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# REG-136459-09

This document contains proposed amendments to §§1.199-0, 1.199-1, 1.199-2, 1.199-3, 1.199-4(b), 1.199-6, and 1.199-8(i) of the Income Tax Regulations (26 CFR part 1). Section 1.199-1 relates to income that is attributable to domestic production activities. Section 1.199-2 relates to W-2 wages as defined in section 199(b). Section 1.199-3 relates to determining domestic production gross receipts (DPGR). Section 1.199-4(b) describes the costs of goods sold allocable to DPGR. Section 1.199-6 applies to agricultural and horticultural cooperatives. Section 1.199-8(i) provides the effective/applicability dates.

Section 199 was added to the Code by section 102 of the American Jobs Creation Act of 2004 (Pub. L. 108-357, 118 Stat. 1418 (2004)), and amended by section 403(a) of the Gulf Opportunity Zone Act of 2005 (Pub. L. 109-135, 119 Stat. 25 (2005)), section 514 of the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. 109-222, 120 Stat. 345 (2005)), section 401 of the Tax Relief and Health Care Act of 2006 (Pub. L. 109-432, 120 Stat. 2922 (2006)), section 401(a), Division B of the Energy Improvement and Extension Act of 2008 (Pub. L. 110-343, 122 Stat. 3765 (2008)) (Energy Extension Act of 2008), sections 312(a) and 502(c), Division C of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (Pub. L. 110-343, 122 Stat. 3765 (2008)) (Tax Extenders Act of 2008), section 746(a) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. 111-312, 124 Stat. 3296 (2010)), section 318 of the American Taxpayer Relief Act of 2012 (Pub. L. 112-240, 126 Stat. 2313 (2013)), and sections 130 and 219(b) of the Tax Increase Prevention Act of 2014 (Pub. L. 113-295, 128 Stat. 4010 (2014)).

General Overview

Section 199(a)(1) allows a deduction equal to nine percent (three percent in the case of taxable years beginning in 2005 or 2006, and six percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of: (A) The qualified production activities income (QPAI) of the taxpayer for the taxable year, or (B) taxable income (determined without regard to section 199) for the taxable year (or, in the case of an individual, adjusted gross income).

Section 199(b)(1) provides that the amount of the deduction allowable under section 199(a) for any taxable year shall not exceed 50 percent of the W-2 wages of the taxpayer for the taxable year. Section 199(b)(2)(A) generally defines W-2 wages, with respect to any person for any taxable year of such person, as the sum of amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Section 199(b)(3), after its amendment by section 219(b) of the Tax Increase Prevention Act of 2014, provides that the Secretary shall provide for the application of section 199(b) in cases of a short taxable year or where the taxpayer acquires, or disposes of, the major portion of a trade or business, or the major portion of a separate unit of a trade or business during the taxable year. Section 199(b)(2)(B) limits the W-2 wages to those properly allocable to DPGR for taxable years beginning after May 17, 2006.

Section 199(c)(1) defines QPAI for any taxable year as an amount equal to the excess (if any) of: (A) The taxpayer's DPGR for such taxable year, over (B) the sum of: (i) The cost of goods sold (CGS) that are allocable to such receipts; and (ii) other expenses, losses, or deductions (other than the deduction under section 199) that are properly allocable to such receipts.

Section 199(c)(4)(A)(i) provides that the term DPGR means the taxpayer's gross receipts that are derived from any lease, rental, license, sale, exchange, or other disposition of: (I) Qualifying production property (QPP) that was manufactured, produced, grown, or extracted (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 (utilities) produced by the taxpayer in the United States.

Section 199(d)(10), as renumbered by section 401(a), Division B of the Energy Extension Act of 2008, authorizes the Secretary to prescribe such regulations as are necessary to carry out the purposes of section 199, including regulations that prevent more than one taxpayer from being allowed a deduction under section 199 with respect to any activity described in section 199(c)(4)(A)(i).

Explanation of Provisions

1. Allocation of W-2 Wages in a Short Taxable Year and in an Acquisition or Disposition of a Trade or Business (or Major Portion)

Temporary regulations in the Rules and Regulations section of this issue of the Federal Register contain amendments to the Income Tax Regulations that provide rules clarifying how taxpayers calculate W-2 wages for purposes of the W-2 wage limitation under section 199(b)(1) in the case of a short taxable year or where a taxpayer acquires, or disposes of, the major portion of a trade or business, or the major portion of a separate unit of a trade or business during the taxable year under section 199(b)(3). The text of those regulations serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

2. Oil Related Qualified Production Activities Income

Section 401(a), Division B of the Energy Extension Act of 2008 added new section 199(d)(9), which applies to taxable years beginning after December 31, 2008. Section 199(d)(9) reduces the otherwise allowable section 199 deduction when a taxpayer has oil related qualified production activities income (oil related QPAI), and defines oil related QPAI. Section 199(d)(9)(A) provides that if a taxpayer has oil related QPAI for any taxable year beginning after 2009, the amount otherwise allowable as a deduction under section 199(a) must be reduced by three percent of the least of: (i) The oil related QPAI of the taxpayer for the taxable year, (ii) the QPAI of the taxpayer for the taxable year, or (iii) taxable income (determined without regard to section 199).

