Reg. Section 1.199-4(e)(2)

Costs allocable to domestic production gross receipts

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

(b) Cost of goods sold allocable to domestic production gross receipts.

(1)In general. When determining its QPAI, a taxpayer must subtract from DPGR the CGS allocable to DPGR. A taxpayer determines its CGS allocable to DPGR in accordance with this paragraph (b) or, if applicable, paragraph (f) of this section. In the case of a sale, exchange, or other disposition of inventory, CGS is equal to beginning inventory plus purchases and production costs incurred during the taxable year and included in inventory costs, less ending inventory. CGS is determined under the methods of accounting that the taxpayer uses to compute taxable income. See sections 263A, 471, and 472. If section 263A requires a taxpayer to include additional section 263A costs (as defined in §1.263A-1(d)(3)) in inventory, additional section 263A costs must be included in determining CGS. CGS allocable to DPGR also includes inventory valuation adjustments such as writedowns under the lower of cost or market method. In the case of a sale, exchange, or other disposition (including, for example, theft, casualty, or abandonment) of non-inventory property, CGS for purposes of this section includes the adjusted basis of the property. CGS allocable to DPGR for a taxable year may include the inventory cost and adjusted basis of qualifying production property (QPP) (as defined in §1.199-3(j)(1)), a qualified film (as defined in §1.199-3(k)(1)), or electricity, natural gas, and potable water (as defined in §1.199-3(l)) (collectively, utilities) that will generate (or have generated) DPGR notwithstanding that the gross receipts attributable to the sale, lease, rental, license, exchange, or other disposition of the QPP, qualified film, or utilities will be, or have been, included in the computation of gross income for a different taxable year. For example, advance payments that are DPGR may be included in gross income under §1.451-5(b)(1)(i) in a different taxable year than the related CGS allocable to that

DPGR. If gross receipts are treated as DPGR pursuant to §1.199-1(d)(3)(i) or §1.199-3(i)(4)(i)(B)(6), (l)(4)(iv)(A), (m)(1)(iii)(A), (n)(6)(i), or (o)(2), then CGS must be allocated to such DPGR. Similarly, if gross receipts are treated as non-DPGR pursuant to §1.199-1(d)(3)(ii) or §1.199-3(i)(4)(ii), (l)(4)(iv)(B), (m)(1)(iii)(B), or (n)(6)(ii), then CGS must be allocated to such non-DPGR. See §1.199-3(m)(6)(iv) for rules relating to treatment of certain costs in the case of a taxpayer that uses the land safe harbor under that paragraph.

(2)Allocating cost of goods sold.

(i) In general. 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. Whether an allocation method is reasonable is based on all of the facts and circumstances including whether the taxpayer uses the most accurate information available; the relationship between CGS and the method used; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the taxpayer for internal management or other business purposes; whether the method is used for other Federal or state income tax purposes; the availability of costing information; the time, burden, and cost of using alternative methods; and whether the taxpayer applies the method consistently from year to year. Depending on the facts and circumstances, reasonable methods may include methods based on gross receipts, number of units sold, number of units produced, or total production costs. Ordinarily, if a taxpayer uses a method to allocate gross receipts between DPGR and non-DPGR, then the use of a different method to allocate CGS that is not demonstrably more accurate than the method used to allocate gross receipts will not be considered reasonable. However, if a taxpayer has information readily available to specifically identify CGS allocable to DPGR and can specifically identify that amount without undue burden or expense, CGS allocable to DPGR is that amount irrespective of whether the taxpayer uses another allocation method to allocate gross receipts between DPGR and non-DPGR. A taxpayer that does not have information readily available to specifically identify CGS allocable to DPGR and that cannot, without undue burden or expense, specifically identify that amount is not required to use a method that specifically identifies CGS allocable to DPGR.

(ii) Gross receipts recognized in an earlier taxable year. If a taxpayer (other than a taxpayer that uses the small business simplified overall method of paragraph (f) of this section) recognizes and reports gross receipts on a Federal income tax return for a taxable year, and incurs CGS related to such gross receipts in a subsequent taxable year, then regardless of whether the gross receipts ultimately qualify as DPGR, the taxpayer must allocate the CGS to-

(A) DPGR if the taxpayer identified the related gross receipts as DPGR in the prior taxable year; or

(B) Non-DPGR if the taxpayer identified the related gross receipts as non-DPGR in the prior taxable year or if the taxpayer recognized under the taxpayer's methods of accounting those gross receipts in a taxable year to which section 199 does not apply.

