July 14, 2005

Dear Mssrs. Solomon and Korb:

Enclosed are comments concerning Notice 2005-14 and Section 199, income attributable to domestic production activities. These comments represent the individual views of those members who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

Kenneth W. Gideon
Chair, Section of Taxation

Enclosure
Comments Concerning Notice 2005-14 and Section 199,
Income Attributable to Domestic Production Activities

The following comments represent the individual views of the members of the Section of Taxation (the “Section”) who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Tax Accounting Committee of the Section. Principal responsibility was exercised by Ellen MacNeil and Edward Morse. Substantive contributions were made by members of the Energy and Environmental Taxes Committee, the Partnership Committee, and the Real Estate Committee. These members were Stephen A. Lee, David Benz, Richard Blaker, David Culpepper, Rebecca Eggers, Shannon Elliott, Jim Lynch, Scott Shmick; Louis Weller, Eliot Kaplan, Justin J. Zarcone, Arnold Kogan, and Allen J. Weiner. Substantive contributions were also made by Charles Mannix and Martha Pugh, members of the Section of Public Utility, Communications and Transportation Law. The comments were reviewed by Patricia Ann Metzer of the Section’s Committee on Government Submissions and by Rudolph Ramelli, Council Director for the Committee on Tax Accounting.

Although the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments, or have advised clients on the application of these principles, no such member (or firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments.

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Date: July 14, 2005
Executive Summary

In Notice 2005-14, the United States Department of the Treasury (“Treasury”) and the Internal Revenue Service (“IRS”) provided interim guidance relating to the deduction for income attributable to domestic production activities under section 199 of the Internal Revenue Code. Section 199 was enacted as part of the American Jobs Creation Act of 2004 to allow a deduction based on the qualified production activities income of the taxpayer.

Implementation of this provision presents many challenges, and the Treasury and the IRS are to be commended for the issuance of interim guidance. We offer these comments to address unresolved issues and matters of complexity for which additional guidance, or refinement of existing guidance, may be appropriate. In addition, we respond to specific requests for comments contained in section 6 of the Notice.

I. Determining Qualified Production Activities Income.

The Notice requires that qualified production activities income (“QPAI”) be determined using an “item-by-item” basis. We recommend clarification that would allow taxpayers to use any reasonable method adaptable to the limits of taxpayer accounting systems.

II. Determining Domestic Production Gross Receipts.

Domestic production gross receipts (“DPGR”) include gross receipts of the taxpayer derived from qualified production property (“QPP”) that is manufactured, produced, grown or extracted wholly or in significant part within the United States. Our comments relate to the identification of the taxpayer eligible to claim a deduction under section 199, as well as the costs associated with QPP.

The Notice states that only the taxpayer who has the “benefits and burdens of ownership” of QPP is engaged in a qualifying activity. However, this standard adds complexity by drawing from an area of law (sales versus financing) which may not be well suited to the focus of section 199. Moreover, focusing narrowly on the benefits and burdens of ownership may fail to take into account other relevant circumstances in defining who should be entitled to the benefits of section 199.

We recommend that the proposed regulations follow the well-developed legal principles in regulations under section 263A and section 460, which address the identity of a producer of property. This approach is likely to enhance consistency and ease of application under section 199.

In determining whether QPP is manufactured or produced “in significant part” within the United States, the Notice provides that taxpayers may meet either of two tests. One is the “substantial in nature” test, which focuses on such factors as the relative value added by taxpayer’s activities and the relative costs incurred in the U.S. The other is the “20% safe harbor test”, which focuses on whether conversion costs incurred within the U.S. account for at least 20% of the total cost of goods sold for the property. For these purposes, development activities (outside of the narrow
exceptions for software and sound recordings) are excluded from the scope of costs for these purposes, despite the fact that they are often closely related to the creation of QPP.

We recommend that these two tests be modified to include costs associated with development activities that are an intrinsic part of manufacturing and production. Neither the statute nor the legislative history suggests that they should be excluded from the purposes of section 199.

In addition to these general matters, particular industries face special problems concerning the scope of DPGR. These include:

**Integrated Utilities.** Section 199(c)(4) includes electricity, natural gas or potable water produced in the United States as part of DPGR, but requires the exclusion of transmission and distribution revenues. Integrated utilities face special challenges when allocating revenues among these functions. We recommend developing a simplified approach using rate base information for regulatory purchases.

**Construction Performed in the United States.** The Notice defines construction in relation to NAICS codes. However, some taxpayers engaged in construction do not have construction-related NAICS codes. We recommend that the regulations omit references to the NAICS codes or qualify their application in order to ensure that appropriate classifications are allowed.

The Notice also excludes land from the scope of DPGR derived from construction. The Section recommends that land be included, but that an anti-abuse rule similar to that in Treas. Reg. § 1.460-1(b)(2)(ii) be adopted to prevent taxpayers from seeking the benefits of section 199 in situations where total allocable costs attributable to construction are less than 10 percent of the total contract price. This approach is simpler and more consistent with the purpose of section 199, while addressing concerns of the Treasury and IRS involving potential abuses.

**Media Advertising.** The Notice expressly includes advertising income in DPGR income derived from newspapers and magazines. We recommend that advertising revenue from other media, such as television network programming, be included as well to the extent the media is otherwise QPP.

**Oil & Gas Industry.** Clarification is needed to ensure that both the operator and the holder of a non-operating interest in an oil and gas project are considered as having received DPGR and an allocable share of related costs. Owners of net profits interests or a royalty interest also need clarification on whether the profits or royalty payment they receive should be treated as DPGR.

**Hedging & Currency Transactions.** Treatment of gains and losses from financial transactions involving hedging and foreign currency require clarification to ensure consistent treatment, whether inclusion in or exclusion from DPGR.
III. Determining Costs.

Cost Allocation Method. Section 199 provides that DPGR must be reduced by allocable costs in order to compute QPAI. For taxpayers with gross receipts that do not exceed $25 million, the Notice provides two simplified methods. Other taxpayers must use an allocation method based on regulations under section 861. We recommend the adoption of rules similar to those under section 263A, rather than those in section 861.

This approach is consistent with language in the Conference Committee Report, which recognizes that section 861 is relevant to determine the source of activities within or outside the United States. However, once the sourcing determination has been made, rules similar to those developed under section 263A appear more suitable to assigning costs between qualified and non-qualified domestic activities. This approach would result in less complex and more easily administrable rules, particularly for companies with purely domestic activities that would otherwise not apply section 861.

Moreover, the treatment of interest expense under the 861 regime, which allocates interest based on the location of assets, rather than income-producing activities, appears inconsistent with section 199. We recommend that future guidance allow taxpayers to take into account facts and circumstances other than asset location in allocating interest expense for purposes of section 199.

Specific Costing Problems in the Oil and Gas Industry. The oil and gas industry requires additional guidance on cost allocation in several areas, which include exploration and development as well as the allocation of certain taxes.

Exploration and Development. The industry faces uncertainty with respect to whether costs incurred in drilling new wells should be considered an expense that offsets revenue from existing wells under section 199(e). We recommend that preproduction costs not be treated as deductions allocable to QPAI. This approach is consistent with the item-by-item approach in the Notice, and it puts the activity on parity with analogous activities such as building a factory. However, to the extent the taxpayer elects to take an immediate deduction for intangible drilling and development costs, it is unclear whether such costs should be allocable to QPAI.

With regard to nonproductive (dry hole) wells, clarification is needed with respect to the treatment of associated costs. We recommend that such costs not be allocable to DPGR because the loss( or gain) from disposition would not be taken into account for DPGR. This treatment is consistent with that suggested for losses in section 4.05(3)(b)(ii) of the Notice.

