The Domestic Production Deduction: An Overview of the Interim Guidance

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In Notice 2005-14, 2005-7 IRB 1, Doc 2005-1241, 2005 TNT 13-7, the IRS provides interim guidance on the new section 199 deduction related to income attributable to domestic production activities, which was enacted as part of the American Jobs Creation Act of 2004, P.L. 108-357. Taxpayers may rely on the rules set forth in Notice 2005-14 until Treasury and the IRS issue regulations under section 199. The rules provided in Notice 2005-14 apply to tax years beginning after December 31, 2004. This article summarizes the interim guidance provided in Notice 2005-14.

I. Executive Summary

Notice 2005-14 provides rules and definitions for taxpayers to use in computing the section 199 deduction. In general, section 199 provides a deduction equal to 3 percent (increasing to 9 percent when fully phased in in 2010) of the lesser of: (a) taxable income derived from a qualified production activity or (b) taxable income, for the tax year in question. However, the deduction is limited to 50 percent of the W-2 wages paid by the taxpayer during the calendar year that ends in that tax year.

The notice defines W-2 wages and provides three alternatives for computing W-2 wages.

The notice defines qualified production activities. Specifically, the notice defines what constitutes the manufacture, production, growth, or extraction (MPGE; with apologies to English language purists, we’re going to use “MPGE” as a verb in a few instances, on the theory that this article is long enough already) in whole or in significant part in the United States of tangible personal property, computer software, or sound recordings. Within that definition, the notice generally provides that only the taxpayer with the benefits and burdens of ownership of the property during the manufacturing process is treated as the manufacturer for purposes of section 199.

Regarding gross receipts from the MPGE of computer software, the notice provides that computer software is not limited to software for computers, but includes, for example, software for video games. However, in determining domestic gross production receipts, receipts for fees for online use of software and embedded services are generally not taken into account in computing the section 199 deduction.
The notice also provides a "substantial in nature" test for determining if the property is manufactured by the taxpayer in the United States in significant part. Also, the notice includes a safe harbor that is satisfied if conversion costs incurred in the United States (excluding certain design and development and packaging costs) are 20 percent or more of the total cost of the property.

Notice 2005-14 defines what constitutes construction activities and permits more than one taxpayer to be regarded as constructing real property with respect to the same activity. The notice clarifies that gross receipts derived from the rental of property constructed by the taxpayer are not considered derived from construction and would not be eligible for the section 199 deduction.

The notice provides rules for allocating cost of goods sold and deductions to domestic production gross receipts. In the case of the latter, the notice generally requires taxpayers to follow the rules under the section 861 regulations. However, two simplified methods are provided for small taxpayers.

The notice also provides rules for applying section 199 to passthrough entities. Also, the notice provides definitions and rules for determining the expanded affiliated group and allocating the section 199 deduction among members of the expanded affiliated group. For example, the notice provides that a consolidated group is treated as a single member of the expanded affiliated group (rather than each member of the consolidated group being treated as a separate member of the expanded affiliated group).

II. Specific Guidance

A. Wage Limitation

Notice 2005-14 generally provides that for purposes of the wage limitation under section 199, the term "W-2 wages" includes amounts that an employer must include on statements under section 6051(a)(3) and (8). A taxpayer may also take into account wages paid by agents of the taxpayer on behalf of the taxpayer for employees of the taxpayer that are included on Forms W-2 issued by the agent (for example, common paymasters). Because the section 199(b)(2) definition of W-2 wages cannot be satisfied by a box on Form W-2, the notice provides three alternative methods for calculating W-2 wages for purposes of section 199:

- **Unmodified box method**: A taxpayer can treat wages as the lesser of (1) the total entries in Box 1 of all Forms W-2 filed with the Social Security Administration (SSA) or (2) the total entries in Box 5 of all Forms W-2 filed with the SSA;

- **Modified Box 1 method**: A taxpayer can calculate W-2 wages by subtracting from the total amounts reported in Box 1 of Forms W-2 (1) amounts that are included in Box 1 that are not wages under section 3401(a) and (2) items that are treated as wages under section 3402(o) (for example, supplemental unemployment compensation benefits), and then adding those elective deferrals that are reported in Box 12 of Forms W-2 with Codes D, E, F, G, and S; or
Tracking wages method: A taxpayer can track the actual amount of wages subject to federal income tax withholding, subtract supplemental unemployment compensation benefits that were included in this amount, and then add specific elective deferrals that are reported in Box 12 of Forms W-2 with Codes D, E, F, G, and S.

