Proposed, temporary Section 199 regulations could affect wide range of taxpayers across numerous sectors and industries

October 2, 2015

In brief

The IRS recently issued both proposed and temporary regulations under Section 199 that provide guidance on a broad array of key technical issues.

The proposed regulations would provide guidance on topics such as determining who has the benefits and burdens of ownership (B&B) in a contract manufacturing arrangement, what constitutes a manufacturing activity, the qualification of qualified films, the allocation of cost of goods sold (CGS), and rules relating to the oil and gas industry.

The temporary regulations provide guidance with respect to application of the W-2 wage limitation to a short tax year as a result of an acquisition or disposition of a trade or business or a change in annual accounting period.

The proposed regulations, if finalized, would apply to tax years beginning on or after the date the final regulations are published in the Federal Register. The temporary regulations apply to tax years beginning after August 26, 2015, and expire on August 24, 2018. Taxpayers may apply the temporary regulations to tax years beginning before August 27, 2015, for which the limitations period for assessment of tax has not expired.

Taxpayers will need to analyze the proposed and temporary regulations to determine the impact they may have on their Section 199 deductions, both retroactively and prospectively.

Written or electronic comments on the proposed regulations must be received by November 25, 2015. Outlines of topics to be discussed at the public hearing on the proposed regulations scheduled for December 16, 2015, at 10:00 am, must be received by November 25.

In detail

Background

The American Jobs Creation Act of 2004, enacted October 22, 2004, added Section 199, the domestic manufacturing deduction, to the Internal Revenue Code. Section 199, which is effective for tax years beginning on or after January 1, 2005, provides a deduction that is computed as a percentage of the lesser of qualified production activities income (QPAI) or taxable income, generally phased in at three percent in 2005 and 2006, six percent in 2007 to 2009, and nine percent in 2010 and thereafter.

For tax years beginning after May 17, 2006, the amount of the deduction is limited to 50 percent of the taxpayer's W-2 wages that are properly allocable to domestic production gross receipts (DPGR) for the tax year. W-2 wages generally are defined as, with respect to any person for any tax year of the person, the sum of amounts described in Sections 6051(a)(3) and (8) paid by the person with respect to employment of employees by the person during the calendar year ending during such tax year.

In general, QPAI is equal to the excess (if any) of: (A) the taxpayer's DPGR for such tax year, over (B) the sum of: (i) the CGS that is allocable to such receipts; and (ii) other expenses, losses, or deductions (other than the deduction under Section 199) that are properly allocable to such receipts. DPGR includes gross receipts that are derived from any lease, rental, license, sale, exchange, or other disposition of: (I) qualifying production property (QPP) that was manufactured, produced, grown, or extracted (MPGE) by the taxpayer in whole or in significant part within the United States; (II) any qualified film produced by the taxpayer; or (III) electricity, natural gas, or potable water (utilities) produced by the taxpayer in the United States.

The IRS issued final regulations under Section 199 on May 24, 2006 (the 2006 Regulations). The 2006 Regulations generally are effective for tax years beginning on or after June 1, 2006, although a taxpayer may elect to apply them to prior tax years, provided the taxpayer applies all provisions in the 2006 Regulations to such years.

The Emergency Economic Stabilization Act of 2008 (the Act), enacted October 31, 2008, included the following Section 199 provisions:

- A six-percent limit on the Section 199 deduction for taxpayers with income attributable to the production of oil and gas.
- An additional two-year extension of the provision that allows US businesses with branches in Puerto Rico to claim the deduction under Section 199.

The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (the Tax Extenders Act), enacted October 3, 2008, amended the rules for qualified films for tax years after December 31, 2007. The Tax Extenders Act broadened the definition of W-2 wages attributable to qualified films to include compensation for services performed in the United States by actors, production personnel, directors, and producers. The definition of a qualified film was modified to mean any motion picture or videotape if at least 50 percent of total compensation relating to the qualified film is related to services performed in the United States by actors, production personnel, directors, and producers. The meaning of qualified film was further expanded to include copyrights, trademarks, or other intangibles. The Tax Extenders Act also introduced an attribution rule for partnerships and S corporations and their partners and shareholders.

Observation: The proposed and temporary regulations originally were intended to address the 2008 legislative changes to Section 199. However, the IRS determined that it also needed to address a variety of other issues that have arisen over the years at IRS exam, Appeals, and in the courts. As a result, the proposed and temporary regulations address the following issues.

The proposed regulations

Benefits and burdens

Section 199(d)(10) directs Treasury to issue regulations that prevent more than one taxpayer from being allowed a deduction under Section 199 with respect to any qualifying activity. The 2006 Regulations provide that, in general, only one taxpayer may claim the Section 199 deduction with respect to any qualifying activity performed in connection with qualifying property.

