March 3, 2006

Hon. Mark W. Everson  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC  20224

Re:   Comments Concerning the Proposed Regulations under Section 199

Dear Commissioner Everson:

Enclosed are comments under Internal Revenue Code Section 199 Proposed Regulations. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Dennis B. Drapkin  
Chair, Section of Taxation

Enclosure

cc:   Donald L. Korb, Chief Counsel, Internal Revenue Service  
Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy), Treasury Department  
Michael J. Desmond, Tax Legislative Counsel, Treasury Department  
George Manousos, Tax Specialist, Treasury Department  
Robert M. Brown, Associate Chief Counsel, Internal Revenue Service  
Heather C. Maloy, Associate Chief Counsel, Internal Revenue Service
Comments Concerning the Proposed Regulations under Section 199

These comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These comments were prepared by the Tax Accounting Committee of the Section of Taxation. Principal responsibility was exercised by Ellen MacNeil. The comments were reviewed by Patricia Ann Metzer of the Section’s Committee on Government Submissions and by Rudolph Ramelli, on behalf of the Council Director for the Committee on Tax Accounting.

Although many 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: February 28, 2006
Executive Summary

On October 19, 2005, the Internal Revenue Service (“IRS”) issued a Notice of Proposed Rule Making (Reg-105847-05) proposing regulations (the “Proposed Regulations”) under Section 199 of the Internal Revenue Code of 1986, as amended. Section 199 was enacted as part of the American Jobs Creation Act of 2004.

The Section of Taxation of the American Bar Association (the “Tax Section”) commends Treasury and the IRS for the prompt issuance of the Proposed Regulations. We further commend Treasury and the IRS for providing safe harbors, simplified methods and de minimis rules to facilitate compliance with this new provision.

I. Determining Qualified Production Activities Income.

The Proposed Regulations require that qualified production activities income (“QPAI”) be determined on an “item-by-item” basis. They also state that, with regard to timing, taxpayers should use the same methods used for reporting federal taxable income. Several helpful examples are provided and additional examples are in the preamble to the Proposed Regulations (the “Preamble”). We recommend that the examples in the Preamble be expanded and included in the final regulations.

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.

The Proposed Regulations state that only the taxpayer who has the “benefits and burdens of ownership” of QPP is engaged in a qualifying activity. They take into account the technical correction clarifying that taxpayers who contract with the federal government will not be subject to this rule if the Federal Acquisition Regulation (“FAR”) requires that title and risk of loss be held by the government. We recommend that this exception be read expansively to include subcontractors that are subject to FAR, and thus the final regulations should be clarified to include subcontractors as well as prime contractors.

The Proposed Regulations define the term “derived from the lease, rental, license, sale, exchange, or other disposition” to mean derived from any of such listed activities, even if the qualified production property had previously been subject to one of the listed activities. Accordingly, Section 199 can apply multiple times to the same property. We recommend that application of Section 199 to such subsequent transactions be limited to situations where it can be reasonably determined based on the taxpayer’s existing records that the property qualifies as...
QPP with regard to the taxpayer and the taxpayer’s books and records contain information that would allow an allocation of gross receipts between DPGR and non-DPGR. We also recommend that with regard to the allocation of lease payments between DPGR and non-DPGR, the allocable percentage be established at the commencement of the lease and not modified.

Regarding the word “license” in the statute, we recommend that it be afforded its legal meaning, which is permission to use property. This will avoid the inconsistency that is created by the Proposed Regulations regarding the use of software.

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

Construction Performed in the United States. The Proposed Regulations provide a de minimis rule for gross receipts from property that is not considered construction. Land is included in the test for de minimis non-qualifying property, which will cause this de minimis rule to be inapplicable in most circumstances. We recommend taxpayers be permitted to exclude land from both the numerator and denominator in applying the de minimis test. In addition, Example 2 in Proposed Treasury Regulation §1.199-3(l)(5)(iii) is unnecessary for administration of the statute, and may create the need for artificial allocations that are inconsistent with the underlying transaction. Therefore, we also recommend that Proposed Treasury Regulation §1.199-3(l)(5)(iii)(Ex.2) be revised to eliminate the implication that gross receipts from construction must be allocated among labor, materials and supplies.

