DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–136459–09]

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Amendments to Domestic Production Activities Deduction Regulations; Allocation of W–2 Wages in a Short Taxable Year and in an Acquisition or Disposition

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking, notice of proposed rulemaking by cross reference to temporary regulations and notice of public hearing.

SUMMARY: This document contains proposed regulations involving the domestic production activities deduction under section 199 of the Internal Revenue Code (Code). The proposed regulations provide guidance to taxpayers on the amendments made to section 199 by the Energy Improvement and Extension Act of 2008 and the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, involving oil related qualified production activities income and qualified films, and the American Taxpayer Relief Act of 2012, involving activities in Puerto Rico. The proposed regulations also provide guidance on: Determining domestic production gross receipts; the terms manufactured, produced, grown, or extracted; contract manufacturing; hedging transactions; construction activities; allocating cost of goods sold; and agricultural and horticultural cooperatives. In the Rules and Regulations of this issue of the **Federal Register**, the Treasury Department and the IRS also are issuing temporary regulations (TD 9731) clarifying how taxpayers calculate W–2 wages for purposes of the W–2 wage limitation in the case of a short taxable year or an acquisition or disposition of a trade or business (including the major portion of a trade or business, or the major portion of a separate unit of a trade or business) during the taxable year. This document also contains a notice of a public hearing on the proposed regulations.

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

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–136459–09), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–136459–09), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC, or sent electronically, via the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS REG–136459–09). The public hearing will be held in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning §§ 1.199–1(f), 1.199–2(c), 1.199–2(e), 1.199–2(f), 1.199–3(b), 1.199–3(e), 1.199–3(h), 1.199–3(k), 1.199–3(m), 1.199–6(m), and 1.199–8(i) of the proposed regulations, James Holmes, (202) 317–4137; concerning § 1.199–4(b) of the proposed regulations, Natasha Mulleneaux (202) 317–7007; concerning submissions of comments, the hearing, or to be placed on the building access list to attend the hearing, Regina Johnson, at (202) 317–6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to §§ 1.199–0, 1.199–1, 1.199–2, 1.199–3, 1.199–4(b), 1.199–6, and 1.199–8(i) of the Income Tax Regulations (26 CFR part 1). Section 1.199–1 relates to income that is attributable to domestic production activities. Section 1.199–2 relates to W–2 wages as defined in section 199(b). Section 1.199–3 relates to determining domestic production gross receipts (DPGR). Section 1.199–4(b) describes the costs of goods sold allocable to DPGR. Section 1.199–6 applies to agricultural and horticultural cooperatives. Section 1.199–8(i) provides the effective/applicability dates.

Section 199 was added to the Code by section 102 of the American Jobs Creation Act of 2004 (Pub. L. 108–357, 118 Stat. 1418 (2004)), and amended by section 403(a) of the Gulf Opportunity Zone Act of 2005 (Pub. L. 109–135, 119 Stat. 25 (2005)), section 514 of the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. 109–222, 120 Stat. 345 (2005)), section 401 of the Tax Relief and Health Care Act of 2006 (Pub. L. 109–432, 120 Stat. 2922 (2006)), section 401(a), Division B of the Energy Improvement and Extension Act of 2008 (Pub. L. 110–343, 122 Stat. 3765 (2008)) (Energy Extension Act of 2008), sections 312(a) and 502(c), Division C of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (Pub. L. 110–343, 122 Stat. 3765 (2008)) (Tax Extenders Act of 2008), section 746(a) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. 111–312, 124 Stat. 3296 (2010)), section 318 of the American Taxpayer Relief Act of 2012 (Pub. L. 112–240, 126 Stat. 2313 (2013)), and sections 130 and 219(b) of the Tax Increase Prevention Act of 2014 (Pub. L. 113–295, 128 Stat. 4010 (2014)).

General Overview

Section 199(a)(1) allows a deduction equal to nine percent (three percent in the case of taxable years beginning in 2005 or 2006, and six percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of: (A) The qualified production activities income (QPAI) of the taxpayer for the taxable year, or (B) taxable income (determined without regard to section 199) for the taxable year (or, in the case of an individual, adjusted gross income).

Section 199(b)(1) provides that the amount of the deduction allowable under section 199(a) for any taxable year shall not exceed 50 percent of the W–2 wages of the taxpayer for the taxable year. Section 199(b)(2)(A) generally defines *W–2 wages,* with respect to any person for any taxable year of such person, as the sum of amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Section 199(b)(3), after its amendment by section 219(b) of the Tax Increase Prevention Act of 2014, provides that the Secretary shall provide for the application of section 199(b) in cases of a short taxable year or where the taxpayer acquires, or disposes of, the major portion of a trade or business, or the major portion of a separate unit of a trade or business during the taxable year. Section 199(b)(2)(B) limits the W–2 wages to those properly allocable to DPGR for taxable years beginning after May 17, 2006.