The 2006 Regulations require a taxpayer to maintain the B&B of the QPP, qualified film, or utilities under federal income tax principles during the period in which the qualifying activity occurs in order for gross receipts derived to be eligible to qualify as DPGR. The 2006 Regulations provide that if one taxpayer performs a qualifying activity pursuant to a contract with another party, then only the taxpayer that has the B&B during the period in which the qualifying activity occurs is treated as engaging in the qualifying activity.

Since the enactment of Section 199 in 2004, the determination of which taxpayer has the B&B in a contract manufacturing arrangement has been the subject of frequent disagreement between taxpayers and the IRS.

Although the 2006 Regulations state that the determination of which party has the B&B during the MPGE process is to be made using all federal income tax principles, the 2006 Regulations do not provide any guidance on how such a determination is to be made or what factors should be considered in making such a determination.

However, the 2006 Regulations provide a few examples that analyze several factors for determining which taxpayer to a contract possesses the B&B, including an express restriction on the unrelated party's use of the property, retention of control over the development process of the property by the taxpayer, who retains legal title to the property during the manufacturing process, the pricing arrangement between the principal and contractor, and which party bears the risk of loss or damage during the manufacturing process.

The primary concern of the IRS with respect to any B&B issue is that both parties to a contract manufacturing agreement may seek to claim the Section 199 deduction with respect to the same qualifying activity. For example, if taxpayer A engages taxpayer B to perform any and all manufacturing activities associated with the manufacture of product C, Section 199 permits either A or B to claim the Section 199 deduction with respect to such activities (assuming that neither party engages in any additional manufacturing activities with respect to product C). The IRS historically has sought ways to eliminate the situation in which both A and B claim the Section 199 deduction with respect to the manufacturing activities performed by B with respect to product C, often referred to by the IRS as a 'whipsaw.'

In an attempt to limit the Section 199 deduction to one taxpayer per qualifying activity, the IRS Large Business and International Division (LB&I) issued an Industry Director Directive on February 1, 2012 (Directive 1), that provided a three-step analysis of facts and circumstances relating to contract terms, production activities, and economic risks to determine whether a taxpayer has the B&B.

LB&I later issued a superseding Industry Director Directive (Directive 2) on July 24, 2013, and a third Industry Director Directive (Directive 3) on October 29, 2013, which updated Directive 2. Directive 3 allows a taxpayer to provide a statement explaining the taxpayer's determination that it had the B&B of ownership, along with certification statements signed under penalties of perjury by the taxpayer and the counterparty verifying that only the taxpayer is claiming the Section 199 deduction.

In *ADVO, Inc. & Subsidiaries v. Commissioner,* 141 T.C. 298 (2013), the Tax Court addressed how Section 199 applies to taxpayers that manufacture products through agreements with contract manufacturers, acknowledging the factually specific nature of the 'by the taxpayer' requirement included in the 2006 Regulations. The court used a list of nine factors to determine whether ADVO had the B&B of ownership of the property during the manufacturing process, noting that no one factor was determinative.

To alleviate the frequent controversy that surrounds a B&B determination, the proposed regulations would remove the rule in the 2006 Regulations that treats a taxpayer in a contract manufacturing arrangement as engaging in the qualifying activity only if the taxpayer has the B&B during the period in which the qualifying activity occurs. In its place, the proposed regulations provide that the party that performs the qualifying activity is the taxpayer that would be entitled to the Section 199 deduction (assuming all other qualification requirements are met).

In other words, the proposed regulations would result in the contract manufacturer always being entitled to the Section 199 deduction for its manufacturing activities (assuming all other requirements of Section 199 are met). The IRS states that this rule will "provide administrable rules that are consistent with Section 199, reduce the burden on taxpayers and the IRS in evaluating factors related to the B&B of ownership, and prevent more than one taxpayer from being allowed a deduction under Section 199 with respect to any qualifying activity." In addition, the IRS states that the proposed rule, which applies solely for purposes of Section 199, "reflects the government's conclusion that the party actually producing the property should be treated as engaging in the qualifying activity for purposes of Section 199, and is therefore consistent with the statute's goal of incentivizing domestic manufacturers and producers."

Observation*:* Abandonment of the current B&B rules, which require an analysis of all facts and circumstances in determining which party has the B&B, in favor of a rule that would treat the contractor as always qualifying for the Section 199 deduction on any activity performed by the contractor, would represent a significant departure from the 2006 Regulations. Although the proposed rule clearly would be more administrable as it would eliminate the need to perform a B&B analysis, always awarding the Section 199 deduction to the contractor (assuming all other requirements of Section 199 are met) may not, in many instances, be supported by the terms of the contract (i.e., that the contractor actually possesses the B&B).