Severance, Sales, and Excise Tax. Section 4.04(2) of the Notice provides special treatment for certain taxes depending on whether the tax is imposed on the purchaser and the seller merely collects the tax, or whether the tax is imposed on the seller. We recommend that taxpayers be allowed to elect whether to exclude these taxes from DPGR or to allocate them as a cost against DPGR regardless of the actual incidence of the tax.
IV. Application of Section 199 to Pass-Through Entities.

Pass-through entities require additional guidance in several areas in order to implement section 199.

**Special Allocations of QPAI/W-2 Wages.** Clarification is needed to ensure that QPAI (DPGR and related items of expense) can be specially allocated, subject to the requirements of section 704. Moreover, with regard to the wage limitation of section 199, examples clarifying the application of allocation rules under section 4.06(1)(a)(iii) of the Notice would be helpful.

**Passive Loss Rules.** Additional guidance is needed to clarify the interplay between the passive activity limitation in section 469 and section 199. An example illustrating the section 199 deduction for a partner who is a passive investor with an overall net passive loss for the taxable year would be particularly helpful.

**Redemption and Transfers of Partnership Interests.** Section 3.06(2) of the Notice provides that gain or loss from the sale, exchange or other disposition of an interest in a pass-through entity gives rise to an item of QPAI to the extent that section 751(a) or (b) applies. Although the Section agrees that section 751 gain generated in a redemption transaction should be treated as QPAI, the appropriate treatment of a sale transaction is less clear. In this situation, the partnership basis is unaffected by the recognition of ordinary gain or loss, in the absence of an election under section 743. Further guidance is needed to illustrate how section 199 should operate in transactions affected by section 751.

**Distribution Partnerships.** Members of an affiliated group commonly form partnerships to distribute goods. The section 702 regulations require a partner to treat all items as having the same character as if realized by the partner. We recommend that proposed regulations include an example indicating that the gross receipts and CGS related to these products are includible in the partner’s computation of QPAI to the extent QPP produced by the partner is involved.

**Fiscal Year Partnerships – Transition Issues.** Fiscal year partnerships with taxable years that overlap the 2005 calendar year will encounter difficulties when determining the appropriate W-2 wages allocable to each partner. Guidance is needed on whether the annual deduction limitation is computed by reference to the entire calendar year or to only a portion of the fiscal year within the calendar year.

**Special Industry Issues: Oil and Gas.** Taxpayers in the energy industry frequently operate joint ventures that elect out of Subchapter K pursuant to Treas. Reg. § 1.761-1(a). We recommend the issuance of guidance indicating that taxpayers who make this election are nevertheless treated as owners of pass-through interests for purposes of applying section 199.
V. Expanded Affiliated Group Issues.

Section 199(d)(4) provides that all members of an expanded affiliated group are to be treated as a single corporation for purposes of applying section 199. Moreover, section 199(c)(7) excludes amounts derived from transactions with related parties from DPGR. However, the Notice suggests related party transactions can produce QPAI. Further guidance (including examples) is needed to illustrate the application of section 199 in this context.

VI. Other Comments.

Section 6.01 of the Notice invited comments with regard to specific issues involving the implementation of section 199. We have responded to several of these issues, including:

- Applicable provisions of the Code, regulations and other administrative guidance dealing with the computation of taxable income, and the order in which they should be applied;
- Examples in which a taxpayer may not have the “benefits and burdens of ownership” and yet may still be treated as satisfying the requirement of production “by the taxpayer” under section 199(c)(4)(A)(i);
- The application of section 199 deductions to trusts and estates, and particularly the apportionment of income between trusts and estates and their beneficiaries;
- Whether methods of allocating or apportioning gross receipts are methods of accounting with respect to which restrictions from change apply (with the Section recommending against such a determination);
- Modification or clarification of the section 861 method for allocating and apportioning expenses;
- Whether members of an expanded affiliated group (“EAG”) should be able to use different methods of allocating and apportioning deductions (with the Section recommending that different methods should be allowed);
- The application of section 199 to computer software;
- The appropriateness of restricting the simplified deduction method to taxpayers below the $25 million gross receipts threshold (with the Section recommending that it be available to all taxpayers).
General Introduction


We commend Treasury and the IRS for the prompt issuance of interim guidance. We further commend Treasury and the IRS for providing safe harbors, simplified methods and de minimis rules to facilitate compliance with this new provision. We also wish to thank Treasury and the IRS for the careful consideration of questions we submitted prior to the publication of the Notice.

I. Determining Qualified Production Activities Income

Section 4.03 of the Notice defines qualified production activities income (“QPAI”) as domestic production gross receipts (“DPGR”) reduced by the costs of goods sold (“CGS”) allocable to those receipts, other deductions, expenses or losses directly allocable to those receipts, and a ratable portion of deductions, expenses or losses not directly allocable to those receipts or to another class of income.

The Notice states that QPAI is to be determined on an item-by-item basis, and not on a transaction-by-transaction basis. We believe this definition needs additional clarification. Many contracts, invoices or other sales documentation contain numerous lines and references to parts, components or other subcategories. The taxpayers’ general accounting system may not separately identify or track revenue from these items.

We recommend that the regulations apply a rule for determining “items” similar to the rule set forth in section 4.04(2) of the Notice, which would provide that the taxpayer may use any reasonable method for identifying “items” that accurately determines QPAI.

1 2005-7 IRB 498.
2 All section references, unless otherwise indicated, are to the Internal Revenue Code of 1986, as amended (the “Code”) and all “Treas. Reg. §” references are to the Treasury Regulations promulgated under the Code.
II. Determining Domestic Production Gross Receipts

A. In General

Section 4.04 of the Notice sets forth the operating rules for determining DPGR, and identifies qualifying production property ("QPP") and qualifying production activities. DPGR includes the gross receipts of the taxpayer derived from any lease, rental, license, sale, exchange or other disposition of QPP that was manufactured, produced, grown, or extracted ("MPGE")\(^4\) in whole or in significant part by the taxpayer within the United States.\(^5\) The Notice defines "production activities" for purposes of section 199 to include activities related to manufacturing, producing, growing, extracting, installing, developing, improving and creating qualified production property.\(^6\) Manufacturing also includes making QPP out of scrap, salvage or junk material; or from new raw material by processing, manufacturing, refining or changing the form of an article; or by combining or assembling two or more articles; and cultivating soil, raising livestock, fishing and mining materials.\(^7\)

B. Definition of “By the Taxpayer”

The Notice states that if one taxpayer performs a qualifying activity pursuant to a contract with another taxpayer, only the party that has the "benefits and burdens of ownership" of the QPP during the period of the qualifying activity is treated as engaged in the qualifying activity.\(^9\) The benefits and burdens of ownership test is based on existing federal income tax principles.\(^10\) The explanation in the Notice states that Treasury and the IRS believe that only one taxpayer should be able to claim the deduction under section 199 with regard to the same function performed on the same property.

The position that a taxpayer must have the “benefits and burdens of ownership” in order to sell, lease license or otherwise dispose of property fails to recognize the legal and economic realities that a person may hold and “otherwise dispose” of an interest in property without having the “benefits and burdens of ownership” of the property. Equitable interests, security interests, lien interests and possessory interests are but a few of the vast array of legal interests that may be held and sold or otherwise disposed. Accordingly, we believe the benefits and burdens test as stated in the Notice applies a limiting interpretation that is not supported by the statute or legislative history.

\(^{4}\) These four activities are referred to hereinafter simply as manufacturing or production. As used herein, these two terms are intended to encompass growing and extracting as well, where applicable.

