

Proposed § 199
Income Attributable to Domestic Production Activities

PURPOSE AND EFFECTIVE DATE

In 2004, the Internal Revenue Service and Treasury Department enacted Internal Revenue Code §199, as part of the American Jobs Creation Act of 2004, Pub L No 108-357, **effective for taxable years beginning after December 31, 2004.**

When fully phased in (**in 2010**), §199 will provide a deduction equal to **9 %** of the lesser of a taxpayer's "qualified production activities income" or taxable income. The deduction is limited, however, to 50 % of the "W-2 wages" paid by the taxpayer.

In 2005 and 2006, the deduction is set at 3 %, and in 2007 through 2009 the deduction is set at 6 %.

Since the deduction is based on a formula, rather than reflecting any actual expenses incurred by the taxpayer, its effect is to **reduce the effective tax rate on OPAL.**

OVERVIEW OF § 199

1. In General

- a. § 199(a) (1) allows a deduction up to 9% of the lesser of
 - i. the qualified production activities income or the taxpayer for the taxable year, or
 - ii. taxable income for the taxable year

The taxpayer's production activities deduction may not exceed the taxpayer's taxable income for the tax year, or, in the case of an individual, the individual's adjusted gross income for the tax year.

- b. § 199(b) (1) limits the deduction for a taxable year to 50% of the W-2 wages paid by the taxpayer during the calendar year that ends in such taxable year.

W-2 wages are the wages of common-law employees and officers of the taxpayer. It does not apply to sole proprietorships or members of partnerships including limited liability companies.

Partnerships that pay substantial amounts of compensation not treated as W-2 wages because of the above rules, but are otherwise eligible for the U S Production Activities deduction may want to consider incorporating in order to qualify for this deduction.

2. Qualified Production Activities Income

- a. Under § 199(c) (1), qualified production activities income is defined as the excess of domestic production gross receipts (DPGR) over the sum of all direct and indirect expenses allocable to such receipts.
- b. § 199 (c) (4) defines domestic production gross receipts (DPGR) to mean the taxpayer's gross receipts that are derived from:
 - i. Any lease, rental, license, sale, exchange, or other disposition of:

Proposed § 199
Income Attributable to Domestic Production Activities

1. Qualified production property (QPP) that was **manufactured, produced, grown, or extracted** (MPGE) by the taxpayer in whole or in significant part **within the United States.**

QPP includes tangible personal property, computer software and certain sound recordings.

The terms MPGE include activities relating to 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 terms also include 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. For example, assume A, B, and C are unrelated taxpayers. A owns grain storage bins in the United States in which it stores for a fee B's corn that was grown in the United States. B sells its corn to C. C processes B's corn into corn syrup in the United States. The gross receipts from A's, B's, and C's activities are DPGR from the MPGE of QPP

2. Any **qualified film** produced by the taxpayer, defined as a motion picture film or video tape, including live or delayed television programming if not less than 50% of the total compensation relating to production of the property is compensation for services performed in the United States by actors, production personnel, directors, and producers.
3. Electricity, natural gas, or potable water **produced** by the taxpayer **in the United States**

- ii. Construction **performed in the United States.**

*Construction activities include those **directly related** to the **erection or substantial renovation** of **real property** by a taxpayer that is in a trade or business that is considered construction for purposes of the NAICS.*

***Substantial renovation** means the renovation of a major component or substantial structural part of real property that materially increases the value of the property, prolongs the useful life or adapts the property to a new or different use. It does not include mere cosmetic changes, such as painting, or improving land by grading and landscaping.*

Proposed § 199
Income Attributable to Domestic Production Activities

***Real property** includes residential and commercial buildings, inherently permanent structures and land improvements, and infrastructure.*

iii. Engineering or architectural services performed in the United States for construction projects in the United States

c. Exceptions from DPGR:

- i. Gross receipts of the taxpayer that are derived from
 1. The sale of food and beverage prepared by the taxpayer at a retail establishment
 2. The transmission or distribution of electricity, natural gas, or potable water.
- ii. Gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any **related person**.

3. Pass-thru Entities

- a. § 199 (d)(1) provides that, in the case of an S corporation, partnership, estate or trust, or other pass-thru entity, § 199 generally is applied at the shareholder, partner, or similar level, except as otherwise provided in rules applicable to individuals and patrons of cooperatives.

4. Individuals

- a. § 199 (d)(2) provides that the deduction is equal to the applicable percent of the lesser of the taxpayers:
 - i. Qualified Production Activities Income (QPAI) for the taxable year, or Adjusted Gross Income (AGI) for the taxable year determined after applying §§ 86, 135, 137, 219, 221, 222, and 468, and without regard to § 199.

Because the US Production Activities deduction is attributable to the taxpayer's trade or business, the deduction is allowed in computing the taxpayer's adjusted gross income (AGI). It is not an itemized deduction.

5. Patrons of Certain Cooperatives

- a. § 199 (d)(3) provides special rules under which a taxpayer receiving certain patronage dividends or certain qualified per-unit retain allocations from a cooperative engaged in the manufacturing, production, growth, extraction (MPGE), or marketing, in whole or in part, of any agricultural or horticultural product is allowed a deduction under § 199

6. Expanded Affiliated Groups

- a. § 199 (d)(4) provides that all members of an expanded affiliated group (EAG) are treated as a single corporation for purposes of § 199.
- b. An EAG is an affiliated group of 1 or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if
 - i. The common parent owns possesses at least 80 percent of the total voting power of the stock of such corporation, and in at least

Proposed § 199
Income Attributable to Domestic Production Activities

- ii. .1 of the other includible corporations, and has a value equal to at least 80 percent of the total value of the stock of such corporation
- iii. Stock meeting the above requirements in each of the includible corporations (except the common parent) is owned directly by 1 or more of the other includible corporations.

In general, the § 199 deduction for an EAG is determined by aggregating each member's taxable income or loss, QPAI, and W-2 wages. A member's QPAI may be positive or negative. Member's taxable income or loss and QPAI shall be determined by reference to the member's method of accounting.

7. Trade or Business Requirements

- a. § 199 (d)(5) provides that § 199 is applied by taking into account only items that are attributable to the actual conduct of a trade or business.

8. Alternative Minimum Tax

- a. § 199 (d)(6) provides rules to coordinate the deduction allowed under § 199 with the alternative minimum tax (AMT) imposed by § 55. The deduction is allowed for purposes of AMT, except that the deduction is equal to the applicable percent of the lesser of the taxpayer's: QPAI or Alternative Minimum Tax Income (AMTI)

9. Authorities to Prescribe Regulations

- a. § 199 (d)(7) authorized the Secretary to prescribe such regulations as are necessary to carry out the purposes of § 199.