(3)Special rules for imported items or services. The cost of any item or service brought into the United States (as defined in §1.199-3(h)) without an arm's length transfer price may not be treated as less than its value immediately after it entered the United States for purposes of determining the CGS to be used in the computation of QPAI. Similarly, the adjusted basis of leased or rented property that gives rise to DPGR that has been brought into the United States (as defined in §1.199-3(h)) without an arm's length transfer price may not be treated as less than its value immediately after it entered the United States. When an item or service is imported into the United States that had been exported by the taxpayer for further manufacture, the increase in cost may not exceed the difference between the value of the property when exported and the value of the property when imported back into the United States after further manufacture. For this purpose, the value of property is its customs value as defined in section 1059A(b)(1).

(4)Rules for inventories valued at market or bona fide selling prices. If part of CGS is attributable to inventory valuation adjustments, then CGS allocable to DPGR includes inventory adjustments to QPP that is MPGE in whole or in significant part within the United States, a qualified film produced by the taxpayer, or utilities produced by the taxpayer in the United States. Accordingly, taxpayers that value inventory under §1.471-4 (inventories at cost or market, whichever is lower) or §1.471-2(c) (subnormal goods at bona fide selling prices) must allocate a proper share of such adjustments (for example, writedowns) to DPGR based on a reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances. Factors taken into account in determining whether the method is reasonable include whether the taxpayer uses the most accurate information available; the relationship between the adjustment and the allocation base chosen; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the taxpayer for internal management or other business purposes; whether the method is used for other Federal or state income tax purposes; the time, burden, and cost of using alternative methods; and whether the taxpayer applies the method consistently from year to year. If a taxpayer has information readily available to specifically identify the proper amount of inventory valuation adjustments allocable to DPGR, then the taxpayer must allocate that amount to DPGR. A taxpayer that does not have information readily available to specifically identify the proper amount of inventory valuation adjustments allocable to DPGR and that cannot, without undue burden or expense, specifically identify the proper amount of inventory valuation adjustments allocable to DPGR, is not required to use a method that specifically identifies inventory valuations adjustments to DPGR.

(5)Rules applicable to inventories accounted for under the last-in, first-out (LIFO) inventory method.

(i) In general. This paragraph applies to inventories accounted for using the specific goods last-in, first-out (LIFO) method or the dollar-value LIFO method. Whenever a specific goods grouping or a dollar-value pool contains QPP, qualified films, or utilities that produces DPGR and goods that do not, the taxpayer must allocate CGS attributable to that grouping or pool between DPGR and non-DPGR using a reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances. Whether a method of allocating CGS between DPGR and non-DPGR is reasonable must be determined in accordance with paragraph (b)(2) of this section. In addition, this paragraph (b)(5) provides methods that a taxpayer may use to allocate CGS for inventories accounted for using the LIFO method. If a taxpayer uses the LIFO/FIFO ratio method provided in paragraph (b)(5)(ii) of this section or the change in relative base-year cost method provided in paragraph (b)(5)(iii) of this section, then the taxpayer must use that method for all inventory accounted for under the LIFO method.

(ii) LIFO/FIFO ratio method. A taxpayer using the specific goods LIFO method or the dollar-value LIFO method may use the LIFO/FIFO ratio method. The LIFO/FIFO ratio method is applied with respect to all LIFO inventory of a taxpayer on a grouping-bygrouping or pool-by-pool basis. Under the LIFO/FIFO ratio method, a taxpayer computes the CGS of a grouping or pool allocable to DPGR by multiplying the CGS of QPP, qualified films, or utilities in the grouping or pool that produced DPGR computed using the first-in, first-out (FIFO) method by the LIFO/FIFO ratio of the grouping or pool. The LIFO/FIFO ratio of a grouping or pool is equal to the total CGS of the grouping or pool computed using the LIFO method over the total CGS of the grouping or pool computed using the FIFO method.

(iii) Change in relative base-year cost method. A taxpayer using the dollar-value LIFO method may use the change in relative base-year cost method. The change in relative base-year cost method is applied with respect to all LIFO inventory of a taxpayer on a pool-by-pool basis. The change in relative base-year cost method determines the CGS allocable to DPGR by increasing or decreasing the total production costs (section 471 costs and additional section 263A costs) of QPP, a qualified film, or utilities that generate DPGR by a portion of any increment or liquidation of the dollar-value pool. The portion of an increment or liquidation allocable to DPGR is determined by multiplying the LIFO value of the increment or liquidation (expressed as a positive number) by the ratio of the change in total base-year cost (expressed as a positive number) of the QPP, qualified film, or utilities that will generate DPGR in ending inventory to the change in total base-year cost (expressed as a positive number) of all goods in the ending inventory. The portion of an increment or liquidation allocable to DPGR may be zero but cannot exceed the amount of the increment or liquidation. Thus, a ratio in excess of 1.0 must be treated as 1.0.