Section 1.199-1(f) of the proposed regulations provides guidance on oil related QPAI. In defining oil related QPAI, the Treasury Department and the IRS considered the relationship between QPAI and oil related QPAI. Section 199(c)(1) defines QPAI as the amount equal to the excess (if any) of the taxpayer's DPGR for the taxable year over the sum of CGS allocable to such receipts and other costs, expenses, losses, and deductions allocable to such receipts. So, for example, if gross receipts are not included within DPGR, those gross receipts are not included when calculating QPAI. Section 199(d)(9)(B) defines oil related QPAI as QPAI attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof. In general, gross receipts from the transportation and distribution of QPP are not includable in DPGR because those activities are not considered part of the MPGE of QPP. See

§1.199-3(e)(1), which defines MPGE. Section 199(c)(4)(B)(ii) specifically excludes gross receipts attributable to the transmission or distribution of natural gas from the definition of DPGR.

Based on these considerations, the proposed regulations define oil related QPAI as an amount equal to the excess (if any) of the taxpayer's DPGR from the production, refining, or processing of oil, gas, or any primary product thereof (oil related DPGR) over the sum of the CGS that is allocable to such receipts and other expenses, losses, or deductions that are properly allocable to such receipts. The proposed regulations specifically provide that oil related DPGR does not include gross receipts derived from the transportation or distribution of oil, gas, or any primary product thereof, except if the de minimis rule under §1.199-1(d)(3)(i) or an exception for embedded services applies under §1.199-3(i)(4)(i)(B). The proposed regulations further provide that, to the extent a taxpayer treats gross receipts derived from the transportation or distribution of oil, gas, or any primary product thereof as DPGR under §1.199-1(d)(3)(i) or §1.199-3(i)(4)(i)(B), the taxpayer must include those gross receipts in oil related DPGR.

The proposed regulations define oil as including oil recovered from both conventional and non-conventional recovery methods, including crude oil, shale oil, and oil recovered from tar/oil sands. Section 199(d)(9)(C) defines primary product as having the same meaning as when used in section 927(a)(2)(C) (relating to property excluded from the term export property under the former foreign sales corporations rules), as in effect before its repeal. The proposed regulations incorporate the rules in §1.927(a)-1T(g)(2)(i) regarding the definition of a primary product with modifications that are consistent with the definition of oil for purposes of section 199(d)(9).

Section 1.199-1(f)(2) of the proposed regulations provides guidance on how a taxpayer should allocate and apportion costs under the section 861 method, the simplified deduction method, and the small business simplified overall method when determining oil related QPAI. The proposed regulations require taxpayers to use the same cost allocation method to allocate and apportion costs to oil related DPGR as the taxpayer uses to allocate and apportion costs to DPGR.

3. Qualified Films

a. Statutory Amendments

Section 502(c), Division C of the Tax Extenders Act of 2008 amended the rules relating to qualified films. Section 502(c)(1) added section 199(b)(2)(D) to broaden the definition of the term W-2 wages as applied to a qualified film to include compensation for services performed in the United States by actors, production personnel, directors, and producers.

Section 502(c)(2), Division C of the Tax Extenders Act of 2008 amended the definition of qualified film in section 199(c)(6) to mean any property described in section 168(f)(3) if not less than 50 percent 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. The term does not include property with respect to which records are required to be maintained under 18 U.S.C. 2257 (generally, films, videotapes, or other matter that depict actual sexually explicit conduct and are produced in whole or in part with materials that have been mailed or shipped in interstate or foreign commerce, or are shipped or transported or are intended for shipment or transportation in interstate or foreign commerce). Section 502(c)(2), Division C of the Tax Extenders Act of 2008 also amended the definition of a qualified film under section 199(c)(6) to include any copyrights, trademarks, or other intangibles with respect to such film. The method and means of distributing a qualified film does not affect the availability of the deduction.

Section 502(c)(3), Division C of the Tax Extenders Act of 2008 added an attribution rule for a qualified film for taxpayers who are partnerships or S corporations, or partners or shareholders of such entities under section 199(d)(1)(A)(iv). Section 199(d)(1)(A)(iv) provides that in the case of each partner of a partnership, or shareholder of an S corporation, who owns (directly or indirectly) at least 20 percent of the capital interests in such partnership or the stock of such S corporation, such partner or shareholder is treated as having engaged directly in any film produced by such partnership or S corporation, and that such partnership or S Corporation is treated as having engaged directly in any film produced by such partner or shareholder.