\(^{5}\) §199(c)(4)(A)(i)(I). Notice 2005-14, §3.04(3). Notice 2005-14, §4.04(3)(b), further provides that a taxpayer that has manufactured or produced QPP for the tax year also should consistently treat itself as a producer under Section 263A with respect to the QPP for the tax year unless the taxpayer is not subject to Section 263A under the Code, regulations or other published guidance.

\(^{6}\) Notice 2005-14, §§3.04 and 4.04.

\(^{7}\) Notice 2005-14, §4.04

\(^{8}\) Id., §4.04(3).

\(^{9}\) Id., §4.04(4).

\(^{10}\) Id., §3.04(4), which also states that Treasury and the IRS will look to the principles of Sections 936 and 263A.
Further, Treasury has stated their intent in drafting regulations under section 199 to apply or adapt existing concepts in tax law, rather than develop new concepts exclusively applicable to section 199. We concur with the approach, both for reasons of simplicity and consistency. The body of law that has developed around the sale of goods versus the provision of services is highly fact specific, and a single rule is unlikely to achieve the right result and advance an administrable rule. By basing this decision solely on the “benefits and burdens of ownership,” Treasury has invoked yet another body of law addressing sales versus financing. The result is more confusion and a rule that is inequitable and difficult to apply and administer, and potentially subject to manipulation.

Treas. Reg. § 1.263A-2(a)(1)(ii)(A) provides that the "determination as to whether a taxpayer is an owner is based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxpayer. A taxpayer may be considered an owner of property produced, even though the taxpayer does not have legal title to the property. (Emphasis added)."

We suggest that the proposed section 199 regulations provide that the taxpayer will be considered the producer of the property if it is considered a producer for other purposes of the tax law, including section 263A and section 460 (we provide examples of this situation in part VI, below). This avoids the complexity created by having different definitions for various sections of the Code. Further, we believe the guidance should conform to the section 263A definition as suggested by legislative history, as well as section 460.

We recommend that Treasury and the IRS consider omitting the references to contract manufacturing in sections 3.04(4) and 4.04(4) of the Notice and allow existing rules including Treas. Reg. §1.263A-2(a)(i)(ii)(A) to govern the applicability of section 199.

C. In Whole or in Significant Part

Under the Notice, QPP will be treated as manufactured or produced in significant part by the taxpayer within the United States if either of the following conditions are met:

- The manufacturing or production activities performed by the taxpayer within the United States are substantial in nature ("substantial in nature test")\(^{11}\), or
- Conversion costs (direct labor and related factory burden) to manufacture or produce the property are incurred by the taxpayer within the United States and these costs account for 20% or more of the total cost of goods sold of the property (the “20% safe harbor test”).\(^{12}\)

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\(^{11}\) Notice 2005-14, §4.04(5)(b).

\(^{12}\) Id., §4.04(5)(c). The safe harbor rule is intended to operate similarly to the safe harbor provided under Treas. Reg. §1.954-3(a)(4)(iii) for determining whether, for purposes of computing foreign base company sales income, the sale of property is treated as the sale of a manufactured product, rather than the sale of a component part, when purchased components constitute part of the property. Notice 2005-14, §3.04(5)(c). See Treas. Reg. §1.954-3(a)(4)(iii), Examples 1 and 2; see also PLR 8146058 (assembly operation satisfied safe harbor); cf. Rev. Rul. 76-272, 1976-2 CB 235 (application of 20% conversion cost rule under the DISC regulations); Rev. Rul. 78-228, 1978-1 CB 252 (same).
Whether a taxpayer's activities are "substantial in nature" depends on all the facts and circumstances, including:

1) the relative value added by, and relative cost of, the taxpayer's manufacturing or production activity in the United States;
2) the nature of the property; and
3) the nature of the manufacturing or production activity that the taxpayer performs in the United States.\(^\text{13}\)

Development costs and the costs of any intangibles are excluded for purposes of this test, except for the production of software and sound recordings.\(^\text{14}\) It has been suggested that design and development activities are excluded because they produce intangible property. Neither the statute nor the legislative history suggest exclusion of development activities that are an intrinsic part of QPP from the determination of qualifying activities. In fact, the value of development costs or intangibles is not excluded for purposes of determining DPGR.

Development activities are clearly related to and inextricably intertwined with manufacturing, producing, growing, extracting, installing, developing and creating qualified production property. Regardless of whether the development activities produce intangible property, the tangible embodiment of the activities is the property produced; gross receipts are derived from the sale of that property, not the sale of the rights to the intangible. Further, development activities often do not result in a separately identifiable intangible asset. Accordingly, we recommend that the 20% safe harbor and the "substantial in nature test" be modified to eliminate the exclusion of development activities and intangibles to the extent incorporated into the tangible product.

### D. Electricity, natural gas and potable water

Section 199(c)(4) defines DPGR to include electricity, natural gas or potable water produced by the taxpayer in the United States, but to exclude gross receipts that are derived from the transmission or distribution of those items. Integrated utilities that generate, transmit and distribute electricity or natural gas will be required to identify the gross receipts derived from qualifying activities and to exclude the gross receipts from non-qualifying activities. These integrated utilities often have access to information prepared for purposes of rate regulation that we believe could provide the basis for a simplified method for determining DPGR.

\(^{13}\) Notice 2005-14\$4.04(5)(b). A taxpayer earns DPGR on the sale of QPP even if production or manufacture of the QPP occurred before the enactment of Section199. This result is particularly relevant for taxpayers that are both engaged in construction activities (i.e., are engaged in construction within the meaning of the NAICS codes) and sell appreciated real property that was constructed many years ago, as well as taxpayers with long production periods.

\(^{14}\) Id., §§4.04(5)(b) and (c). With respect to computer software and sound recordings, the Notice provides that a significant portion of the "production" may be viewed as design and development (for example, writing the programming code in the case of computer software, and recording and editing the master copy in the case of sound recordings).
We recommend that future guidance consider a simplified approach that uses the proportion of rate base associated with the electric production activities compared to total rate base as the starting point for determining QPAI. The guidance could provide for an election to use such a method to reduce the administrative burden in this area on the IRS and on the taxpayers. We believe this simplified approach could minimize the complexity of determining DPGR from unbundled electricity rates that are common throughout the industry, and it could also minimize the extensive allocation issues associated with applying section 861 principles in a regulated environment.

E. Construction Performed in the United States

1. Taxpayer Nexus to Construction Activity

Section 4.04(11)(a) of the Notice states that the term construction means the construction or erection of real property, inherently permanent structures, or inherently permanent land improvements by a taxpayer that is in a trade or business that is considered construction for purposes of the NAICS codes.

It is unclear how the NAICS system will be employed to determine whether taxpayers are engaged in the trade or business of construction.

Many taxpayers are engaged in construction activities; however, their businesses may employ a non-construction NAICS code. Home improvement companies and various contractors (such as electricians) may employ a variety of NAICS codes. Taxpayers in the business of developing real estate for sale would qualify as producers of QPP; however, it is unlikely they would use a construction NAICS code. We recommend that the proposed regulations omit reference to the NAICS codes, or qualifying the application of the NAICS system to assure application of section 199 in a manner consistent with Congress’ intent.

2. Status of Land

Section 4.04(11)(e) of the Notice states that proceeds attributable to the disposition of land will not be considered DPGR derived from construction.