(6)Taxpayers using the simplified production method or simplified resale method for additional section 263A costs. A taxpayer that uses the simplified production method or simplified resale method to allocate additional section 263A costs, as defined in §1.263A-1(d)(3), to ending inventory must follow the rules in paragraph (b)(2) of this section to determine the amount of additional section 263A costs allocable to DPGR. Allocable additional section 263A costs include additional section 263A costs included in beginning inventory as well as additional section 263A costs incurred during the taxable year. Ordinarily, if a taxpayer uses the simplified production method or the simplified resale method, the additional section 263A costs should be allocated in the same proportion as section 471 costs are allocated.

(7)Examples. The following examples illustrate the application of this paragraph (b) and assume that the taxpayer does not use the small business simplified overall method provided in paragraph (f) of this section:

Example (1). Advance payments. T, a calendar year taxpayer, is a manufacturer of furniture in the United States. Under its method of accounting, T includes advance payments and other gross receipts derived from the sale of furniture in gross income when the payments are received. In December 2007, T receives an advance payment of $5,000 from X with respect to an order of furniture to be manufactured for a total price of $20,000. In 2008, T produces and sells the furniture to X. In 2008, T incurs $14,000 of section 471 and additional section 263A costs to produce the furniture ordered by X. T receives the remaining $15,000 of the contract price from X in 2008. Assuming that in 2007, T can reasonably determine that all the requirements of §§1.199-1 and 1.199-3 will be met with respect to the furniture, the advance payment qualifies as DPGR in 2007. Assuming further that all the requirements of §§1.199-1 and 1.199-3 are met with respect to the furniture in 2008, the remaining $15,000 of the contract price must be included in income and DPGR when received by T in 2008. T must include the $14,000 it incurred to produce the furniture in CGS and CGS allocable to DPGR in 2008. See §1.199-4(b)(2)(ii) for rules regarding gross receipts and costs recognized in different taxable years.
Example (2). Use of standard cost method. X, a calendar year taxpayer, manufactures item A in a factory located in the United States and item B in a factory located in Country Y. Item A is produced by X within the United States and the sale of A generates DPGR. X uses the FIFO inventory method to account for its inventory and determines the cost of item A using a standard cost method. At the beginning of its 2007 taxable year, X's inventory contains 2,000 units of item A at a standard cost of $5 per unit. X did not incur significant cost variances in previous taxable years. During the 2007 taxable year, X produces 8,000 units of item A at a standard cost of $6 per unit. X determines that with regard to its production of item A it has incurred a significant cost variance. When X reallocates the cost variance to the units of item A that it has produced, the production cost of item A is $7 per unit. X sells 7,000 units of item A during the taxable year. X can identify from its books and records that CGS related to the sales of item A during the taxable year are $45,000 ((2,000 x $5) + (5,000 x $7)). Accordingly, X has CGS allocable to DPGR of $45,000.
Example (3). Change in relative base-year cost method.
(i) Y elects, beginning with the calendar year 2007, to compute its inventories using the dollar-value, LIFO method under section 472. Y establishes a pool for items A and B. Y produces item A within the United States and the sales of item A generate DPGR. Y does not produce item B within the United States and the sale of item B does not generate DPGR. The composition of the inventory for the pool at the base date, January 1, 2007, is as follows:

Item	Unit	Unit cost	Total cost
A	2,000	$5.00	$10,000
B	1,250	4.00	5,000
Total			$15,000

(ii) Y uses a standard cost method to allocate all direct and indirect costs (section 471 and additional section 263A costs) to the units of item A and item B that it produces. During 2007, Y incurs $52,500 of section 471 costs and additional section 263A costs to produce 10,000 units of item A and $114,000 of section 471 costs and additional section 263A costs to produce 20,000 units of item B.