The amendments made by section 502(c), Division C of the Tax Extenders Act of 2008 apply to taxable years beginning after December 31, 2007.

b. W-2 Wages

Section 1.199-2(e)(1) of the proposed regulations modifies the definition of W-2 wages to include compensation for services (as defined in §1.199-3(k)(4)) performed in the United States by actors, production personnel, directors, and producers (as defined in §1.199-3(k)(1)).

c. Definition of Qualified Films

To address the amendments to the definition of qualified film in section 199(c)(6) for taxable years beginning after 2007, the proposed regulations amend the definition of qualified film in §1.199-3(k)(1) to include copyrights, trademarks, or other intangibles with respect to such film. The proposed regulations define other intangibles with a non-exclusive list of intangibles that fall within the definition.

Section 1.199-3(k)(10) provides a special rule for disposition of promotional films to address concerns of the Treasury Department and the IRS that the inclusion of intangibles in the definition of qualified film could be interpreted too broadly. This rule clarifies that, when a taxpayer produces a qualified film that is promoting a product or service, the gross receipts a taxpayer later derives from the disposition of the product or service promoted in the qualified film are derived from the disposition of the product or service and not from a disposition of the qualified film (including any intangible with respect to such qualified film). The rule is intended to prevent taxpayers from claiming that gross receipts are derived from the disposition of a qualified film (rather than the product or service itself) when a taxpayer sells a product or service with a logo, trademark, or other intangible that appears in a promotional film produced by the taxpayer. The Treasury Department and the IRS recognize that a taxpayer can, in certain cases, derive gross receipts from a disposition of a promotional film or the intangibles in a promotional film. The proposed regulations add Example 9 in §1.199-3(k)(11) relating to a license to reproduce a character used in a promotional film to illustrate a situation where gross receipts can qualify as DPGR because the gross receipts are distinct (separate and apart) from the disposition of the product or service. The Treasury Department and the IRS request comments on how to determine when gross receipts are distinct.

The proposed regulations add four examples in redesignated § 1.199-3(k)(11), formerly §1.199-3(k)(10), to illustrate application of the amended definition of qualified film that includes copyrights, trademarks, or other intangibles.

The proposed regulations remove the last sentence of §1.199-3(k)(3)(ii) (which states that gross receipts derived from a license of the right to use or exploit film characters are not gross receipts derived from a qualified film) because gross receipts derived from a license of the right to use or exploit film characters are now considered gross receipts derived from a qualified film.

Section 1.199-3(k)(2)(ii), which allows a taxpayer to treat certain tangible personal property as a qualified film (for example, a DVD), is amended to exclude film intangibles because tangible personal property affixed with a film intangible (such as a trademark) should not be treated as a qualified film. For example, the total revenue from the sale of an imported t-shirt affixed with a film intangible should not be treated as gross receipts derived from the sale of a qualified film. The portion of the gross receipts attributable to the qualified film intangible separate from receipts attributable to the t-shirt may qualify as DPGR, however. The proposed regulations also add Example 10 and Example 11 in redesignated §1.199-3(k)(11) to address situations in which tangible personal property is offered for sale in combination with a qualified film affixed to a DVD.

Section 1.199-3(k)(3)(i) and (k)(3)(ii) of the proposed regulations address the amendment to section 199(c)(6) (effective for taxable years beginning after 2007) that provides the methods and means of distributing a qualified film will not affect the availability of the deduction under section 199. The exception that describes the receipts from showing a qualified film in a movie theater or by broadcast on a television station as not derived from a qualified film is removed from §1.199-3(k)(3)(ii) because, if a taxpayer produces a qualified film, then the receipts the taxpayer derives from these showings qualify as DPGR in taxable years beginning after 2007. In addition, Example 4 in §1.199-3(i)(5)(iii) and Example 3 in §1.199-3(k)(11) (formerly §1.199-3(k)(10)) have been revised to illustrate that, for taxable years beginning after 2007, product placement and advertising income derived from the distribution of a qualified film qualifies as DPGR if the qualified film containing the product placements and advertising is broadcast over the air or watched over the Internet.

The proposed regulations also add a sentence to §1.199-3(k)(6) to clarify that production activities do not include activities related to the transmission or distribution of films. The Treasury Department and the IRS are aware that some taxpayers have taken the inappropriate position that these activities are part of the production of a film. The Treasury Department and the IRS consider film production as distinct from the transmission and distribution of films. This clarification is also consistent with the amendment to the definition of qualified film, which provides that the methods and means of distribution do not affect the availability of the deduction under section 199.

d. Partnerships and S Corporations

Section 1.199-3(i)(9) of the proposed regulations describes the application of section 199(d)(1)(A)(iv) to partners and partnerships and shareholders and S corporations for taxable years beginning after 2007. The Treasury Department and the IRS have determined that for a partnership to apply the provisions of section 199(d)(1)(A)(iv) to treat itself as having engaged directly in a film produced by a partner, the partnership must treat itself as a partnership for all purposes of the Code. Further, a partner of a partnership can apply the provisions of section 199(d)(1)(A)(iv) to treat itself as having engaged directly in a film produced by the partnership only if the partnership treats itself as a partnership for all purposes of the Code. Section 1.199-3(i)(9)(i) describes generally that a partner of a partnership or shareholder of an S corporation who owns (directly or indirectly) at least 20 percent of the capital interests in such partnership or the stock of such S corporation is treated as having engaged directly in any film produced by such partnership or S corporation. Further, such partnership or S corporation is treated as having engaged directly in any film produced by such partner or shareholder.

