedded training services are less than 5% of the gross receipts derived from the sale of X's QPP to Z, after applying the exceptions under paragraphs (i)(4)(i)(B)(*1*) through (*5*) of this section, then the gross receipts may be included in DPGR under the de minimis exception in paragraph (i)(4)(i)(B)(*6*) of this section.

Example 3. X MPGE QPP within the United States. As part of the sale of the QPP to retailers, X charges a fee for delivering the QPP. In the normal course of X's business, the price of the QPP and the delivery fee are separately stated in X's sales contracts. Because, in the normal course of X's business, the delivery fee is separately stated, the delivery fee does not qualify as DPGR under the qualified delivery exception in paragraph (i)(4)(i)(B)(*2*) of this section or the de minimis exception under paragraph (i)(4)(i)(B)(*6*) of this section. The result would be the same even if the retailer's customers cannot purchase the QPP without paying the delivery fee.

Example 4. (i) *Facts.* X manufactures industrial sewing machines within the United States that X offers for sale individually to customers. X enters into a single, lump-sum priced contract with Y, an unrelated person, and the contract has the following terms: X will manufacture industrial sewing machines within the United States for Y; X will deliver the industrial sewing machines to Y; X will provide a one-year warranty on the industrial sewing machines; X will provide operating manuals with the industrial sewing machines; X will provide 100 hours of training and training manuals to Y's employees on the use and maintenance of the industrial sewing machines; X will provide purchased spare parts for the industrial sewing machines; and X will provide a 3-year service agreement for the industrial sewing machines. In the normal course of X's business, none of the services or property described above are separately stated, separately offered or separately bargained for.

(ii) *Analysis.* The receipts for the manufacture of the industrial sewing machines are DPGR under paragraphs (e)(1) and (g) of this section (assuming all the other requirements of this section are met). X may include in DPGR the gross receipts derived from delivering the industrial sewing machines, which is a qualified delivery under paragraph (i)(4)(i)(B)(*2*) of this section; the gross receipts derived from the one-year warranty, which is a qualified warranty under paragraph (i)(4)(i)(B)(*1*) of this section; and the gross receipts derived from the operating manuals, which is a qualified operating manual under paragraph (i)(4)(i)(B)(*3*) of this section. If the gross receipts allocable to each industrial sewing machine for the embedded services consisting of the employee training and 3-year service agreement, and for the non-qualified property consisting of the purchased spare parts and the employee training manuals, which are not qualified operating manuals, are in total less than 5% of the gross receipts derived from the sale of each industrial sewing machine to Y (after applying the exceptions under paragraphs (i)(4)(i)(B)(*1*) through (*5*) of this section), then those gross receipts may be included in DPGR under the de minimis exception in paragraph (i)(4)(i)(B)(*6*) of this section. If, however, the gross receipts allocable to each industrial sewing machine for the embedded services and non-qualified property consisting of employee training, the 3-year service agreement, purchased spare parts, and employee training manuals equal or exceed, in total, 5% of the gross receipts derived from the sale of each industrial sewing machine to Y (after applying the exceptions under paragraphs (i)(4)(i)(B)(*1*) through (*5*) of this section), then those gross receipts do not qualify as DPGR under the de minimis exception in paragraph (i)(4)(i)(B)(*6*) of this section (and X must allocate gross receipts between DPGR and non-DPGR under §1.199–1(d)(1)).

(5) *Advertising income*—(i) *In general.* Except as provided in paragraph (i)(5)(ii) of this section, gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP, a qualified film, or utilities do not include advertising income and product-placement income.

(ii) *Exceptions*—(A) *Tangible personal property.* A taxpayer's gross receipts that are derived from the lease, rental, license, sale, exchange, or other disposition of newspapers, magazines, telephone directories, periodicals, and other similar printed publications that are MPGE in whole or in significant part within the United States include advertising income from advertisements placed in those media, but only if the gross receipts, if any, derived from the lease, rental, license, sale, exchange, or other disposition of the newspapers, magazines, telephone directories, or periodicals are (or would be) DPGR.

(B) *Computer software.* A taxpayer's gross receipts that are derived from the lease, rental, license, sale, exchange, or other disposition of computer software that is MPGE in whole or in significant part within the United States include advertising income and product-placement income with respect to that computer software, but only if the gross receipts, if any, derived from the lease, rental, license, sale, exchange, or other disposition of computer software are (or would be) DPGR. For this purpose, advertising income and product-placement income mean compensation for placing or integrating advertising or a product into the computer software. This paragraph (i)(5)(ii)(B) does not extend to the exceptions provided in paragraph (i)(6)(iii) of this section. See paragraph (i)(6)(iv)(F) of this section.

(C) *Qualified film.* A taxpayer's gross receipts that are derived from the lease, rental, license, sale, exchange, or other disposition of a qualified film include advertising income and product-placement income with respect to that qualified film, but only if the gross receipts, if any, derived from the lease, rental, license, sale, exchange, or other disposition of a qualified film are (or would be) DPGR. For this purpose, advertising income and product-placement income mean compensation for placing or integrating advertising or a product into the qualified film.

(iii) *Examples.* The following examples illustrate the application of this paragraph (i)(5):

Example 1. X MPGE, and sells, newspapers within the United States. X's gross receipts from the newspapers include gross receipts derived from the sale of newspapers to customers and payments from advertisers to publish display advertising or classified advertisements in X's newspapers. X's gross receipts described above are DPGR derived from the sale of X's newspapers.

Example 2. The facts are the same as in *Example 1* except that X disposes of the newspapers free of charge to customers, rather than selling them. X's gross receipts from the display advertising or classified advertisements are DPGR.

Example 3. X produces two live television programs that are qualified films. X licenses the first television program to Y's television station and X licenses the second television program to Z's television station. Z broadcasts the second television program on its station. Both television programs contain product placements and advertising for which X received compensation. X and Y are unrelated persons. X and Z are non-consolidated members of an EAG. The gross receipts derived by X from licensing the first television program to Y are DPGR. As a result, pursuant to paragraph (i)(5)(ii)(C) of this section, all of X's product placement and advertising income for the first television program is treated as gross receipts that are derived from the license of the qualified film. The gross receipts derived by X from licensing the second television program to Z are non-DPGR under paragraph (b)(1) of this section. Paragraph (b)(2) of this section does not apply because Z's broadcast of the second television program on Z's television station is not a lease, rental, license, sale, exchange, or other disposition of the second television program. As a result, pursuant to paragraph (i)(5)(ii)(C) of this section, none of X's product placement and advertising income for the second television program is treated as gross receipts derived from the qualified film.

Example 4. The facts are the same as in *Example 3* except that Z sublicenses to an unrelated person the television program instead of broadcasting the television program on its station. The gross receipts derived by X from licensing the television program to Z are DPGR under paragraph (b)(2) of this section. As a result, pursuant to paragraph (i)(5)(ii)(C) of this section, X's product placement and advertising income for the television program licensed to Z is treated as gross receipts derived from the qualified film. In addition, Z's receipts from the sublicense of the qualified film are DPGR under §1.199–7(a)(3)(i).

Example 5. X produces television programs that are qualified films. X licenses the qualified films to Y, an unrelated person, and the license agreement provides that X will receive advertising time slots as part of its payments from Y under the license agreement. X's gross receipts derived from the license of the qualified films to Y include income attributable to the advertising time slots and are DPGR under paragraph (b)(2) of this section.

(6) *Computer software*—(i) *In general.* DPGR include the gross receipts of the taxpayer that are derived from the lease, rental, license, sale, exchange, or other disposition of computer software MPGE by the taxpayer in whole or in significant part within the United States. Such gross receipts qualify as DPGR even if the customer provides the computer software to its employees or others over the Internet.

(ii) *Gross receipts derived from services.* Gross receipts derived from customer and technical support, telephone and other telecommunication services, online services (such as Internet access services, online banking services, providing access to online electronic books, newspapers, and journals), and other similar services do not constitute gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of computer software.

(iii) *Exceptions.* Notwithstanding paragraph (i)(6)(ii) of this section, if a taxpayer derives gross receipts from providing customers access to computer software MPGE in whole or in significant part by the taxpayer within the United States for the customers' direct use while connected to the Internet or any other public or private communications network (online software), then such gross receipts will be treated as being derived from the lease, rental, license, sale, exchange, or other disposition of computer software only if—

(A) The taxpayer also derives, on a regular and ongoing basis in the taxpayer's business, gross receipts from the lease, rental, license, sale, exchange, or other disposition to customers that are not related persons (as defined in paragraph (b)(1) of this section) of computer software that—

(*1*) Has only minor or immaterial differences from the online software;

(*2*) Has been MPGE by the taxpayer in whole or in significant part within the United States; and

(*3*) Has been provided to such customers either affixed to a tangible medium (for example, a disk or DVD) or by allowing them to download the computer software from the Internet; or

(B) Another person derives, on a regular and ongoing basis in its business, gross receipts from the lease, rental, license, sale, exchange, or other disposition of substantially identical software (as described in paragraph (i)(6)(iv)(A) of this section) (as compared to the taxpayer's online software) to its customers pursuant to an activity described in paragraph (i)(6)(iii)(A)(*3*) of this section.