(iii) The closing inventory of the pool at December 31, 2007, contains 3,000 units of item A and 2,500 units of item B. The closing inventory of the pool at December 31, 2007, shown at base-year and current-year cost is as follows:

Item	Quantity	Base-year cost	Amount	Current-year cost	Amount
A	3,000	$5.00	$15,000	$5.25	$15,750
B	2,500	4.00	10,000	5.70	14,250
Totals			$25,000		$30,000

(iv) The base-year cost of the closing LIFO inventory at December 31, 2007, amounts to $25,000, and exceeds the $15,000 base-year cost of the opening inventory for the taxable year by $10,000 (the increment stated at base-year cost). The increment valued at current-year cost is computed by multiplying the increment stated at base-year cost by the ratio of the current-year cost of the pool to total base-year cost of the pool (that is, $30,000/$25,000, or 120%). The increment stated at current-year cost is $12,000 ($10,000 x 120%).

(v) The change in relative base-year cost of item A is $5,000 ($15,000 - $10,000). The change in relative base-year cost (the increment stated at base-year cost) of the total inventory is $10,000 ($25,000 - $15,000). The ratio of the change in base-year cost of item A to the change in base-year cost of the total inventory is 50% ($5,000/$10,000).

(vi) CGS allocable to DPGR is $46,500, computed as follows:

Current-year production costs related to DPGR		$52,500
Less: Increment stated at current-year cost	$12,000	
Ratio	50%	
Total		(6,000)
Total		$46,500

Example (4). Change in relative base-year cost method.

(i) The facts are the same as in Example 3 except that, during the calendar year 2008, Y experiences an inventory decrement. During 2008, Y incurs $66,000 of section 471 costs and additional section 263A costs to produce 12,000 units of item A and $150,000 of section 471 costs and additional section 263A costs to produce 25,000 units of item B.

(ii) The closing inventory of the pool at December 31, 2008, contains 2,000 units of item A and 2,500 units of item B. The closing inventory of the pool at December 31, 2008, shown at base-year and current-year cost is as follows:

Item	Quantity	Base-year cost	Amount	Current-year cost	Amount
A	2,000	$5.00	$10,000	$5.50	$11,000
B	2,500	4.00	10,000	6.00	15,000
Totals			$20,000		$26,000

(iii) The base-year cost of the closing LIFO inventory at December 31, 2008, amounts to $20,000, and is less than the $25,000 base-year cost of the opening inventory for that taxable year by $5,000 (the decrement stated at base-year cost). This liquidation is reflected by reducing the most recent layer of increment. The LIFO value of the inventory at December 31, 2008 is:

Base cost		Index	LIFO value
January 1, 2008, base cost	$15,000	1.00	$15,000

December 31, 2008, increment 5,000 1.20 6,000
Total $21,000

(iv) The change in relative base-year cost of item A is $5,000 ($15,000 -$10,000). The change in relative base-year cost of the total inventory is $5,000 ($25,000 - $20,000). The ratio of the change in base-year cost of item A to the change in base-year cost of the total inventory is 100% ($5,000/$5,000).
(v) CGS allocable to DPGR is $72,000, computed as follows:
Current-year production costs related to DPGR $66,000
Plus: LIFO value of decrement $6,000
Ratio 100%
Total 6,000
Total $72,000

Example (5). LIFO/FIFO ratio method.
(i) The facts are the same as in Example 3 except that Y uses the LIFO/FIFO ratio method to determine its CGS allocable to DPGR.
(ii) Y's CGS related to item A on a FIFO basis is $46,750 ((2,000 units at $5) + (7,000 units at $5.25)).
(iii) Y's total CGS computed on a LIFO basis is $154,500 (beginning inventory of $15,000 plus total production costs of $166,500 less ending inventory of $27,000).
(iv) Y's total CGS computed on a FIFO basis is $151,500 (beginning inventory of $15,000 plus total production costs of $166,500 less ending inventory of $30,000).
(v) The ratio of Y's CGS computed using the LIFO method to its CGS computed using the FIFO method is 102% ($154,500/$151,500). Y's CGS related to DPGR computed using the LIFO/FIFO ratio method is $47,685 ($46,750 x 102%).
Example (6). LIFO/FIFO ratio method.
(i) The facts are the same as in Example 4 except that Y uses the LIFO/FIFO ratio method to compute CGS allocable to DPGR.
(ii) Y's CGS related to item A on a FIFO basis is $70,750 ((3,000 units at $5.25) + (10,000 units at $5.50)).
(iii) Y's total CGS computed on a LIFO basis is $222,000 (beginning inventory of $27,000 plus total production costs of $216,000 less ending inventory of $21,000).
(iv) Y's total CGS computed on a FIFO basis is $220,000 (beginning inventory of $30,000 plus total production costs of $216,000 less ending inventory of $26,000).
(v) The ratio of Y's CGS computed using the LIFO method to its CGS computed using the FIFO method is 101% ($222,000/$220,000). Y's CGS related to DPGR computed using the LIFO/FIFO ratio method is $71,457 ($70,750 x 101%).