Section 199(c)(1) defines QPAI for any taxable year as an amount equal to the excess (if any) of: (A) The taxpayer's DPGR for such taxable year, over (B) the sum of: (i) The cost of goods sold (CGS) that are 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.

Section 199(c)(4)(A)(i) provides that the term DPGR means the taxpayer's 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.

Section 199(d)(10), as renumbered by section 401(a), Division B of the Energy Extension Act of 2008, authorizes the Secretary to prescribe such regulations as are necessary to carry out the purposes of section 199, including regulations that prevent more than one taxpayer from being allowed a deduction under section 199 with respect to any activity described in section 199(c)(4)(A)(i).

Explanation of Provisions

1. Allocation of W–2 Wages in a Short Taxable Year and in an Acquisition or Disposition of a Trade or Business (or Major Portion)

Temporary regulations in the Rules and Regulations section of this issue of the **Federal Register** contain amendments to the Income Tax Regulations that provide rules clarifying how taxpayers calculate W–2 wages for purposes of the W–2 wage limitation under section 199(b)(1) in the case of a short taxable year or where a taxpayer acquires, or disposes of, the major portion of a trade or business, or the major portion of a separate unit of a trade or business during the taxable year under section 199(b)(3). The text of those regulations serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

2. Oil Related Qualified Production Activities Income

Section 401(a), Division B of the Energy Extension Act of 2008 added new section 199(d)(9), which applies to taxable years beginning after December 31, 2008. Section 199(d)(9) reduces the otherwise allowable section 199 deduction when a taxpayer has oil related qualified production activities income (oil related QPAI), and defines oil related QPAI. Section 199(d)(9)(A) provides that if a taxpayer has oil related QPAI for any taxable year beginning after 2009, the amount otherwise allowable as a deduction under section 199(a) must be reduced by three percent of the least of: (i) The oil related QPAI of the taxpayer for the taxable year, (ii) the QPAI of the taxpayer for the taxable year, or (iii) taxable income (determined without regard to section 199).

Section 1.199–1(f) of the proposed regulations provides guidance on oil related QPAI. In defining oil related QPAI, the Treasury Department and the IRS considered the relationship between QPAI and oil related QPAI. Section 199(c)(1) defines QPAI as the amount equal to the excess (if any) of the taxpayer's DPGR for the taxable year over the sum of CGS allocable to such receipts and other costs, expenses, losses, and deductions allocable to such receipts. So, for example, if gross receipts are not included within DPGR, those gross receipts are not included when calculating QPAI. Section 199(d)(9)(B) defines oil related QPAI as QPAI attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof. In general, gross receipts from the transportation and distribution of QPP are not includable in DPGR because those activities are not considered part of the MPGE of QPP. See § 1.199–3(e)(1), which defines MPGE. Section 199(c)(4)(B)(ii) specifically excludes gross receipts attributable to the transmission or distribution of natural gas from the definition of DPGR.

Based on these considerations, the proposed regulations define *oil related QPAI* as an amount equal to the excess (if any) of the taxpayer's DPGR from the production, refining, or processing of oil, gas, or any primary product thereof (oil related DPGR) over the sum of the CGS that is allocable to such receipts and other expenses, losses, or deductions that are properly allocable to such receipts. The proposed regulations specifically provide that oil related DPGR does not include gross receipts derived from the transportation or distribution of oil, gas, or any primary product thereof, except if the de minimis rule under § 1.199–1(d)(3)(i) or an exception for embedded services applies under § 1.199–3(i)(4)(i)(B). The proposed regulations further provide that, to the extent a taxpayer treats gross receipts derived from the transportation or distribution of oil, gas, or any primary product thereof as DPGR under § 1.199–1(d)(3)(i) or § 1.199–3(i)(4)(i)(B), the taxpayer must include those gross receipts in oil related DPGR.

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. Section 199(d)(9)(C) defines *primary product* as having the same meaning as when used in section 927(a)(2)(C) (relating to property excluded from the term *export property* under the former foreign sales corporations rules), as in effect before its repeal. The proposed regulations incorporate the rules in § 1.927(a)–1T(g)(2)(i) regarding the definition of a primary product with modifications that are consistent with the definition of oil for purposes of section 199(d)(9).

Section 1.199–1(f)(2) of the proposed regulations provides guidance on how a taxpayer should allocate and apportion costs under the section 861 method, the simplified deduction method, and the small business simplified overall method when determining oil related QPAI. The proposed regulations 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.

3. Qualified Films

a. Statutory Amendments

Section 502(c), Division C of the Tax Extenders Act of 2008 amended the rules relating to qualified films. Section 502(c)(1) added section 199(b)(2)(D) to broaden the definition of the term *W–2 wages* as applied to a qualified film to include compensation for services performed in the United States by actors, production personnel, directors, and producers.