The cost of land incorporated in a construction project will always reduce QPAI. This addresses the need to exclude land from the amount on which the production deduction will be based without requiring a novel and ultimately unworkable valuation regime. Any valuation rule that attempts to measure the relative values of land and land appreciation to construction activity in connection with defining QPAI from construction projects unnecessarily creates the potential for ongoing valuation disputes with respect to every taxpayer who constructs and sells real property improvements and claims a section 199 deduction for those activities. We do not believe Congress intended such a result when it made construction activities eligible for this deduction.
Excluding land from the computation of QPAI is inconsistent with the general rules for application of section 199 and will add an additional level of complication. The Notice recognizes in the jewelry example\textsuperscript{15} that a production activity may involve expensive materials with a relatively small labor component. Implicit in this example is the premise that precious metals or gems may be held for an extended period of time and that the qualifying gross receipts from the sale of the jewelry produced will reflect this appreciation.

We are aware that Treasury and the IRS are concerned about a taxpayer who holds highly appreciated land and engages in minimal construction activity in order to treat receipts from the sale of the land as DPGR. As others have observed, this is likely to occur only when the taxpayer is not eligible for favorable long term capital gains tax rates, since conversion of capital gains on sale to ordinary income would generally be far more disadvantageous than any benefit available from section 199. There will, however, be construction businesses as well as corporate or non-resident taxpayers for whom the rate differential is not a deterrent. Therefore, we suggest use of the existing rule of Treas Reg. § 1.460-1(b)(2)(ii) as an anti-abuse rule. This provides that contracts for sale of property are not construction contracts if they involve the sale of land where estimated total allocable costs attributable to construction by a taxpayer are less than 10 percent of the contract’s total price. In the appreciated land scenario, this would require construction expenditures that exceed the tax benefits derived by a taxpayer from section 199, thus providing a significant economic deterrent to behavior that gives rise to the Treasury and IRS concerns.

F. Other Special Industry Issues

1. Media: Advertising Income

The Notice states that gross receipts that are “derived from” the sale or other disposition of newspapers and magazines include advertising income.\textsuperscript{16} We concur with this analysis and suggest it apply to advertising in all media that is otherwise QPP. Revenue from media advertising and subscription revenue are inextricably intertwined. In the case of television network programming, the media advertising revenue may be the only revenue derived from the qualifying activity.

2. Oil & Gas Industry

Non-Operator Working Interests. Two participants in the energy industry may jointly develop and operate a project for the extraction of oil and gas. The two participants share in the costs and the revenue of the project. One party is designated as the operator of the property and is responsible for day-to-day operations. The other party has what is frequently referred to in the industry as a "non-operating working interest." Generally, these agreements are contractual and are not partnership agreements.

\textsuperscript{15} Notice 2005-14, §3.04(5)(b), describing activities that are substantial in nature.

\textsuperscript{16} Notice 2005-14, §4.04(7)(c).
In Rev. Rul. 89-27, the IRS addressed whether a non-operating working interest owner is actually engaged in a trade or business for purposes of section 355. This ruling provides an accurate description of the typical situation, and it attributes the activities of the operator to the non-operating working interest owner. In accordance with this position, we recommend that both parties be treated as receiving DPGR and a share of the related costs.

**Revenue from Royalties and Net Profits Interests.** A taxpayer may own a royalty interest or net profits interest that does not require the taxpayer to advance capital for development or operating expenses. (The costs related to development or operation of the property may, however, reduce the amount paid to the owner of the net profits interest.) The owner of a royalty interest is entitled to a percentage of the gross proceeds derived from the sale of qualifying production property extracted. The net profits interest owner is entitled to a percentage of the net profits derived from the sale of qualifying production property extracted.

We recommend that Treasury and the IRS clarify whether gross receipts from the net profits or royalty interests are properly treated as DPGR.

### 3. Hedging and Currency Gains and Losses

Taxpayers frequently enter into financial transactions to assure a desired economic result. It is possible that the gains from such transactions could be treated as non-DPGR, while the losses could be associated with a cost of production. We recommend that the IRS and Treasury clarify the treatment of such transactions so that gains and losses are treated consistently. In any event, netting of gains and losses in similar transactions should be allowed for these purposes.

### III. Determining Costs

#### A. Cost Allocation Method

Section 199 requires a taxpayer to reduce DPGR by the CGS directly allocable to DPGR, the amount of deductions directly allocable to DPGR, and a ratable portion of other deductions not directly allocable to DPGR or to another class of income.

First, the Notice provides that a taxpayer engaged in the sale of qualifying production property should allocate its expenses to cost of goods sold in accordance with the general principles of section 263A. Section 263A requires the capitalization of direct costs and, with few exceptions, the indirect costs that “directly benefit or are incurred by reason of” a production activity.

The Notice also provides that, if a taxpayer cannot specifically identify the CGS allocable to the DPGR, the taxpayer may make the allocation using a reasonable method. The allocation method must be the same as the one used for allocation of DPGR, and depending on the facts and circumstances may include methods based on gross receipts, number of units sold or produced, or total production costs.\(^{18}\)

\(^{17}\) 1989-1 C.B. 109-110.

\(^{18}\) Notice 2005-14, §4.05(2).
The Notice provides three methods for allocation of deductions (other than CGS) to qualified production activities. Two simplified methods are available to taxpayers with gross receipts that do not exceed $25 million. The Notice provides that all other taxpayers generally must allocate and apportion deductions using the rules provided in the section 861 regulations. The Notice states that, under the section 861 method, section 199 is treated as an “operative section” described in Treas. Reg. § 1.861-8(f). Accordingly, the taxpayer applies the rules of the section 861 regulations to allocate and apportion deductions to gross income attributable to DPGR. In general, the section 861 regulations are applied on a single-entity basis, although the rules are applied on the basis of the affiliated group (as determined under the section 861 regulations) for certain expenses such as interest expense and research and experimental expenses.

We note first that, although section 199 was enacted as a replacement for ETI, its application is solely domestic. It applies only to specified net income generated by activities in the United States. Footnote 24 of the Conference Committee Report states:

The Secretary shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining income attributable to domestic production activities. Where appropriate, such rules shall be similar to and consistent with relevant present-law rules (e.g., section 263A, in determining the cost of goods sold, and section 861, in determining the source of such items). Other deductions, expenses or losses that are directly allocable to such receipts include, for example, selling and marketing expenses. A proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income include, for example, general and administrative expenses allocable to selling and marketing expenses.

This Conference Committee Report refers to the section 861 regulations as appropriate for determining the source of items, but does not refer to it for allocating and apportioning other expenses. Section 861 operates to allocate and apportion expenses to domestic and foreign source income. It was not designed as the exclusive method for allocating and apportioning expenses among qualified and non-qualified domestic activities. We do not believe its use in this manner is supported by section 199 or its legislative history.

We believe it is appropriate and consistent with the legislative history of section 199 to apply section 861 only to determine the source of activities within or outside the United States. It is more appropriate to apply rules that are similar to section 263A to allocate and apportion expenses among activities. The section 263A rules are less complex and more easily administrable in a domestic context.

Specifically, the use of section 861 to allocate interest expense produces a result that may not be consistent with the statute. The section 861 regulations are based on a presumption that money is fungible and that the activities of the taxpayer are similar across geographic borders. Accordingly, it allocates interest expense based on the location of assets.

Section 199(c) states that QPAI equals the taxpayer’s DPGR reduced by CGS allocable to such receipts, other deductions, expenses or losses directly allocable to such receipts, and a ratable portion of other deductions, expenses and losses “that are not directly allocable to such receipts.
or another class of income”. The statute specifically states that the broad allocation rule that applies to residual expenses should be applied only after directly allocating expenses to the classes of income that gave rise to them.