(c)Other deductions properly allocable to domestic production gross receipts or gross income attributable to domestic production gross receipts.
(1)In general. In determining its QPAI, a taxpayer must subtract from its DPGR, in addition to its CGS allocable to DPGR, the deductions that are properly allocable to DPGR. A taxpayer generally must allocate and apportion these deductions using the rules of the section 861 method. In lieu of the section 861 method, certain taxpayers may apportion these deductions using the simplified deduction method provided in paragraph (e) of this section. Paragraph (f) of this section provides a small business simplified

overall method that may be used by a qualifying small taxpayer, as defined in that paragraph. A taxpayer using the simplified deduction method or the small business simplified overall method must use that method for all deductions. A taxpayer eligible to use the small business simplified overall method may choose at any time for any taxable year to use the small business simplified overall method, the simplified deduction method, or the section 861 method for a taxable year. A taxpayer eligible to use the simplified deduction method may choose at any time for any taxable year to use the simplified deduction method or the section 861 method for a taxable year.

(2)Treatment of net operating losses. A deduction under section 172 for a net operating loss is not allocated or apportioned to DPGR or gross income attributable to DPGR.

(3)W-2 wages. Although only W-2 wages as described in §1.199-2 are taken into account in computing the W-2 wage limitation, all wages paid (or incurred in the case of an accrual method taxpayer) in a taxpayer's trade or business during the taxable year are taken into account in computing QPAI for that taxable year.

(d)Section 861 method.

(1)In general. Under the section 861 method, a taxpayer must allocate and apportion its deductions using the allocation and apportionment rules provided under the section 861 regulations under which section 199 is treated as an operative section described in §1.861-8(f). Accordingly, the taxpayer applies the rules of the section 861 regulations to allocate and apportion deductions (including, if applicable, its distributive share of deductions from pass-thru entities) to gross income attributable to DPGR. Gross receipts that are allocable to land under the safe harbor provided in §1.199-3(m)(6)(iv) are treated as non-DPGR. See §1.199-3(m)(6)(iv)(B). If the taxpayer applies the allocation and apportionment rules of the section 861 regulations for section 199 and another operative section, then the taxpayer must use the same method of allocation and the same principles of apportionment for purposes of all operative sections (subject to the rules provided in paragraphs (c)(2) and (d)(2) and (3) of this section). See §1.861-8(f)(2)(i).

(2)Deductions for charitable contributions. Deductions for charitable contributions (as allowed under section 170 and section 873(b)(2) or 882(c)(1)(B)) must be ratably apportioned between gross income attributable to DPGR and gross income attributable to non-DPGR based on the relative amounts of gross income.

(3)Research and experimental expenditures. Research and experimental expenditures must be allocated and apportioned in accordance with §1.861-17 without taking into account the exclusive apportionment rule of §1.861-17(b).

(4)Deductions allocated or apportioned to gross receipts treated as domestic production gross receipts. If gross receipts are treated as DPGR pursuant to §1.199-1(d)(3)(i) or §1.199-3(i)(4)(i)(B)(6), (l)(4)(iv)(A), (m)(1)(iii)(A), (n)(6)(i), or (o)(2), then deductions must be allocated or apportioned to the gross income attributable to such DPGR. Similarly, if gross receipts are treated as non-DPGR pursuant to §1.199-1(d)(3)(ii) or §1.199-3(i)(4)(ii), (l)(4)(iv)(B), (m)(1)(iii)(B), or (n)(6)(ii), then deductions must be allocated or apportioned to the gross income attributable to such non-DPGR.

(5)Treatment of items from a pass-thru entity reporting qualified production activities income. If, pursuant to §1.199-5(e)(2) or §1.199-9(e)(2), or to the authority granted in §1.199-5(b)(1)(ii) or (c)(1)(ii), or §1.199-9(b)(1)(ii) or (c)(1)(ii), a taxpayer must combine QPAI and W-2 wages from a partnership, S corporation, trust (to the extent not described in §1.199-5(d) or §1.199-9(d)) or estate with the taxpayer's total QPAI and W-2 wages from other sources, then for purposes of apportioning the taxpayer's interest expense under this paragraph (d), the taxpayer's interest in such partnership (and, where relevant in apportioning the taxpayer's interest expense, the partnership's assets), the taxpayer's shares in such S corporation, or the taxpayer's interest in such trust shall be disregarded.