Advertising Income. The Proposed Regulations appear to take different positions regarding advertising income derived from publishing and advertising income derived from the production of qualified films. In both cases, advertising revenues are inextricably linked with the production of the qualified property. Further, the Conference Report specifically states that the term “qualified film” includes live or delayed television programming, and that the means of distribution is irrelevant. In many cases advertising revenue is the only revenue derived from the production of live or delayed television programming. We recommend that the regulations, as finalized, be revised to recognize that the sale of advertising slots in live or delayed television broadcasts that are produced by the taxpayer, and that otherwise meet the qualified film requirements, produces DPGR.

III. Determining Costs.

Cost Allocation Method. Section 199 provides that DPGR must be reduced by allocable costs in order to compute qualified production activities income. For certain taxpayers, the Proposed Regulations provide 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.

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The Conference Report recognizes that Section 861 is relevant to determine the source of activities within or outside the United States. While the approach adopted in the Proposed Regulations is consistent with language in the Conference Report, rules similar to those developed under Section 263A appear more suitable to assigning costs between qualified and non-qualified domestic activities once the sourcing determination has been made. This approach would result in less complex and more easily administrable rules, particularly for companies with purely domestic activities that would otherwise never apply Section 861.

Moreover, the treatment of interest expense under the Section 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.

IV. Consolidated Rules.

The Proposed Regulations state that taxpayers should apply the timing rules of Treasury Regulation §1.1502-13. As an example, Proposed Treasury Regulation §1.199-7(e) illustrates the application of the attribute recharacterization rule. We recommend that the regulations, as finalized, specifically make reference to the attribute rules of Treasury Regulations §1.1502-13.

V. Effective Date.

Because of the complexity of these rules and the record keeping requirements, we recommend that the final regulations be made effective for taxable years beginning after date of publication.

VI. Other Comments.

The Preamble invites comment on four subjects. The following summarizes our responses.

1. We recommend that the regulations, as finalized, allow the use of statistical or other simplifying techniques, as well as other reasonable approaches used consistently, to identify and document any information needed for application of Section 199. We do not believe the estimation techniques should be limited to specific areas of Section 199.

2. We recommend that IRS and Treasury grant broad automatic consent to taxpayers to change any election under Section 861 for three years following the issuance of the proposed revenue procedure granting automatic consent to change elections under the Section 861 regulations. We believe this period of time is necessary for taxpayers to develop procedures to comply with this new Code section, evaluate its effect in

5 Id. P.258.
combination with the international provisions, and revise their current Section 861 methods for any proposed changes.

3. We recommend that the reference to the Section 861 regulations be limited to the allocation and apportionment of deductions and expenses within and outside the United States, and that intra-U.S. allocations be based on a facts and circumstances model using principles similar to those developed under Section 263A. We further recommend that the simplified method be made available to all taxpayers.

4. We recommend that the regulations, as finalized, allow an allocation of gross receipts between software that is used online and any related services.

**Comments**

Implementation of Section 199 presents many challenges. The Tax Section commends the IRS for the prompt issuance of Proposed Regulations. Further, we appreciate the IRS’s consideration of our earlier comments filed in response to Notice 2005-14. 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 are responding to specific requests for comments contained in the Preamble.

I. Determining Qualified Production Activities Income

Section 1.199-1(c)(i) of the Proposed Regulations defines QPAI as 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. QPAI is determined on an item-by-item basis. We commend Treasury and the IRS for clarifying that the term “item” means the property that is offered for sale to customers that meets all the requirements of Proposed Treasury Regulations §§1.199-1 and 1.199-3. The Proposed Regulations also provide a “shrink back” rule so that if the final item does not satisfy the requirements of Proposed Treasury Regulations §§1.199-1 and 1.199-3, taxpayers may apply the rules to the components of the property that do meet the requirements.