Thus, section 199 seeks to segregate net income based on the type of activities that produced it, and a special deduction is provided based on net income from production activities. It is important to recognize that money is used differently in different types of businesses. In a financial service business money functions as an item of inventory. In an expanded affiliated group (“EAG”) that includes a member in a financial service business, the section 861 allocation regime based on the location of assets will generally not achieve a result that correctly attributes interest expense to the related income producing activities.

We believe that taxpayers should be permitted to allocate and apportion interest expense based on facts and circumstances, and by allocating interest expense first within the entity in which it was incurred. We recommend that the IRS and Treasury consider such an approach in future guidance.

**B. Specific Costing Problems in the Oil and Gas Industry**

**Exploration and Development Costs.** The following issues relate to the oil and gas industry, which faces several areas of uncertainty in matters of cost allocation. Industry participants frequently drill new wells in addition to producing oil and gas from previously drilled wells. It is unclear whether the cost of drilling and equipping new wells in order to produce oil and gas from them is an expense that offsets the revenue from existing wells under section 199(e).

Similarly, it is unclear whether the cost of drilling exploratory wells is treated differently from the costs of drilling developmental wells. An exploratory well is drilled in an unproven or semi-proven territory for the purposes of ascertaining the presence of a commercial petroleum deposit. A developmental well is drilled with the expectation of producing oil or gas from a known productive formation.

Similarly unclear is whether the costs of drilling a well that is nonproductive (dry hole) are treated differently from the costs of drilling a productive well.

Section 4.03(1) of the Notice provides that QPAI is determined on an item-by-item basis and is the sum of QPAI derived from each item. QPAI from each item may be positive or negative. For an oil and gas producing company, drilling and equipping a well is analogous to the cost of building a factory. The depreciation and depletion from the well, once it is placed in service, are costs that must be allocated to and reduce QPAI. We believe it would be helpful to clarify that the costs incurred prior to the well being placed in service would not be deductions allocable or apportionable to QPAI.

Section 263 allows some taxpayers to take an immediate deduction for intangible drilling and development costs (“IDC”) in the case of oil and gas wells and geothermal wells in the year that the costs are incurred or paid, depending on the taxpayer's method of accounting (integrated oil companies are only permitted to deduct 70% of the IDC). It is not clear whether the taxpayer must allocate these costs against QPAI since the costs are deductible prior to the time that the
wells are placed in service. Without the deduction permitted by section 263, the costs of productive wells would be capitalized and amortized against DPGR.

A taxpayer may elect to deduct dry hole costs as an ordinary loss. The rules regarding the proper treatment of such costs if an election is made are not well defined. If all further efforts to obtain production from the property fail, the dry hole costs would apparently be recoverable as a loss on the sale or abandonment of the property.

In the mineral context, section 614(a) defines property as each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land. Section 614(b)(1) does permit aggregation of separate properties in some situations. Nevertheless, the property, as that term is used for federal tax purposes, is rather small in most situations, particularly in the domestic oil and gas context where the separate tract or parcel is a separate oil and gas lease from a landowner. In most cases, there will probably not be other producing wells on a tax property where the taxpayer has drilled a dry hole.

Section 4.05(3)(b)(ii) of the Notice states "a deduction under section 165 for a loss related to property (including theft, casualty or abandonment losses) is allocated or apportioned to DPGR or gross income attributable to DPGR only if the proceeds from the sale of the property are, or would have been, included in DPGR." The sale of the oil and gas property would not have been included in DPGR since it is the proceeds from sale of a real property interest, typically the sale of an oil and gas lease. It therefore appears that the loss on the sale or abandonment of the oil and gas property would not reduce DPGR.

If a taxpayer elects to deduct dry hole costs, we do not believe the dry hole costs reduce DPGR. Had the taxpayer not deducted dry hole costs but taken the loss when it abandoned or sold the property, the costs would not be directly allocable to related DPGR. We recommend that Treasury provide clarification as to the treatment of IDC's and dry hole costs.

Severance, Sales and Excise Tax. The energy industry is subject to many different taxes. Many states impose a severance tax on the value of the minerals extracted in that state. There are also taxes imposed on the sale of products, particularly gasoline and motor fuels.

Section 4.04(2) of the Notice provides that with respect to sales and other similar taxes, the seller must determine whether (1) the tax is imposed on the purchaser and the seller simply collects the tax or (2) the tax is imposed on the seller. In the first case, the tax is excluded from DPGR, whereas in the second case the tax is a cost allocated against DPGR. The results in either case should be the same.

It would be administratively easier for taxpayers and the IRS if taxpayers were allowed to elect either to reduce DPGR by the tax and exclude the cost from DPGR cost allocations, or to include the tax in DPGR and as a cost allocable against DPGR, regardless of the incidence of the tax.

IV. Application of Section 199 to Pass-Through Entities

A. Special Allocations of the Qualified Production Activities Income/W-2 Wages

We recommend that future guidance clarify that QPAI and related items of expense can be specially allocated among partners in any manner the partners agree on so long as the allocations meet the requirements of section 704(b) (either as having substantial economic effect or otherwise being consistent with the partners’ overall interests in the partnership).

Additionally, it would be helpful to have examples showing the effect of special allocations of DPGR, CGS and other deductions directly allocable to DPGR; and other deductions, expenses and losses not directly allocable to DPGR, QPAI, net income and payroll expense of a partnership.

Examples expanding and clarifying the rules for allocating a partnership’s W-2 wages set forth in section 4.06(1)(a)(iii) of the Notice would be helpful. We note that W-2 wages may not always be an item of partnership expense for a taxable period (either because the partnership may be required to accrue the payroll expense in a different taxable period, or may be required to capitalize the payroll expenditure). We believe that additional guidance is needed to clarify whether the allocation rules in section 4.06(1)(a)(iii) of the Notice are intended to provide a specific type of special allocation of partnership expense, or whether they are merely providing an allocation solely for the purposes of computing the W-2 wage limitation for section 199 purposes.

B. Passive Loss Rules

We believe that additional guidance is needed to clarify the interplay of the passive activity loss limitations of section 469 with section 199. Under the Notice, a partner is required to determine QPAI after applying certain limitations, such as the passive loss rules in order to determine whether the taxpayer is eligible to utilize any expenses (incurred with respect to a partnership’s qualified production activities) passed through to the partner.

We suggest an example illustrating the operation of section 199 where a taxpayer obtains a pass through of QPAI from one partnership in which the taxpayer is a passive investor for section 469 purposes and also has net passive losses or deductions from another partnership or activity. It would be helpful if the example clarified whether the section 199 deduction would be limited by the passive activity loss limitations if the taxpayer has an overall net passive loss for a taxable year.

C. Redemptions and Transfers of Partnership Interests

Section 3.06(2) of the Notice provides:

(2) Gain or loss from the disposition of an interest in a pass-thru entity. Because the sale of an interest in a pass-thru entity does not reflect the realization of QPAI by that entity, QPAI generally does not include gain or loss recognized on the sale, exchange or other
disposition of an interest in the entity. However, if § 751(a) or (b) applies, gain or loss allocated to assets of the partnership the sale, exchange, or other disposition of which would give rise to an item of QPAI is taken into account in computing the partner's § 199 deduction.”

Section 751 can apply to a sale of a partnership interest (to another partner or to a third party) or to a redemption of a partnership interest by the partnership. For a sale of a partnership interest, section 751 requires that the transferring partner treat the transfer as including (on an aggregate basis) a sale or other transfer of the transferor’s pro rata share of the partnership’s “hot assets”.