(iv) *Definitions and special rules*—(A) *Substantially identical software.* For purposes of paragraph (i)(6)(iii)(B) of this section, *substantially identical software* is computer software that—

(*1*) From a customer's perspective, has the same functional result as the online software described in paragraph (i)(6)(iii) of this section; and

(*2*) Has a significant overlap of features or purpose with the online software described in paragraph (i)(6)(iii) of this section.

(B) *Safe harbor for computer software games.* For purposes of paragraph (i)(6)(iv)(A) of this section, all computer software games are deemed to be substantially identical software. For example, computer software sports games are deemed to be substantially identical to computer software card games.

(C) *Regular and ongoing basis.* For purposes of paragraph (i)(6)(iii) of this section, in the case of a newly-formed trade or business or a taxpayer in its first taxable year, the taxpayer is considered to be engaged in an activity described in paragraph (i)(6)(iii) of this section on a regular and ongoing basis if the taxpayer reasonably expects that it will engage in the activity on a regular and ongoing basis.

(D) *Attribution.* For purposes of paragraph (i)(6)(iii)(A) of this section—

(*1*) All members of an expanded affiliated group (as defined in §1.199–7(a)(1)) are treated as a single taxpayer; and

(*2*) In the case of an EAG partnership (as defined in §1.199–3T(i)(8)), the EAG partnership and all members of the EAG to which the EAG partnership's partners belong are treated as a single taxpayer.

(E) *Qualified computer software maintenance agreements.* Paragraph (i)(4)(i)(B)(*5*) of this section does not apply if the computer software is online software under paragraph (i)(6)(iii) of this section.

(F) *Advertising income and product-placement income.* Paragraph (i)(5)(ii)(B) of this section does not apply if the computer software is online software under paragraph (i)(6)(iii) of this section. If a taxpayer provides a customer with access to online software in conjunction with providing computer software to such customer either affixed to a tangible medium or by download, paragraph (i)(5)(ii)(B) of this section will only apply to compensation for the placement or integration of advertising or a product into the computer software transferred to such customer either affixed to the tangible medium or by download.

(v) *Examples.* The following examples illustrate the application of this paragraph (i)(6):

Example 1. L is a bank and produces computer software within the United States that enables its customers to receive online banking services for a fee. Under paragraph (i)(6)(ii) of this section, gross receipts derived from online banking services are attributable to a service and do not constitute gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of computer software. Therefore, L's gross receipts derived from the online banking services are non-DPGR.

Example 2. M is an Internet auction company that produces computer software within the United States that enables its customers to participate in Internet auctions for a fee. Under paragraph (i)(6)(ii) of this section, gross receipts derived from online auction services are attributable to a service and do not constitute gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of computer software. M's activities constitute the provision of online services. Therefore, M's gross receipts derived from the Internet auction services are non-DPGR.

Example 3. N provides telephone services, voicemail services, and e-mail services. N produces computer software within the United States that runs all of these services. Under paragraph (i)(6)(ii) of this section, gross receipts derived from telephone and related telecommunication services are attributable to a service and do not constitute gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of computer software. Therefore, N's gross receipts derived from the telephone and other telecommunication services are non-DPGR.

Example 4. O produces tax preparation computer software within the United States. O derives, on a regular and ongoing basis in its business, gross receipts from both the sale to customers that are unrelated persons of O's computer software that has been affixed to a compact disc as well as from the sale to customers of O's computer software that customers have downloaded from the Internet. O also derives gross receipts from providing customers access to the computer software for the customers' direct use while connected to the Internet. The computer software sold on compact disc or by download has only minor or immaterial differences from the online software, and O does not provide any other goods or services in connection with the online software. Under paragraph (i)(6)(iii)(A) of this section, O's gross receipts derived from providing access to the online software will be treated as derived from the lease, rental, license, sale, exchange, or other disposition of computer software and are DPGR (assuming all the other requirements of this section are met).

Example 5. The facts are the same as in *Example 4*, except that O does not sell the tax preparation computer software to customers affixed to a compact disc or by download. In addition, one of O's competitors, P, derives, on a regular and ongoing basis in its business, gross receipts from the sale to customers of P's substantially identical tax preparation computer software that has been affixed to a compact disc as well as from the sale to customers of P's substantially identical tax preparation computer software that customers have downloaded from the Internet. Under paragraph (i)(6)(iii)(B) of this section, O's gross receipts derived from providing access to its tax preparation online software will be treated as derived from the lease, rental, license, sale, exchange, or other disposition of computer software and are DPGR (assuming all the other requirements of this section are met).

Example 6. Q produces payroll management computer software within the United States. For a fee, Q provides customers access to the payroll management computer software for the customers' direct use while connected to the Internet. This is Q's sole method of providing access to its payroll management computer software to customers. In conjunction with the payroll management computer software, Q provides storage of customers' data and telephone support. One of Q's competitors, R, derives, on a regular and ongoing basis in its business, gross receipts from the sale to customers of R's substantially identical payroll management software that has been affixed to a compact disc as well as from the sale to customers of R's substantially identical payroll management software that customers have downloaded from the Internet. Under paragraph (i)(6)(iii)(B) of this section, Q's gross receipts derived from providing access to its payroll management online software will be treated as derived from the lease, rental, license, sale, exchange, or other disposition of computer software and are DPGR (assuming all the other requirements of this section are met). However, Q's gross receipts derived from the fees that are properly allocable to the storage of customers' data and telephone support are non-DPGR.

Example 7. The facts are the same as in *Example 6*, except that R produces inventory computer software, not payroll management computer software. R's inventory computer software is not substantially identical software as defined in paragraph (i)(6)(iv)(A) of this section because R's inventory software, from a customer's perspective, does not have the same functional result as Q's payroll management computer software and does not have significant overlap of features or purpose with Q's payroll management computer software. No other person provides substantially identical software to customers affixed to a compact disc or by download. Under paragraph (i)(6)(ii) of this section, gross receipts derived from providing access to Q's payroll online software do not constitute gross receipts derived from a lease, rental, license, sale, exchange or other disposition of payroll computer software. Therefore, Q's gross receipts derived from the payroll management computer software are non-DPGR.

Example 8. S produces computer software games within the United States. S derives, on a regular and ongoing basis in its business, gross receipts from both the sale to customers that are not related to S of S's computer software games that have been affixed to a compact disc as well as from the sale to customers of S's computer software games that customers have downloaded from the Internet. S also derives gross receipts from providing customers access to the computer software games for the customers' direct use while connected to the Internet (online software games). The computer software games sold on compact disc or by download have only minor or immaterial differences from the online software games, and S does not provide any other goods or services in connection with the online software games. Under paragraph (i)(6)(iii)(A) of this section, S's gross receipts derived from providing customers access to its online software games will be treated as derived from the lease, rental, license, sale, exchange, or other disposition of computer software and are DPGR (assuming all the other requirements of this section are met).

Example 9. The facts are the same as in *Example 8*, except S's gross receipts also include advertising income from integrating advertisers' logos into the computer software games. Under paragraph (i)(5)(ii)(B) of this section, for S's computer software games sold affixed to a compact disc or by download, S's advertising income is treated as gross receipts derived from the sale of the computer software games and, therefore, is DPGR (assuming all the other requirements of this section are met). However, under paragraphs (i)(5)(i) and (i)(6)(iv)(F) of this section, for S's online software games, S's advertising income is not derived from the lease, rental, license, sale, exchange, or other disposition of computer software and, therefore, is non-DPGR.

(7) *Qualifying in-kind partnership for taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005—(i) In general*. If a partnership is a qualifying in-kind partnership described in paragraph (i)(7)(ii) of this section, then each partner is treated as having MPGE or produced the property MPGE or produced by the partnership that is distributed to that partner. If a partner of a qualifying in-kind partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of the property that was MPGE or produced by the qualifying in-kind partnership and distributed to that partner, then, provided such partner is a partner of the qualifying in-kind partnership at the time the partner disposes of the property, the partner is treated as conducting the MPGE or production activities previously conducted by the qualifying in-kind partnership with respect to that property. With respect to a lease, rental, or license, the partner is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts derived from the lease, rental, or license under its method of accounting. With respect to a sale, exchange, or other disposition, the partner is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account.

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

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

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

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

(iii) *Other rules*. Except as provided in this paragraph (i)(7), a qualifying in-kind partnership is treated the same as other partnerships for purposes of section 199. Accordingly, a qualifying in-kind partnership is subject to the rules of this section regarding the application of section 199 to pass-thru entities, including application of the section 199(d)(1)(A)(iii) rule for determining a partner's share of the amounts described in §1.199–2(e)(1) (paragraph (e)(1) wages) from the partnership under §1.199–5(b)(3). In determining whether a qualifying in-kind partnership or its partners MPGE QPP in whole or in significant part within the United States, see paragraphs (g)(2) and (3) of this section.

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

Example. X, Y, and Z are partners in PRS, a qualifying in-kind partnership described in paragraph (i)(7)(ii) of this section. X, Y, and Z are corporations. In 2007, PRS distributes oil to X that PRS derived from its oil extraction. PRS incurred $600 of CGS extracting the oil distributed to X, and X's adjusted basis in the distributed oil is $600. X incurs

$200 of CGS in refining the oil within the United States. In 2007, X, while it is a partner in PRS, sells the oil to a customer for $1,500. X is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes. Under paragraph (i)(7)(i) of this section, X is treated as having extracted the oil. The extraction and refining of the oil each qualify as an MPGE activity under paragraph (e)(1) of this section. Therefore, X's $1,500 of gross receipts qualify as DPGR. X subtracts from the $1,500 of DPGR the $600 of CGS incurred by PRS and the $200 of refining costs it incurred. Thus, X's QPAI is $700 for 2007.