***Observation**:* To qualify for the Section 199 deduction, a taxpayer must derive its gross receipts from a qualifying disposition — i.e., a lease, rental, license, sale, exchange, or other disposition — of the qualifying property. Although the proposed rule would result in the contractor being considered the taxpayer that performed the qualifying activity, the contractor would still need to 'own' the property in order to derive its gross receipts from the 'sale' of the property. Accordingly, a B&B requirement is arguably still required for the contractor to have a qualifying disposition. Otherwise, the proposed rule could result in neither party being eligible for the Section 199 deduction, which is a result that should not occur.

Observation: Although at first glance the rule may appear favorable to contractors and unfavorable to principals in contract manufacturing arrangements, in many instances the proposed rule may not yield such a result. For example, a contractor may not welcome the proposed rule if the contract is a loss contract that would reduce the taxpayer's Section 199 deduction. Alternatively, a principal would welcome the proposed rule if its contract were a loss contract that no longer had to be included in its Section 199 deduction. Accordingly, all taxpayers, both principals and contractors alike, need to carefully analyze their contracts and business arrangements to determine the potential impact of the proposed regulations.

Observation: It is unclear what impact the proposed regulations, if finalized, would have on Directive 3. Many taxpayers have structured their contracts and provided (with counterparties) the statement described in Directive 3 regarding which party will claim the Section 199 deduction. If the proposed rule were finalized, then it would appear that LB&I likely would revoke Directive 3, although it could grandfather contracts that complied with Directive 3 prior to the effective date of the proposed regulations.

The IRS requests comments on whether there are narrow circumstances that could justify an exception to the proposed rule. In particular, the IRS requests comments on whether there should be a limited exception to the proposed rule for certain fully cost-plus or cost-reimbursable contracts. Under such an exception, the party that is not performing the qualifying activity would be treated as the taxpayer engaged in the qualifying activity if the party performing the qualifying activity is (i) reimbursed for, or provided with, all materials, labor, and overhead costs related to fulfilling the contract, and (ii) provided with an additional payment to allow for a profit. The IRS is uncertain regarding the extent to which such fully cost-plus or cost-reimbursable contracts are in fact used in practice.

CGS allocations

The 2006 Regulations specifically provide that if a taxpayer recognizes and reports gross receipts on a federal income tax return for a tax year, and incurs CGS related to such receipts in a subsequent tax year, the taxpayer must allocate the CGS to non-DPGR if the taxpayer recognized those gross receipts in a tax year to which Section 199 does not apply (i.e., a 'pre-199 year') (the CGS Allocation Rule).

The policy reason behind the CGS Allocation Rule was to require consistency in the allocation of CGS between gross receipts earned in pre-199 years and gross receipts earned in Section 199 years in the way that 'below-the-line' costs are allocated and apportioned under Section 861. Without the rule, a taxpayer could be adversely affected by having CGS allocable to DPGR for the tax year in which the costs are incurred although the corresponding gross receipts, or portion thereof, were recognized prior to 2005 when Section 199 first became effective.

Taxpayers have availed themselves of the CGS Allocation Rule in allocating items of CGS between pre-199 years and 199 years, e.g., by allocating pension expense related to prior-period services and gross receipts to non-DPGR to the extent the taxpayer can demonstrate a factual relationship between the expenses and gross receipts earned in a pre-199 year.

The IRS would clarify in the proposed regulations that the CGS must be allocated between DPGR and non-DPGR, regardless of whether any component of the costs included in CGS can be associated with activities undertaken in an earlier tax year. In addition, the IRS is aware that in the case of transactions accounted for under a long-term contract method of accounting (either the percentage-of-completion method (PCM) or the completed-contract method (CCM)), a taxpayer incurs allocable contract costs. The IRS recognizes that allocable contract costs under PCM or CCM are analogous to CGS and should be treated in the same manner. The proposed regulations would provide that in the case of a long-term contract accounted for under PCM or CCM, CGS includes allocable contract costs described in the Section 460 regulations, as applicable.

Observation: The proposed regulations for CGS allocations are consistent with the IRS position taken in CCA 200946037, which addressed the inclusion in CGS of certain costs — retiree medical benefits, environmental remediation, and worker compensation. In the CCA, the taxpayer had argued that costs included in 199-year CGS were related to pre-199-year gross receipts and therefore were allocable to non-DPGR. The IRS concluded, however, that the CGS are related to current-year production costs and therefore related to current, 199-year gross receipts.

Observation: Although the proposed regulations could prospectively prevent the ability to segregate CGS between pre-199-year and 199-year gross receipts, the addition of such a rule would appear to support a taxpayer's position under current law to allocate CGS to pre-199 years.