In a redemption transaction, where a partnership redeems all or a portion of the interest of a partner for cash or for other than a pro-rata share of all partnership assets, the partnership is deemed to distribute a pro rata portion of all its assets to the partner and the partnership and the partner are deemed to exchange cash or assets in a taxable transaction. Thus a partner could be deemed to have sold hot assets to the partnership (where for example the partner had actually received all cash) or the partnership could be deemed to have sold hot assets to the partner (where for example the assets actually distributed to the partner included more than the partner's pro rata share of hot assets).

The limited guidance in the Notice indicates that any gain generated by the deemed sale of “assets of the partnership the sale, exchange, or other disposition of which would give rise to an item of QPAI” is included by the transferor partner for purposes of determining the partner’s QPAI. Based upon this language, it seems clear that, in the case of a partial or complete liquidation of a partner’s interest in the partnership, the deemed sale of hot assets between the partner and the partnership would produce QPAI if an actual sale of the hot assets would do so (e.g., in the case of inventory, the sale of which by the partnership would produce QPAI). Because the deemed sale of qualifying assets (by the partner to the partnership or by the partnership to the partner) would result in a cost basis to the deemed purchaser, such treatment would not pose any problem of double counting the QPAI. Thus, the result appears consistent with the statute.

In the case of a sale of a partnership interest (to another partner or to a third party) it is less clear whether it is appropriate for the application of section 751 to generate DPGR. In both cases, a portion of the transferor partner’s gain is converted to ordinary income, but the partnership remains unaffected. As a result, the partnership could, in the absence of a section 743 basis adjustment, recognize additional QPAI upon the sale of the same partnership hot assets. Furthermore, if a sale of a partnership interest does generate QPAI, it is not clear how the partnership’s expenses associated with the QPAI should be allocated (i.e., it is not clear how the partnership would allocate expenses in order to insure that the transferor partner does not recognize too much QPAI). A similar problem arises with regard to the W-2 wage allocation. These issues are accentuated by the fact that the partnership might not even receive notice of the transfer.

We recommend further guidance, including illustrative examples, concerning the application of the section 199 deduction in a context of section 751.
D. Distribution Partnerships

In many industries it is common for members of an affiliated group of corporations to form a partnership to distribute goods for one or more members of the group. Partnership income is allocated to each partner to reflect the sales of each partner's merchandise.

Treas. Reg. 1.702-1(a)(8)(ii) states that each partner must take into account separately the partner's distributive share of any partnership item which, if separately taken into account by the partner, would result in an income tax liability different from that were the partner not required to take it into account separately. Treas. Reg. 1.702-1(b) states that the character of any item of income gain, loss or deduction in the hands of the partner shall be determined as if such item were realized directly by the partner.

The section 702 regulations require the partner to treat all items as if realized directly by the partner and as having the same character as if realized by the partner. Thus it appears that if a taxpayer sells QPP to a partnership in which it is a partner, the gross receipts from the sale of the goods by that partnership are to be treated as if the sale were made directly by the partner. Since the partner produced the property, the gross receipts would be treated as DPGR to that partner. The amount paid by the partnership to the partner for the products will be included in CGS with regard to the partnership's sale of the goods.

We recommend an example to illustrate the application of section 702 to the section 199 computation.

E. Fiscal Year Partnerships – Transition Issues

Under the Notice, a partner’s share of W-2 wages is passed through to the partner and must be aggregated with the partner’s other W-2 wages for purposes of determining the taxpayer’s section 199(b) limitation (i.e., a cap on the deduction equal to 50 percent of the taxpayer’s W-2 wages).

In the case of fiscal year partnerships, complications may arise. Under section 199(b)(2), the W-2 wages passed through are those wages incurred during the calendar year that ends during the taxable year in issue. However, the Notice provides that with respect to pass-through entities, section 199 is effective for taxable years beginning in 2005. Accordingly, the deduction will not be available to fiscal year partnerships until a new fiscal year begins.

For example, it appears that a partnership with a September year-end would not have any W-2 wages for this purpose until its 2006 tax year that begins October 1, 2005. However, section 199(b)(2) clearly provides that W-2 wages are determined on a calendar year basis. Accordingly, guidance is needed on whether the W-2 wages used to measure the 2006 deduction should be those arising between January 1, 2005 and December 31, 2005, or those arising between the effective date (October 2005) and the end of 2005.

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F. Special Industry Issues: Oil and Gas Joint Ventures

In the energy industry, taxpayers frequently join together and operate a joint venture that elects not to be treated as a partnership for purposes of subchapter K of the Code. Treas. Reg. §1.761-1(a) permits taxpayers who join together for purposes of the joint production or extraction of natural resources to make this election if they meet certain specified requirements.

Section 199(d) and the Notice provide special rules for pass-through entities. It is not clear whether a joint venture that elects out of subchapter K is a pass-through entity for purposes of section 199.

Electing out of subchapter K likely would undermine the benefit intended to be provided under section 199. The most significant effect of the election out might be that the owners of the joint venture are not entitled to the benefit of the W-2 wages paid by the partnership or the deemed W-2 wages provided for under section 199(d)(1)(B)(ii) for purposes of the wage limitation under section 199. Taxpayers electing out of subchapter K should nevertheless be treated as owners of a flow-through entity for purposes of section 199. In any event, it would be useful for taxpayers if Treasury could provide guidance on the treatment of joint venturers that elect out of subchapter K.

V. Expanded Affiliated Group Issues

For section 199 purposes, all members of an expanded affiliated group ("EAG") are treated as a single corporation. An EAG is an affiliated group of includible corporations as defined in section 1504(a) determined by substituting "50 percent" for "80 percent" each place it appears, and includes insurance companies and corporations that have made an election under the possessions tax credit rules. Therefore, for many taxpayers, the EAG will be comprised of the same affiliated group of corporations joining in the filing of a consolidated tax return.

Under the Notice, each member of an EAG is treated as conducting the activities conducted by each other member of the EAG. This "attribution of activities" rule follows a single entity approach and is similar in application to the treatment of attributes under the intercompany transaction rules in the consolidated return regulations. That is, each EAG member’s separate entity activities are essentially redetermined to the extent necessary to produce the same effect as if all members were divisions of a single corporation engaged in all of the activities of the EAG.

The rules promulgated in the Notice are inconsistent with the statute. Section 199(c)(7) explicitly denies DPGR treatment for amounts derived from the lease, license or rent of property to a related party, including another member of a consolidated group.

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20 §199(d)(4)(A).
21 §199(d)(4)(B).
22 Notice 2005-14, §§ 3.08 and 4.09.
23 Treas. Reg. §1.1502.
We recommend further guidance, including illustrative examples, concerning the application of the section 199 deduction in the expanded affiliate group context.

VI. Notice 2005-14 – Request for Comments

Section 6.01 of Notice 2005-14 invite comments with respect to certain specific issues. The following are provided in response to that request.

(1) The Service and Treasury are aware that several provisions of the Code and regulations require computations based upon taxable income, and that there is confusion concerning the order in which these provisions are to be applied. Taxpayers are invited to submit a list of all provisions of the Code, regulations, and other administrative guidance (if any) that require computations based upon taxable income, and the order in which taxpayers believe they should be applied.

Many provisions make reference to taxable income, and it is inevitable that future legislation or regulatory guidance will also have computations or limitations that are tied to taxable income.

Any other item of income or deduction that affects taxable income would also affect the computation of QPAI, either directly or indirectly through apportionment ratios. This results not just in a bilateral equation that can be solved by using two variables, but rather requires adjusting complex computations. It may be advisable to compute QPAI before other items that are based on or limited by taxable income.