(6)Examples. The following examples illustrate the operation of the section 861 method. Assume in the following examples that all corporations are calendar year taxpayers, that all taxpayers have sufficient W-2 wages as defined in §1.199-2(e) so that the section 199 deduction is not limited under section 199(b)(1), and that, with respect to the allocation and apportionment of interest expense, §1.861-10T does not apply.
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), engages in activities that generate both DPGR and non-DPGR. 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 2010, the adjusted basis of X's assets is $5,000, $4,000 of which generates gross income attributable to DPGR and $1,000 of which generates gross income attributable to non-DPGR. For 2010, 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	($600)
CGS allocable to non-DPGR	($1,800)
Section 162 selling expenses	($840)
Section 174 R&E-SIC AAA	($300)
Section 174 R&E-SIC BBB	($600)
Interest expense (not included in CGS)	($300)
Charitable contributions	($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 of this paragraph (d). In this case, the section 162 selling expenses are definitely related to all of X's gross income. Based on the facts and circumstances of this specific case, apportionment of those expenses between DPGR and non-DPGR on the basis of X's gross receipts 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 2010 is $1,320, as shown below:

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)

Interest expense (not included in CGS) ($300 x ($4,000 (X's DPGR assets)/$5,000 (X's total assets))) ($240)

Charitable contributions (not included in CGS) ($180 x ($2,400 gross income attributable to DPGR/$3,600 total gross income))($120)

Section 174 R&E-SIC AAA ($300)

X's QPAI $1,320

(iii) Section 199 deduction determination. X's tentative deduction under §1.199-1(a) is $119 (.09 x (lesser of QPAI of $1,320 and taxable income of $1,380)). Because the facts of this example assume that X's W-2 wages as defined in §1.199-2(e) are sufficient to avoid a limitation on the section 199 deduction, X's section 199 deduction for 2010 is $119.

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 stock of Y and 80% of the total value of stock in 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. For 2010, the adjusted basis of Y's assets is $45,000, $21,000 of which generates gross income attributable to DPGR and $24,000 of which generates 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 2010, Y's taxable income is $1,910 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 ($1,200)

CGS allocated to non-DPGR ($1,200)

Section 162 selling expenses ($ 840)

Section 174 R&E-SIC AAA ($ 100)

Section 174 R&E-SIC BBB ($ 200)

Interest expense (not included in CGS and not subject to §1.861-10T) ($ 500)

Charitable contributions ($50)

Y's taxable income $1,910

(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 2010 is $1,410, as shown below:

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)
Interest expense (not included in CGS and not subject to §1861-10T) ($300 x ($25,000 (tax book value of X's and Y's DPGR assets)/$50,000 (tax book value of X's and Y's total assets))) ($150)
Charitable contributions (not included in CGS) ($180 x ($2,400 gross income attributable to DPGR/$3,600 total gross income))($120)
Section 174 R&E-SIC AAA ($300)
X's QPAI $1,410

(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 2010 is $1,005, as shown below:

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)
Interest expense (not included in CGS and not subject to §1.861-10T) ($500 x ($25,000 (tax book value of X's and Y's DPGR assets)/$50,000 (tax book value of X's and Y's total assets))) ($250)
Charitable contributions (not included in CGS)($50 x ($1,800 gross income attributable to DPGR/$3,600 total gross income))($25)
Section 174 R&E-SIC AAA ($100)
Y's QPAI $1,005

(iii) Section 199 deduction determination. The section 199 deduction of the X and Y EAG is determined by aggregating the separately determined QPAI, taxable income, 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 $217 (.09 x (lesser of combined taxable incomes of X and Y of $3,290 (X's taxable income of $1,380 plus Y's taxable income of $1,910) and combined QPAI of $2,415 (X's QPAI of $1,410 plus Y's QPAI of $1,005)). Because the facts of this example assume that the W-2 wages of X and Y are sufficient to avoid a limitation on the section 199 deduction, X and Y EAG's section 199 deduction for 2010 is $217. The $217 is allocated to X and Y in proportion to their QPAI. See §1.199-7(c).

(e)Simplified deduction method.