Oil-related QPAI

The Act added Section 199(d)(9), which applies to tax years beginning after December 31, 2008. This provision reduces the otherwise allowable Section 199 deduction when a taxpayer has 'oil-related QPAI.' Under this provision, the Section 199 deduction is reduced by three percent of the least of: (i) the oil-related QPAI of the taxpayer for the tax year, (ii) the QPAI of the taxpayer for the tax year, or (iii) taxable income (determined without regard to Section 199).

The proposed regulations would provide guidance on oil-related QPAI, which would be defined as QPAI attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product of oil or gas. For this purpose, the proposed regulations define oil as including oil recovered from both conventional and non-conventional recovery methods, including crude oil, shale oil, and oil recovered from tar/oil sands. Further, the proposed regulations define primary product from oil as all products derived from the destructive distillation of oil, including volatile products; light oils; distillates such as naphtha; lubricating oils; greases and waxes; and residues such as fuel oil. Primary products of gas is defined as all gas and associated hydrocarbon components from gas wells or oil wells, including natural gas; condensates; liquefied petroleum gas such as ethane, propane, and butane; liquefied petroleum gases such as ethane, propane, and butane; and liquid products such as natural gas. The proposed regulations further indicate that petrochemicals, medicinal products, and alcohols are not primary products of oil and gas.

Observation: If petrochemicals, medicinal products, and alcohols are not considered primary products of oil and gas, the sale of these items produced by a taxpayer would not result in oil-related QPAI that would be subject to the Section 199 limitation.

The proposed regulations also specifically would provide that oil-related DPGR generally does not include gross receipts derived from the transportation or distribution of oil, gas, or any primary product of oil or gas. However, to the extent that a taxpayer treats gross receipts derived from transportation or distribution of oil, gas, or any primary product of oil or gas as DPGR under the de minimis rule or as an embedded service, the taxpayer must treat those gross receipts as oil-related DPGR when determining oil-related QPAI.

The proposed regulations also require taxpayers to use the same cost allocation method to allocate and apportion costs to oil-related DPGR as the taxpayer uses to allocate and apportion costs to DPGR.

Determining DPGR on item-by-item basis

The 2006 Regulations allow a taxpayer, in certain situations, to use any reasonable method that is satisfactory to the IRS to determine whether gross receipts qualify as DPGR on an item-by-item basis. The 2006 Regulations specifically provide that, in the case of construction activities and services or engineering and architectural services, a taxpayer may use any reasonable method that is satisfactory to the IRS to determine what activities constitute an item.

The preamble to the proposed regulations state that in applying this rule, some construction companies have treated an entire multiple-building project as one item when determining the DPGR derived from the sale of a multiple-building project when only one building in the project was substantially renovated by the taxpayer. In analyzing this fact pattern, the IRS has concluded that treating gross receipts from the sale of a multiple building project as DPGR, and the multiple-building project as one item, is not a reasonable method satisfactory to the IRS if a taxpayer did not substantially renovate each building in the multiple-building project. Accordingly, to address the issue, the proposed regulations add an example illustrating that treating the multiple building project as a single item is not appropriate when only one building in the multiple building project is substantially renovated by the taxpayer and the taxpayer's construction activities do not substantially renovate all the buildings in the multiple building project if the buildings were considered one item.

In addition, the proposed regulations include a new example to clarify the item rule when the property offered for disposition to customers includes embedded services. This example illustrates that gross receipts derived from an embedded service, such as a coupon for a car wash included with a sale of a car, do not qualify as DPGR unless the de minimis exception applies. However, the gross receipts derived from the sale of the car (i.e., qualified property), without the car wash, qualify as DPGR. Accordingly, this example clarifies that the item rule is applied after excluding the gross receipts attributable to services.

MPGE activities

The regulatory history to the 2006 Regulations indicates that Congress intended the definition of MPGE to be construed broadly, and that MPGE activities are based on the definition of manufacturing as provided in Section 263A and the regulations thereunder. As a result, the 2006 Regulations define the term broadly to include manufacturing, producing, growing, extracting, installing, developing, improving, and creating qualified production property, among other activities.

Due to the breadth of the activities included as MPGE, there have been disagreements between the IRS and taxpayers as to whether certain activities qualify as MPGE. Particularly, the IRS has taken issue with some taxpayers including testing activities as MPGE, when the taxpayer engages in no other MPGE activity. In addition, the IRS lost at the district court level in *United States v. Dean,* 945 F. Supp.2d 1110 (C.D. Cal. 2013), in which the court concluded that a taxpayer's activity of preparing gift baskets was an MPGE activity and not solely packaging or repackaging for purposes of Section 199.