We also recommend that future guidance consider clarifying the treatment of net operating loss carryforwards into the section 199 year and the computation of any amount that will be carried out of the section 199 year. In certain circumstances it appears that section 172(b)(2) may operate to permit taxpayers with current year income and NOL carryforwards to compute a section 199 deduction and take it into account in determining the section 172 loss that is carried forward to a subsequent year.

(2) The Service and Treasury Department are concerned that there may be situations in which a contractor does not bear the benefits and burdens of ownership with respect to property (for example, for security reasons), but nevertheless should be regarded as satisfying the “by the taxpayer” requirement of section 199(c)(4)(A)(i). Taxpayers are invited to submit comments in such situations.

As previously discussed, we believe that a taxpayer should be treated as having satisfied the “by the taxpayer” requirement of section 199(c)(4)(A)(i) if the taxpayer is considered the producer of property for purposes of section 263A or produces the property under a long-term contract subject to section 460. The benefits and burdens of ownership of property produced by the taxpayer may transfer to the customer at various stages in the production process. This may reflect security reasons, liability reasons, or a myriad of other business driven exigencies. Taxpayers may be treated as producers of the subject property and recognize income and expense as producers of inventory property or under long-term contract rules, notwithstanding benefits and burdens of ownership. It is fundamentally inconsistent to treat a taxpayer as the producer of tangible personal property for purposes of section 263A or as a long-

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term contractor under section 460, but not as a producer of that same property for purposes of section 199. This would result in the taxpayer being treated as a producer of property for some applications of the Code, but as a service provider for others. This inconsistency will lead to confusion and misapplication of the law.

The following examples illustrate circumstances where the benefits and burdens of ownership may vest in whole or in part in the customer or transfer to the customer before the production process is complete, but such activities nevertheless are appropriately within the scope of section 199.

**Example 1:** For some industrial equipment, the manufacturing process is completed at the customer’s site. In these cases, ownership of components may transfer to the customer at various stages in the manufacturing process.

Corporation A manufactures industrial boilers used in chemical manufacturing. Chem Co. contracts with Corporation A to manufacture and install three boilers. The components of the boilers are manufactured at Corporation A’s factory and are transported to Chem Co.’s location. The production of the boilers is not complete until they are assembled and installed. However, title to the components transfers to Chem Co. as they are delivered to Chem Co.’s location (this may occur for liability or numerous other reasons). Corporation A’s employees complete the manufacturing process, and assemble and install the boiler components at Chem Co.’s location. Corporation A is considered the producer of the boilers through the completed installation of the boilers for purposes of section 263A. Corporation A reports the revenue from the contract, including the revenue associated with the manufacturing activity taking place at Chem Co.’s location, as sales of manufactured property in accordance with its regular methods of accounting. Assuming the revenue otherwise meets the requirements of section 199, it will be considered DPGR.

**Example 2:** Businesses frequently enter into contracts to rebuild existing heavy industrial equipment. X Co. contracts with the original manufacturer of a printing press, Y Co., to rebuild or remanufacture its 25 year-old printing press. X Co. shuts down the press for the period of the remanufacture. Y Co. employees disassemble the press and transport many of the parts to Y Co.’s facility for testing and remanufacture. Nevertheless, at all times ownership of the printing press remains with X Co. Y Co. replaces some parts and adds some new features, assemblies and sub-components to bring the press up to current operational standards. Y Co. incurs labor costs by its employees in the United States of $20. The total costs incurred under the contract were $100. The value of the press, after the completion of the contract is $200.

Y Co. can treat the gross receipts under the contract as DPGR. Remanufacture of the printing press is considered property produced by the taxpayer in the United States because it meets the “20% safe harbor test”.

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The Service and Treasury Department request comments on the application of section 199 to trusts and estates. In particular, comments are requested on whether the apportionment of distributable net income between the trust and estate and its beneficiaries should govern the determination of the section 199 deduction for the taxable year, what rules should apply if there is no distributable net income for the taxable year, how these rules should be applied to split-interest trusts, and the information reporting requirements that should be imposed on the trust or estate and its beneficiaries. Comments are also requested on the application of section 199 to pass-thru entities other than partnerships, S corporations, trusts and estates.

In response to this specific request, we are providing comments concerning whether the apportionment of distributable net income between the trust and estate and its beneficiaries should govern the determination of the section 199 deduction for the taxable year.

Preliminarily, we recognize that because the section 199 deduction is allowed for income attributable to domestic production activities, the types of trusts most likely to receive such income are those trusts that hold stock in an S corporation. Subchapter S permits only certain types of trusts to hold S stock: wholly-owned grantor trusts, testamentary trusts, qualified subchapter S trusts (“QSST”), and electing small business trusts (“ESBT”). Each type of permitted Subchapter S trust has a different person who is treated as the shareholder for federal tax purposes. With the wholly-owned grantor trust, the deemed owner of the trust under subchapter E who must be an individual United States citizen or resident is treated as the shareholder. For a testamentary trust, the trust is treated as the shareholder for federal tax purposes. For the QSST, the income beneficiary of the trust who must be an individual United States citizen or resident is treated as the shareholder for federal tax purposes. For the ESBT, the S portion of the trust as defined under Treas. Reg. §1.641(c)-1(b)(2) is treated as the shareholder for federal tax purposes.

The testamentary trust that holds S corporation stock is the only type of Subchapter S trust to which any section 199 deduction will flow through to a trust beneficiary. In other words, the testamentary trust is the only type of S trust that must determine distributable net income for purposes of the section 199 deduction. For the wholly-owned grantor trust or grantor portions of an ESBT, the proportional share of the section 199 deduction attributable the S corporation stock held by such trust must be taken directly by the individual deemed owner. For the QSST, the pro rata share of the section 199 deduction passes directly to the individual income beneficiary. For the non-grantor portion of an ESBT, the pro rata share of the deduction would be allocable to the S portion taken only at the trust level as a deduction allowed under Treas. Reg. §1.641(c)-1(c)(2)(i).

While the determination of the allocation of the allowable section 199 deduction to most subchapter S trusts is straightforward as described above, the determination of the allocation of the allowable deduction to testamentary, simple or complex trusts and estates is anything but straightforward.

We realize that the determination of the portion of the section 199 deduction that may pass to a trust beneficiary could be made upon the basis of the percentage of the section 199 deduction attributable to DNI, trust accounting income (“TAI”) or taxable income (“TI”). We considered
proposing a number of different scenarios to determine such percentages. Unfortunately, none of these scenarios produced a consistently reasonable result, partly because it is possible that DNI, TAI or TI may be zero. Dividing by zero will not produce a workable result regardless of the formula used.

A simple example will demonstrate this problem. Assume a testamentary trust or estate holds S stock and the governing instrument requires all net income to be distributed at least annually. The trust or estate has the following items for tax year 2004:

- $1,000 of S corporation income (100% QPAI)
- $200 of income from other investments, all received in cash
- $400 of cash distributions received from the S Corporation
- $100 of expenses allocable to TAI
- $3,000 of state taxes paid on prior year capital gain, chargeable to corpus

TAI is $500 ($200 of investment income + $400 of S corporation cash distribution - $100 of expenses). This amount is distributed to the beneficiary in accordance with the terms of the governing instrument. DNI is negative $1,900 or effectively zero. For 2004, there should be a section 199 deduction of $3024 to be allocated between the trust and the beneficiary.

A possible allocation method would be to allocate the section 199 deduction in accordance with the distribution of TAI. Because the TAI of $500 was distributed to the beneficiary, 100 percent of the deduction should be allocated to the beneficiary as well. Unfortunately, because the DNI of the trust was zero, the beneficiary has no QPAI on his or her return against which to take the $30 section 199 deduction, and the deduction is lost.