The notice also provides rules to prevent the duplicate reporting of wages in computing the section 199 deduction (for example, an amount of nonqualified deferred compensation treated as W-2 wages under the unmodified box method for one tax year cannot be treated as W-2 wages in any other tax year).

Also, the notice provides that if a taxpayer (the successor) acquires a major portion of a trade or business, or a major portion of a separate unit of a trade or business, from another taxpayer (the predecessor), the successor may not take into account wages paid to common law employees of the predecessor employer for services rendered to the predecessor employer, even if those wages are reported on Forms W-2 furnished by the successor.

B. Qualified Production Activities Income (QPAI)

Section 199(c)(1) provides that QPAI is the excess of domestic production gross receipts over the sum of (a) the cost of goods sold (CGS) allocable to those receipts; (b) other deductions, expenses, or losses directly allocable to those receipts; and (c) a ratable portion of deductions, expenses, or losses not directly allocable to those receipts or another class of income. Notice 2005-14 provides that QPAI is determined on an item-by-item basis (not a division-by-division, product line-by-product line, or transaction-by-transaction basis). QPAI for each item may be positive or negative. Thus, a taxpayer that is engaged exclusively in the manufacture of qualifying production property (QPP) within the United States and has no other sources of income generally will have QPAI that is equal to taxable income.

C. Domestic Production Gross Receipts (DPGR)

Section 199(c)(4)(A) defines DPGR as the taxpayer’s gross receipts that are derived from (a) any lease, rental, license, sale, exchange, or other disposition of (i) QPP that was MPGE by the taxpayer in whole or in significant part within the United States; (ii) any qualified film produced by the taxpayer; or (iii) electricity, natural gas, or potable water produced by the taxpayer in the United States; (b) construction performed in the United States; or (c) engineering or architectural services performed in the United States for construction projects in the United States. For this purpose, the notice defines gross receipts as those properly recognized for the tax year under the taxpayer’s method of accounting. Also, the term “within the United States” does not include possessions or territories of the United States.

Under the notice, a taxpayer must determine the portion of its gross receipts that are DPGR using a reasonable method that accurately identifies the gross receipts derived from activities described in section 199 based on all information available to the taxpayer.
However, if a taxpayer uses a specific identification method (a method that specifically identifies where the item was MPGE) for any other purpose, the taxpayer must use that method to determine DPGR.

The notice provides a safe harbor that allows taxpayers with less than 5 percent of total gross receipts from items other than DPGR to treat all gross receipts as DPGR and, therefore, the taxpayer is not required to allocate its gross receipts. For example, interest and late fees related to QPP manufactured in the United States by a taxpayer and sold by the taxpayer on credit are not DPGR, but may be treated as DPGR if the taxpayer’s interest and late fees, when aggregated with other non-DPGR, are collectively less than 5 percent of the taxpayer’s total gross receipts.

1. Gross receipts derived from the transfer of qualifying property.

The notice limits gross receipts “derived from the lease, rental, license, sale, exchange, or other disposition” of QPP to the direct proceeds of those activities. Examples of receipts that would qualify under that definition (assuming the section 199(c) requirements are otherwise met) include:

- direct proceeds from the sale of QPP manufactured in whole or significant part within the United States for sale;
- direct proceeds from the sale of self-constructed QPP manufactured in whole or in significant part in the United States by the taxpayer and used in the taxpayer’s trade or business;
- business interruption insurance and payments not to produce, to the extent they are substitutes for gross receipts that would qualify as DPGR;
- gross receipts from the sale of newspapers and magazines including advertising income (the notice appears to limit the allowance for advertising income to newspapers and magazines despite the existence of other, similarly functioning mediums);
- gross receipts derived by certain oil and gas partnerships from the sale of oil and gas products; and
- gross receipts from the sale of U.S.-developed computer software that customers purchase by downloading it from the Web.