Section 502(c)(2), Division C of the Tax Extenders Act of 2008 amended the definition of qualified film in section 199(c)(6) to mean any property described in section 168(f)(3) if not less than 50 percent of the total compensation relating to production of the property is compensation for services performed in the United States by actors, production personnel, directors, and producers. The term does not include property with respect to which records are required to be maintained under 18 U.S.C. 2257 (generally, films, videotapes, or other matter that depict actual sexually explicit conduct and are produced in whole or in part with materials that have been mailed or shipped in interstate or foreign commerce, or are shipped or transported or are intended for shipment or transportation in interstate or foreign commerce). Section 502(c)(2), Division C of the Tax Extenders Act of 2008 also amended the definition of a qualified film under section 199(c)(6) to include any copyrights, trademarks, or other intangibles with respect to such film. The method and means of distributing a qualified film does not affect the availability of the deduction.

Section 502(c)(3), Division C of the Tax Extenders Act of 2008 added an attribution rule for a qualified film for taxpayers who are partnerships or S

corporations, or partners or shareholders of such entities under section 199(d)(1)(A)(iv). Section 199(d)(1)(A)(iv) provides that in the case of each partner of a partnership, or shareholder of an S corporation, who owns (directly or indirectly) at least 20 percent of the capital interests in such partnership or the stock of such S corporation, such partner or shareholder is treated as having engaged directly in any film produced by such partnership or S corporation, and that such partnership or S Corporation is treated as having engaged directly in any film produced by such partner or shareholder.

The amendments made by section 502(c), Division C of the Tax Extenders Act of 2008 apply to taxable years beginning after December 31, 2007.

b. W–2 Wages

Section 1.199–2(e)(1) of the proposed regulations modifies the definition of W–2 wages to include compensation for services (as defined in § 1.199–3(k)(4)) performed in the United States by actors, production personnel, directors, and producers (as defined in § 1.199–3(k)(1)).

c. Definition of Qualified Films

To address the amendments to the definition of qualified film in section 199(c)(6) for taxable years beginning after 2007, the proposed regulations amend the definition of qualified film in § 1.199–3(k)(1) to include copyrights, trademarks, or other intangibles with respect to such film. The proposed regulations define other intangibles with a non-exclusive list of intangibles that fall within the definition.

Section 1.199–3(k)(10) provides a special rule for disposition of promotional films to address concerns of the Treasury Department and the IRS that the inclusion of intangibles in the definition of qualified film could be interpreted too broadly. This rule clarifies that, when a taxpayer produces a qualified film that is promoting a product or service, the gross receipts a taxpayer later derives from the disposition of the product or service promoted in the qualified film are derived from the disposition of the product or service and not from a disposition of the qualified film (including any intangible with respect to such qualified film). The rule is intended to prevent taxpayers from claiming that gross receipts are derived from the disposition of a qualified film (rather than the product or service itself) when a taxpayer sells a product or service with a logo, trademark, or other intangible that appears in a promotional film produced by the taxpayer. The Treasury Department and the IRS recognize that a taxpayer can, in certain cases, derive gross receipts from a disposition of a promotional film or the intangibles in a promotional film. The proposed regulations add *Example 9* in § 1.199–3(k)(11) relating to a license to reproduce a character used in a promotional film to illustrate a situation where gross receipts can qualify as DPGR because the gross receipts are distinct (separate and apart) from the disposition of the product or service. The Treasury Department and the IRS request comments on how to determine when gross receipts are distinct.

The proposed regulations add four examples in redesignated § 1.199–3(k)(11), formerly § 1.199–3(k)(10), to illustrate application of the amended definition of qualified film that includes copyrights, trademarks, or other intangibles.

The proposed regulations remove the last sentence of § 1.199–3(k)(3)(ii) (which states that gross receipts derived from a license of the right to use or exploit film characters are not gross receipts derived from a qualified film) because gross receipts derived from a license of the right to use or exploit film characters are now considered gross receipts derived from a qualified film.

Section 1.199–3(k)(2)(ii), which allows a taxpayer to treat certain tangible personal property as a qualified film (for example, a DVD), is amended to exclude film intangibles because tangible personal property affixed with a film intangible (such as a trademark) should not be treated as a qualified film. For example, the total revenue from the sale of an imported t-shirt affixed with a film intangible should not be treated as gross receipts derived from the sale of a qualified film. The portion of the gross receipts attributable to the qualified film intangible separate from receipts attributable to the t-shirt may qualify as DPGR, however. The proposed regulations also add *Example 10* and *Example 11* in redesignated § 1.199–3(k)(11) to address situations in which tangible personal property is offered for sale in combination with a qualified film affixed to a DVD.

Section 1.199–3(k)(3)(i) and (k)(3)(ii) of the proposed regulations address the amendment to section 199(c)(6) (effective for taxable years beginning after 2007) that provides the methods and means of distributing a qualified film will not affect the availability of the deduction under section 199. The exception that describes the receipts from showing a qualified film in a movie theater or by broadcast on a television station as not derived from a qualified film is removed from § 1.199–3(k)(3)(ii) because, if a taxpayer produces a qualified film, then the receipts the taxpayer derives from these showings qualify as DPGR in taxable years beginning after 2007. In addition, *Example 4* in § 1.199–3(i)(5)(iii) and *Example 3* in § 1.199–3(k)(11) (formerly § 1.199–3(k)(10)) have been revised to illustrate that, for taxable years beginning after 2007, product placement and advertising income derived from the distribution of a qualified film qualifies as DPGR if the qualified film containing the product placements and advertising is broadcast over the air or watched over the Internet.