(1)In general. An eligible taxpayer may use the simplified deduction method to apportion deductions between DPGR and non-DPGR. The simplified deduction method does not apply to CGS. Under the simplified deduction method, a taxpayer's deductions (except the net operating loss deduction as provided in paragraph (c)(2) of this section) are ratably apportioned between DPGR and non-DPGR based on relative gross receipts. Accordingly, the amount of deductions for the current taxable year apportioned to DPGR is equal to the same proportion of the total deductions for the current taxable year that the amount of DPGR bears to total gross receipts. Gross receipts that are allocable to land under the safe harbor provided in §1.199-3(m)(6)(iv) are treated as non-DPGR. See §1.199-3(m)(6)(iv)(B). Whether a trust (to the extent not described in §1.199-5(d) or §1.199-9(d)) or an estate may use the simplified deduction method is determined at the trust or estate level. If a trust or estate qualifies to use the simplified deduction method, the simplified deduction method must be applied at the trust or estate level, taking into account the trust's or estate's DPGR, non-DPGR, and other items from all sources, including its distributive or allocable share of those items of any lower-tier entity, prior to any charitable or distribution deduction. Whether the owner of a pass-thru entity may use the simplified deduction method is determined at the level of the entity's owner. If the owner of a pass-thru entity qualifies and uses the simplified deduction method, then the simplified deduction method is applied at the level of the owner of the pass-thru entity taking into account the owner's DPGR, non-DPGR, and other items from all sources including its distributive or allocable share of those items of the pass-thru entity.

(2)Eligible taxpayer. For purposes of this paragraph (e), an eligible taxpayer is-

(i) A taxpayer that has average annual gross receipts (as defined in paragraph (g) of this section) of $100,000,000 or less; or

(ii) A taxpayer that has total assets (as defined in paragraph (e)(3) of this section) of $10,000,000 or less.

(3)Total assets.

(i) In general. For purposes of the simplified deduction method, total assets means the total assets the taxpayer has at the end of the taxable year. In the case of a C corporation, the corporation's total assets at the end of the taxable year is the amount required to be reported on Schedule L of Form 1120, "United States Corporation Income Tax Return," in accordance with the Form 1120 instructions.

(ii) Members of an expanded affiliated group. To compute the total assets of an EAG, the total assets at the end of the taxable year of each corporation that is a member of the EAG at the end of the taxable year that ends with or within the taxable year of the computing member (as described in §1.199-7(h)) are aggregated. For purposes of this paragraph, a consolidated group is treated as one member of the EAG.

(4)Members of an expanded affiliated group.

(i) In general. Whether the members of an EAG may use the simplified deduction method is determined by reference to all the members of the EAG. If the average annual gross receipts of the EAG are less than or equal to $100,000,000 or the total assets of the EAG are less than or equal to $10,000,000, then each member of the EAG may individually determine whether to use the simplified deduction method, regardless of the cost allocation method used by the other members.

(ii) Exception. Notwithstanding paragraph (e)(4)(i) of this section, all members of the same consolidated group must use the same cost allocation method.

(iii) Examples. The following examples illustrate the application of paragraph (e) of this section:

Example (1). Corporations X, Y, and Z are the only three members of an EAG. Neither X, Y, nor Z is a member of a consolidated group. X, Y, and Z have average annual gross receipts of $20,000,000, $70,000,000, and $5,000,000, respectively. X, Y, and Z each have total assets at the end of the taxable year of $5,000,000. Because the average annual gross receipts of the EAG are less than or equal to $100,000,000, each of X, Y, and Z may use either the simplified deduction method or the section 861 method.

Example (2). The facts are the same as in Example 1 except that X and Y are members of the same consolidated group. X, Y, and Z may use either the simplified deduction method or the section 861 method. However, X and Y must use the same cost allocation method.

Example (3). The facts are the same as in Example 1 except that Z's average annual gross receipts are $15,000,000. Because the average annual gross receipts of the EAG are greater than $100,000,000 and the total assets of the EAG at the end of the taxable year are greater than $10,000,000, X, Y, and Z must each use the section 861 method.

(f)Small business simplified overall method.

(1)In general. A qualifying small taxpayer may use the small business simplified overall method to apportion CGS and deductions between DPGR and non-DPGR. Under the small business simplified overall method, a taxpayer's total costs for the current taxable year (as defined in paragraph (f)(3) of this section) are apportioned between DPGR and non-DPGR based on relative gross receipts. Accordingly, the amount of total costs for the current taxable year apportioned to DPGR is equal to the same proportion of total costs for the current taxable year that the amount of DPGR bears to total gross receipts. Total gross receipts for this purpose do not include gross receipts that are allocated to land under the land safe harbor provided in §1.199-3(m)(6)(iv). See §1.199-3(m)(6)(iv)(B).