Examples of receipts that would not qualify under the notice include:

- gross receipts allocable to non-de minimis embedded services (that is, a service element contained in the lease, rental, license, sale, exchange, or other disposition of property). Embedded services do not include gross receipts from a qualified warranty; and
gross receipts derived by a taxpayer that offers software to customers online for a fee, including gross receipts derived from Internet access services, online services, customer support, telephone services, games played through a Web site, and provider-controlled online access services.

Also, under section 199(c)(4)(B), DPGR does not include gross receipts derived from the sale of food and beverages prepared by a taxpayer at a retail establishment. The notice defines “retail establishment” as real property leased, occupied, or otherwise used by the taxpayer in its trade or business of selling food or beverages to the public and at which the taxpayer makes retail sales. The term does not include facilities that are used solely to prepare food or beverages for wholesale sale. Similarly, food or beverage preparation facilities that derive less than 5 percent of their total gross receipts for the tax year from retail food and beverage sales will not be considered retail establishments. For taxpayers with retail establishments that prepare food and beverages for wholesale and retail sales, the notice indicates that the IRS and Treasury will permit those taxpayers, as a matter of administrative grace, to allocate their gross receipts between their wholesale and retail sales.

a. MPGE and QPP. The notice defines MPGE broadly to include all of the activities listed in sections 199(c)(4)(A)(I) and 263A(g)(1), and reg. sections 1.48-1(d)(2) and 1.263A-2(a)(1)(i). However, the notice narrowly construes the term “by the taxpayer” to mean that only one taxpayer may claim the deduction under section 199 for the same function performed for the same property. The notice states that “benefits and burdens of ownership” principles will apply for that purpose. For example, in contract manufacturing situations in which one taxpayer performs activities that are the MPGE activities applicable to QPP or the production activities associated with qualified film, electricity, natural gas, or potable water under a contract with another taxpayer, generally only one taxpayer has the benefits and burdens of ownership of the property under federal income tax principles (although arguably those principles do not approach bright-line clarity under existing tax law) during the period the qualifying activity occurs. As such, only that taxpayer is treated as engaging in the qualifying activity. There is an exception to this rule for members of the expanded affiliated group.

As noted above, to qualify for the section 199 deduction, QPP must be MPGE in whole or in significant part by the taxpayer within the United States. The gross receipts that are considered DPGR are not limited to the gross receipts attributable to QPP MPGE entirely by the taxpayer. Thus, for example, if a taxpayer purchases partially manufactured QPP from another taxpayer and the taxpayer satisfies the “in whole or in significant part” requirement for the manufacture of the QPP, the taxpayer’s gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of that QPP will be considered DPGR.

Under Notice 2005-14, QPP is MPGE in significant part if a taxpayer’s MPGE activity is substantial in nature based on all facts and circumstances, including (1) the retail value added by, and relative cost of, the taxpayer’s MPGE activity in the United States;
(2) the nature of the property; and (3) the nature of the MPGE activity that the taxpayer performs in the United States. That substantial-in-nature requirement is not the same as the “not the property which it purchased” standard in reg. section 1.954-3(a)(4). Specifically, the substantial transformation test of reg. section 1.954-3(a)(4)(ii) is not relevant to the determination of substantial in nature for purposes of section 199(c)(4)(A)(i)(I).