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

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

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

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

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

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

Example 1. Contribution. X and Y are the only partners in PRS, a partnership, for PRS's entire 2007 taxable year. X and Y are both members of a single EAG for the entire 2007 year. In 2007, X MPGE QPP within the United States and contributes the QPP to PRS. In 2007, PRS sells the QPP for $1,000. Under this paragraph (i)(8), PRS is treated as having MPGE the QPP within the United States, and PRS's $1,000 gross receipts constitute DPGR. PRS, X, and Y must apply the rules of this section regarding the application of section 199 to pass-thru entities with respect to the activity of PRS, including the section 199(d)(1)(A)(iii) rule for determining a partner's share of the paragraph (e)(1) wages from the partnership under §1.199–5(b)(3).

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

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

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

Example 5. Multiple sales. (i) Facts. X and Y are the only partners in PRS, a partnership, for PRS's entire 2007 taxable year. X and Y are both non-consolidated members of a single EAG for the entire 2007 year. PRS produces in bulk form in the United States the active ingredient for a drug. Assume that PRS's own MPGE activity with respect to the active ingredient is not substantial in nature, taking into account all of the facts and circumstances, and PRS's direct labor and overhead to MPGE the active ingredient within the United States are $15 and account for 15% of PRS's $100 CGS of the active ingredient. In 2007, PRS sells the active ingredient in bulk form to X. X uses the active ingredient to produce the finished dosage form drug. Assume that X's own MPGE activity with respect to the 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 drug. In 2007, X sells the finished dosage form drug 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 paragraph (g)(3) of this section 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 paragraph (g)(3) of this section 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 finished dosage form 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 finished dosage form drug in significant part in the United States pursuant to the safe harbor described in paragraph (g)(3) of this section 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.

(9) *Non-operating mineral interests.* DPGR does not include gross receipts derived from non-operating mineral interests (for example, interests other than operating mineral interests within the meaning of §1.614–2(b)).

(j) *Definition of qualifying production property*—(1) *In general. QPP* means—

(i) Tangible personal property (as defined in paragraph (j)(2) of this section);

(ii) Computer software (as defined in paragraph (j)(3) of this section); and

(iii) Sound recordings (as defined in paragraph (j)(4) of this section).

(2) *Tangible personal property*—(i) *In general.* The term *tangible personal property* is any tangible property other than land, real property described in paragraph (m)(3) of this section, and any property described in paragraph (j)(3), (j)(4), (k)(1), or (l) of this section. For purposes of the preceding sentence, tangible personal property also includes any gas (other than natural gas described in paragraph (l)(2) of this section), chemical, and similar property, for example, steam, oxygen, hydrogen, and nitrogen. Property such as machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs that are contained in or attached to a building constitutes tangible personal property for purposes of this paragraph (j)(2)(i). Except as provided in paragraphs (j)(5)(ii) and (k)(2)(i) of this section, computer software, sound recordings, and qualified films are not treated as tangible personal property regardless of whether they are affixed to a tangible medium. However, the tangible medium to which such property may be affixed (for example, a videocassette, a computer diskette, or other similar tangible item) is tangible personal property.

(ii) *Local law.* In determining whether property is tangible personal property, local law is not controlling.

(iii) *Intangible property.* The term *tangible personal property* does not include property in a form other than in a tangible medium. For example, mass-produced books are tangible personal property, but neither the rights to the underlying manuscript nor an online version of the book is tangible personal property.

(3) *Computer software*—(i) *In general.* The term *computer software* means any program or routine or any sequence of machine-readable code that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine. Thus, for example, an electronic book available online or for download is not computer software. For purposes of this paragraph (j)(3), computer software also includes the machine-readable code for video games and similar programs, for equipment that is an integral part of other property, and for typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, regardless of whether the code is designed to operate on a computer (as defined in section 168(i)(2)(B)). Computer programs of all classes, for example, operating systems, executive systems, monitors, compilers and translators, assembly routines, and utility programs, as well as application programs, are included. Except as provided in paragraph (j)(5) of this section, if the medium in which the software is contained, whether written, magnetic, or otherwise, is tangible, then such medium is considered tangible personal property for purposes of this section.

(ii) *Incidental and ancillary rights.* Computer software also includes any incidental and ancillary rights that are necessary to effect the acquisition of the title to, the ownership of, or the right to use the computer software, and that are used only in connection with that specific computer software. Such incidental and ancillary rights are not included in the definition of trademark or trade name under §1.197–2(b)(10)(i). For example, a trademark or trade name that is ancillary to the ownership or use of a specific computer software program in the taxpayer's trade or business and is not acquired for the purpose of marketing the computer software is included in the definition of computer software and is not included in the definition of trademark or trade name.

(iii) *Exceptions.* Computer software does not include any data or information base unless the data or information base is in the public domain and is incidental to a computer program. For this purpose, a copyrighted or proprietary data or information base is treated as in the public domain if its availability through the computer program does not contribute significantly to the cost of the program. For example, if a word-processing program includes a dictionary feature that may be used to spell-check a document or any portion thereof, then the entire program (including the dictionary feature) is computer software regardless of the form in which the dictionary feature is maintained or stored.

(4) *Sound recordings*—(i) *In general.* The term *sound recordings* means any works that result from the fixation of a series of musical, spoken, or other sounds under section 168(f)(4). The definition of sound recordings is limited to the master copy of the recordings (or other copy from which the holder is licensed to make and produce copies), and, except as provided in paragraph (j)(5) of this section, if the medium (such as compact discs, tapes, or other phonorecordings) in which the sounds may be embodied is tangible, then the medium is considered tangible personal property for purposes of paragraph (j)(2) of this section.

(ii) *Exception.* The term *sound recordings* does not include the creation of copyrighted material in a form other than a sound recording, such as lyrics or music composition.

(5) *Tangible personal property with computer software or sound recordings—(i) Computer software and sound recordings.* If a taxpayer MPGE in whole or in significant part computer software or sound recordings within the United States that is affixed or added to tangible personal property (for example, a computer diskette, or an appliance), whether or not the taxpayer MPGE such tangible personal property in whole or in significant part within the United States, then for purposes of this section—

(A) The computer software and the tangible personal property may be treated by the taxpayer as computer software. If the taxpayer treats the computer software and the tangible personal property as computer software, activities the cost of which are described in Rev. Proc. 2000–50 (2000–1 C.B. 601), activities giving rise to research and experimental expenditures under section 174, and the creation of intangible assets for computer software are considered in determining whether the taxpayer's MPGE activity is substantial in nature under paragraph (g)(2) of this section. In determining direct labor and overhead under paragraph (g)(3)(i) of this section, the costs of direct labor and overhead for developing the computer software as described in Rev. Proc. 2000–50 (2000–1 C.B. 601), research and experimental expenditures under section 174, and any other costs of creating intangible assets for the computer software are treated as direct labor and overhead. These costs must be included in the taxpayer's CGS of the computer software for purposes of determining whether the taxpayer meets the safe harbor under paragraph (g)(3)(i) of this section. However, any costs under section 174, and the costs to create intangible assets, attributable to the tangible personal property are not considered in determining whether the taxpayer's activity is substantial in nature under paragraph (g)(2) of this section and are not direct labor and overhead under paragraph (g)(3)(i) of this section; and

(B) The sound recordings and the tangible personal property with the sound recordings may be treated by the taxpayer as sound recordings. If the taxpayer treats the sound recordings and the tangible personal property as sound recordings, activities giving rise to research and experimental expenditures under section 174 and the creation of intangible assets for sound recordings are considered in determining whether the taxpayer's MPGE activity is substantial in nature under paragraph (g)(2) of this section. In determining direct labor and overhead under paragraph (g)(3)(i) of this section, research and experimental expenditures under section 174 and any other costs of creating intangible assets for sound recordings are treated as direct labor and overhead. These costs must be included in the taxpayer's CGS of sound recordings for purposes of determining whether the taxpayer meets the safe harbor under paragraph (g)(3)(i) of this section. However, any costs under section 174, and the costs to create intangible assets, attributable to the tangible personal property are not considered in determining whether the taxpayer's activity is substantial in nature under paragraph (g)(2) of this section and are not direct labor and overhead under paragraph (g)(3)(i) of this section.

(ii) *Tangible personal property.* If a taxpayer MPGE tangible personal property (for example, a computer diskette or an appliance) in whole or in significant part within the United States but not the computer software or sound recordings that is affixed or added to such tangible personal property, then for purposes of this section the tangible personal property with the computer software or sound recordings may be treated by the taxpayer as tangible personal property under paragraph (j)(2) of this section. Any costs under section 174, and the costs to create intangible assets, attributable to the tangible personal property are not considered in determining whether the taxpayer's activity is substantial in nature under paragraph (g)(2) of this section and are not direct labor or overhead under paragraph (g)(3)(i) of this section. For purposes of paragraph (g)(3) of this section, the taxpayer's CGS (or unadjusted depreciable basis, if applicable) for each item of tangible personal property includes the taxpayer's cost of leasing, renting, licensing, buying, or otherwise acquiring the computer software or sound recordings.