The proposed regulations also add a sentence to § 1.199–3(k)(6) to clarify that production activities do not include activities related to the transmission or distribution of films. The Treasury Department and the IRS are aware that some taxpayers have taken the inappropriate position that these activities are part of the production of a film. The Treasury Department and the IRS consider film production as distinct from the transmission and distribution of films. This clarification is also consistent with the amendment to the definition of qualified film, which provides that the methods and means of distribution do not affect the availability of the deduction under section 199.

d. Partnerships and S Corporations

Section 1.199–3(i)(9) of the proposed regulations describes the application of section 199(d)(1)(A)(iv) to partners and partnerships and shareholders and S corporations for taxable years beginning after 2007. The Treasury Department and the IRS have determined that for a partnership to apply the provisions of section 199(d)(1)(A)(iv) to treat itself as having engaged directly in a film produced by a partner, the partnership must treat itself as a partnership for all purposes of the Code. Further, a partner of a partnership can apply the provisions of section 199(d)(1)(A)(iv) to treat itself as having engaged directly in a film produced by the partnership only if the partnership treats itself as a partnership for all purposes of the Code. Section 1.199–3(i)(9)(i) describes generally that a partner of a partnership or shareholder of an S corporation who owns (directly or indirectly) at least 20 percent of the capital interests in such partnership or the stock of such S corporation is treated as having engaged directly in any film produced by such partnership or S corporation. Further, such partnership or S corporation is treated as having engaged directly in any film produced by such partner or shareholder.

Section 1.199–3(i)(9)(ii) of the proposed regulations generally prohibits attribution between partners of a partnership or shareholders of an S corporation, partnerships with a partner in common, or S corporations with a shareholder in common. Thus, when a partnership or S corporation is treated as having engaged directly in any film produced by a partner or shareholder, any other partners or shareholders who did not participate directly in the production of the film are treated as not having engaged directly in the production of the film at the partner or shareholder level. Similarly, when a partner or shareholder is treated as having engaged directly in any film produced by a partnership or S corporation, any other partnerships or S corporations in which that partner or shareholder owns an interest (excluding the partnership or S corporation that produced the film) are treated as not having engaged directly in the production of the film at the partnership or S corporation level.

Section 1.199–3(i)(9)(iii) of the proposed regulations describes the attribution period for a partner or partnership or shareholder or S corporation under section 199(d)(1)(A)(iv). A partner or shareholder is treated as having engaged directly in any qualified film produced by the partnership or S corporation, and a partnership or S corporation is treated as having engaged directly in any qualified film produced by the partner or shareholder, regardless of when the qualified film was produced, during the period in which the partner or shareholder owns (directly or indirectly) at least 20 percent of the capital interests in the partnership or the stock of the S corporation. During any period that a partner or shareholder owns less than 20 percent of the capital interests in such partnership or the stock of such S corporation that partner or shareholder is not treated as having engaged directly in the qualified film produced by the partnership or S corporation for purposes of § 1.199–3(i)(9)(iii), and that partnership or S corporation is not treated as having engaged directly in any qualified film produced by the partner or shareholder.

Section 1.199–3(i)(9)(iv) of the proposed regulations provides examples that illustrate section 199(d)(1)(A)(iv).

e. Qualified Film Safe Harbor

Existing § 1.199–3(k)(7)(i) provides a safe harbor that treats a film as a qualified film produced by the taxpayer if not less than 50 percent of the total compensation for services paid by the taxpayer is compensation for services performed in the United States and the taxpayer satisfies the safe harbor in § 1.199–3(g)(3) for treating a taxpayer as MPGE QPP in whole or significant part in the United States. The Treasury Department and the IRS are aware that it may be unclear how the safe harbor in § 1.199–3(k)(7)(i) applies to costs of live or delayed television programs that may be expensed (specifically, whether such expensed costs are part of the CGS or unadjusted depreciable basis of the qualified film for purposes of § 1.199–3(g)(3)). Further, it may be unclear whether license fees paid for third-party produced programs are included in direct labor and overhead when applying the safe harbor in § 1.199–3(g)(3). The proposed regulations clarify how a taxpayer producing live or delayed television programs should apply the safe harbor in § 1.199–3(k)(7)(i); in particular, how a taxpayer should calculate its unadjusted depreciable basis under § 1.199–3(g)(3)(ii). Specifically, proposed § 1.199–3(k)(7)(i) requires a taxpayer to include all costs paid or incurred in the production of a live or delayed television program in the taxpayer's unadjusted depreciable basis of such program under § 1.199–3(g)(3)(ii), including the licensing fees paid to a third party under § 1.199–3(g)(3)(ii). The proposed regulations further clarify that license fees for third-party produced programs are not included in the direct labor and overhead to produce the film for purposes of applying § 1.199–3(g)(3).