Section 1.199-3(i)(9)(ii) of the proposed regulations generally prohibits attribution between partners of a partnership or shareholders of an S corporation, partnerships with a partner in common, or S corporations with a shareholder in common. Thus, when a partnership or S corporation is treated as having engaged directly in any film produced by a partner or shareholder, any other partners or shareholders who did not participate directly in the production of the film are treated as not having engaged directly in the production of the film at the partner or shareholder level. Similarly, when a partner or shareholder is treated as having engaged directly in any film produced by a partnership or S corporation, any other partnerships or S corporations in which that partner or shareholder owns an interest (excluding the partnership or S corporation that produced the film) are treated as not having engaged directly in the production of the film at the partnership or S corporation level.

Section 1.199-3(i)(9)(iii) of the proposed regulations describes the attribution period for a partner or partnership or shareholder or S corporation under section 199(d)(1)(A)(iv). A partner or shareholder is treated as having engaged directly in any qualified film produced by the partnership or S corporation, and a partnership or S corporation is treated as having engaged directly in any qualified film produced by the partner or shareholder, regardless of when the qualified film was produced, during the period in which the partner or shareholder owns (directly or indirectly) at least 20 percent of the capital interests in the partnership or the stock of the S corporation. During any period that a partner or shareholder owns less than 20 percent of the capital interests in such partnership or the stock of such S corporation that partner or shareholder is not treated as having engaged directly in the qualified film produced by the partnership or S corporation for purposes of §1.199-3(i)(9)(iii), and that partnership or S corporation is not treated as having engaged directly in any qualified film produced by the partner or shareholder.

Section 1.199-3(i)(9)(iv) of the proposed regulations provides examples that illustrate section 199(d)(1)(A)(iv).

e. Qualified Film Safe Harbor

Existing §1.199-3(k)(7)(i) provides a safe harbor that treats a film 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 §1.199-3(g)(3) for treating a taxpayer as MPGE QPP in whole or significant part in the United States. The Treasury Department and the IRS are aware that it may be unclear how the safe harbor in §1.199-3(k)(7)(i) applies to costs of live or delayed television programs that may be expensed (specifically, whether such expensed costs are part of the CGS or unadjusted depreciable basis of the qualified film for purposes of §1.199-3(g)(3)). Further, it may be unclear whether license fees paid for third-party produced programs are included in direct labor and overhead when applying the safe harbor in §1.199-3(g)(3). The proposed regulations clarify how a taxpayer producing live or delayed television programs should apply the safe harbor in §1.199-3(k)(7)(i); in particular, how a taxpayer should calculate its unadjusted depreciable basis under §1.199-3(g)(3)(ii). Specifically, proposed §1.199-3(k)(7)(i) requires a taxpayer to include all costs paid or incurred in the production of a live or delayed television program in the taxpayer's unadjusted depreciable basis of such program under §1.199-3(g)(3)(ii), including the licensing fees paid to a third party under §1.199-3(g)(3)(ii). The proposed regulations further clarify that license fees for third-party produced programs are not included in the direct labor and overhead to produce the film for purposes of applying §1.199-3(g)(3).

4. Treatment of Activities in Puerto Rico

Section 199(d)(8)(A) provides that in the case of any taxpayer with gross receipts for any taxable year from sources within the Commonwealth of Puerto Rico, if all of such receipts are taxable under section 1 or 11 for such taxable year, then for purposes of determining the DPGR of such taxpayer for such taxable year under section 199(c)(4), the term United States includes the Commonwealth of Puerto Rico. Section 199(d)(8)(B) provides that in the case of a taxpayer described in section 199(d)(8)(A), for purposes of applying the wage limitation under section 199(b) for any taxable year, the determination of W-2 wages of such taxpayer is made without regard to any exclusion under section 3401(a)(8) for remuneration paid for services performed in Puerto Rico. Section 130 of the Tax Increase Prevention Act of 2014 amended section 199(d)(8)(C) for taxable years beginning after December 31, 2013. As amended, section 199(d)(8)(C) provides that section 199(d)(8) applies only with respect to the first nine taxable years of the taxpayer beginning after December 31, 2005, and before January 1, 2015.