(k) *Definition of qualified film*—(1) *In general.* The term *qualified film* means any motion picture film or video tape under section 168(f)(3), or live or delayed television programming (film), if not less than 50 percent of the total compensation relating to the production of such film is compensation for services performed in the United States by actors, production personnel, directors, and producers. For purposes of this paragraph (k), the term *actors* includes players, newscasters, or any other persons who are compensated for their performance or appearance in a film. For purposes of this paragraph (k), the term *production personnel* includes writers, choreographers and composers who are compensated for providing services during the production of a film, as well as casting agents, camera operators, set designers, lighting technicians, make-up artists, and other persons who are compensated for providing services that are directly related to the production of the film. Except as provided in paragraph (k)(2) of this section, the definition of a qualified film does not include tangible personal property embodying the qualified film, such as DVDs or videocassettes.

(2) *Tangible personal property with a film*—(i) *Film not produced by a taxpayer*. If a taxpayer MPGE tangible personal property (for example, a DVD) in whole or in significant part in the United States and a film not produced by a taxpayer is affixed to the tangible personal property, then the taxpayer may treat the tangible personal property with the affixed film as tangible personal property, regardless of whether the film is a qualified film. The determination of whether the gross receipts of such a taxpayer derived from the lease, rental, license, sale, exchange, or other disposition of the tangible personal property with the affixed film are DPGR is made under the rules of this section. For purposes of paragraph (g)(2) of this section, in determining whether the taxpayer's MPGE activity is substantial in nature, the taxpayer must consider the value of the licensed film. For purposes of paragraph (g)(3) of this section, the taxpayer's CGS (or unadjusted depreciable basis, as applicable) for each item of tangible personal property includes the taxpayer's cost of leasing, renting, licensing, buying, or otherwise acquiring the film.

(ii) *Film produced by a taxpayer*. If a taxpayer produces a film and the film is affixed to tangible personal property (for example, a DVD), then for purposes of this section—

(A) *Qualified film*. If the film is a qualified film, the taxpayer may treat the tangible personal property, whether or not the taxpayer MPGE such tangible personal property, to which the qualified film is affixed as part of the qualified film; and

(B) *Nonqualified film*. If the film is not a qualified film (nonqualified film), a taxpayer cannot treat the tangible personal property to which the nonqualified film is affixed as part of the nonqualified film.

(3) *Derived from a qualified film*—(i) *In general*. DPGR include the gross receipts of a taxpayer that are derived from any lease, rental, license, sale, exchange, or other disposition of any qualified film produced by such taxpayer.

(ii) *Exceptions*. The showing of a qualified film (for example, in a movie theater or by broadcast on a television station) by a taxpayer is not a lease, rental, license, sale, exchange, or other disposition of the qualified film by such taxpayer. Ticket sales for viewing a qualified film do not constitute DPGR because the gross receipts are not derived from the lease, rental, license, sale, exchange, or other disposition of a qualified film. Because a taxpayer that merely writes a screenplay or other similar material is not considered to have produced a qualified film under paragraph (k)(1) of this section, the amounts that the taxpayer receives from the sale of the script or screenplay, even if the script is developed into a qualified film, are not gross receipts derived from a qualified film. In addition, revenue from the sale of film-themed merchandise is revenue from the sale of tangible personal property and not gross receipts derived from a qualified film. Gross receipts derived from a license of the right to use or exploit the film characters are not gross receipts derived from a qualified film.

(4) *Compensation for services*. For purposes of this paragraph (k), the term *compensation for services* means all payments for services performed by actors, production personnel, directors, and producers relating to the production of the film, including participations and residuals. Payments for services include all elements of compensation as provided for in §1.263A–1(e)(2)(i)(B) and (3)(ii)(D). Compensation for services is not limited to W–2 wages and includes compensation paid to independent contractors. In the case of a taxpayer that uses the income forecast method of

section 167(g) and capitalizes participations and residuals into the adjusted basis of the qualified film, the taxpayer must use the same estimate of participations and residuals in determining compensation for services. In the case of a taxpayer that excludes participations and residuals from the adjusted basis of the qualified film under section 167(g)(7)(D)(i), the taxpayer must use the amount expected to be paid as participations and residuals based on the total forecasted income used in determining income forecast depreciation in determining compensation for services.

(5) *Determination of 50 percent.* The not-less-than-50-percent-of-the-total-compensation requirement under paragraph (k)(1) of this section is calculated using a fraction. The numerator of the fraction is the compensation for services performed in the United States and the denominator is the total compensation for services regardless of where the production activities are performed. A taxpayer may use any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, including all historic information available, to determine the compensation for services performed in the United States and the total compensation for services regardless of where the production activities are performed. Among the factors to be considered in determining whether a taxpayer's method of allocating compensation is reasonable is whether the taxpayer uses that method consistently from one taxable year to another.

(6) *Produced by the taxpayer.* A qualified film will be treated as produced by the taxpayer for purposes of §199(c)(4)(A)(i)(II) if the production activity performed by the taxpayer is substantial in nature within the meaning of paragraph (g)(2) of this section. The special rules of paragraph (g)(4) of this section regarding a contract with an unrelated person and aggregation apply in determining whether the taxpayer's production activity is substantial in nature. Paragraphs (g)(2) and (4) of this section are applied by substituting the term *qualified film* for QPP and disregarding the requirement that the production activity must be within the United States. The production activity of the taxpayer must consist of more than the minor or immaterial combination or assembly of two or more components of a film. For purposes of paragraph (g)(2) of this section, the relative value added by affixing trademarks or trade names as defined in §1.197–2(b)(10)(i) will be treated as zero.

(7) *Qualified film produced by the taxpayer—safe harbor.* A film will be treated as a qualified film under paragraph (k)(1) of this section and produced by the taxpayer under paragraph (k)(6) of this section (qualified film produced by the taxpayer) if the taxpayer meets the requirements of paragraphs (k)(7)(i) and (ii) of this section. A taxpayer that chooses to use this safe harbor must apply all the provisions of this paragraph (k)(7).

(i) *Safe harbor.* A film will be treated as a qualified film produced by the taxpayer if not less than 50 percent of the total compensation for services paid by the taxpayer is compensation for services performed in the United States and the taxpayer satisfies the safe harbor in paragraph (g)(3) of this section. The special rules of paragraph (g)(4) of this section regarding a contract with an unrelated person and aggregation apply in determining whether the taxpayer satisfies paragraph (g)(3) of this section. Paragraphs (g)(3) and (4) of this section are applied by substituting the term *qualified film* for QPP but not disregarding the requirement that the direct labor and overhead of the taxpayer to produce the qualified film must be within the United States. Paragraph (g)(3)(ii)(A) of this section includes any election under section 181.

(ii) *Determination of 50 percent.* The not-less-than-50-percent-of-the-total-compensation requirement under paragraph (k)(7)(i) of this section is calculated using a fraction. The numerator of the fraction is the compensation for services paid by the taxpayer for services performed in the United States and the denominator is the total compensation for services paid by the taxpayer regardless of where the production activities are performed. For purposes of this paragraph (k)(7)(ii), the term *paid by the taxpayer* includes amounts that are treated as paid by the taxpayer under paragraph (g)(4) of this section. A taxpayer may use any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, including all historic information available, to determine the compensation for services paid by the taxpayer for services performed in the United States and the total compensation for services paid by the taxpayer regardless of where the production activities are performed. Among the factors to be considered in determining whether a taxpayer's method of allocating compensation is reasonable is whether the taxpayer uses that method consistently from one taxable year to another.

(8) *Production pursuant to a contract.* With the exception of the rules applicable to an expanded affiliated group (EAG) under §1.199–7 and EAG partnerships under §1.199–3(i)(8), only one taxpayer may claim the deduction under §1.199–1(a) with respect to any activity related to the production of a qualified film performed in connection with the same qualified film. If one taxpayer performs a production activity pursuant to a contract with another party, then only the taxpayer that has the benefits and burdens of ownership of the qualified film under Federal income tax principles during the period in which the production activity occurs is treated as engaging in the production activity.

(9) *Exception.* A *qualified film* does not include property with respect to which records are required to be maintained under 18 U.S.C. 2257. Section 2257 of Title 18 requires maintenance of certain records with respect to any book, magazine, periodical, film, videotape, or other matter that—

(i) Contains one or more visual depictions made after November 1, 1990, of actual sexually explicit conduct; and

(ii) Is produced in whole or in part with materials that have been mailed or shipped in interstate or foreign commerce, or is shipped or transported or is intended for shipment or transportation in interstate or foreign commerce.

(10) *Examples.* The following examples illustrate the application of this paragraph (k):

Example 1. X produces a qualified film and duplicates the film onto purchased DVDs. X sells the DVDs with the qualified film to customers. Under paragraph (k)(2)(ii)(A) of this section, X treats the DVD with the qualified film as a qualified film. Accordingly, X's gross receipts derived from the sale of the qualified film to customers are DPGR (assuming all the other requirements of this section are met).