The notice states that the IRS and Treasury have concluded that a single, quantitative criterion would not be appropriate in determining whether a taxpayer’s activities are substantial in nature. Therefore, the substantial-in-nature test should be considered in light of all the facts and circumstances. That standard is similar to the substantial-in-nature test outlined in Example 2 of reg. section 1.954-(3)(a)(4)(iii). The notice also provides a safe harbor under which a taxpayer will be treated as MPGE property in whole or in significant part within the United States if the conversion costs to MPGE the property are incurred by the taxpayer within the United States and the costs account for 20 percent or more of the total CGS of the property. That rule is similar to the safe harbor under reg. section 1.954-3(a)(4)(iii), and illustrated by Example 1.

Under the notice, specified activities and costs are disregarded in determining whether a taxpayer’s MPGE activities are substantial in nature and in applying the 20 percent safe harbor. Disregarded activities include packaging, repackaging, labeling, minor assembly operations, and design and development activities (except design and development activities for computer software and sound recordings).

As noted, section 199(c)(4)(A) defines DPGR to include gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of QPP. Under section 199(c)(5), QPP includes (1) tangible personal property; (2) computer software; and (3) sound recordings. Consistent with reg. section 1.48-1(c), the notice defines tangible personal property as any tangible property other than land, buildings (including items that are structural components of buildings), and any property described in section 199(c)(4)(A)(i)(II) and (III) or section 199(c)(5)(B) and (C). Tangible personal property does not include qualified films, computer software, sound recordings, or the creation of copyrighted material, such as a manuscript, in a form other than in a tangible medium.

Consistent with the definition in reg. section 1.197-2(c)(4)(iv), the notice defines computer software as 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, but expands the definition to include the machine-readable coding for video games and similar programs, regardless of whether the program is designed to operate on a “computer” (as defined in section 168(1)(2)(B). For purposes of section 199, computer software does not include diskettes or other tangible personal property on which machine-reading code is placed. As such, taxpayers that sell diskettes or other tangible personal property encoded with software must allocate their gross receipts between those attributable to the software and those attributable to the tangible personal property (the diskettes). (The requirement to allocate between tangible and intangible elements of the
software distributed through a tangible medium (such as diskette) appears to require a largely meaningless allocation exercise since the cost of the tangible element is usually de minimis. This is an area in which a de minimis safe harbor would serve to provide for a more administrable rule seemingly without compromising the specific requirements of section 199.)

Consistent with section 168(f)(4), the notice defines sound recordings as any works that result from the fixation of a series of musical, spoken, or other sounds. The term does not include the tangible personal property in which the sound recording is fixed, such as a compact disc.

b. Qualified film. Under section 199(c)(4)(A), DPGR includes gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of any qualified film the taxpayer produces. Section 199(c)(6) defines qualified film as any property described in section 168(f)(3). Under the notice, a motion picture or video tape, as well as live or delayed television programming, may be a qualified film, provided that 50 percent or more of the total compensation paid for its production is compensation for services performed by actors, production personnel, directors, and producers in the United States. The notice provides definitions for production personnel, but does not provide a specific method for computing the 50 percent or more of total compensation.

Qualified films do not include copies of the film (other than the master copy), the tangible personal property embodying the qualified film, such as DVDs or videocassettes, or sexually explicit films.

The notice points out that gross receipts from ticket sales for viewing qualified films will not qualify as DPGR. Similarly, gross receipts “derived from” a qualified film do not include (1) amounts a taxpayer receives from the sale of a script or screenplay, even if it is developed into a qualified film; (2) revenue from the sale of film-themed merchandise; and (3) gross receipts derived from the a license of the right to use the film characters.

c. Electricity, natural gas, and potable water. Under section 199(c)(4)(A), DPGR includes gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water, but does not include gross receipts derived from the transmission or distribution of those items. As such, the notice requires integrated producers that both produce and deliver electricity, natural gas, or potable water to allocate their gross receipts between (1) production that qualifies as DPGR and (2) distribution and transmission (which do not qualify). The notice does not provide a method for making that allocation. However, if less than 5 percent of gross receipts derived from the sale of those items is allocable to transmission and distribution, however, the notice treats those receipts as DPGR.