In the proposed regulations, the IRS has modified an example (Example 5 in Reg. sec. 1.199-3(e)(5)) to further illustrate that certain activities will not be treated as MPGE activities if they are not performed as part of the MPGE of QPP. The modified example now indicates that if a taxpayer does not otherwise MPGE QPP, activities such as testing of component parts do not constitute the MPGE of QPP.

The proposed regulations also would challenge the definition of MPGE adopted by the court in *United States v. Dean,* by adding to the regulations an example (Example 9 in Reg. sec. 1.199-3(e)(5)) that appears to include facts that are nearly identical to the facts in *Dean,* but that concludes that if a taxpayer packages, repackages, labels, or performs minor assembly of QPP and the taxpayer engages in no other MPGE activities with respect to that QPP, the taxpayer's packaging, repackaging, labeling, or minor assembly does not qualify as MPGE with respect to that QPP. More specifically, this example provides that a taxpayer in the business of selling gift baskets that are purchased by the taxpayer and arranged by the taxpayer into the baskets is not engaged in the MPGE of qualified production property.

Observation: The addition of these examples intends to narrow the scope of activities included in the term MPGE and strengthen the IRS's litigating position, which appears contrary to the IRS's stated belief (noted above) that Congress intended that the term MPGE be construed broadly. However, because the proposed regulations do not modify any substantive rules, but include only an additional example, it is unclear whether a court would defer to the IRS position set forth in the example.

Observation: The recent decision in *Precision Dose, Inc. v. United States*, No. 3:12-cv-50180 (N.D. Ill. 2015), which was issued after the proposed regulations, further demonstrates the breadth of the term MPGE. In *Precision Dose*, the US District Court for the Northern District of Illinois concluded that for purposes of Section 199, a company purchasing drugs in bulk and reselling them in non-reusable containers for single-dose administration qualified for the Section 199 deduction. The *Precision Dose* court, in accepting the analysis set forth in *Dean*, rejected the government's argument that the taxpayer's activities were excluded from Section 199 because they constituted packaging, repackaging, labelling, and minor assembly.

The preamble to the proposed regulations also includes a discussion of IRS concerns over what constitutes 'minor assembly,' because such activity is excluded from the definition of MPGE in the 2006 Regulations. The preamble notes two ways the government may consider defining minor assembly: (1) whether the activity is a single process that does not transform an article into a materially different QPP, and (2) whether an end user reasonably could engage in the same assembly activity of the taxpayer. The preamble requests comments and examples on how the term minor assembly should be defined.

Construction activities

Gross receipts derived from construction of real property performed in the United States by the taxpayer in the ordinary course of business are DPGR. The 2006 Regulations provide that activities constituting construction include activities performed by a general contractor, including management and oversight of the construction process such as approvals, periodic inspection of progress of the construction project, and required job modifications.

The preamble to the proposed regulations states that some taxpayers have interpreted the Regulations to mean that a taxpayer that only approves or authorizes payments is engaged in activities typically performed by a general contractor. To clarify the definition of construction, the proposed regulations would add that a taxpayer whose engagement in the activity is primarily limited to approving or authorizing invoices or payments is not considered engaged in a construction activity as a general contractor or in any other capacity.

The proposed regulations also revise certain definitions to conform to the final tangible property regulations under Section 263(a). The proposed regulations define a 'substantial renovation' of real property as a renovation the costs of which must be capitalized as an improvement under Reg. sec. 1.263(a)-3.

Qualified Films

W-2 wages

Consistent with the Code's definition of W-2 wages, the proposed regulations would define W-2 wages as applied to qualified films to include compensation for services performed in the United States by actors, production personnel, directors, and producers.

Definition of qualified films

Under the proposed regulations, the definition of a qualified film would include copyrights, trademarks, and other intangibles such as endorsement rights, video game rights, merchandising rights, and other similar rights. The proposed regulations provide four examples addressing the application of advertising, copyrights, and other intangibles within the context of a qualified film. The proposed regulations also provide rules regarding the classification of receipts from film intangibles affixed to tangible property, the exploitation of film characters, and showing a qualified film via broadcast television or in movie theaters.

According to the IRS, the inclusion of intangibles in the definition of qualified films could be interpreted too broadly when a taxpayer produces a qualified film that is promoting a product or service. As a result, the proposed regulations introduce a rule under which, when a taxpayer produces a qualified film that is promoting a product or service, the gross receipts the taxpayer later derives from the disposition of the product or service promoted in the qualified film are not derived from the disposition of a qualifying film but from the disposition of the advertised product or service. However, the proposed regulations also recognize that a taxpayer can, in certain cases, derive gross receipts from a disposition of a promotional film or its related intangibles if the film's disposition is distinct from the promoted product or service.