Example 2. The facts are the same as in *Example 1* except that the film is a nonqualified film because the film does not satisfy the not-less-than-50-percent-of-the-total-compensation requirement under (k)(1) of this section and X manufactures the DVDs in the United States. Under paragraph (k)(2)(ii)(B) of this section, X cannot treat the DVD as part of the nonqualified film. X's gross receipts (not including the gross receipts attributable to the nonqualified film) derived from the sale of the tangible personal property are DPGR (assuming all the other requirements of this section are met).

Example 3. X produces live television programs that are qualified films. X shows the programs on its own television station. X sells advertising time slots to advertisers for the television programs. Because showing a qualified film on a television station is not a lease, rental, license, sale, exchange, or other disposition pursuant to paragraph (k)(3)(ii) of this section, the advertising income X receives from advertisers is not derived from the lease, rental, license, sale, exchange, or other disposition of the qualified films and is non-DPGR.

Example 4. The facts are the same as in *Example 3* except that X also licenses the qualified films to Y, an unrelated cable company that broadcasts X's qualified films. As part of the license agreement, X can sell advertising time slots. Because X's gross receipts from Y are derived from the licensing of qualified films pursuant to paragraph (k)(3)(i) of this section, X's gross receipts derived from licensing the qualified film are DPGR. In addition, the gross receipts derived from the advertising income X receives that is related to the qualified films licensed to Y is DPGR pursuant to paragraph (i)(5)(ii) of this section. Because showing a qualified film on a television station is not a lease, rental, license, sale, exchange, or other disposition pursuant to paragraph (k)(3)(ii) of this section, the portion of the advertising income X derives from advertisers for the qualified films it broadcasts on its own television station is not derived from the lease, rental, license, sale, exchange, or other disposition of the qualified films and is non-DPGR.

Example 5. X produces a qualified film and contracts with Y, an unrelated person, to duplicate the film onto DVDs. Y manufactures blank DVDs within the United States, duplicates X's film onto the DVDs in the United

States, and sells the DVDs with the qualified film to X who then sells them to customers. Y has all of the benefits and burdens of ownership under Federal income tax principles of the DVDs during the MPGE and duplication process. Assume Y's activities relating to manufacture of the blank DVDs and duplicating the film onto the DVDs collectively satisfy the safe harbor under paragraph (g)(3) of this section. Y's gross receipts from manufacturing the DVDs and duplicating the film onto the DVDs are DPGR (assuming all the other requirements of this section are met). X's gross receipts from the sale of the DVDs to customers are DPGR (assuming all the other requirements of this section are met).

Example 6. X creates a television program in the United States that includes scenes from films licensed by X from unrelated persons Y and Z. Assume that Y and Z produced the films licensed by X. The not-less-than-50-percent-of-the-total-compensation requirement under paragraph (k)(1) of this section is determined by reference to all compensation for services paid in the production of the television program, including the films licensed by X from Y and Z, and is calculated using a fraction as described in paragraph (k)(5) of this section. The numerator of the fraction is the compensation for services performed in the United States and the denominator is the total compensation for services regardless of where the production activities are performed. However, for purposes of calculating the denominator, in determining the total compensation paid by Y and Z, X need only include the total compensation paid by Y and Z to actors, production personnel, directors, and producers for the production of the scenes used by X in creating its television program.

(l) *Electricity, natural gas, or potable water*—(1) *In general.* DPGR include gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of utilities produced by the taxpayer in the United States if all other requirements of this section are met. In the case of an integrated producer that both produces and delivers utilities, see paragraph (l)(4) of this section that describes certain gross receipts that do not qualify as DPGR.

(2) *Natural gas.* The term *natural gas* includes only natural gas extracted from a natural deposit and does not include, for example, methane gas extracted from a landfill. In the case of natural gas, production activities include all activities involved in extracting natural gas from the ground and processing the gas into pipeline quality gas.

(3) *Potable water.* The term *potable water* means unbottled drinking water. In the case of potable water, production activities include the acquisition, collection, and storage of raw water (untreated water), transportation of raw water to a water treatment facility, and treatment of raw water at such a facility. Gross receipts attributable to any of these activities are included in DPGR if all other requirements of this section are met.

(4) *Exceptions*—(i) *Electricity.* Gross receipts attributable to the transmission of electricity from the generating facility to a point of local distribution and gross receipts attributable to the distribution of electricity to customers are non-DPGR.

(ii) *Natural gas.* Gross receipts attributable to the transmission of pipeline quality gas from a natural gas field (or, if treatment at a natural gas processing plant is necessary to produce pipeline quality gas, from a natural gas processing plant) to a local distribution company's citygate (or to another customer) are non-DPGR. Likewise, gross receipts of a local gas distribution company attributable to distribution from the citygate to the local customers are non-DPGR.

(iii) *Potable water.* Gross receipts attributable to the storage of potable water after completion of treatment of the potable water, as well as gross receipts attributable to the transmission and distribution of potable water, are non-DPGR.

(iv) *De minimis exception*—(A) *DPGR.* Notwithstanding paragraphs (l)(4)(i), (ii), and (iii) of this section, if less than 5 percent of a taxpayer's gross receipts derived from a sale, exchange, or other disposition of utilities are attributable to the transmission or distribution of the utilities and the storage of potable water after completion of treatment of the potable water, then the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the utilities that are attributable to the transmission and distribution of the utilities and the storage of potable water after completion of treatment of the potable water may be treated as being DPGR (assuming all other requirements of this section are met). In the case of gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of utilities that are received over a period of time (for example, a multi-year lease or installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from the lease, rental, license, sale, exchange, or other disposition of the utilities. For purposes of the preceding sentence, if a taxpayer treats gross receipts as DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as DPGR.

(B) *Non-DPGR*. If less than 5 percent of a taxpayer's gross receipts derived from a sale, exchange, or other disposition of utilities are DPGR, then the gross receipts derived from the sale, exchange, or other disposition of the utilities may be treated as non-DPGR. In the case of gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of utilities that are received over a period of time (for example, a multi-year lease or installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from the lease, rental, license, sale, exchange, or other disposition of the utilities. For purposes of the preceding sentence, if a taxpayer treats gross receipts as non-DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as non-DPGR.

(5) *Example*. The following example illustrates the application of this paragraph (l):

Example. X owns a wind turbine in the United States that generates electricity and Y owns a high voltage transmission line that passes near X's wind turbine and ends near the system of local distribution lines of Z. X sells the electricity produced at the wind turbine to Z and contracts with Y to transmit the electricity produced at the wind turbine to Z who sells the electricity to customers using Z's distribution network. The gross receipts received by X from the sale of electricity produced at the wind turbine are DPGR. The gross receipts of Y derived from transporting X's electricity to Z are non-DPGR under paragraph (l)(4)(i) of this section. Likewise, the gross receipts of Z derived from distributing the electricity are non-DPGR under paragraph (l)(4)(i) of this section. If X made direct sales of electricity to customers in Z's service area and Z receives remuneration for the distribution of electricity, the gross receipts of Z are non-DPGR under paragraph (l)(4)(i) of this section. If X, Y, and Z are related persons (as defined in paragraph (b) of this section), then X, Y, and Z must allocate gross receipts among the production activities (that are DPGR), and the transmission and distribution activities (that are non-DPGR).

(m) *Definition of construction performed in the United States*—(1) *Construction of real property*—(i) *In general*. The term *construction* means activities and services relating to the construction or erection of real property (as defined in paragraph (m)(3) of this section) in the United States by a taxpayer that, at the time the taxpayer constructs the real property, is engaged in a trade or business (but not necessarily its primary, or only, trade or business) that is considered construction for purposes of the North American Industry Classification System (NAICS) on a regular and ongoing basis. A trade or business that is considered construction under the NAICS means a construction activity under the two-digit NAICS code of 23 and any other construction activity in any other NAICS code provided the construction activity relates to the construction of real property such as NAICS code 213111 (drilling oil and gas wells) and 213112 (support activities for oil and gas operations). For purposes of this paragraph (m), the term *construction project* means the construction activities and services treated as the item under paragraph (d)(2)(iii) of this section. Tangible personal property (for example, appliances, furniture, and fixtures) that is sold as part of a construction project is not considered real property for purposes of this paragraph (m)(1)(i). In determining whether property is real property, the fact that property is real property under local law is not controlling. Conversely, property may be real property for purposes of this paragraph (m)(1)(i) even though under local law the property is considered tangible personal property.

(ii) *Regular and ongoing basis*—(A) *In general*. For purposes of paragraph (m)(1)(i) of this section, a taxpayer engaged in a construction trade or business will be considered to be engaged in such trade or business on a regular and ongoing basis if the taxpayer derives gross receipts from an unrelated person by selling or exchanging the constructed real property described in paragraph (m)(3) of this section within 60 months of the date on which construction is complete (for example, on the date a certificate of occupancy is issued for the property).

(B) *New trade or business.* In the case of a newly-formed trade or business or a taxpayer in its first taxable year, the taxpayer is considered to be engaged in a trade or business on a regular and ongoing basis if the taxpayer reasonably expects that it will engage in a trade or business on a regular and ongoing basis.

