Reg. Section 1.199-2(e)(2)
Wage limitation

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(e) Definition of W-2 wages.

(1) In general. Under section 199(b)(2), the term W-2 wages means, with respect to any person for any taxable year of such person, the sum of the 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. Thus, the term W-2 wages includes the total amount of wages as defined in section 3401(a); the total amount of elective deferrals (within the meaning of section 402(g)(3)); the compensation deferred under section 457; and for taxable years beginning after December 31, 2005, the amount of designated Roth contributions (as defined in section 402A).

(2) Limitation on W-2 wages for taxable years beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005

(i) In general. The term W-2 wages includes only amounts described in paragraph (e)(1) of this section (paragraph (e)(1) wages) that are properly allocable to domestic production gross receipts (DPGR) (as defined in §1.199-3) for purposes of section 199(c)(1). A taxpayer may determine the amount of paragraph (e)(1) wages that is properly allocable to DPGR using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances.

(ii) Wage expense safe harbor.

(A) In general. A taxpayer using either the section 861 method of cost allocation under §1.199-4(d) or the simplified deduction method under §1.199-4(e) may determine the amount of paragraph (e)(1) wages that is properly allocable to DPGR for a taxable year by multiplying the amount of paragraph (e)(1) wages for the taxable year by the ratio of the taxpayer's wage expense included in calculating qualified production activities income (QPAI) (as defined in §1.199-1(c)) for the taxable year to the taxpayer's total wage expense used in calculating the taxpayer's taxable income (or adjusted gross income, if applicable) for the taxable year, without regard to any wage expense disallowed by section 465, 469, 704(d), or 1366(d). A taxpayer that uses the section 861 method of cost allocation under §1.199-4(d) or the simplified deduction method under § 1.199-4(e) to determine QPAI must use the same expense allocation and apportionment methods that it uses to determine QPAI to allocate and apportion wage expense for purposes of this safe harbor. For purposes of this paragraph (e)(2)(ii), the term wage expense means wages (that is, compensation paid by the employer in the active conduct of a trade or business to its employees) that are properly taken into account under the taxpayer's method of accounting.

(B) Wage expense included in cost of goods sold. For purposes of paragraph (e)(2)(ii)(A) of this section, a taxpayer may determine its wage expense included in cost of goods sold (CGS) using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, such as using the amount of direct labor included in CGS or using section 263A labor costs (as defined in §1.263A-1(h)(4)(ii)) included in CGS.

(iii) Small business simplified overall method safe harbor. A taxpayer that uses the small business simplified overall method under §1.199-4(f) may use the small business simplified overall method safe harbor for determining the amount of paragraph (e)(1) wages that is properly allocable to DPGR. Under this safe harbor, the amount of paragraph (e)(1) wages that is properly allocable to DPGR is equal to the same proportion of paragraph (e)(1) wages that the amount of DPGR bears to the taxpayer's total gross receipts.

(iv) Examples. The following examples illustrate the application of this paragraph (e)(2). See §1.199-5(e)(4) for an example of the application of paragraph (e)(2)(ii) of this section to a trust or estate. The examples read as follows:
Example (1). Section 861 method and no EAG.
(i) Facts. X, a United States corporation that is not a member of an expanded affiliated group (EAG) (as defined in §1.199-7) or an affiliated group as defined in the regulations under section 861, engages in activities that generate both DPGR and non-DPGR. X's taxable year ends on April 30, 2011. For X's taxable year ending April 30, 2011, X has $3,000 of paragraph (e)(1) wages reported on 2010 Forms W-2. All of X's production activities that generate DPGR are within Standard Industrial Classification (SIC) Industry Group AAA (SIC AAA). All of X's production activities that generate non-DPGR are within SIC Industry Group BBB (SIC BBB). X is able to specifically identify CGS allocable to DPGR and to non-DPGR. X incurs $900 of research and experimentation expenses (R&E) that are deductible under section 174, $300 of which are performed with respect to SIC AAA and $600 of which are performed with respect to SIC BBB. None of the R&E is legally mandated R&E as described in §1.861-17(a)(4) and none of the R&E is included in CGS. X incurs section 162 selling expenses that are not includible in CGS and are definitely related to all of X's gross income. For X's taxable year ending April 30, 2011, the adjusted basis of X's assets is $50,000, $40,000 of which generate gross income attributable to DPGR and $10,000 of which generate gross income attributable to non-DPGR. For X's taxable year ending April 30, 2011, the total square footage of X's headquarters is 8,000 square feet, of which 2,000 square feet is set aside for domestic production activities. For its taxable year ending April 30, 2011, X's taxable income is $1,380 based on the following Federal income tax items:

DPGR (all from sales of products within SIC AAA)	$3,000
Non-DPGR (all from sales of products within SIC BBB)	3,000
CGS allocable to DPGR (includes $200 of wage expense)	(600)
CGS allocable to non-DPGR (includes $600 of wage expense)	(1,800)

Section 162 selling expenses (includes $600 of wage expense) (840)
Section 174 R&E-SIC AAA (includes $100 of wage expense) (300)
Section 174 R&E-SIC BBB (includes $200 of wage expense) (600)
Interest expense (not included in CGS) (300)
Headquarters overhead expense (includes $100 of wage expense) (180)
X's taxable income 1,380

(ii) X's QPAI. X allocates and apportions its deductions to gross income attributable to DPGR under the section 861 method in §1.199-4(d). In this case, the section 162 selling expenses and overhead expense are definitely related to all of X's gross income. Based on the facts and circumstances of this specific case, apportionment of the section 162 selling expenses between DPGR and non-DPGR on the basis of X's gross receipts is appropriate. In addition, based on the facts and circumstances of this specific case, apportionment of the headquarters overhead expense between DPGR and non-DPGR on the basis of the square footage of X's headquarters is appropriate. For purposes of apportioning R&E, X elects to use the sales method as described in §1.861-17(c). X elects to apportion interest expense under the tax book value method of §1.861-9T(g). X has $2,400 of gross income attributable to DPGR (DPGR of $3,000 - CGS of $600 allocated based on X's books and records). X's QPAI for its taxable year ending April 30, 2011, is $1,395, as shown in the following table:

DPGR (all from sales of products within SIC AAA) $3,000
CGS allocable to DPGR (600)
Section 162 selling expenses ($840 x ($3,000 DPGR/$6,000 total gross receipts)) (420)
Section 174 R&E-SIC AAA (300)
Interest expense (not included in CGS) ($300 x ($40,000 (X's DPGR assets)/$50,000 (X's total assets))) (240)
Headquarters overhead expense ($180 x (2,000 square feet attributable to DPGR activity/total 8,000 square feet)) (45)
X's QPAI 1,395

(iii) W-2 wages. X chooses to use the wage expense safe harbor under paragraph (e)(2)(ii) of this section to determine its W-2 wages, as shown in the following steps:

(A) Step one. X determines that $625 of wage expense were taken into account in determining its QPAI in paragraph (ii) of this Example 1, as shown in the following table:

CGS wage expense $200
Section 162 selling expenses wage expense ($600 x ($3,000 DPGR/$6,000 total gross receipts)) 300
Section 174 R&E-SIC AAA wage expense 100
Headquarters overhead wage expense ($100 x (2,000 square feet attributable to DPGR activity/ 8,000 total square feet)) 25
Total wage expense taken into account 625

(B) Step two. X determines that $1,042 of the $3,000 in paragraph (e)(1) wages are properly allocable to DPGR, and are therefore W-2 wages, as shown in the following calculation:

Step one wage expense × X's paragraph (e)(1) wages
X's total wage expense for taxable year ending April 30, 2011