4. Treatment of Activities in Puerto Rico

Section 199(d)(8)(A) provides that in the case of any taxpayer with gross receipts for any taxable year from sources within the Commonwealth of Puerto Rico, if all of such receipts are taxable under section 1 or 11 for such taxable year, then for purposes of determining the DPGR of such taxpayer for such taxable year under section 199(c)(4), the term *United States* includes the Commonwealth of Puerto Rico. Section 199(d)(8)(B) provides that in the case of a taxpayer described in section 199(d)(8)(A), for purposes of applying the wage limitation under section 199(b) for any taxable year, the determination of W–2 wages of such taxpayer is made without regard to any exclusion under section 3401(a)(8) for remuneration paid for services performed in Puerto Rico. Section 130 of the Tax Increase Prevention Act of 2014 amended section 199(d)(8)(C) for taxable years beginning after December 31, 2013. As amended, section 199(d)(8)(C) provides that section 199(d)(8) applies only with respect to the first nine taxable years of the taxpayer beginning after December 31, 2005, and before January 1, 2015.

Section 1.199–2(f) of the proposed regulations modifies the W–2 wage limitation under section 199(b) to the extent provided by section 199(d)(8). Section 1.199–3(h)(2) of the proposed regulations modifies the term *United States* to include the Commonwealth of Puerto Rico to the extent provided by section 199(d)(8).

5. Determining DPGR on Item-by-Item Basis

Section 1.199–3(d)(1) provides that a taxpayer determines, using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, whether gross receipts qualify as DPGR on an item-by-item basis. Section 1.199–3(d)(1)(i) provides that item means the property offered by the taxpayer in the normal course of the taxpayer's business for lease, rental, license, sale, exchange, or other disposition (for purposes of § 1.199–3(d), collectively referred to as disposition) to customers, if the gross receipts from the disposition of such property qualify as DPGR. Section 1.199–3(d)(2)(iii) provides 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 Secretary based on all of the facts and circumstances to determine what construction activities and services or engineering or architectural services constitute an item.

The Treasury Department and the IRS are aware that the item rule in § 1.199–3(d)(2)(iii) has been interpreted to mean that the gross receipts derived from the sale of a multiple-building project may be treated as DPGR when only one building in the project is substantially renovated. The Treasury Department and the IRS have 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 Secretary for purposes of § 1.199–3(d)(2)(iii) if a taxpayer did not substantially renovate each building in the multiple-building project. Section 1.199–3(d)(4) of the proposed regulations includes an example (*Example 14*) illustrating the appropriate application of § 1.199–3(d)(2)(iii) to a multiple building project.

In addition, the Treasury Department and the IRS are aware that taxpayers may be unsure how to apply the item rule in § 1.199–3(d)(2)(i) when the property offered for disposition to customers includes embedded services

as described in § 1.199–3(i)(4)(i). The proposed regulations add *Example 6* to § 1.199–3(d)(4) to clarify that the item rule applies after excluding the gross receipts attributable to services.

6. MPGE

Section 1.199–3(e)(1) provides that the term *MPGE* includes manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP; making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles; cultivating soil, raising livestock, fishing, and mining minerals. The Treasury Department and the IRS are aware that *Example 5* in § 1.199–3(e)(5) has been interpreted to mean that testing activities qualify as an MPGE activity even if the taxpayer engages in no other MPGE activity. The Treasury Department and the IRS disagree that testing activities, alone, qualify as an MPGE activity. The proposed regulations add a sentence to *Example 5* in § 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. Taxpayers are not required to allocate gross receipts to certain activities that are not MPGE activities when those activities are performed in connection with the MPGE of QPP. However, if the taxpayer in *Example 5* in § 1.199–3(e)(5) did not MPGE QPP, then the activities described in the example, including testing, are not MPGE activities.

Section 1.199–3(e)(2) provides 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. This rule has been the subject of recent litigation. See *United States* v. *Dean*, 945 F. Supp. 2d 1110 (C.D. Cal. 2013) (concluding that the taxpayer's activity of preparing gift baskets was a manufacturing activity and not solely packaging or repackaging for purposes of section 199). The Treasury Department and the IRS disagree with the interpretation of § 1.199–3(e)(2) adopted by the court in *United States* v. *Dean*, and the proposed regulations add an example (*Example 9*) that illustrates the appropriate application of this rule in a situation in which the taxpayer is engaged in no other MPGE activities with respect to the QPP other than those described in § 1.199–3(e)(2).

7. Definition of ''by the taxpayer''

Section 1.199–3(f)(1) provides that if one taxpayer performs a qualifying activity under § 1.199–3(e)(1), § 1.199–3(k)(1), or § 1.199–3(l)(1) pursuant to a contract with another party, then only the taxpayer that has the benefits and burdens of ownership of the QPP, qualified film, or utilities under Federal income tax principles during the period in which the qualifying activity occurs is treated as engaging in the qualifying activity.