A. Timing Rules for QPAI

Proposed Treasury Regulations §1.199-1(e) states that a taxpayer should use the same methods for recognizing QPAI that it uses for reporting federal taxable income. Proposed Treasury Regulations §1.199-1(d) states that a taxpayer must determine the portion of its gross receipts that is DPGR and that which is not DPGR based on a reasonable method.

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6 2005-7 IRB 498.
Under a taxpayer’s method of accounting, gross receipts from a single contract or transaction may be reported in more than one year and the related CGS and deductions may be reported in more than one year. The Preamble includes an example of the treatment of an advance payment for a multiyear contract where the revenue and expense from a maintenance contract includes both DPGR and non-DPGR. The example states that the taxpayer should use a reasonable method to allocate the gross receipts between DPGR and non-DPGR in the first year of the contract, and that no adjustment is required or permitted if the ultimate amounts are different.

We recommend that Treasury and the IRS include that example in the regulations, as finalized, and expand it to cover contracts that have taxable income in more than one year.

We also recommend that the example in the Preamble involving a taxpayer that produces software that it affixes to a router be included in the regulations, as finalized. Both of these examples are illustrative and will provide needed guidance in the regulations, as finalized.

II. Determining Domestic Production Gross Receipts

A. In General

Section 1.199-3 of the Proposed Regulations sets forth the operating rules for determining DPGR, and identifies 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”) in whole or in significant part by the taxpayer within the United States.\(^7\) The Proposed Regulations define "production activities" for purposes of Section 199 to include activities related to manufacturing, producing, growing, extracting, installing, developing, improving, and creating qualified production property.\(^8\)

B. Definition of “By the Taxpayer”

The Proposed Regulations\(^9\) state 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. The benefits and burdens of ownership test is based on existing federal income tax principles.\(^10\) The Proposed Regulations provide an exception from this rule for taxpayers that produce property pursuant to a contract with the Federal Government, and where the FAR requires that title or risk of loss with respect to the property be transferred to the Federal Government before production is complete.\(^11\) This is an important clarification that assures that

\(^7\) §199(c)(4)(A)(i)(I). Proposed Treasury Regulation §1.199-3(d)(4) 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.

\(^8\) Proposed Treasury Regulation §1.199-3(d).

\(^9\) Proposed Treasury Regulation §1.199-3(e)(i).

\(^10\) Proposed Treasury Regulation §1.199-3(e)(i).

\(^11\) Proposed Treasury Regulation §1.199-3(e)(2).
taxpayers who contract with the federal government will not be placed at a disadvantage. We recommend that the regulations, as finalized, state that this exception is to be interpreted broadly to include subcontractors or other parties who are subject to the FAR.

C. Definition of “Derived from the Lease, Rental, License, Sale, Exchange or Other Disposition”

Proposed Treasury Regulation §1.199-3(h)(1) defines the term “derived from the lease, rental, license, sale, exchange, or other disposition” to mean “gross receipts directly derived from the lease, rental, license, sale, exchange or other disposition, even if the taxpayer has already recognized gross receipts from a previous lease, rental, license, sale, exchange, or other disposition of the same property.” The Proposed Regulations also state that applicable Federal income tax principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition, or whether it is a service (or some combination thereof).

1. Multiple Dispositions

Property that was MPGE by the taxpayer may be reacquired by the taxpayer many months or years after its original production. The taxpayer may not have maintained records that would indicate whether the property was originally QPP. The taxpayer may have no way of knowing whether the property, that was originally QPP, is still QPP, or has been modified or repaired in such a way that it no longer qualifies for the deduction. Further, property that was produced by the taxpayer may be included in a larger asset acquired by the taxpayer and used in its business or held for lease.

For example, a taxpayer enters into a transaction to buy a manufacturing plant and lease it back to its original owner. The plant may have machinery and equipment in it that was originally manufactured by the taxpayer. Under the “shrink back” rule, and Proposed Treasury Regulation §1.199-3(h)(i), the portion of the lease income that is attributable to the lease of QPP would be DPGR. However, the taxpayer may not know if there is such property in the plant, and may have no reasonable way to determine its qualification.