$625$1,800 × $3,000 = $1,042

(iv) Section 199 deduction determination. X's tentative deduction under §1.199-1(a) (section 199 deduction) is $124 (.09 × (lesser of QPAI of $1,395 or taxable income of $1,380)) subject to the wage limitation under section 199(b)(1) (W-2 wage limitation) of $521 (50% × $1,042). Accordingly, X's section 199 deduction for its taxable year ending April 30, 2011, is $124.
Example (2). Section 861 method and EAG.
(i) Facts. The facts are the same as in Example 1 except that X owns stock in Y, a United States corporation, equal to 75% of the total voting power of the stock of Y and 80% of the total value of the stock of Y. X and Y are not members of an affiliated group as defined in section 1504(a). Accordingly, the rules of §1.861-14T do not apply to X's and Y's selling expenses, R&E, and charitable contributions. X and Y are, however, members of an affiliated group for purposes of allocating and apportioning interest expense (see §1.861-11T(d)(6)) and are also members of an EAG. Y's taxable year ends April 30, 2011. For Y's taxable year ending April 30, 2011, Y has $2,000 of paragraph (e)(1) wages reported on 2010 Forms W-2. For Y's taxable year ending April 30, 2011, the adjusted basis of Y's assets is $50,000, $20,000 of which generate gross income attributable to DPGR and $30,000 of which generate gross income attributable to non-DPGR. All of Y's activities that generate DPGR are within SIC Industry Group AAA (SIC AAA). All of Y's activities that generate non-DPGR are within SIC Industry Group BBB (SIC BBB). None of X's and Y's sales are to each other. Y is not able to specifically identify CGS allocable to DPGR and non-DPGR. In this case, because CGS is definitely related under the facts and circumstances to all of Y's gross receipts, apportionment of CGS between DPGR and non-DPGR based on gross receipts is appropriate. For Y's taxable year ending April 30, 2011, the total square footage of Y's headquarters is 8,000 square feet, of which 2,000 square feet is set aside for domestic production activities. Y incurs section 162 selling expenses that are not includible in CGS and are definitely related to all of Y's gross income. For Y's taxable year ending April 30, 2011, Y's taxable income is $1,710 based on the following Federal income tax items:

DPGR (all from sales of products within SIC AAA)	$3,000
Non-DPGR (all from sales of products within SIC BBB)	3,000
CGS allocated to DPGR (includes $300 of wage expense)	(1,200)
CGS allocated to non-DPGR (includes $300 of wage expense)	(1,200)
Section 162 selling expenses (includes $300 of wage expense)	(840)
Section 174 R&E-SIC AAA (includes $20 of wage expense)	(100)
Section 174 R&E-SIC BBB (includes $60 of wage expense)	(200)
Interest expense (not included in CGS and not subject to §1.861-10T)	(500)
Charitable contributions	(50)
Headquarters overhead expense (includes $40 of wage expense)	(200)
Y's taxable income	1,710

(ii) QPAI.
(A) X's QPAI. Determination of X's QPAI is the same as in Example 1 except that interest is apportioned to gross income attributable to DPGR based on the combined adjusted bases of X's and Y's assets. See §1.861-11T(c). Accordingly,

X's QPAI for its taxable year ending April 30, 2011, is $1,455, as shown in the following table:

DPGR (all from sales of products within SIC AAA)	$3,000
CGS allocated to DPGR	(600)
Section 162 selling expenses ($840 x ($3,000 DPGR/$6,000 total gross receipts))	(420)
Section 174 R&E-SIC AAA	(300)
Interest expense (not included in CGS and not subject to §1.861-10T)($300 x ($60,000 (tax book value of X's and Y's DPGR assets)/$100,000 (tax book value of X's and Y's total assets)))	(180)
Headquarters overhead expense ($180 x (2,000 square feet attributable to DPGR activity/total 8,000 square feet))	(45)
X's QPAI	1,455

(B) Y's QPAI. Y makes the same elections under the section 861 method as does X. Y has $1,800 of gross income attributable to DPGR (DPGR of $3,000 - CGS of $1,200 allocated based on Y's gross receipts). Y's QPAI for its taxable year ending April 30, 2011, is $905, as shown in the following table:

DPGR (all from sales of products within SIC AAA)	$3,000
CGS allocated to DPGR	(1,200)
Section 162 selling expenses ($840 x ($3,000 DPGR/$6,000 total gross receipts))	(420)
Section 174 R&E-SIC AAA	(100)
Interest expense (not included in CGS and not subject to §1.861-10T) ($500 x ($60,000 (tax book value of X's and Y's DPGR assets)/$100,000 (tax book value of X's and Y's total assets)))	(300)
Charitable contributions (not included in CGS) ($50 x ($1,800 gross income attributable to DPGR/$3,600 total gross income))	(25)
Headquarters overhead expense ($200 x (2,000 square feet attributable to DPGR activity/total 8,000 square feet))	(50)
Y's QPAI	905

(iii) W-2 wages.
(A) X's W-2 wages. X's W-2 wages are $1,042, the same as in Example 1.
(B) Y's W-2 wages. Y chooses to use the wage expense safe harbor under paragraph (e)(2)(ii) of this section to determine its W-2 wages, as shown in the following steps:
(1) Step one. Y determines that $480 of wage expense were taken into account in determining its QPAI in paragraph (ii)(B) of this Example 2, as shown in the following table:

CGS wage expense	$300
Section 162 selling expenses wage expense ($300 x ($3,000 DPGR/$6,000 total gross receipts))	150
Section 174 R&E-SIC AAA wage expense	20
Headquarters overhead wage expense ($40 x (2,000 square feet attributable to DPGR activity/ 8,000 total square feet))	10
Total wage expense taken into account	480

(2) Step two. Y determines that $941 of the $2,000 paragraph (e)(1) wages are properly allocable to DPGR, and are therefore W-2 wages, as shown in the following calculation:
Step one wage expense × Y's paragraph (e)(1) wages

Y's total wage expense for taxable
year ending April 30, 2011

$480$1,020 × $2,000 = $941

(iv) Section 199 deduction determination. The section 199 deduction of the X and Y EAG is determined by aggregating the separately determined taxable income, QPAI, and W-2 wages of X and Y. See §1.199-7(b). Accordingly, the X and Y EAG's tentative section 199 deduction is $212 (.09 x (lesser of combined QPAI of X and Y of $2,360 (X's QPAI of $1,455 plus Y's QPAI of $905) or combined taxable incomes of X and Y of $3,090 (X's taxable income of $1,380 plus Y's taxable income of $1,710)) subject to the combined W-2 wage limitation of X and Y of $992 (50% x ($1,042 (X's W-2 wages) + $941 (Y's W-2 wages)))). Accordingly, the X and Y EAG's section 199 deduction is $212. The $212 is allocated to X and Y in proportion to their QPAI. See §1.199-7(c).

Example (3). Simplified deduction method.

(i) Facts. Z, a corporation that is not a member of an EAG, engages in activities that generate both DPGR and non-DPGR. Z is able to specifically identify CGS allocable to DPGR and to non-DPGR. Z's taxable year ends on April 30, 2011. For Z's taxable year ending April 30, 2011, Z has $3,000 of paragraph (e)(1) wages reported on 2010 Forms W-2, and Z's taxable income is $1,380 based on the following Federal income tax items:

DPGR	$3,000
Non-DPGR	3,000
CGS allocable to DPGR (includes $200 of wage expense)	(600)
CGS allocable to non-DPGR (includes $600 of wage expense)	(1,800)
Expenses, losses, or deductions (deductions) (includes $1,000 of wage expense)	(2,220)
Z's taxable income	1,380

(ii) Z's QPAI. Z uses the simplified deduction method under §1.199-4(e) to apportion deductions between DPGR and non-DPGR. Z's QPAI for its taxable year ending April 30, 2011, is $1,290, as shown in the following table:

DPGR	$3,000
CGS allocable to DPGR	(600)
Deductions apportioned to DPGR ($2,220 x ($3,000 DPGR/$6,000 total gross receipts))	(1,110)
Z's QPAI	1,290

(iii) W-2 wages. Z chooses to use the wage expense safe harbor under paragraph (e)(2)(ii) of this section to determine its W-2 wages, as shown in the following steps:

(A) Step one. Z determines that $700 of wage expense were taken into account in determining its QPAI in paragraph (ii) of this Example 3, as shown in the following table:

Wage expense included in CGS allocable to DPGR	$200
Wage expense included in deductions ($1,000 in wage expense x ($3,000 DPGR/$6,000 total gross receipts))	500
Wage expense allocable to DPGR	700

(B) Step two. Z determines that $1,167 of the $3,000 paragraph (e)(1) wages are properly allocable to DPGR, and are therefore W-2 wages, as shown in the following calculation:

Step one wage expense × Z's paragraph (e)(1) wages
Z's total wage expense for taxable year ending April 30, 2011

$700$1,800 × $3,000 = $1,167

(iv) Section 199 deduction determination. Z's tentative section 199 deduction is $116 (.09 x (lesser of QPAI of $1,290 or taxable income of $1,380)) subject to the W-2 wage limitation of $584 (50% x $1,167). Accordingly, Z's section 199 deduction for its taxable year ending April 30, 2011, is $116.

Example (4). Small business simplified overall method.

(i) Facts. Z, a corporation that is not a member of an EAG, engages in activities that generate both DPGR and non-DPGR. Z's taxable year ends on April 30, 2011. For Z's taxable year ending April 30, 2011, Z has $3,000 of paragraph (e)(1) wages reported on 2010 Forms W-2, and Z's taxable income is $1,380 based on the following Federal income tax items:

DPGR	$3,000
Non-DPGR	3,000
CGS and deductions	(4,620)
Z's taxable income	1,380

(ii) Z's QPAI. Z uses the small business simplified overall method under §1.199-4(f) to apportion CGS and deductions between DPGR and non-DPGR. Z's QPAI for its taxable year ending April 30, 2011, is $690, as shown in the following table:

DPGR	$3,000
CGS and deductions apportioned to DPGR ($4,620 x ($3,000 DPGR/$6,000 total gross receipts))	(2,310)
Z's QPAI	690

(iii) W-2 wages. Z's W-2 wages under paragraph (e)(2)(iii) of this section are $1,500, as shown in the following calculation:

$3,000 in paragraph (e)(1) wages x ($3,000 DPGR/$6,000 total gross receipts) $1,500

(iv) Section 199 deduction determination. Z's tentative section 199 deduction is $62 (.09 x (lesser of QPAI of $690 or taxable income of $1,380)) subject to the W-2 wage limitation of $750 (50% x $1,500). Accordingly, Z's section 199 deduction for its taxable year ending April 30, 2011, is $62.

Example (5). Corporation uses employees of non-consolidated EAG member.

(i) Facts. Corporations S and B are the only members of a single EAG but are not members of a consolidated group. S and B are both calendar year taxpayers. All the activities described in this Example 5 take place during the same taxable year and they are the only activities of S and B. S and B each use the section 861 method described in §1.199-4(d) for allocating and apportioning their deductions. B is a manufacturer but has only three employees of its own. S employs the remainder of the personnel who perform the manufacturing activities for B. S's only receipts are from supplying employees to B. In 2010, B manufactures qualifying production property (QPP) (as defined in §1.199-3(j)(1)), using its three employees and S's employees, and sells the QPP for $10,000,000. B's total CGS and other deductions are $6,000,000, including $1,000,000 paid to S for the use of S's employees and $100,000 paid to its own employees. B reports the $100,000 paid to its employees on the 2010 Forms W-2 issued to its employees. S pays its employees $800,000 that is reported on the 2010 Forms W-2 issued to the employees.

(ii) B's W-2 wages. In determining its W-2 wages, B utilizes the wage expense safe harbor described in paragraph (e)(2)(ii) of this section. The entire $100,000 paid by B to its employees is included in B's wage expense included in calculating its QPAI and is the only wage expense used in calculating B's taxable income. Thus, under the wage expense safe harbor described in paragraph (e)(2)(ii) of this section, B's W-2 wages are $100,000 ($100,000 (paragraph (e)(1) wages) x ($100,000 (wage expense used in calculating B's QPAI)/$100,000 (wage expense used in calculating B's taxable income))).