Taxpayers and the IRS have had difficulty determining which party to a contract manufacturing arrangement has the benefits and burdens of ownership of the property while the qualifying activity occurs. Cases analyzing the benefits and burdens of ownership have considered the following factors relevant: (1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity interest was acquired; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser and which party has control of the property or process; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; (8) which party receives the profits from the operation and sale of the property; and (9) whether a taxpayer actively and extensively participated in the management and operations of the activity. See *ADVO, Inc. & Subsidiaries* v. *Commissioner*, 141 T.C. 298, 324–25 (2013); see also *Grodt & McKay Realty, Inc.* v. *Commissioner*, 77 T.C. 1221 (1981). The *ADVO* court noted that the factors it used in its analysis are not exclusive or controlling, but that they were in the particular case sufficient to determine which party had the benefits and burdens of ownership. *ADVO, Inc.*, 141 T.C. at 325 n. 21. Determining which party has the benefits and burdens of ownership under Federal income tax principles for purposes of section 199 requires an analysis and weighing of many factors, which in some contexts could result in more than one taxpayer claiming the benefits of section 199 with respect to a particular activity. Resolving the benefits and burdens of ownership issue often requires significant IRS and taxpayer resources.

Section 199(d)(10) directs the Treasury Department to provide regulations that prevent more than one taxpayer from being allowed a deduction under section 199 with respect to any qualifying activity (as described in section 199(c)(4)(A)(i)). The Treasury Department and the IRS have interpreted the statute to mean that only one taxpayer may claim the section 199 deduction with respect to the same activity performed with respect to the same property. See § 1.199–3(f)(1). *Example 1* and *Example 2* in § 1.199–3(f)(4) currently illustrate this one-taxpayer rule using factors that are relevant to the determination of who has the benefits and burdens of ownership.

The Large Business and International (LB&I) Division issued an Industry Director Directive on February 1, 2012 (LB&I Control No. LB&I–4–0112–01) (Directive) addressing the benefits and burdens factors. The Directive provides a three-step analysis of facts and circumstances relating to contract terms, production activities, and economic risks to determine whether a taxpayer has the benefits and burdens of ownership for purposes of § 1.199–3(f)(1). LB&I issued a superseding second directive on July 24, 2013 (LB&I Control No. LB&I–04–0713–006), and a third directive updating the second directive on October 29, 2013 (LB&I Control No. LB&I–04–1013–008). The third directive allows a taxpayer to provide a statement explaining the taxpayer's determination that it had the benefits and burdens 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.

To provide administrable rules that are consistent with section 199, reduce the burden on taxpayers and the IRS in evaluating factors related to the benefits and burdens of ownership, and prevent more than one taxpayer from being allowed a deduction under section 199 with respect to any qualifying activity, the proposed regulations remove the rule in § 1.199–3(f)(1) that treats a taxpayer in a contract manufacturing arrangement as engaging in the qualifying activity only if the taxpayer has the benefits and burdens of ownership during the period in which the qualifying activity occurs. In place of the benefits and burdens of ownership rule, these proposed regulations provide that if a qualifying activity is performed under a contract, then the party that performs the activity is the taxpayer for purposes of section 199(c)(4)(A)(i). This rule, which applies solely for purposes of section 199, reflects the 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. The proposed rule would also provide a readily administrable approach that would prevent more than one taxpayer from being allowed a deduction under section 199 with respect to any qualifying activity.

Example 1 has been revised, and current *Example 2* has been removed, to reflect the new rule. In addition, the benefits and burdens language has been removed from: (1) The definition of MPGE in § 1.199–3(e)(1) and (3), including *Example 1, Example 4,* and *Example 5* in § 1.199–3(e)(5); (2) the definition of in whole or in significant part in § 1.199–3(g)(1); (3) *Example 5* in the qualified film rules in existing § 1.199–3(k)(7); and (4) the production pursuant to a contract in the qualified film rules in § 1.199–3(k)(8).

The Treasury Department and the IRS request comments on whether there are narrow circumstances that could justify an exception to the proposed rule. In particular, the Treasury Department and the IRS request 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 Treasury Department and the IRS are uncertain regarding the extent to which such fully cost-plus or cost-reimbursable contracts are in fact used in practice. Comments suggesting circumstances that could justify an exception to the proposed rule should address the rationale for the proposed exception, the ability of the IRS to administer the exception, and how the suggested exception will prevent two taxpayers from claiming the deduction for the qualifying activity.

8. Hedging Transactions

The proposed regulations make several revisions to the hedging rules in § 1.199–3(i)(3). Section 1.199–3(i) of the proposed regulations defines a hedging transaction to include transactions in which the risk being hedged relates to property described in section 1221(a)(1) giving rise to DPGR, whereas the existing regulations require the risk being hedged relate to QPP described in section 1221(a)(1). A taxpayer commented in a letter to the Treasury Department and the IRS that there is no reason to limit the hedging rules to QPP giving rise to DPGR, and the proposed regulations accept the comment.