(iii) *De minimis exception*—(A) *DPGR.* For purposes of paragraph (m)(1)(i) of this section, if less than 5 percent of the total gross receipts derived by a taxpayer from a construction project (as described in paragraph (m)(1)(i) of this section) are derived from activities other than the construction of real property in the United States (for example, from non-construction activities or the sale of tangible personal property or land), then the total gross receipts derived by the taxpayer from the project may be treated as DPGR from construction. If a taxpayer applies the land safe harbor under paragraph (m)(6)(iv) of this section, for a construction project (as described in paragraph (m)(1)(i) of this section), then the gross receipts excluded under the land safe harbor are excluded in determining total gross receipts under this paragraph (m)(1)(iii)(A). If a taxpayer does not apply the land safe harbor and uses any reasonable method (for example, an appraisal of the land) to allocate gross receipts attributable to the land to non-DPGR, then a taxpayer applies this paragraph (m)(1)(iii)(A) by excluding such gross receipts derived from the sale, exchange, or other disposition of the land from total gross receipts. In the case of gross receipts derived from construction that are received over a period of time (for example, an installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from construction. For purposes of the preceding sentence, if a taxpayer treats gross receipts as DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as DPGR.

(B) *Non-DPGR.* For purposes of paragraph (m)(1)(i) of this section, if less than 5 percent of the total gross receipts derived by a taxpayer from a construction project qualify as DPGR, then the total gross receipts derived by the taxpayer from the construction project may be treated as non-DPGR. In the case of gross receipts derived from construction that are received over a period of time (for example, an installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from construction. For purposes of the preceding sentence, if a taxpayer treats gross receipts as non-DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as non-DPGR.

(2) *Activities constituting construction*—(i) *In general.*

Activities constituting construction are activities performed in connection with a project to erect or substantially renovate real property, including activities performed by a general contractor or that constitute activities typically performed by a general contractor, for example, activities relating to management and oversight of the construction process such as approvals, periodic inspection of the progress of the construction project, and required job modifications.

(ii) *Tangential services.* Activities constituting construction do not include tangential services such as hauling trash and debris, and delivering materials, even if the tangential services are essential for construction. However, if the taxpayer performing construction also, in connection with the construction project, provides tangential services such as delivering materials to the construction site and removing its construction debris, then the gross receipts derived from the tangential services are DPGR.

(iii) *Other construction activities*. Improvements to land that are not capitalizable to the land (for example, landscaping) and painting are activities constituting construction only if these activities are performed in connection with other activities (whether or not by the same taxpayer) that constitute the erection or substantial renovation of real property and provided the taxpayer meets the requirements under paragraph (m)(1) of this section. Services such as grading, demolition (including demolition of structures under section 280B), clearing, excavating, and any other activities that physically transform the land are activities constituting construction only if these services are performed in connection with other activities (whether or not by the same taxpayer) that constitute the erection or substantial renovation of real property and provided the taxpayer meets the requirements under paragraph (m)(1) of this section. A taxpayer engaged in these activities must make a reasonable inquiry or a reasonable determination as to whether the activity relates to the erection or substantial renovation of real property in the United States. Construction activities also include activities relating to drilling an oil or gas well and mining and include any activities the cost of which are intangible drilling and development costs within the meaning of §1.612–4 or development expenditures for a mine or natural deposit under section 616.

(iv) *Administrative support services*. If the taxpayer performing construction activities also provides, in connection with the construction project, administrative support services (for example, billing and secretarial services) incidental and necessary to such construction project, then these administrative support services are considered construction activities.

(v) *Exceptions*. The lease, license, or rental of equipment, for example, bulldozers, generators, or computers, for use in the construction of real property is not a construction activity under this paragraph (m)(2). The term construction does not include any activity that is within the definition of engineering and architectural services under paragraph (n) of this section.

(3) *Definition of real property*. The term *real property* means buildings (including items that are structural components of such buildings), inherently permanent structures (as defined in §1.263A–8(c)(3)) other than machinery (as defined in §1.263A–8(c)(4)) (including items that are structural components of such inherently permanent structures), inherently permanent land improvements, oil and gas wells, and infrastructure (as defined in paragraph (m)(4) of this section). For purposes of the preceding sentence, an entire utility plant including both the shell and the interior will be treated as an inherently permanent structure. Property produced by a taxpayer that is not real property in the hands of that taxpayer, but that may be incorporated into real property by another taxpayer, is not treated as real property by the producing taxpayer (for example, bricks, nails, paint, and windowpanes). For purposes of this paragraph (m)(3), structural components of buildings and inherently permanent structures include property such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property.

(4) *Definition of infrastructure*. The term *infrastructure* includes roads, power lines, water systems, railroad spurs, communications facilities, sewers, sidewalks, cable, and wiring. The term also includes inherently permanent oil and gas platforms.

(5) *Definition of substantial renovation*. The term *substantial renovation* means the renovation of a major component or substantial structural part of real property that materially increases the value of the property, substantially prolongs the useful life of the property, or adapts the property to a new or different use.

(6) *Derived from construction*—(i) *In general*. Assuming all the requirements of this section are met, DPGR derived from the construction of real property performed in the United States includes the proceeds from the sale, exchange, or other disposition of real property constructed by the taxpayer in the United States (whether or not

the property is sold immediately after construction is completed and whether or not the construction project is completed). DPGR derived from the construction of real property includes compensation for the performance of construction services by the taxpayer in the United States. DPGR derived from the construction of real property includes gross receipts derived from materials and supplies consumed in the construction project or that become part of the constructed real property, assuming all the requirements of this section are met.

(ii) *Qualified construction warranty*. DPGR derived from the construction of real property includes gross receipts from any qualified construction warranty, that is, a warranty that is provided in connection with the constructed real property if, in the normal course of the taxpayer's business—

(A) The price for the construction warranty is not separately stated from the amount charged for the constructed real property; and

(B) The construction warranty is neither separately offered by the taxpayer nor separately bargained for with customers (that is, the customer cannot purchase the constructed real property without the construction warranty).

(iii) *Exceptions*. DPGR derived from the construction of real property performed in the United States does not include gross receipts derived from the sale, exchange, or other disposition of real property acquired by the taxpayer even if the taxpayer originally constructed the property. In addition, DPGR derived from the construction of real property does not include gross receipts from the lease or rental of real property constructed by the taxpayer or, except as provided in paragraph (m)(2)(iii) of this section, gross receipts derived from the sale or other disposition of land (including zoning, planning, entitlement costs, and other costs capitalized to the land).

(iv) *Land safe harbor*—(A) *In general*. For purposes of paragraph (m)(6)(i) of this section, a taxpayer may allocate gross receipts between the gross receipts derived from the sale, exchange, or other disposition of real property constructed by the taxpayer and the gross receipts derived from the sale, exchange, or other disposition of land by reducing its costs related to DPGR under §1.199–4 by the costs of the land and any other costs capitalized to the land (collectively, land costs) (including zoning, planning, entitlement costs, and other costs capitalized to the land (except costs for activities listed in paragraph (m)(2)(iii) of this section) and land costs in any common improvements as defined in section 2.01 of Rev. Proc. 92–29 (1992–1 C.B. 748) (see §601.601(d)(2) of this chapter)) and by reducing its DPGR by those land costs plus a percentage. Generally, the percentage is based on the number of months that elapse between the date the taxpayer acquires the land (not including any options to acquire the land) and ends on the date the taxpayer sells each item of real property on the land. However, a taxpayer will be deemed, for purposes of this paragraph (m)(6)(iv)(A), to acquire the land on the date the taxpayer entered into an option agreement to acquire the land if the taxpayer acquired the land pursuant to such option agreement and the purchase price of the land under the option agreement does not approximate the fair market value of the land. In the case of a sale or disposition of land between related persons (as defined in paragraph (b)(1) of this section) for less than fair market value, for purposes of determining the percentage, the purchaser or transferee of the land must include the months during which the land was held by the seller or transferor. The percentage is 5 percent for land held not more than 60 months, 10 percent for land held more than 60 months but not more than 120 months, and 15 percent for land held more than 120 months but not more than 180 months. Land held by a taxpayer for more than 180 months is not eligible for the safe harbor under this paragraph (m)(6)(iv)(A).

(B) *Determining gross receipts and costs*. In the case of a taxpayer that uses the small business simplified overall method of cost allocation under §1.199–4(f), gross receipts derived from the sale, exchange, or other disposition of land, and costs attributable to the land, pursuant to the land safe harbor under paragraph (m)(6)(iv)(A) of this section, are not taken into account for purposes of computing QPAI under §§1.199–1 through 1.199–9 except that the gross receipts are taken into account for determining eligibility for that method of cost allocation. All other taxpayers must treat the gross receipts derived from the sale, exchange, or other disposition of land, pursuant to the land safe harbor under paragraph (m)(6)(iv)(A) of this section, as non-DPGR. In the case of a pass-thru entity, if the pass-thru entity would be eligible to use the small business simplified overall method of cost allocation if the method were applied at the pass-thru entity level, then the gross receipts derived from the sale, exchange, or other disposition of land, and costs allocated to the land, pursuant to the land safe harbor under paragraph (m)(6)(iv)(A) of this section, are not taken into account by the pass-thru entity or its owner or owners for purposes of computing QPAI under §§1.199–1 through 1.199–9. For purposes of the preceding sentence, in determining whether the pass-thru entity would be eligible for the small business simplified overall method of cost allocation, the gross receipts excluded pursuant to the land safe harbor under paragraph (m)(6)(iv)(A) of this section are taken into account for determining eligibility for that method of cost allocation. All other pass-thru entities (including all trusts and estates described in §§1.199–5(e) and 1.199–9(e)) must treat the gross receipts attributable to the sale, exchange, or other disposition of land, pursuant to the land safe harbor under paragraph (m)(6)(iv)(A) of this section, as non-DPGR.