A further illustration relates to a steel manufacturer that sells sheets of steel. The steel manufacturer also purchases rail cars, trucks, and other products that have steel content. The steel manufacturer may sell or otherwise dispose of these rail cars, trucks, or other products that have steel content. The steel manufacturer may not have records that allow it to identify the relative cost or value of the steel content to the larger product, and may not have records that document whether the steel was manufactured by the taxpayer or another manufacturer.

We have two recommendations to facilitate compliance. First, we suggest that the subsequent disposition of property be limited to situations where it can be reasonably determined based on the taxpayer’s existing records that property is QPP that was MPGE by the taxpayer and that the taxpayer’s books and records contain information that would allow an allocation of gross

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12 Proposed Treasury Regulation §1.199-1(c)(2).
receipts between DPGR and non-DPGR. Second, we recommend that where the property has some content that is QPP with regard to the lessor, the allocation of lease payments (or other situations where taxable income derived from the property is reported in more than one year) between DPGR and non-DPGR be established at the commencement of the lease. We recommend that an example of a lease of QPP and non-QPP be included in the regulations, as finalized. This would be similar to the rule that is described in the Preamble for multi-year maintenance contracts that include both DPGR and non-DPGR.

2. Meaning of “License”

The use of the term “license” indicates a transaction that does not involve a disposition of property. A license is a mere permission to use, and specifically does not require a disposition of property. Proposed Treasury Regulation §1.199-3(h)(1) requires a disposition of property and appears to be based on the phrase or “other disposition” of property in Section 199(c)(4)(A)(i); however, the Proposed Regulations use that phrase to limit the previous terms, rather than expand them. We believe that this interpretation is contrary to the legislative history of Section 199. The Conference Report states that DPGR “generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying product property… (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film, (3) any sale, exchange or other disposition electricity, natural gas, or potable water…”\(^\text{13}\) In doing so, the Conference Report recognizes that the term “other disposition” acts to modify and expand “sale or exchange” and not to limit the terms “lease, rental, or license” by requiring a disposition.

This interpretation impacts sales of software. By requiring a disposition or transfer of property, rather than a license of property, the Proposed Regulations require a different treatment of software that is sold on a disc, downloaded from the internet, or used in a hosted environment. In all cases, the seller has sold, and the customer has purchased, the right to use software. The medium in which it is used is irrelevant for all purposes, except the Proposed Regulations. By requiring a transfer of property and concluding that software that is used on the vendor’s server is not such a transfer, the Proposed Regulations create a distinction that has no economic basis.

If the regulations, as finalized, interpreted the term “license” to mean a permission to use, this inconsistency would be avoided. Then an on-line use of software would give rise to DPGR. Any embedded or associated services would not. Separating the portion of gross receipts that qualifies as DPGR from the use of software from the portion that is for services would be a matter of allocation, as described in Proposed Treasury Regulation §1.199-1(d)(i).

Accordingly, we suggest the word “license” be defined to mean a mere permission to use property, and not require a physical transfer of property.

D. Construction Performed in the United States

Proposed Treasury Regulation §1.199-3(l) 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.

1. **De Minimis Rule**

The Proposed Regulations exclude proceeds of the sale of land from DPGR and provide a very useful safe harbor that will greatly simplify the computation.\(^{14}\) The Proposed Regulations also provide a *de minimis* rule, stating that if less than 5% of the total gross receipts derived from a construction project are from activities other than construction (for example, tangible personal property or land sold with a building), the total gross receipts may be treated as DPGR from construction. This *de minimis* rule, while intended to apply to personal property and non-construction services is only available if gross receipts derived from personal property, non-construction services and land are less than 5% of the gross receipts from the sale of the constructed building. The inclusion of land will result in the *de minimis* exception being inapplicable in most situations involving the sale of a building. We recommend that the *de minimis* rule be changed to exclude land from both the numerator and the denominator of the *de minimis* computation.

2. **Construction and Structural Components**

Proposed Treasury Regulation §1.199-3(l)(5)(iii)(Ex.2) describes an electrical contractor who purchases wires and other electrical materials, and installs them in a construction project. The electrical materials are considered structural components of the building. The example concludes that the gross receipts derived from installation qualify as DPGR; however, the gross receipts derived from the purchased materials do not.