Section 1.199-2(f) of the proposed regulations modifies the W-2 wage limitation under section 199(b) to the extent provided by section 199(d)(8). Section 1.199-3(h)(2) of the proposed regulations modifies the term United States to include the Commonwealth of Puerto Rico to the extent provided by section 199(d)(8).

5. Determining DPGR on Item-by-Item Basis

Section 1.199-3(d)(1) provides that 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. Section 1.199-3(d)(1)(i) provides that 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 §1.199-3(d), collectively referred to as disposition) to customers, if the gross receipts from the disposition of such property qualify as DPGR. Section 1.199-3(d)(2)(iii) provides that, 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.

The Treasury Department and the IRS are aware that the item rule in §1.199-3(d)(2)(iii) has been interpreted to mean that the gross receipts derived from the sale of a multiple-building project may be treated as DPGR when only one building in the project is substantially renovated. The Treasury Department and the IRS have concluded that treating gross receipts from the sale of a multiple-building project as DPGR, and the multiple-building project as one item, is not a reasonable method satisfactory to the Secretary for purposes of § 1.199-3(d)(2)(iii) if a taxpayer did not substantially renovate each building in the multiple-building project. Section 1.199-3(d)(4) of the proposed regulations includes an example (Example 14) illustrating the appropriate application of §1.199-3(d)(2)(iii) to a multiple building project.

In addition, the Treasury Department and the IRS are aware that taxpayers may be unsure how to apply the item rule in §1.199-3(d)(2)(i) when the property offered for disposition to customers includes embedded services as described in §1.199-3(i)(4)(i). The proposed regulations add Example 6 to §1.199-3(d)(4) to clarify that the item rule applies after excluding the gross receipts attributable to services.

6. MPGE

Section 1.199-3(e)(1) provides that 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 Treasury Department and the IRS are aware that Example 5 in §1.199-3(e)(5) has been interpreted to mean that testing activities qualify as an MPGE activity even if the taxpayer engages in no other MPGE activity. The Treasury Department and the IRS disagree that testing activities, alone, qualify as an MPGE activity. The proposed regulations add a sentence to Example 5 in §1.199-3(e)(5) to further illustrate that certain activities will not be treated as MPGE activities if they are not performed as part of the MPGE of QPP. Taxpayers are not required to allocate gross receipts to certain activities that are not MPGE activities when those activities are performed in connection with the MPGE of QPP. However, if the taxpayer in Example 5 in §1.199-3(e)(5) did not MPGE QPP, then the activities described in the example, including testing, are not MPGE activities.

Section 1.199-3(e)(2) provides that if a taxpayer packages, repackages, labels, or performs minor assembly of QPP and the taxpayer engages in no other MPGE activities with respect to that QPP, the taxpayer's packaging, repackaging, labeling, or minor assembly does not qualify as MPGE with respect to that QPP. This rule has been the subject of recent litigation. See United States v. Dean, 945 F. Supp. 2d 1110 (C.D. Cal. 2013) (concluding that the taxpayer's activity of preparing gift baskets was a manufacturing activity and not solely packaging or repackaging for purposes of section 199). The Treasury Department and the IRS disagree with the interpretation of §1.199-3(e)(2) adopted by the court in United States v. Dean, and the proposed regulations add an example (Example 9) that illustrates the appropriate application of this rule in a situation in which the taxpayer is engaged in no other MPGE activities with respect to the QPP other than those described in §1.199-3(e)(2).

7. Definition of "by the taxpayer"

Section 1.199-3(f)(1) provides that if one taxpayer performs a qualifying activity under §1.199-3(e)(1), §1.199-3(k)(1), or §1.199-3(l)(1) 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.

Taxpayers and the IRS have had difficulty determining which party to a contract manufacturing arrangement has the benefits and burdens of ownership of the property while the qualifying activity occurs. Cases analyzing the benefits and burdens of ownership have considered the following factors relevant: (1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity interest was acquired; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser and which party has control of the property or process; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; (8) which party receives the profits from the operation and sale of the property; and (9) whether a taxpayer actively and extensively participated in the management and operations of the activity. See ADVO, Inc. & Subsidiaries v. Commissioner, 141 T.C. 298, 324-25 (2013); see also Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981). The ADVO court noted that the factors it used in its analysis are not exclusive or controlling, but that they were in the particular case sufficient to determine which party had the benefits and burdens of ownership. ADVO, Inc., 141 T.C. at 325 n. 21. Determining which party has the benefits and burdens of ownership under Federal income tax principles for purposes of section 199 requires an analysis and weighing of many factors, which in some contexts could result in more than one taxpayer claiming the benefits of section 199 with respect to a particular activity. Resolving the benefits and burdens of ownership issue often requires significant IRS and taxpayer resources.