(v) *Examples*. The following examples illustrate the application of this paragraph (m)(6):

Example 1. A, who is in the trade or business of construction under NAICS code 23 on a regular and ongoing basis, purchases a building in the United States and retains B, an unrelated person, to oversee a substantial renovation of the building (within the meaning of paragraph (m)(5) of this section). Although not licensed as a general contractor, B performs general contractor level work and activities relating to management and oversight of the construction process such as approvals, periodic inspection of the progress of the construction project, and required job modifications. B retains C (a general contractor) to oversee day-to-day operations and hire subcontractors. C hires D (a subcontractor) to install a new electrical system in the building as part of that substantial renovation. The amounts that B receives from A for construction services, the amounts that C receives from B for construction services, and the amounts that D receives from C for construction services qualify as DPGR under paragraph (m)(6)(i) of this section provided B, C, and D meet all of the requirements of paragraph (m)(1) of this section. The gross receipts that A receives from the subsequent sale of the building do not qualify as DPGR because A did not engage in any activity constituting construction under paragraph (m)(2) of this section even though A is in the trade or business of construction. The results would be the same if A, B, C, and D were members of the same EAG under §1.199–7(a). However, if A, B, C, and D were members of the same consolidated group, see §1.199–7(d)(2).

Example 2. X is engaged as an electrical contractor under NAICS code 238210 on a regular and ongoing basis. X purchases the wires, conduits, and other electrical materials that it installs in construction projects in the United States. In a particular construction project, all of the wires, conduits, and other electrical materials installed by X for the operation of that building are considered structural components of the building. X's gross receipts derived from installing that property are derived from the construction of real property under paragraph (m)(1) of this section. In addition, pursuant to paragraph (m)(6)(i) of this section, X's gross receipts derived from the purchased materials qualify as DPGR because the wires, conduits, and other electrical materials are consumed during the construction of the building or become structural components of the building.

Example 3. X is engaged in a trade or business on a regular and ongoing basis that is considered construction under the two-digit NAICS code of 23. X buys unimproved land in the United States. X gets the land zoned for residential housing through an entitlement process. X grades the land and sells the land to home builders who construct houses on the land. The gross receipts that X derives from the sale of the land that are attributable to the grading qualify as DPGR under paragraphs (m)(2)(iii) and (6)(i) of this section because those services are undertaken in connection with a construction project in the United States. X's gross receipts derived from the land including capitalized costs of entitlements (including zoning) do not qualify as DPGR under paragraph (m)(6)(i) of this section because the gross receipts are not derived from the construction of real property.

Example 4. The facts are the same as in *Example 3* except that X constructs roads, sewers, and sidewalks, and installs power and water lines on the land. X conveys the roads, sewers, sidewalks, and power and water lines to the local government and utilities. The gross receipts that X derives from the sale of lots that are attributable to grading, and the construction of the roads, sewers, sidewalks, and power and water lines (that qualify as infrastructure under paragraph (m)(4) of this section) are DPGR. X's gross receipts derived from the land including capitalized costs of entitlements (including zoning) do not qualify as DPGR under paragraph (m)(6)(i) of this section because the gross receipts are not derived from the construction of real property.

Example 5. (i) *Facts.* X, who is engaged in the trade or business of construction under NAICS code 23 on a regular and ongoing basis, constructs housing that is real property under paragraph (m)(3) of this section. On June 1, 2007, X pays $50,000,000 and acquires 1,000 acres of land that X will develop as a new housing development. In November 2007, after the expenditure of $10,000,000 for entitlement costs, X receives permits to begin construction. After this expenditure, X's land costs total $60,000,000. The development consists of 1,000 houses to be built on half-acre lots over 5 years. On January 31, 2012, the first house is sold for $300,000. Construction costs for each house are $170,000. Common improvements consisting of streets, sidewalks, sewer lines, playgrounds, clubhouses, tennis courts, and swimming pools that X is contractually obligated or required by law to provide cost $55,000 per lot. The common improvements of $55,000 per lot include $30,000 in land costs underlying the common improvements.

(ii) *Land safe harbor.* Pursuant to the land safe harbor under paragraph (m)(6)(iv) of this section, X calculates the basis for each house sold as $195,000 (total costs of $255,000 ($170,000 in construction costs plus $55,000 in common improvements (including $30,000 in land costs) plus $30,000 in land costs for the lot), which are reduced by land costs of $60,000). X calculates the DPGR for each house sold by taking the gross receipts of $300,000 and reducing that amount by land costs of $60,000 plus a percentage of $60,000. As X acquired the land on June 1, 2007, for each house sold on the land between January 31, 2012, and June 1, 2012, the percentage reduction for X is 5% because X has held the land for not more than 60 months from the date of acquisition. Thus, X's DPGR for each house is $237,000 ($300,000 − $60,000 − $3,000) with costs for each house of $195,000 ($255,000 − $60,000). For each house sold on the land between June 2, 2012 and June 1, 2017, the percentage reduction for X is 10% because X has held the land for more than 60 months but not more than 120 months from the date of acquisition. Thus, of the $300,000 of gross receipts, X's DPGR for each house is $234,000 ($300,000 − $60,000 − $6,000) with costs for each house of $195,000 ($255,000 − $60,000).

Example 6. The facts are the same as in *Example 5* except that on December 31, 2007, after X received the permits to begin construction, X sold the entitled land to Y, an unrelated corporation, for $75,000,000. Y is engaged in a trade or business on a regular and ongoing basis that is considered construction under NAICS code 23. Y subsequently incurred the construction costs and the costs of the common improvements, and Y sold the houses. Because X did not perform any construction activities, none of X's $75,000,000 in gross receipts derived from Y are DPGR and none of X's costs are allocable to DPGR. Pursuant to the land safe harbor under paragraph (m)(6)(iv) of this section, Y calculates the basis for each house sold as $195,000 (total costs of $270,000 ($170,000 in construction costs plus $62,500 in common improvements (including $37,500 in land costs) plus $37,500 in land costs for the lot), which are reduced by land costs of $75,000). Y calculates the DPGR for each house sold by taking the gross receipts of $300,000 and reducing that amount by land costs of $75,000 plus a percentage of $75,000. As Y acquired the land on December 31, 2007, for the houses sold on the land between January 31, 2012, and December 31, 2012, the percentage reduction for Y is 5% because Y held the land for not more than 60 months from the date of acquisition. Thus, of the $300,000 of gross receipts, the DPGR for each house is $221,250 ($300,000 − $75,000 − $3,750) with costs for each house of $195,000. For the houses sold on the land between January 1, 2013, and December 31, 2017, the percentage reduction for Y is 10% because Y held the land for more than 60 months but not more than 120 months from the date of acquisition. Thus, of the $300,000 of gross receipts, the DPGR for each house is $217,500 ($300,000 − $75,000 − $7,500) with costs for each house of $195,000. The results would be the same if X and Y were members of the same EAG, provided X and Y were not members of the same consolidated group.

Example 7. The facts are the same as in *Example 6* except that Y is a member of the same consolidated group as X. Pursuant to §1.1502–13(c)(1)(ii), Y's holding period in the land includes the period of time X held the land. In order to produce the same effect as if X and Y were divisions of a single corporation (see §1.1502–13(c)(1)(i)), for each house sold between January 31, 2012, and June 1, 2012, Y's DPGR are redetermined to be $237,000, the same as X's DPGR for houses sold between January 31, 2012, and June 1, 2012, in *Example 5*. Y's costs for each house do not have to be redetermined because Y's costs are $195,000, the same as the costs would be if X and Y were divisions of a single corporation. For each house sold between June 2, 2012, and June 1, 2017, Y's DPGR are redetermined to be $234,000, the same as X's DPGR for each house sold between June 2, 2012, and June 1, 2017, in *Example 5*. Y's costs for each house do not have to be redetermined because Y's costs are $195,000, the same as the costs would be if X and Y were divisions of a single corporation.

Example 8. X, who is engaged in the trade or business of construction under NAICS code 23 on a regular and ongoing basis, purchases land for development and builds an office building on the land. Y enters into a contract with X to purchase the office building. As part of the contract, X is required to furnish the office space with desks, chairs, and lamps. Upon completion of the sale of the building, X uses the land safe harbor under paragraph (m)(6)(iv) of this section to account for the land. After application of the land safe harbor, X uses the *de minimis* exception under paragraph (m)(1)(iii)(A) of this section in determining whether the gross receipts derived from the sale of the desks, chairs, and lamps qualify as DPGR. If the gross receipts derived from the sale of the desks, chairs, and lamps are less than 5% of the total gross receipts derived by X from the sale of the furnished office building (excluding any gross receipts taken into account under the land safe harbor pursuant to paragraph (m)(6)(iv)(B) of this section), then all of the gross receipts derived from the sale of the furnished office building, after the reduction under the land safe harbor, may be treated as DPGR.