An alternative method would be to allocate the section 199 deduction in accordance with the DNI distribution. However, DNI was zero, so the formula would be unsolvable. The same would be true for allocating the deduction in accordance with TI. At first glance, this does not appear to be a problem. Because the trust had no income, it should be limited to zero deduction under section 199(a)(1)(B). However, it will have $1,10025 Alternative Minimum Taxable Income (“AMTI”), which is then reduced by the distribution of $500 to the beneficiary. So the trust does have the ability to use $18 of section 199 deduction ($600 x 3%)26 against its AMTI. This does seem to be an equitable result because the trust retained 60% of the QPAI. However, the only ratio that produces a 60% answer is “ratio of undistributed TI to total S Corporation income,” and that only works in this example because there are no other complicating factors.

Our other attempts to produce a workable formula also ended in similar dead ends. Therefore, we suggest that the guidance give the trustee or executor the flexibility to allocate the QPAI and the accompanying deduction each year in a reasonable manner without prescribing a rigid

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24 This is based on the 2005 §199 limit of 3%
25 $1000 S corporation income + $200 investment income - $100 expenses = $1,100.
26 3% (2005 limit) x lesser of (i) undistributed QPAI ($1,000 QPAI from S corporation - $400 distributed to the beneficiary as part of TAI), or (ii) AMTI of $1,100 - $500 distribution deduction. The AMTI exemption is ignored in this example.
formula. This is the approach allowed to cooperatives under section 199(d)(3), and is not inconsistent with the flexibility given to trustees and executors under the revised TAI regulations under section 643. Given that section 199 contains dual limitations on the ability of trust beneficiaries to deduct the appropriate percentage of QPAI, the possibility for abuse is limited. In the example above, the trustee would probably choose to retain the entire $30 deduction, because that would be the only way to take the deduction albeit limited to the $18 deducted against the trust’s AMTI.

If the IRS and Treasury decides that it is necessary to prescribe formulas for allocation of the section 199 deduction, we would like the opportunity to comment again to discuss in detail some of the problems we encountered in attempting to create suggested formulae.

(4) The Service and Treasury Department request comments on whether taxpayers should be able to change any allocation or apportionment method of gross receipts or deductions on an amended return and whether there should be restrictions on a taxpayer’s ability to change from one method to another.

Treas. Reg. § 1.446-1(e) provides that a change of accounting method is a change in the timing of an item of income or deduction. Rev. Proc. 97-27 notes that an item involves timing if the treatment of the item does not permanently affect the amount of the taxpayer’s lifetime income. The deduction under section 199 affects the lifetime income of a taxpayer. It does not affect merely the timing of an item of income or expense. Accordingly, the calculation of the section 199 deduction and subsidiary elements such as allocation and apportionment of expenses are not methods of accounting, and should not be treated as such.

(5) The Service and Treasury Department request comments on whether additional modifications or clarifications to the section 861 method would be appropriate, including modifications relating to the determination of the “affiliated group” for purposes of allocating and apportioning expenses that are allocated and apportioned on an affiliated group basis.

Section 4.05(3) of the Notice provides that a taxpayer must determine deductions allocated and apportioned to DPGR using the section 861 regulations. Simplified methods are provided for taxpayers with average annual gross receipts of $25 million or less.

The reference to section 861 rules as an acceptable methodology assisted with issuing timely useful guidance. However, as previously discussed, the section 861 regime is concerned with geographic allocation and apportionment of deductions. It is not intended to provide rules for allocating and apportioning deductions within classes of domestic income. Further, there are a significant number of taxpayers with income in excess of $25 million that do not currently apply a section 861 regime, because they have no foreign operations. For example, many electrical utilities and home builders are not multinational. Section 861 is both cumbersome and ill-fitted to the intent of section 199.

27 1997-1 C.B. 680.
Accordingly, we recommend that future guidance permit taxpayers to use alternative reasonable methods, such as the simplified method described above, which generally avoids the detail of allocating costs altogether, or permit taxpayers to use an allocation method employed for non-tax purposes. This would avoid the need for taxpayers to undertake extensive and burdensome studies to allocate costs under a section 861 format and will undoubtedly produce a result that is far more meaningful in the context of section 199.

(6) The Service and Treasury Department request comments regarding whether members of an EAG should be required to use the same method of allocating and apportioning deductions to DPGR. If members of an EAG were to be able to use different methods of allocating and apportioning deductions, the Service and Treasury Department request comments regarding whether a member’s ability to use the simplified deduction method or the small business simplified overall method should depend on the average annual gross receipts of that member alone or the aggregate average annual gross receipts of all members of the EAG.

Each member of the EAG should be able to use different methods of allocating and apportioning deductions. The Notice states that each member of the EAG is to be treated as conducting the activities of the other members of the EAG. In certain industries, this creates specific concerns. For example, in the unregulated electricity markets, due to the fungible nature of electricity and the inability to store and tag this product, it will be necessary to determine a method for allocating sales when an affiliated energy marketing company is selling power that it buys from a producing member of the EAG, as well as power purchased from producers outside the EAG. One simplified approach would be to prorate the sales based on the number of KwH generated within the EAG versus the total KwH sold by the EAG. Other industries have similar specific issues that will require the use of different allocation and apportionment methods among different members of an EAG.

In addition, the Notice provides that the section 199 deduction is allocated among members of a consolidated group in proportion to each member’s QPAI, if any, regardless of whether the member has taxable income or loss for the taxable year and regardless of whether the member has W-2 wages for the taxable year. Certain regulatory groups, such as utility regulators, generally require a separate company return method for allocating taxes. The guidance in this area should allow flexibility for taxpayers to use a separate return method for purposes of allocating the section 199 deduction among members of the EAG.

(7) The Service and Treasury Department request comments related to the application of section 199 to computer software.

Section 199 includes any computer software in the definition of qualifying production property. The Notice provides interim guidance that “gross receipts derived from computer software do not include gross receipts from internet access services, online services, customer support, telephone services, games played through a website, provider-controlled software online services and other services that do not constitute the lease, rental, license, sale, exchange, or other

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28 §199(c)(5).
The explanation expands this by stating: “A service provided using computer software that does not involve a transfer of the computer software does not result in [qualifying] gross receipts.” Further, “gross receipts derived by a taxpayer from software that is merely offered for use to customers online for a fee are not DPGR.”

In situations where customers pay rental or license fees for the use of the taxpayer’s software, the fees appear to qualify as DPGR under the statute. It is unclear why the explanation in the Notice contains the requirement of a “transfer of computer software”. The statute includes the word license which means merely “permission to do an act.” With regard to intangible property, Black’s Law dictionary defines a license to use a patent as follows: “A written authority granted by the owner of a patent to another person to make or use the patented article for a limited period or in a limited territory.” In neither definition is a “transfer” contemplated, much less required. In the definition of licenses with regard to real property, Black’s defines a license as permission or authority to do particular acts or series of acts on the land of another without possessing any estate or interest therein.” That definition makes clear that a license does not involve an ownership interest and therefore a transfer of property is not required.

We believe the explanation to the guidance is not consistent with the statute in requiring a transfer of the qualified production property, in that a license contemplates a permit or use, not a transfer of property. Gross receipts related to services are not DPGR; however, we believe licenses for software are DPGR without regard to whether the software is transferred to the customer.

(8) The Service and Treasury Department invite comments on the appropriateness of the $25 million gross receipts threshold for use of the simplified deduction method.

We commend Treasury and the IRS for providing simplified rules that will be available to many taxpayers. We recommend the simplified rule be made available to all taxpayers on an elective basis.

30 Id., §3.04(7)(d).
32 Id.