The other changes to the hedging rules are administrative. Section 1.199–3(i)(3)(ii) of the existing regulations on currency fluctuations was eliminated because the regulations under sections 988(d) and 1221 adequately cover the treatment of currency hedges. Similarly, the rules in § 1.199–3(i)(3)(iii) that address the effect of identification and non-identification were duplicative of the rules in the section 1221 regulations. Accordingly, § 1.199–3(i)(3)(ii) has been revised to cross-reference the appropriate rules in § 1.1221–2(g), and to clarify that the consequence of an abusive identification or non-identification is that deduction or loss, but not income or gain, is taken into account in calculating DPGR.

9. Construction Activities

Section 199(c)(4)(A)(ii) includes in DPGR, in the case of a taxpayer engaged in the active conduct of a construction trade or business, gross receipts derived from construction of real property performed in the United States by the taxpayer in the ordinary course of such trade or business. Under § 1.199–3(m)(2)(i), activities constituting construction include activities performed by a general contractor or activities typically performed by a general contractor, for example, activities relating to management and oversight of the construction process such as approvals, periodic inspection of progress of the construction project, and required job modifications. The Treasury Department and the IRS are aware that some taxpayers have interpreted this language to mean that a taxpayer who only approves or authorizes payments is engaged in activities typically performed by a general contractor under § 1.199–3(m)(2)(i). The Treasury Department and the IRS disagree that a taxpayer who only approves or authorizes payments is engaged in construction for purposes of § 1.199–3(m)(2)(i). Accordingly, § 1.199–3(m)(2)(i) of the proposed regulations clarifies that a taxpayer must engage in construction activities that include more than the approval or authorization of payments or invoices for that taxpayer's activities to be considered as activities typically performed by a general contractor.

Section 1.199–3(m)(2)(i) provides that activities constituting construction are activities performed in connection with a project to erect or substantially renovate real property. Section 1.199–3(m)(5) currently defines substantial renovation to mean the renovation of a major component or substantial structural part of real property that materially increases the value of the property, substantially prolongs the useful life of the property, or adapts the property to a new or different use. This standard reflects regulations under § 1.263(a)–3 related to amounts paid to improve tangible property that existed at the time of publication of the final § 1.199–3(m)(5) regulations (TD 9263 [71 FR 31268] June 19, 2006) but which have since been revised. See (TD 9636 [78 FR 57686] September 19, 2013).

The proposed regulations under § 1.199–3(m)(5) revise the definition of substantial renovation to conform to the final regulations under § 1.263(a)-3, which provide rules requiring capitalization of amounts paid for improvements to a unit of property owned by a taxpayer. Improvements under § 1.263(a)–3 are amounts paid for a betterment to a unit of property, amounts paid to restore a unit of property, and amounts paid to adapt a unit of property to a new or different use. See § 1.263(a)–3(j), (k), and (l). Under the proposed regulations, a substantial renovation of real property is a renovation the costs of which are required to be capitalized as an improvement under § 1.263(a)–3, other than an amount described in § 1.263(a)–3(k)(1)(i) through (iii) (relating to amounts for which a loss deduction or basis adjustment requires capitalization as an improvement). The improvement rules under § 1.263(a)–3 provide specific rules of application for buildings (see § 1.263(a)–3(j)(2)(ii), (k)(2), and (l)(2)), which apply for purposes of § 1.199–3(m)(5).

10. Allocating Cost of Goods Sold

Section 1.199–4(b)(1) describes how a taxpayer determines its CGS allocable to DPGR. The Treasury Department and the IRS are 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 Treasury Department and the IRS recognize that allocable contract costs under PCM or CCM are analogous to CGS and should be treated in the same manner. Section 1.199–4(b)(1) of the proposed regulations provides that in the case of a long-term contract accounted for under PCM or CCM, CGS for purposes of § 1.199–4(b)(1) includes allocable contract costs described in § 1.460–5(b) or § 1.460–5(d), as applicable.

Existing § 1.199–4(b)(2)(i) provides that a taxpayer must use a reasonable method that is satisfactory to the

Secretary based on all of the facts and circumstances to allocate CGS between DPGR and non-DPGR. This allocation must be determined based on the rules provided in § 1.199–4(b)(2)(i) and (ii). Taxpayers have asserted that under § 1.199–4(b)(2)(ii) the portion of current year CGS associated with activities in earlier tax years (including pre-section 199 tax years) may be allocated to non-DPGR even if the related gross receipts are treated by the taxpayer as DPGR. Section 1.199–4(b)(2)(iii)(A) of the proposed regulations clarifies 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 taxable year. Section 1.199–4(b)(2)(iii)(B) of the proposed regulations provides an example illustrating this rule.