The proposed regulations also would allow gross receipts derived from the right to use or exploit film characters and the receipts from showing a qualified film in a movie theater or by broadcast television to be categorized as DPGR if the taxpayer produced the qualifying film. In addition, the examples in the 2006 Regulations would be revised to illustrate that product placement and advertising income derived from a qualified film qualifies as DPGR if broadcast over the air or watched over the Internet.

Finally, the IRS also notes that some taxpayers have taken the position that activities related to the distribution or transmission of qualified films is a production activity. The proposed regulations, according to the IRS, clarify that transmission and distribution are not considered to be the production of a qualified film for purposes of Section 199.

Partnerships and S corporations

The proposed regulations would address the qualified film attribution rules for partnerships, S corporations, and the partners and shareholders thereof. Under the proposed regulations, a partnership may treat itself as having engaged directly in a film produced by a partner only if the partnership treats itself as a partnership for all purposes of the Code. Likewise, under the proposed regulations, a partner would be allowed to treat itself as having engaged directly in a qualified film produced by the partnership only if the partnership treats itself as such for all purposes of the Code.

Observation: The proposed regulations requirement that the partnership treats itself as such for all purposes of the Code is consistent with the IRS conclusion in Chief Counsel Advice 201323015 that a written collaboration agreement under which the collaborators did not treat their venture as a partnership for federal income tax purposes nonetheless constituted a partnership for all federal income tax purposes.

However, the proposed regulations would prohibit the double attribution of film production. In other words, when a partnership or S corporation is treated as having engaged directly in a qualified film produced by a partner or shareholder, a different partner or shareholder that did not participate in the film production is not treated as having engaged directly in the production of the film. As a result, there is no double attribution from the partner or shareholder that produces the film to the non-participating partner. Similarly, when a partner or shareholder is treated as having engaged directly in a film produced by a partnership or S corporation, a different partnership or S corporation in which that partner or shareholder owns an interest is treated as not having engaged directly in the production of the film.

The proposed regulations also would address the attribution period for a partner or partnership or shareholder or S corporation. Under these rules, a partner in a partnership or a shareholder in an S Corporation is treated as having directly engaged in the qualified film produced by the partnership or S Corporation during the period the partner or shareholder owns, directly or indirectly, at least 20 percent of the partnership or S corporation, regardless of when the qualified film was produced.

Similarly, a partnership or S corporation is treated as having engaged directly in the qualified film produced by a partner or shareholder during the period the partner or shareholder owns at least 20 percent of that entity, regardless of when the qualified film was produced. In contrast, during any period that a partner or shareholder owns less than 20 percent of the capital interests in the partnership or S corporation, the partner or shareholder is not treated as having engaged directly in the qualified film produced by the partnership or S corporation and the partnership or S corporation is not treated as having engaged directly in any qualified film produced by the partner or shareholder.

Qualified film safe harbor

In general, a film is treated as a qualified film produced by a taxpayer if at least 50 percent of total compensation for services paid by the taxpayer is for services performed in the United States and the taxpayer satisfies a safe harbor that treats a taxpayer as having produced a qualified film. Under this safe harbor, a taxpayer is treated as producing a qualified film if the sum of the taxpayer's direct labor and overhead incurred to produce the qualified film comprises at least 20 percent of the CGS of the qualified film or 20 percent of the taxpayer's unadjusted depreciable basis in the qualified film if CGS is not available.

In the preamble to the proposed regulations, the IRS notes that there has been uncertainty as to how to apply the safe harbor to costs of live or delayed television, and whether to include third-party license fees paid for third-party produced programs in direct labor and overhead. The proposed regulations provide that, in applying the safe harbor, a taxpayer should include all costs paid or incurred in the production of a live or delayed television program, as well as the licensing fees paid to a third party, in unadjusted depreciable basis. The proposed regulations specifically exclude license fees for third-party produced programs from inclusion in direct labor and overhead incurred for film production.

Observation: The safe harbor provides that the determination of overhead for this purpose is based on the definition of overhead for purposes of Section 263A. The proposed regulations would depart from the current-law provision of Section 263A under which license fees for licensed content constitutes overhead. Accordingly, if the proposed regulations' definition of overhead for purposes of the safe harbor is finalized in its current form, taxpayers that have relied on the definition of overhead under the 2006 Regulations will need to recompute their safe-harbor calculations to determine if they still satisfy the safe harbor under the definition in the proposed regulations.