(iii) S's W-2 wages. In determining its W-2 wages, S utilizes the wage expense safe harbor described in paragraph (e)(2)(ii) of this section. Because S's $1,000,000 in receipts from B do not qualify as DPGR and are S's only gross receipts, none of the $800,000 paid by S to its employees is included in S's wage expense included in calculating its QPAI. However, the entire $800,000 is included in calculating S's taxable income. Thus, under the wage expense safe harbor described in paragraph (e)(2)(ii)(A) of this section, S's W-2 wages are $0 ($800,000 (paragraph (e)(1) wages) x ($0 (wage expense used in calculating S's QPAI)/$800,000 (wage expense used in calculating S's taxable income))).

(iv) Determination of EAG's section 199 deduction. The section 199 deduction of the S and B EAG is determined by aggregating the separately determined taxable income or loss, QPAI, and W-2 wages of S and B. See §1.199-7(b). B's taxable income and QPAI are each $4,000,000 ($10,000,000 DPGR - $6,000,000 CGS and other deductions). S's taxable income is $200,000 ($1,000,000 gross receipts - $800,000 total deductions). S's QPAI is $0 ($0 DPGR - $0 CGS and other deductions). B's W-2 wages (as calculated in paragraph (ii) of this Example 5) are $100,000 and S's W-2 wages (as calculated in paragraph (iii) of this Example 5) are $0. The EAG's tentative section 199 deduction is $360,000 (.09 x (lesser of combined QPAI of $4,000,000 (B's QPAI of $4,000,000 + S's QPAI of $0) or combined taxable income of $4,200,000 (B's taxable income of $4,000,000 + S's taxable income of $200,000))) subject to the W-2 wage limitation of $50,000 (50% x ($100,000 (B's W-2 wages) + $0 (S's W-2 wages))). Accordingly, the S and B EAG's section 199 deduction for 2010 is $50,000. The $50,000 is allocated to S and B in proportion to their QPAI. See §1.199-7(c). Because S has no QPAI, the entire $50,000 is allocated to B.

Example (6). Corporation using employees of consolidated EAG member. The facts are the same as in Example 5 except that B and S are members of the same consolidated group. Ordinarily, as demonstrated in Example 5, S's $1,000,000 of receipts would not be DPGR and its $800,000 paid to its employees would not be W-2 wages (because the $800,000 would not be properly allocable to DPGR). However, because S and B are members of the same consolidated group, §1.1502-13(c)(1)(i) provides that the separate entity attributes of S's intercompany items or B's corresponding items, or both, may be redetermined in order to produce the same effect as if S and B were divisions of a single corporation. If S and B were divisions of a single corporation, S and B would have QPAI and taxable income of $4,200,000 ($10,000,000 DPGR received from the sale of the QPP - $5,800,000 CGS and other deductions) and, under the wage expense safe harbor described in paragraph (e)(2)(ii) of this section, would have $900,000 of W-2 wages ($900,000 (combined paragraph (e)(1) wages of S and B) x ($900,000 (wage expense used in calculating QPAI)/$900,000 (wage expense used in calculating taxable income))). The single corporation would have a tentative section 199 deduction equal to 9% of $4,200,000, or $378,000, subject to the W-2 wage limitation of 50% of $900,000, or $450,000. Thus, the single corporation would have a section 199 deduction of $378,000. To obtain this same result for the consolidated group, S's $1,000,000 of receipts from the intercompany transaction are redetermined as DPGR. Thus, S's $800,000 paid to its employees are costs properly allocable to DPGR and S's W-2 wages are $800,000. Accordingly, the consolidated group has QPAI and taxable income of $4,200,000 ($11,000,000 DPGR (from the sale of the QPP and the redetermined intercompany transaction) - $6,800,000 CGS and other deductions) and W-2 wages of $900,000. The consolidated group's section 199 deduction is $378,000, the same as the single corporation. However, for purposes of allocating the section 199 deduction between S and B, the redetermination of S's income as DPGR under §1.1502-13(c)(1)(i) is not taken into account. See §1.199-7(d)(5). Accordingly, the consolidated group's entire section 199 deduction of $378,000 is allocated to B.

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