This example implies that the sale of a constructed building creates DPGR from the construction activity, and gross receipts from the materials that are structural components of the building, such as electrical wiring, dry wall, nails, lumber, concrete and so forth are not DPGR.

It does not appear to be necessary to allocate gross receipts in these circumstances. The cost of all purchased materials will be CGS and will reduce QPAI. The only reason to allocate gross receipts is to capture an implied markup in the construction materials. The transaction between the parties is not a sale of materials, but rather the sale of a constructed building. The implied treatment in the Proposed Regulations would attempt to account for something differently from the actual transaction between the parties. Accordingly, we recommend that the example be revised to state that the gross receipts are DPGR, and the cost of the electrical components is CGS.

3. **Use of the Term General Contractor**

Proposed Treasury Regulation §1.199-3(l)(5)(iii)(Ex.1) addresses a situation where a taxpayer who is in the trade or business of construction purchases a building and retains an unrelated

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\(^{14}\) Proposed Treasury Regulation §1.199-3(l)(5)(ii).
taxpayer (a general contractor) to oversee substantial renovation of the building. The example states that because the taxpayer is not the “general contractor”, the taxpayer is not considered to have constructed the building for purposes of Section 199. This example fails to recognize commercial complexity by putting too much reliance on the term “general contractor”. We recommend that this example be eliminated. If it is retained, we recommend that it be clarified to state that the taxpayer engaged in no construction activities with regard to the renovation and did not bear risk regarding the renovation, and accordingly is not considered to have constructed the property.

E. Other Special Industry Issues - Broadcast Income

Proposed Treasury Regulation §§1.199-3(h)(5) and 1.199-3(j) appear to take different positions regarding advertising income derived from print media and advertising income derived from qualified films. In both cases, advertising revenue is inextricably linked with the production and distribution of the property, as well as any other revenue from producing the qualified property, and we believe should be afforded the same treatment.

In the case of print media, such as newspapers, magazines, or periodicals produced in whole or significant part in the United States, advertising income from the advertisements placed in those media is DPGR, but only to the extent the gross receipts, if any, from the lease, rental, license, sale, exchange, or other disposition of the publication are DPGR. Thus, advertising revenue qualifies as DPGR, even if the publication produces no other gross receipts.

The ways in which the publishing and broadcasting industries operate, as well as their respective economic models for generating income, are strikingly similar. Both industries rely heavily on advertising revenue derived from publishing and broadcasting activities. In both cases, the pricing of advertising is directly correlated to readership or viewership. Advertising revenue is the primary revenue stream in both industries, and in some cases may be the only source of revenue derived from the production of live or delayed television programming, just as it is for free print media, such as “shoppers” or telephone directories.

The Proposed Regulations state that showing a qualified film on a television station is not a lease, rental, license, sale, exchange, or other disposition of the qualified film. Proposed Treasury Regulation §1.199-3(j)(4)(Ex.3) discusses a taxpayer that produces and broadcasts television shows on its own station. The taxpayer “sells advertising slots” for these television programs. The example concludes that because showing the qualified film on a television station is not a disposition, the advertising revenue does not qualify as derived from a lease, rental, license, sale or other disposition of qualified films. The position is not consistent with the position taken on print advertising.

Television networks produce live and delayed television programming. Assuming the television program otherwise meets the test for qualified film, the “sale of advertising slots” is a sale of the qualified film. Typically, the producer of the qualified film (e.g., live or delayed television programming) grants to television stations or cable networks a license to distribute the qualified

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film in the market that the station or cable network serves. The television station or cable network receives the right to display the qualified film in an unaltered form, in exchange for displaying advertising slots for the producer of the qualified film. The producer sells the advertising slots to third party advertisers that seek to reach the audience that will view the qualified film. The advertising is included in the qualified film that is distributed (broadcast) by the producer. The television station or cable network cannot alter or eliminate any part of the produced film, including the embedded advertising. Thus, the sale of advertising slots to third party advertisers by producers of a qualified film (television networks) is income derived from the production of a qualified film and should be treated as DPGR. Each hour of qualified film broadcast consists of about 40 to 45 minutes of entertainment content, and 15 to 20 minutes that is sold to advertisers. Advertisers buy specific slots in a broadcast film based on the time and content of the live or delayed broadcast. Therefore, the sale of advertising slots is the transfer of produced property. The economics of the transaction are that the qualified film is produced in order to sell portions of it in the form of advertising slots to advertisers. The television viewer is not the customer or buyer of the QPP; the advertiser is the customer.