2. Construction.

Under section 199(c)(4)(A), DPGR also includes gross receipts derived from construction performed within the United States. The notice defines construction as the construction, by a taxpayer that is in a
trade or business that is considered construction for purposes of the North American Industry Classification System (NAICS), of real property, including:

- residential and commercial buildings (including their structural components);
- inherently permanent structures other than tangible property such as machinery;
- inherently permanent land improvements; and
- infrastructure (including roads, power lines, water systems, railroad spurs, communications facilities, sewers, sidewalks, cable, wiring, and inherently permanent oil and gas platforms).

It is not clear whether the reference to NAICS codes means that a taxpayer’s primary trade or business must be construction, or whether the taxpayer must have construction as one of its trades or businesses. However, according to the notice the term “construction” includes most activities that are typically performed when erecting or substantially renovating real property, but does not include tangential services such as hauling trash and debris and delivering materials, unless the taxpayer provides tangential services as part of the construction it is performing. The notice also provides that if more than 95 percent of the total gross receipts derived from a construction project is attributable to real property, a taxpayer’s total gross receipts from the project are treated as DPGR.

Under the notice, land improvements, such as grading and landscaping and painting may be considered “construction,” but only if they are performed in connection with the erection or substantial renovation of real property. Consistent with section 263(a), the notice defines substantial renovation as the renovation of a major component or substantial structural part of real property that materially increases the value of the property, substantially prolongs the property’s useful life, or adapts the property to a new or different use.

The notice provides that DPGR may include the proceeds of a sale, exchange, or other disposition of real property constructed in the United States (whether or not the property is sold immediately after construction is completed), as well as compensation for construction services, but does not include gross receipts from the lease or rental of constructed real property. Also, DPGR derived from construction does not include gross receipts attributable to the sale or other disposition of land despite the fact that the notice defines real property by reference to reg. section 1.263A-8(c), which includes land in its definition of real property.

Unlike the contract manufacturing rules for QPP MPGE by a taxpayer, the notice points out that it may be appropriate, in certain instances, for more than one taxpayer to claim the deduction for the same activity and the same construction project. Thus, under the notice, both a general contractor and any hired subcontractor could claim the deduction for gross receipts they derived from the same renovation project.
3. Engineering and architectural services.

Under section 199(c)(4)(A), DPGR also includes gross receipts derived from engineering or architectural services performed in the United States for construction projects in the United States. Consistent with reg. sections 1.924(a)-1T(e)(2) and -1T(e)(3), the notice defines engineering services as 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 designs. Architectural services 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.

Under the notice, gross receipts derived from engineering and architectural services qualify as DPGR if (1) the services relate to real property; (2) the services are performed in the United States; and (3) the taxpayer providing the services can substantiate that the services relate to a construction project in the United States. The construction project to which the services relate need not be undertaken or completed to satisfy those requirements.

The notice provides a de minimis exception for engineering or architectural services (1) performed outside the United States or (2) related to property other than real property, for a construction project within the United States. To qualify as DPGR under the exception, the gross receipts derived from those services must be less than 5 percent of the total gross receipts derived from those services on the same construction project.

D. Determining Costs

To determine QPAI for the tax year, a taxpayer must reduce its DPGR by the amount of CGS directly allocable to DPGR, the amount of deductions, expenses, and losses (deductions) directly allocable to DPGR, and a ratable portion of other deductions not directly allocable to DPGR, or another class of income.

The notice provides rules that CGS generally must be specifically identified with, or directly traced to, DPGR in accordance with the taxpayer’s books and records. If the taxpayer’s books and records, however, do not allow the taxpayer to identify the CGS directly allocable to DPGR, the taxpayer can use a reasonable method to allocate CGS between DPGR and other gross receipts. If, however, a method is used to allocate gross receipts between DPGR and non-DPGR, the taxpayer cannot use a different method for purposes of allocating CGS.