Section 199(d)(10) directs the Treasury Department to provide regulations that prevent more than one taxpayer from being allowed a deduction under section 199 with respect to any qualifying activity (as described in section 199(c)(4)(A)(i)). The Treasury Department and the IRS have interpreted the statute to mean that only one taxpayer may claim the section 199 deduction with respect to the same activity performed with respect to the same property. See §1.199-3(f)(1). Example 1 and Example 2 in §1.199-3(f)(4) currently illustrate this one-taxpayer rule using factors that are relevant to the determination of who has the benefits and burdens of ownership.

The Large Business and International (LB&I) Division issued an Industry Director Directive on February 1, 2012 (LB&I Control No. LB&I-4-0112-01) (Directive) addressing the benefits and burdens factors. The Directive provides a three-step analysis of facts and circumstances relating to contract terms, production activities, and economic risks to determine whether a taxpayer has the benefits and burdens of ownership for purposes of §1.199-3(f)(1). LB&I issued a superseding second directive on July 24, 2013 (LB&I Control No. LB&I-04-0713-006), and a third directive updating the second directive on October 29, 2013 (LB&I Control No. LB&I-04-1013-008). The third directive allows a taxpayer to provide a statement explaining the taxpayer's determination that it had the benefits and burdens of ownership, along with certification statements signed under penalties of perjury by the taxpayer and the counterparty verifying that only the taxpayer is claiming the section 199 deduction.

To provide administrable rules that are consistent with section 199, reduce the burden on taxpayers and the IRS in evaluating factors related to the benefits and burdens of ownership, and prevent more than one taxpayer from being allowed a deduction under section 199 with respect to any qualifying activity, the proposed regulations remove the rule in §1.199-3(f)(1) that treats a taxpayer in a contract manufacturing arrangement as engaging in the qualifying activity only if the taxpayer has the benefits and burdens of ownership during the period in which the qualifying activity occurs. In place of the benefits and burdens of ownership rule, these proposed regulations provide that if a qualifying activity is performed under a contract, then the party that performs the activity is the taxpayer for purposes of section 199(c)(4)(A)(i). This rule, which applies solely for purposes of section 199, reflects the conclusion that the party actually producing the property should be treated as engaging in the qualifying activity for purposes of section 199, and is therefore consistent with the statute's goal of incentivizing domestic manufacturers and producers. The proposed rule would also provide a readily administrable approach that would prevent more than one taxpayer from being allowed a deduction under section 199 with respect to any qualifying activity.

Example 1 has been revised, and current Example 2 has been removed, to reflect the new rule. In addition, the benefits and burdens language has been removed from: (1) The definition of MPGE in §1.199-3(e)(1) and (3), including Example 1, Example 4, and Example 5 in § 1.199-3(e)(5); (2) the definition of in whole or in significant part in §1.199-3(g)(1); (3) Example 5 in the qualified film rules in existing §1.199-3(k)(7); and (4) the production pursuant to a contract in the qualified film rules in §1.199-3(k)(8).

The Treasury Department and the IRS request comments on whether there are narrow circumstances that could justify an exception to the proposed rule. In particular, the Treasury Department and the IRS request comments on whether there should be a limited exception to the proposed rule for certain fully cost-plus or cost-reimbursable contracts. Under such an exception, the party that is not performing the qualifying activity would be treated as the taxpayer engaged in the qualifying activity if the party performing the qualifying activity is (i) reimbursed for, or provided with, all materials, labor, and overhead costs related to fulfilling the contract, and (ii) provided with an additional payment to allow for a profit. The Treasury Department and the IRS are uncertain regarding the extent to which such fully cost-plus or cost-reimbursable contracts are in fact used in practice. Comments suggesting circumstances that could justify an exception to the proposed rule should address the rationale for the proposed exception, the ability of the IRS to administer the exception, and how the suggested exception will prevent two taxpayers from claiming the deduction for the qualifying activity.

8. Hedging Transactions

The proposed regulations make several revisions to the hedging rules in §1.199-3(i)(3). Section 1.199-3(i) of the proposed regulations defines a hedging transaction to include transactions in which the risk being hedged relates to property described in section 1221(a)(1) giving rise to DPGR, whereas the existing regulations require the risk being hedged relate to QPP described in section 1221(a)(1). A taxpayer commented in a letter to the Treasury Department and the IRS that there is no reason to limit the hedging rules to QPP giving rise to DPGR, and the proposed regulations accept the comment.

The other changes to the hedging rules are administrative. Section 1.199-3(i)(3)(ii) of the existing regulations on currency fluctuations was eliminated because the regulations under sections 988(d) and 1221 adequately cover the treatment of currency hedges. Similarly, the rules in §1.199-3(i)(3)(iii) that address the effect of identification and non-identification were duplicative of the rules in the section 1221 regulations. Accordingly, §1.199-3(i)(3)(ii) has been revised to cross-reference the appropriate rules in §1.1221-2(g), and to clarify that the consequence of an abusive identification or non-identification is that deduction or loss, but not income or gain, is taken into account in calculating DPGR.