The Conference Report states that “qualified film” includes any motion picture film or videotape (including live or delayed television programming). The Conference Report further states: “The conferees intend that the … means of distribution of such properties shall not affect their qualification under this provision.” This indicates Congressional intent that the gross receipts derived from the production of live and delayed television broadcasting are DPGR. The sale of advertising slots is generally the only revenue derived from the production of live and delayed television broadcasts and is inextricably linked with the production of the property. Accordingly, we recommend that the regulations, as finalized, state that the revenue from the sale of advertising slots in live and delayed broadcasts that are produced by the taxpayer and that otherwise meet the requirements to be a qualified film, is DPGR.

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.

Proposed Treasury Regulation §1.199-4(b) 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, indirect costs that “directly benefit or are incurred by reason of” a production activity.

17 Id.
Proposed Treasury Regulation §1.199-4 provides three methods for the allocation of deductions (other than CGS) to qualified production activities.\textsuperscript{18} Two simplified methods are available to certain taxpayers. All other taxpayers must allocate and apportion deductions using the rules provided in the Section 861 regulations. Under the Section 861 method, Section 199 is treated as an “operative section” described in Treasury Regulation § 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 were designed to produce an allocation of expenses between U.S.-source and non-U.S. source income. They do not allocate deductions based on where the underlying production activities took place.

The Conference Report provides that the principles of Section 861 should be applied to allocating costs where appropriate.\textsuperscript{19} In broad terms, the approach in the proposed regulations may be viewed as consistent with language in the Conference 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 ever 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.\textsuperscript{20} We recommend that the regulations, as finalized, allow taxpayers to take into account facts and circumstances other than asset location in allocating interest expense for purposes of Section 199.

Many taxpayers, even very large ones, may not be subject to the Section 861 allocation rules because their activities are all domestic. Accordingly, we suggest that taxpayers be allowed to apply the more familiar principles of Section 263A to allocate costs or to use one of the simplified methods.

IV. **Consolidated Return Rules.**

The Proposed Regulations address the application of Section 199 to members of the same consolidated group by referring to the timing rules of Treasury Regulation §1.1502-13.

Proposed Treasury Regulation §1.199-7(d) states: “In the case of an intercompany transaction between consolidated group members S and B… S takes an intercompany transaction into account in computing the Section 199 deduction at the same time and in the same proportion as S takes into account the income, gain, deduction, or loss from the intercompany transaction under Section 1.1502-13.” In addition, the Preamble makes reference to the attribution

\textsuperscript{18} Proposed Treasury Regulation §1.199-4(e) and (f).
\textsuperscript{20} Treasury Regulation §1.861-8.
recharacterization rule and Proposed Treasury Regulation §1.199-7(e) appears to illustrate its application.

Applying the attribute rules in Treasury Regulation §1.1502-13 appears to be consistent with the overarching principle of the consolidated return regulations to treat the members of a consolidated group as if they were divisions of a single corporation. However, the Proposed Regulations do not specifically refer to the attribute rules. We recommend that the regulations, as finalized, specifically refer to the consolidated return regulations regarding attributes and attribute recharacterization.

V. **Effective Date.**

The regulations are proposed to be effective for taxable years beginning after December 31, 2004.

Compliance with Section 199 will entail significant information gathering, and will require development of systems and processes. Regulations that are effective retroactively may present practical implementation difficulties. Therefore, we suggest that the regulations, as finalized, be made effective for taxable years beginning after date of publication. This will allow taxpayers time to modify their processes and systems to comply with the regulations.
The Preamble invites comments on four specific issues. We submit the following comments in response to this request.