Treatment of activities in Puerto Rico

Consistent with Section 199(d)(8)(C), the proposed regulations would provide that activities performed in the Commonwealth of Puerto Rico are considered to be performed in the United States to determine DPGR and W-2 wages, provided certain statutory requirements are met. However, unless extended, the statutory provision that includes Puerto Rico within the definition of United States once again will expire and will not be effective for tax years beginning on or after January 1, 2015.

Hedging transactions

The proposed regulations would modify existing hedging rules and eliminate duplicative regulations related to currency fluctuation and the effect of identification and non-identification. The proposed regulations broaden the definition of a hedging transaction to include transactions in which the risk being hedged relates to property in Section 1221(a)(1) giving rise to DPGR, as opposed to existing regulations which require the risk being hedged relate specifically to QPP. Reg. sec. 1.199-3(i)(3)(ii) of the existing regulations on currency fluctuations would be eliminated because Sections 988(d) and 1221 adequately address currency hedges.

The proposed regulations also revise rules regarding the effect of identification and non-identification and clarifies that abusive identification or nonidentification will result in a deduction or loss, but not income or gain, in calculating DPGR.

Agricultural products

Under current Section 199 guidance, any person who receives a qualified payment from a specified agricultural or horticultural cooperative is allowed a deduction under Section 199 equal to the portion of the deduction allowed under Section 199 to such cooperative. A 'qualified payment' is defined as any amount of a patronage dividend or per-unit retain allocation, as described in Section 1385(a)(1) or Section 1385(a)(3), received by a patron from a cooperative that is attributable to the portion of the cooperative's QPAI for which the cooperative is allowed a Section 199 deduction. The term 'per-unit retain allocation' means any allocation by an organization to which part I of subchapter T applies to a patron with respect to products marketed for him, the amount of which is fixed without reference to net earnings of the organization pursuant to an agreement between the organization and the patron. Per-unit retain allocations may be made in money, property, or certificates.

The preamble to the proposed regulations provides that Example 1 in

Reg. sec. 1.199-6(m) has been interpreted as describing that the cooperative's payment for its members' corn is a per-unit retain allocation paid in money as defined in Sections 1382(b)(3) and 1388(f). The preamble clarifies that Example 1 does not identify the cooperative's payment for its members' corn as a per-unit retain allocation and is not intended to illustrate how QPAI is computed when a cooperative's payments to its patrons are per-unit retain allocations. The proposed regulations provide Example 4 to illustrate how QPAI is computed when the cooperative's payments to members for corn qualify as per-unit retain allocations paid in money under Section 1388(f).

The temporary regulations

The more limited temporary regulations provide rules related to the allocation of W-2 wages for purposes of the W-2 wage limitation on the amount of a taxpayer's deduction related to domestic production activities. The temporary regulations provide guidance on the allocation of W-2 wages paid by two or more taxpayers that are employers of the same employees during a calendar year, and the determination of W-2 wages if a taxpayer has a short tax year.

W-2 wage limitation

Background

Under Section 199(b)(1), the amount of the deduction allowable under Section 199 for any tax year shall not exceed 50 percent of the W-2 wages of the taxpayer for the tax year (the W-2 wage limitation). For purposes of the W-2 wage limitation, the term 'W-2 wages' means, with respect to any person for any tax year of the person, the sum of amounts described in Section 6501(a)(3) and (8) paid by the person with respect to employment of employees by the person during the calendar year ending during such tax year.

The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) modified the W-2 wage limitation to provide that the term 'W-2 wages' does not include any amount that is not properly allocable to DPGR. The computation of the W-2 wage limitation requires a two-step computation. First, determine the total amount of W-2 wages paid by the taxpayer to common-law employees during the tax year. Second, determine the portion of such W-2 wages that are allocable to DPGR. The 2006 Regulations provide guidance for determining the amount of W-2 wages that are properly allocable to DPGR.

The 2006 Regulations provide rules for determining W-2 wages in the case of a taxpayer with a short tax year. The 2006 Regulations provide that the W-2 wages of a taxpayer for a short tax year include only those wages paid during the short tax year to employees of the taxpayer, only those elective deferrals made during the short tax year by employees of the taxpayer, and only compensation actually deferred under Section 457 during the short tax year with respect to employees of the taxpayer.

Due to the limitation imposed by Section 199 requiring that the amount included as W-2 wages be only those amounts paid *during the calendar year ending during the tax year of a taxpayer,* instances arise in which a taxpayer does not have a calendar year ending within the tax year. Section 199 contemplates this fact pattern, and provides Treasury with authority to publish guidance setting forth the application of the W-2 wage limitation in the case of a taxpayer with a short tax year due to an acquisition or disposition of a trade or business.