(n) *Definition of engineering and architectural services*—(1) *In general.* DPGR include gross receipts derived from engineering or architectural services performed in the United States for a construction project described in paragraph (m)(1)(i) of this section. At the time the taxpayer performs the engineering or architectural services, the taxpayer must be engaged in a trade or business (but not necessarily its primary, or only, trade or business) that is considered engineering or architectural services for purposes of the NAICS, for example NAICS codes 541330 (engineering services) or 541310 (architectural services), on a regular and ongoing basis. In the case of a newly-formed trade or business or a taxpayer in its first taxable year, a taxpayer is considered to be engaged in a trade or business on a regular and ongoing basis if the taxpayer reasonably expects that it will engage in a trade or business on a regular and ongoing basis. DPGR include gross receipts derived from engineering or architectural services, including feasibility studies for a construction project in the United States, even if the planned construction project is not undertaken or is not completed.

(2) *Engineering services.* Engineering services in connection with any construction project include any professional services requiring engineering education, training, and experience and the application of special knowledge of the mathematical, physical, or engineering sciences to those professional services such as consultation, investigation, evaluation, planning, design, or responsible supervision of construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project.

(3) *Architectural services.* Architectural services in connection with any construction project include the offering or furnishing of any professional services such as consultation, planning, aesthetic and structural design, drawings and specifications, or responsible supervision of construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project.

(4) *Administrative support services.* If the taxpayer performing engineering or architectural services also provides administrative support services (for example, billing and secretarial services) incidental and necessary to such engineering or architectural services, then these administrative support services are considered engineering or architectural services.

(5) *Exceptions.* Engineering or architectural services do not include post-construction services such as annual audits and inspections.

(6) *De minimis exception for performance of services in the United States*—(i) *DPGR.* If less than 5 percent of the total gross receipts derived by a taxpayer from engineering or architectural services performed in the United States for a construction project (described in paragraph (m)(1)(i) of this section) are derived from services not relating to a construction project (for example, the services are performed outside the United States or in connection with property other than real property), then the total gross receipts derived by the taxpayer may be treated

as DPGR from engineering or architectural services performed in the United States for the construction project. In the case of gross receipts derived from engineering or architectural services that are received over a period of time (for example, an installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from engineering or architectural services. For purposes of the preceding sentence, if a taxpayer treats gross receipts as DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as DPGR.

(ii) *Non-DPGR.* If less than 5 percent of the total gross receipts derived by a taxpayer from engineering or architectural services performed in the United States for a construction project qualify as DPGR, then the total gross receipts derived by the taxpayer from engineering or architectural services performed in the United States for the construction project may be treated as non-DPGR. In the case of gross receipts derived from engineering or architectural services that are received over a period of time (for example, an installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from engineering or architectural services. For purposes of the preceding sentence, if a taxpayer treats gross receipts as non-DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as non-DPGR.

(7) *Example.* The following example illustrates the application of this paragraph (n):

Example. X is engaged in the trade or business of providing engineering services under NAICS code 541330 on a regular and ongoing basis. Y buys unimproved land. Y hires X to provide engineering services for roads, sewers, sidewalks, and power and water lines that qualify as infrastructure under paragraph (m)(4) of this section and that will be constructed on Y's land. X's gross receipts from engineering services for the infrastructure are DPGR. X's gross receipts from engineering services relating to land (except as provided in paragraph (m)(2)(iii) of this section) do not qualify as DPGR under paragraph (n)(1) of this section because the gross receipts are not derived from engineering services for a construction project described in paragraph (m)(1)(i) of this section.

(o) *Sales of certain food and beverages*—(1) *In general.* DPGR does not include gross receipts of the taxpayer that are derived from the sale of food or beverages prepared by the taxpayer at a retail establishment. A retail establishment is defined as tangible property (both real and personal) owned, leased, occupied, or otherwise used by the taxpayer in its trade or business of selling food or beverages to the public at which retail sales are made. In addition, a facility that prepares food and beverages for take out service or delivery is a retail establishment (for example, a caterer). If a taxpayer's facility is a retail establishment, then, for purposes of this section, the taxpayer may allocate its gross receipts between the gross receipts derived from the retail sale of the food and beverages prepared and sold at the retail establishment (that are non-DPGR) and gross receipts derived from the wholesale sale of the food and beverages prepared and sold at the retail establishment (that are DPGR assuming all the other requirements of section 199 are met). Wholesale sales are defined as food and beverages held for resale by the purchaser. The exception for sales of certain food and beverages also applies to food and beverages for non-human consumption. A retail establishment does not include the bonded premises of a distilled spirits plant or wine cellar, or the premises of a brewery (other than a tavern on the brewery premises). See Chapter 51 of Title 26 of the United States Code and the implementing regulations thereunder.

(2) *De minimis exception.* A taxpayer may treat a facility at which food or beverages are prepared as not being a retail establishment if less than 5 percent of the gross receipts derived from the sale of food or beverages at that facility during the taxable year are attributable to retail sales.

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

Example 1. X buys coffee beans and roasts those beans at a facility in the United States, the only activity of which is the roasting and packaging of coffee beans. X sells the roasted coffee beans through a variety of unrelated third-party vendors and also sells roasted coffee beans at X's retail establishments. At X's retail establishments, X prepares brewed coffee and other foods. To the extent that the gross receipts of X's retail establishments are derived from the sale of coffee beans roasted at the facility, the receipts are DPGR (assuming all the other requirements of this section are met). To the extent the gross receipts of X's retail establishments are derived from the retail sale of brewed coffee or food prepared at the retail establishments, the receipts are non-DPGR. However, pursuant to §1.199–1(d)(1)(ii), X must allocate part of the receipts from the retail sale of the brewed coffee as DPGR to the extent of the value of the coffee beans that were roasted at the facility and that were used to brew coffee.

Example 2. Y operates a bonded winery within the United States. Bottles of wine produced by Y at the bonded winery are sold to consumers at the taxpaid premises. Pursuant to paragraph (o)(1) of this section, the bonded premises is not considered a retail establishment and is treated as separate and apart from the taxpaid premises, which is considered a retail establishment for purposes of paragraph (o)(1) of this section. Accordingly, the wine produced by Y in the bonded premises and sold by Y from the taxpaid premises is not considered to have been produced at a retail establishment, and the gross receipts derived from the sales of the wine are DPGR (assuming all the other requirements of this section are met).

(p) *Guaranteed payments.* DPGR does not include guaranteed payments under section 707(c). Thus, partners, including partners in partnerships described in paragraphs (i)(7) and (8) of this section and §1.199–9(i) and (j), may not treat guaranteed payments as DPGR. See §§1.199–5(b)(6) *Example 5* and 1.199–9(b)(6) *Example 5.*

[T.D. 9263, 71 FR 31283, June 1, 2006, as amended by T.D. 9293, 71 FR 61669, Oct. 19, 2006; T.D. 9263, 72 FR 5, Jan. 3, 2007; T.D. 9317, 72 FR 12971, Mar. 20, 2007; T.D. 9381, 73 FR 8804, Feb. 15, 2008; T.D. 9384, 73 FR 12270, Mar. 7, 2008]

§ 1.199–4 Costs allocable to domestic production gross receipts.

(a) *In general.* The provisions of this section apply solely for purposes of section 199 of the Internal Revenue Code (Code). To determine its qualified production activities income (QPAI) (as defined in §1.199–1(c)) for a taxable year, a taxpayer must subtract from its domestic production gross receipts (DPGR) (as defined in §1.199–3(a)) the cost of goods sold (CGS) allocable to DPGR and other expenses, losses, or deductions (deductions), other than the deduction allowed under section 199, that are properly allocable to such receipts. Paragraph (b) of this section provides rules for determining CGS allocable to DPGR. Paragraph (c) of this section provides rules for determining the deductions that are properly allocable to DPGR. Paragraph (d) of this section provides that a taxpayer generally must determine deductions allocable to DPGR or to gross income attributable to DPGR using §§1.861–8 through 1.861–17 and §§1.861–8T through 1.861–14T (the section 861 regulations), subject to the rules in paragraph (d) of this section (the section 861 method). Paragraph (e) of this section provides that certain taxpayers may apportion deductions to DPGR using the simplified deduction method. Paragraph (f) of this section provides a small business simplified overall method that a qualifying small taxpayer may use to apportion CGS and deductions to DPGR.

(b) *Cost of goods sold allocable to domestic production gross receipts*—(1) *In general.* When determining its QPAI, a taxpayer must subtract from DPGR the CGS allocable to DPGR. A taxpayer determines its CGS allocable to DPGR in accordance with this paragraph (b) or, if applicable, paragraph (f) of this section. In the case of a sale, exchange, or other disposition of inventory, CGS is equal to beginning inventory plus purchases and production costs incurred during the taxable year and included in inventory costs, less ending inventory. CGS is determined under the methods of accounting that the taxpayer uses to compute taxable income. See sections 263A, 471, and 472. If section 263A requires a taxpayer to include additional section 263A costs (as defined in §1.263A–1(d)(3)) in inventory, additional section 263A costs must be included in determining CGS. CGS allocable to DPGR also includes inventory valuation adjustments such as writedowns under the lower of cost