1. **Questions have arisen as to the applicability under Section 199 of a Large and Mid-Size Business (LMSB) directive dated March 14, 2002, “Field Directive on the Use of Estimates from Probability Samples,” that authorizes in appropriate circumstances the use of statistical sampling by taxpayers. LMSB taxpayers are not precluded from applying the concepts of the LMSB directive for purposes of Section 199. The proposed regulations do not provide specific rules on the use of statistical sampling for 199 purposes, however comments are requested on how taxpayers can apply statistical sampling to Section 199 and what specific areas of Section 199 statistical sampling could be applied to, and whether application of statistical sampling should be limited to specific areas of Section 199.**

Section 199 and the Proposed Regulations require information that may not generally be maintained for any other reason. For example, segregating embedded services, the so-called “shrink back” rule, reacquiring previously produced property, and identifying the U.S. content of previously produced films, are some of the areas that require information that has not previously been maintained and would not be maintained for any other reason. Moreover, recordkeeping may differ among taxpayers, as well as among industries.

Accordingly, we suggest that the regulations, as finalized, allow the use of statistical or other simplifying techniques, as well as other reasonable approaches used consistently to identify and document any information needed for the application of Section 199. We do not believe the estimation techniques should be limited to specific areas of Section 199.

2. **Taxpayers are eligible to make certain elections under the Section 861 regulations. For example, Section 1.861-9T(g)(1)(ii) permits a taxpayer to elect to determine value of its assets on the basis of either their tax book value or fair market value. Some of the elections under the Section 861 regulations require the consent of the Commissioner to revoke or to change to another method. See Sections 1.861-8T(c)(2), 1.871-9T(i)(2), and 1.861-117(e). Because the Section 861 method requires certain taxpayers to use the rules contained in Section 861 regulations in a new context, these taxpayers may want to reconsider previously made elections under those regulations. The IRS and Treasury Department intend to issue a revenue procedure granting taxpayers automatic consent to change certain elections under the Section 861 regulations. Comments are requested concerning such an automatic consent procedure, including which elections should be included and appropriate time period during which the automatic consent should apply.**

We recommend that IRS and Treasury grant broad automatic consent to taxpayers to change any election under Section 861 for three years following the issuance of the revenue procedure. We believe this period of time is necessary for taxpayers to develop procedures to comply with this new code section, evaluate its effect in combination with the international provisions, and revise their current Section 861 methods for any proposed changes.
3. The IRS and the Treasury Department note that there are special rules regarding application of the Section 861 method in the case of affiliated groups. See Section 864(e)(5) and (6); see also Sections 1.861-11(d)(7), -11T(d)(6), -14(d) and -14T. Comments are requested regarding whether additional guidance is needed to clarify how the rules under Sections 1.861-11T(c) and (g) and 1.861-14T(c) apply under the Section 861 method to allocate and apportion interest and other expenses such as research and experimentation expenses in computing QPAI of the members of such affiliated groups in which otherwise includible corporations are owned indirectly through foreign corporations and partnerships.

The Section 861 regulations were promulgated to allocate and apportion expenses based on the source of the income. In contrast, Section 199 seeks to allocate and apportion expenses based on the location of production. We believe the committee reports refer to Section 861 for purposes of allocating and apportioning expenses within and without the United States. The further allocation and apportionment required by Section 199 would be best accomplished by a facts and circumstances approach based on Section 263A. The question raised for comment is just one of the anomalies that may result from the application of the Section 861 rules.

We recommend that the reference to the Section 861 regulations be limited to the allocation and apportionment of deductions and expenses within and without the United States, and that intra-U.S. allocations be based on a facts and circumstances model using principles similar to those developed under Section 263A. We further recommend that the simplified method be made available to all taxpayers.

4. Comments are requested concerning whether gross receipts derived from the provision of certain types of online software should qualify under Section 199 as being derived from a lease, rental, license, sale, exchange, or other disposition of the software and, if so, how to distinguish between such types of online software.

Please refer to the earlier discussion under “meaning of license”.