9. Construction Activities

Section 199(c)(4)(A)(ii) includes in DPGR, in the case of a taxpayer engaged in the active conduct of a construction trade or business, gross receipts derived from construction of real property performed in the United States by the taxpayer in the ordinary course of such trade or business. Under §1.199-3(m)(2)(i), activities constituting construction include activities performed by a general contractor or 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 progress of the construction project, and required job modifications. The Treasury Department and the IRS are aware that some taxpayers have interpreted this language to mean that a taxpayer who only approves or authorizes payments is engaged in activities typically performed by a general contractor under §1.199-3(m)(2)(i). The Treasury Department and the IRS disagree that a taxpayer who only approves or authorizes payments is engaged in construction for purposes of § 1.199-3(m)(2)(i). Accordingly, §1.199-3(m)(2)(i) of the proposed regulations clarifies that a taxpayer must engage in construction activities that include more than the approval or authorization of payments or invoices for that taxpayer's activities to be considered as activities typically performed by a general contractor.

Section 1.199-3(m)(2)(i) provides that activities constituting construction are activities performed in connection with a project to erect or substantially renovate real property. Section 1.199-3(m)(5) currently defines substantial renovation to mean 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. This standard reflects regulations under §1.263(a)-3 related to amounts paid to improve tangible property that existed at the time of publication of the final §1.199-3(m)(5) regulations (TD 9263 [71 FR 31268] June 19, 2006) but which have since been revised. See (TD 9636 [78 FR 57686] September 19, 2013).

The proposed regulations under §1.199-3(m)(5) revise the definition of substantial renovation to conform to the final regulations under §1.263(a)-3, which provide rules requiring capitalization of amounts paid for improvements to a unit of property owned by a taxpayer. Improvements under §1.263(a)-3 are amounts paid for a betterment to a unit of property, amounts paid to restore a unit of property, and amounts paid to adapt a unit of property to a new or different use. See §1.263(a)-3(j), (k), and (l). Under the proposed regulations, a substantial renovation of real property is a renovation the costs of which are required to be capitalized as an improvement under §1.263(a)-3, other than an amount described in §1.263(a)-3(k)(1)(i) through (iii) (relating to amounts for which a loss deduction or basis adjustment requires capitalization as an improvement). The improvement rules under §1.263(a)-3 provide specific rules of application for buildings (see §1.263(a)-3(j)(2)(ii), (k)(2), and (l)(2)), which apply for purposes of § 1.199-3(m)(5).

10. Allocating Cost of Goods Sold

Section 1.199-4(b)(1) describes how a taxpayer determines its CGS allocable to DPGR. The Treasury Department and the IRS are aware that in the case of transactions accounted for under a long-term contract method of accounting (either the percentage-of-completion method (PCM) or the completed-contract method (CCM)), a taxpayer incurs allocable contract costs. The Treasury Department and the IRS recognize that allocable contract costs under PCM or CCM are analogous to CGS and should be treated in the same manner. Section 1.199-4(b)(1) of the proposed regulations provides that in the case of a long-term contract accounted for under PCM or CCM, CGS for purposes of §1.199-4(b)(1) includes allocable contract costs described in §1.460-5(b) or §1.460-5(d), as applicable.

Existing §1.199-4(b)(2)(i) provides that a taxpayer must use a reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances to allocate CGS between DPGR and non-DPGR. This allocation must be determined based on the rules provided in §1.199-4(b)(2)(i) and (ii). Taxpayers have asserted that under §1.199-4(b)(2)(ii) the portion of current year CGS associated with activities in earlier tax years (including pre-section 199 tax years) may be allocated to non-DPGR even if the related gross receipts are treated by the taxpayer as DPGR. Section 1.199-4(b)(2)(iii)(A) of the proposed regulations clarifies that the CGS must be allocated between DPGR and non-DPGR, regardless of whether any component of the costs included in CGS can be associated with activities undertaken in an earlier taxable year. Section 1.199-4(b)(2)(iii)(B) of the proposed regulations provides an example illustrating this rule.

11. Agricultural and Horticultural Cooperatives

Section 199(d)(3)(A) provides that any person who receives a qualified payment from a specified agricultural or horticultural cooperative must be allowed for the taxable year in which such payment is received a deduction under section 199(a) equal to the portion of the deduction allowed under section 199(a) to such cooperative that is (i) allowed with respect to the portion of the QPAI to which such payment is attributable, and (ii) identified by such cooperative in a written notice mailed to such person during the payment period described in section 1382(d).

Under §1.199-6(c), the cooperative's QPAI is computed without taking into account any deduction allowable under section 1382(b) or section 1382(c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

Section 1.199-6(e) provides that the term qualified payment means any amount of a patronage dividend or per-unit retain allocation, as described in section 1385(a)(1) or section 1385(a)(3), received by a patron from a cooperative that is attributable to the portion of the cooperative's QPAI for which the cooperative is allowed a section 199 deduction. For this purpose, patronage dividends and per-unit retain allocations include any advances on patronage and per-unit retains paid in money during the taxable year.