The 2006 Regulations provide that, in situations relating to the acquisition or disposition of a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business from another taxpayer (a predecessor), for purposes of computing the respective Section 199 deduction of the successor and of the predecessor, the W-2 wages paid for that calendar year shall be allocated between the successor and the predecessor based on whether the wages are for employment by the successor or for employment by the predecessor. Thus, the W-2 wages are allocated based on whether the wages are for employment for a period during which the employee was employed by the predecessor or for employment for a period during which the employee was employed by the successor.

The IRS has interpreted the aforementioned rule in the 2006 Regulations as applying only to instances in which the short period was due to the acquisition of a taxpayer's assets. However, the more common fact pattern that creates a short period arises when the stock of a taxpayer is acquired. For example, if taxpayer A acquires on October 1, 2015, the stock of calendar-year taxpayer B, taxpayer B has a short period of January 1, 2015, through October 1, 2015. Accordingly, taxpayers have questioned whether taxpayer B would be eligible for the Section 199 deduction because it does not have a calendar year ending during its short tax year and therefore has no W-2 wages with which to compute the W-2 wage limitation.

In addition, because Section 199 provides Treasury the authority to provide W-2 rules only in the case of an acquisition or disposition of a trade or business, Treasury and the IRS did not have authority to provide rules for situations in which a taxpayer had a short period due to a change in accounting period. However, the Tax

Increase Prevention Act of 2014 provided Treasury the authority to provide guidance to address this situation.

The temporary regulations provide rules for calculating W-2 wages for purposes of the W-2 wage limitation in the case of an acquisition or disposition of a trade or business, the major portion of a trade or business, the major portion of a separate unit of a trade or business during the tax year, or a short tax year. The temporary regulations provide a rule for acquisitions and dispositions if one or more taxpayers may be considered the employer of the employees of the acquired or disposed of- trade or business during that calendar year.

The temporary regulations provide that in that case, the W-2 wages paid during the calendar year to employees of the acquired or disposed of- trade or business are allocated between each taxpayer based on the period during which the employees of the acquired or disposed of- trade or business were employed by the taxpayer. For this purpose, the temporary regulations describe the types of transactions that are considered either an acquisition or disposition for purposes of Section 199(b)(3). Specifically, an acquisition or disposition includes an incorporation, a formation, a liquidation, a reorganization, or a purchase or sale of assets.

In addition, the temporary regulations provide a rule to apply in the case of a short tax year in which there is no calendar year ending within such short tax year (the short-tax-year rule). Under this rule, which would apply to taxpayers with a short tax year due to a change in accounting period, wages paid by a taxpayer during the short tax year to employees for employment by such taxpayer are treated as W-2 wages for such short tax year for purposes of Section 199(b)(1).

Observation: Although the temporary regulations provide taxpayer-favorable certainty that has been long sought by taxpayers, there is one issue that is not resolved by the temporary regulations. Assume, for example, that a calendar-year taxpayer changes its year to September 30, resulting in a short tax year ending September 30, 2015 (2015 year), and a full fiscal year ending September 30, 2016 (2016 year). The temporary regulations would permit the W-2 wages for calendar year 2015 to be allocated between the 2015 year and the 2016 year. However, if nine months of the 2015 W-2 wages are allocated to the 2015 year, that would leave only the remaining three months of the 2015 W-2 wages to be allocated to the 2016 year because of the non-duplication rule in the 2006 Regulations (Reg. sec. 1.199-2(d), which prevents W-2 wages from being taken into account in more than one tax year. Accordingly, the 2016 year would have only three months of W-2 wages, which could result in a W-2 wage limitation for the 2016 year. To alleviate this unintended result, the IRS may need to provide an exception to the non-duplication rule in the fact pattern described above.

Observation: As noted earlier, the temporary regulations can be relied on immediately and can be applied by taxpayers to tax years for which the statute of limitations is still open. Accordingly, taxpayers may have refund opportunities, via amending prior-year returns, to the extent they did not claim a Section 199 deduction in a prior-year short period due to not having a calendar year ending during their year and a resulting W-2 wage limitation of zero.

The takeaway

The proposed and temporary regulations reflect the IRS's effort to address issues that have affected taxpayers and the IRS for years. The proposed regulations would provide guidance in a variety of issues and would affect taxpayers in a broad array of areas and industries. Taxpayers need to determine the impact, if any, of the proposed regulations on their Section 199 deductions, not only prospectively but also on prior-year positions. Because the regulations are proposed, taxpayers have an opportunity to comment on any issues raised in the proposed regulations, or other issues for which they would like additional clarity. In addition, the temporary regulations may provide an immediate opportunity for affected taxpayers to amend prior-year returns and claim Section 199 benefits for those years.

Let's talk

For a deeper discussion of how this may affect your business, please contact:

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