(2)Qualifying small taxpayer. Except as provided in paragraph (f)(5), for purposes of this paragraph (f), a qualifying small taxpayer is-

(i) A taxpayer that has average annual gross receipts (as defined in paragraph (g) of this section) of $5,000,000 or less;

(ii) A taxpayer that is engaged in the trade or business of farming that is not required to use the accrual method of accounting under section 447; or

(iii) A taxpayer that is eligible to use the cash method as provided in Rev. Proc. 2002-28 (2002-1 C.B. 815) (that is, certain taxpayers with average annual gross receipts of $10,000,000 or less that are not prohibited from using the cash method under section 448, including partnerships, S corporations, C corporations, or individuals). See §601.601(d)(2) of this chapter.

(3)Total costs for the current taxable year.

(i) In general. For purposes of the small business simplified overall method, total costs for the current taxable year means the total CGS and deductions (excluding the net operating loss deduction as provided in paragraph (c)(2) of this section) for the current taxable year. Total costs for the current taxable year are determined under the methods of accounting that the taxpayer uses to compute taxable income.

(ii) Land safe harbor. A taxpayer that uses the land safe harbor provided in §1.199-3(m)(6)(iv) must reduce total costs for the current taxable year by the costs of land and any other costs capitalized to the land (except costs for activities listed in §1.199-3(m)(2)(iii)) prior to applying the small business simplified overall method. See §1.199-3(m)(6)(iv)(B). For example, if a taxpayer has $1,000 of total costs for the current taxable year and $600 of such costs is attributable to land under the land safe harbor, then only $400 of such costs is apportioned between DPGR and non-DPGR under the small business simplified overall method.

(4)Members of an expanded affiliated group.

(i) In general. Whether the members of an EAG may use the small business simplified overall method is determined by reference to all the members of the EAG. If the average annual gross receipts of the EAG are less than or equal to $5,000,000, the EAG (viewed as a single corporation) is engaged in the trade or business of farming that is not required to use the accrual method of accounting under section 447, or the EAG (viewed as a single corporation) is eligible to use the cash method as provided in Rev. Proc. 2002-28, then each member of the EAG may individually determine whether to use the small business simplified overall method, regardless of the cost allocation method used by the other members.

(ii) Exception. Notwithstanding paragraph (f)(4)(i) of this section, all members of the same consolidated group must use the same cost allocation method.

(iii) Examples. The following examples illustrate the application of paragraph (f) of this section:

Example (1). Corporations L, M, and N are the only three members of an EAG. Neither L, M, nor N is a member of a consolidated group. L, M, and N have average annual gross receipts for the current taxable year of $1,000,000, $1,500,000, and $2,000,000, respectively. Because the average annual gross receipts of the EAG are less than or equal to $5,000,000, each of L, M, and N may use the small business simplified overall method, the simplified deduction method, or the section 861 method.

Example (2). The facts are the same as in Example 1 except that M and N are members of the same consolidated group. L, M, and N may use the small business simplified overall method, the simplified deduction method, or the section 861 method. However, M and N must use the same cost allocation method.

Example (3). The facts are the same as in Example 1 except that N has average annual gross receipts of $4,000,000. Unless the EAG, viewed as a single corporation, is engaged in the trade or business of farming that is not required to use the accrual method of accounting under section 447, or the EAG, viewed as a single corporation, is eligible to use the cash method as provided in Rev. Proc. 2002-28, because the average annual gross receipts of the EAG are greater than $5,000,000, L, M, and N are all ineligible to use the small business simplified overall method.

(5)Trusts and estates. Trusts and estates under §§1.199-5(e) and 1.199-9(e) may not use the small business simplified overall method.

(g)Average annual gross receipts.

(1)In general. For purposes of the simplified deduction method and the small business simplified overall method, average annual gross receipts means the average annual gross receipts of the taxpayer (including gross receipts attributable to the sale, exchange, or other disposition of land under the land safe harbor provided in §1.199-3(m)(6)(iv)) for the 3 taxable years (or, if fewer, the taxable years during which the taxpayer was in existence) preceding the current taxable year, even if one or more of such taxable years began before the effective date of section 199. In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts shall be annualized by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in the short period.

(2)Members of an expanded affiliated group. To compute the average annual gross receipts of an EAG, the gross receipts, for the entire taxable year, of each corporation that is a member of the EAG at the end of its taxable year that ends with or within the taxable year of the computing member are aggregated. For purposes of this paragraph, a consolidated group is treated as one member of the EAG.