Section 1388(f) defines the term per-unit retain allocation to mean any allocation by an organization to which part I of subchapter T applies to a patron with respect to products marketed for him, the amount of which is fixed without reference to net earnings of the organization pursuant to an agreement between the organization and the patron. Per-unit retain allocations may be made in money, property, or certificates.

The Treasury Department and the IRS are aware that Example 1 in §1.199-6(m) has been interpreted as describing that the cooperative's payment for its members' corn is a per-unit retain allocation paid in money as defined in sections 1382(b)(3) and 1388(f). Example 1 in §1.199-6(m) does not identify the cooperative's payment for its members' corn as a per-unit retain allocation and is not intended to illustrate how QPAI is computed when a cooperative's payments to its patrons are per-unit retain allocations. The proposed regulations provide an example (Example 4) in §1.199-6(m) illustrating how QPAI is computed when the cooperative's payments to members for corn qualify as per-unit retain allocations paid in money under section 1388(f). The new example has the same facts as Example 1 in §1.199-6(m), except that the cooperative's payments for its members' corn qualify as per-unit retain allocations paid in money under section 1388(f) and the cooperative reports per-unit retain allocations paid in money on Form 1099-PATR, "Taxable Distributions Received From Cooperatives."

Request for Comments

Existing §1.199-3(e)(2) provides that 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.

The term minor assembly for purposes of section 199 was first introduced in Notice 2005-14 (2005-1 CB 498 (February 14, 2005)) (see §601.601(d)(2)(ii)(b)) (Notice 2005-14), and was used (by exclusion) in determining whether a taxpayer met the in-whole-or-in-significant-part requirement. Specifically, section 3.04(5)(d) of Notice 2005-14 states that in connection with the MPGE of QPP, packaging, repackaging, and minor assembly operations should not be considered in applying the general "substantial in nature" test, and the costs should not be considered in applying the safe harbor. The section further states that this rule is similar to the rule in § 1.954-3(a)(4)(iii). The rule in §1.954-3(a)(4)(iii) applies when deciding whether a taxpayer selling property will be treated as selling a manufactured product rather than components of that sold property.

Section 1.199-3(g) of the current regulations, which superseded Notice 2005-14, does not provide a specific definition of minor assembly, but it does allow taxpayers to consider minor assembly activities to determine whether the taxpayer has met the in-whole-or-in-significant-part requirement (either by showing their activities were substantial in nature under §1.199-3(g)(2) or by meeting the safe harbor in §1.199-3(g)(3)). However, the current regulations also contain §1.199-3(e)(2), which excludes certain activities from the definition of MPGE. Section 1.199-3(e)(2) provides that 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. Therefore, a taxpayer with only minor assembly activities would not meet the definition of MPGE and a determination of whether a taxpayer met the in-whole-or-in-significant-part requirement is not made.

In considering whether to provide a specific definition of minor assembly, the Treasury Department and the IRS have found it difficult to identify an objective test that would be widely applicable.

The definition of minor assembly could focus on whether a taxpayer's activity is only a single process that does not transform an article into a materially different QPP. Such process may include, but would not be limited to, blending or mixing two materials together, painting an article, cutting, chopping, crushing (non-agricultural products), or other similar activities. An example of blending or mixing two materials is using a paint mixing machine to combine paint with a pigment to match a customer's color selection when a taxpayer did not MPGE the paint or the pigment. An example of cutting is a taxpayer using an industrial key cutting machine to custom cut keys for customers using blank keys that taxpayer purchased from unrelated third parties. Examples of other similar activities include adding an additive to extend the shelf life of a product and time ripening produce that was purchased from unrelated third parties.

Another possible definition could be based on whether an end user could reasonably engage in the same assembly activity of the taxpayer. For example, assume QPP made up of component parts purchased by taxpayer is sold by a taxpayer to end users in either assembled or disassembled form. To the extent an end user can reasonably assemble the QPP sold in disassembled form, the taxpayer's assembly activity would be considered minor assembly.

The Treasury Department and the IRS request comments on how the term minor assembly in §1.199-3(e)(2) should be defined and encourage the submission of examples illustrating the term.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866 of, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. Comments are requested on all aspects of the proposed regulations. All comments will be available for public inspection and copying at http://www.regulations.gov or upon request.

A public hearing has been scheduled for December 16, 2015, beginning at 10 a.m. in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. In addition, all visitors must present photo identification to enter the building. For information about having your name placed on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments by November 25, 2015, and an outline of the topics to be discussed and the time to be devoted to each topic by November 25, 2015. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is James Holmes, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

1. INCOME TAXES

PAR. 1 The authority citation for part 1 continues to read in part as follows:

26 U.S.C. 7805

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John Dalrymple,

Deputy Commissioner for Services and Enforcement.

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