The notice provides three alternative methods for allocating and apportioning deductions:
Section 861 method: A taxpayer determines the deductions allocated and apportioned to DPGR by applying the allocation and apportionment rules provided by the section 861 regulations. Those regulations are modified by the notice to provide that charitable contributions are to be ratably apportioned based on gross income. Research and experimental expenditures will be apportioned based on reg. section 1.861-17. However, exclusive apportionment will not apply because apportionment based on geographic sources is not required. Subject to the above modifications, if the taxpayer uses the section 861 rules for another operative section of the code (for example, foreign tax credit, computation of earnings and profits, and branch profits), it must use the same method and principles for all operative sections. Treasury and the IRS have requested comments on whether there should be restrictions on a taxpayer’s ability to change from one allocation or apportionment method to another. Any suggestion that taxpayers are not able to change their methods of allocation or apportionment under section 861 from year to year is a significant change to current practice under section 861.

Simplified deduction method: A taxpayer with average annual gross receipts of $25 million or less (determined at the expanded affiliated group (EAG) level), may elect to ratably apportioned deductions between DPGR and other receipts based on relative gross receipts.

Small business simplified overall method: A taxpayer that has average annual gross receipts of $5 million or less (determined at the EAG level), or a taxpayer that is eligible to use the cash method as provided in Rev. Proc. 2002-28, 2002-1 C.B. 815, Doc 2002-9029, 2002 TNT 72-6, may elect to ratably apportion total CGS and deductions between DPGR and other receipts based on relative gross receipts.

A member of an EAG that qualifies for either of the simplified methods may use the simplified method only if all members of the EAG do so.

The notice clarifies that some deductions (for example, some section 165 losses, section 172 net operating loss deductions, and deductions not attributable to the actual conduct of a trade or business) do not reduce DPGR or gross income attributable to DPGR under any of the above three methods.

E. Application of Section 199 to Passthrough Entities

The section 199 deduction is applied at the shareholder, partner, or similar level. Notice 2005-14 provides that each owner may compute its section 199 deduction by taking into account its distributive or proportionate share of the items allocated or attributable to the passthrough entity’s activities described in section 199(c)(4), provided the items are not otherwise disallowed by the code. The owner of the passthrough entity must aggregate its items of income or expense allocated or attributable to the passthrough entity’s qualified production activities, including those expenses incurred by the owner
of the passthrough entity directly that are allocated to the passthrough entity’s qualified production activities, and the owner’s items of income or expense allocated or attributable to its other qualified production activities.

The notice states that QPAI generally does not include gain or loss recognized on the sale, exchange, or other disposition of an interest in the entity. However, if section 751(a) or (b) applies, gain or loss allocated to assets of the partnership, the sale, exchange, or other disposition of which would give rise to an item of QPAI is taken into account in computing the partner’s section 199 deduction.

The notice clarifies that section 199 applies only to tax years of passthrough entities that begin on or after January 1, 2005. Thus, for example, if a passthrough entity has a tax year beginning September 30, 2004, and ending September 30, 2005, and the owners of the passthrough are calendar-year taxpayers, the provisions of section 199 do not apply to the passthrough entity until its tax year beginning October 1, 2005.

F. EAGs

Section 199(d)(4)(A) provides that all members of an EAG are treated as a single corporation for purposes of section 199. Section 199(d)(4)(B) provides that an EAG is an affiliated group as defined in section 1504(a), determined by substituting 50 percent for 80 percent each place it appears and without regard to section 1504(b)(2) and (4). The section 199 deduction is allocated among the members of the EAG in proportion to each member’s respective amount of QPAI.

Notice 2005-14 provides that a member’s QPAI is the member’s DPGR less the sum of the CGS allocable to the receipts and other costs required to be allocated to DPGR. A member’s QPAI may be positive or negative and the member’s taxable income or loss and QPAI will be determined by reference to the member’s methods of accounting. However, under section 199(c)(7)(A), a member’s DPGR will not include any gross receipts of the member derived from property leased, licensed, or rented by it for use by any related person as defined in section 199(c)(7)(B).

For purposes of determining whether gross receipts are DPGR, the notice provides that each member of an EAG should be treated as conducting the activities conducted by each other member of the EAG. Thus, for example, Corporation A, manufacturer of QPP, and Corporation B, reseller of A’s QPP, are members of the same EAG, but do not file a consolidated return. But for this rule, B would not qualify for the section 199 deduction. However, under this provision, B, as a member of the same EAG as A, is treated as conducting A’s manufacturing activities such that B’s gross receipts attributable to the sale of QPP purchased from A are DPGR (assuming all other requirements of section 199 are met).

Notice 2005-14 provides that the EAG’s section 199 deduction is allocated among the EAG members in proportion to each member’s QPAI, regardless of whether the EAG member has taxable income or loss for the tax year and regardless of whether the EAG member has W-2 wages for the tax year. Accordingly, if a member has negative QPAI, the member’s QPAI
will be treated as zero. Under Notice 2005-14, members of a consolidated group are treated as a single member of the EAG. Thus, if an EAG includes corporations that are members of a consolidated group and corporations that are not members of a consolidated group, in determining the taxable income limitation of the EAG, the consolidated taxable income of the consolidated group, not the separate taxable income of the members of the consolidated group members, is taken into account.

Under Notice 2005-14, a corporation’s status as a member of an EAG must be determined on a daily basis. For example, a corporation may be an EAG member on January 1, but not a member on January 2. If a corporation becomes or ceases to be an EAG member, the corporation is treated as becoming or ceasing to be a member at the end of the day on which its status as a member changes.

A corporation that is a member of an EAG for a portion of the tax year must allocate its taxable income or loss, QPAI, and W-2 wages between the portion of the tax year during which it is an EAG member and the portion of the tax year during which it is not an EAG member. That allocation is generally done on a pro rata basis. However, the corporation may elect to use a closing of the books method, under which the taxable income or loss, QPAI, and W-2 wages for the period during which the corporation was an EAG member are calculated treating the corporation’s tax year as two separate tax years, the first of which ends at the close of the day on which the corporation’s status as an EAG member changes and the second of which begins at the beginning of the day after the corporation’s status as an EAG member changes.

Under Notice 2005-14, if a corporation is an EAG member for its entire tax year, its section 199 deduction for the tax year is the amount of the section 199 deduction of the EAG allocated to the corporation by the EAG. If a corporation is an EAG member for a portion of its tax year, and is either not a member of any EAG, or is a member of another EAG, or both, for another portion of the tax year, the corporation’s section 199 deduction for the tax year is the sum of its section 199 deductions for each portion of the tax year.

The notice also provides that if EAG members have different tax years, in determining the section 199 deduction of a member (the computing member), for each EAG member, the computing member must take into account the taxable income or loss, QPAI, and W-2 wages that are both (1) attributable to the period during which the EAG member and the computing member are both EAG members, and (2) taken into account in a tax year that begins after the effective date of section 199 and ends with or within the tax year of the computing member for which the section 199 deduction is computed.

III. Conclusion

Notice 2005-14 is detailed and provides answers to many of the questions that arose as a result of the enactment of section 199. In that respect, Treasury and the IRS were responsive to the need of taxpayers to have definitive answers as quickly as possible following the enactment of section 199. Nevertheless, many issues remain unresolved and much of the guidance relies on taxpayers using a “reasonable method.” Presumably, future guidance will provide more
clarity and certainty for taxpayers in computing the section 199 production deduction.

The goal of much of the recent guidance issued by Treasury and the IRS has been to create tax simplification and to minimize controversy by providing administrable rules. Notice 2005-14 does include some practical administrable guidance. However, the computation of the section 199 production deduction will require taxpayers to spend valuable time and resources gathering and analyzing information that was not previously required to determine the taxpayer’s tax compliance burdens. Moreover, controversy will likely exist as taxpayers and the IRS struggle to reach agreement on what is, for example, “reasonable” in light of the existing facts and circumstances, or decide to test the boundaries of existing tax principles already the subject of dispute, but nevertheless “borrowed” for purposes of section 199.