11. Agricultural and Horticultural Cooperatives

Section 199(d)(3)(A) provides that any person who receives a qualified payment from a specified agricultural or horticultural cooperative must be allowed for the taxable year in which such payment is received a deduction under section 199(a) equal to the portion of the deduction allowed under section 199(a) to such cooperative that is (i) allowed with respect to the portion of the QPAI to which such payment is attributable, and (ii) identified by such cooperative in a written notice mailed to such person during the payment period described in section 1382(d).

Under § 1.199–6(c), the cooperative's QPAI is computed without taking into account any deduction allowable under section 1382(b) or section 1382(c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

Section 1.199–6(e) provides that the term *qualified payment* means 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. For this purpose, patronage dividends and per-unit retain allocations include any advances on patronage and per-unit retains paid in money during the taxable year.

Section 1388(f) defines the term *per-unit retain allocation* to mean 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 Treasury Department and the IRS are aware that *Example 1* in § 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). *Example 1* in § 1.199–6(m) 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 an example (*Example 4*) in § 1.199–6(m) illustrating 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 new example has the same facts as *Example 1* in § 1.199–6(m), except that the cooperative's payments for its members' corn qualify as per-unit retain allocations paid in money under section 1388(f) and the cooperative reports per-unit retain allocations paid in money on Form 1099–PATR, ''Taxable Distributions Received From Cooperatives.''

Request for Comments

Existing § 1.199–3(e)(2) provides that if a taxpayer packages, repackages, labels, or performs minor assembly of QPP and the taxpayer engages in no other MPGE activity with respect to that QPP, the taxpayer's packaging, repackaging, labeling, or minor assembly does not qualify as MPGE with respect to that QPP.

The term *minor assembly* for purposes of section 199 was first introduced in Notice 2005–14 (2005–1 CB 498 (February 14, 2005)) (see § 601.601(d)(2)(ii)(*b*)) (Notice 2005–14), and was used (by exclusion) in determining whether a taxpayer met the in-whole-or-in-significant-part requirement. Specifically, section 3.04(5)(d) of Notice 2005–14 states that in connection with the MPGE of QPP, packaging, repackaging, and minor assembly operations should not be considered in applying the general ''substantial in nature'' test, and the costs should not be considered in applying the safe harbor. The section further states that this rule is similar to the rule in § 1.954–3(a)(4)(iii). The rule in § 1.954–3(a)(4)(iii) applies when deciding whether a taxpayer selling property will be treated as selling a manufactured product rather than components of that sold property.

Section 1.199–3(g) of the current regulations, which superseded Notice 2005–14, does not provide a specific definition of minor assembly, but it does allow taxpayers to consider minor assembly activities to determine whether the taxpayer has met the in-whole-or-in-significant-part requirement (either by showing their activities were substantial in nature under § 1.199–3(g)(2) or by meeting the safe harbor in § 1.199–3(g)(3)). However, the current regulations also contain § 1.199–3(e)(2), which excludes certain activities from the definition of MPGE. Section 1.199–3(e)(2) provides that if a taxpayer packages, repackages, labels, or performs minor assembly of QPP and the taxpayer engages in no other MPGE activity with respect to that QPP, the taxpayer's packaging, repackaging, labeling, or minor assembly does not qualify as MPGE with respect to that QPP. Therefore, a taxpayer with only minor assembly activities would not meet the definition of MPGE and a determination of whether a taxpayer met the in-whole-or-in-significant-part requirement is not made.

In considering whether to provide a specific definition of minor assembly, the Treasury Department and the IRS have found it difficult to identify an objective test that would be widely applicable.

The definition of minor assembly could focus on whether a taxpayer's activity is only a single process that does not transform an article into a materially different QPP. Such process may include, but would not be limited to, blending or mixing two materials together, painting an article, cutting, chopping, crushing (non-agricultural products), or other similar activities. An example of blending or mixing two materials is using a paint mixing machine to combine paint with a pigment to match a customer's color selection when a taxpayer did not MPGE the paint or the pigment. An example of cutting is a taxpayer using an industrial key cutting machine to custom cut keys for customers using blank keys that taxpayer purchased from unrelated third parties. Examples of other similar activities include adding an additive to extend the shelf life of a product and time ripening produce that was purchased from unrelated third parties.

Another possible definition could be based on whether an end user could reasonably engage in the same assembly activity of the taxpayer. For example, assume QPP made up of component parts purchased by taxpayer is sold by a taxpayer to end users in either assembled or disassembled form. To the

extent an end user can reasonably assemble the QPP sold in disassembled form, the taxpayer's assembly activity would be considered minor assembly.

The Treasury Department and the IRS request comments on how the term *minor assembly* in § 1.199–3(e)(2) should be defined and encourage the submission of examples illustrating the term.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866 of, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. Comments are requested on all aspects of the proposed regulations. All comments will be available for public inspection and copying at *http://www.regulations.gov* or upon request.

A public hearing has been scheduled for December 16, 2015, beginning at 10 a.m. in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. In addition, all visitors must present photo identification to enter the building. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments by November 25, 2015, and an outline of the topics to be discussed and the time to be devoted to each topic by November 25, 2015. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is James Holmes, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

■ **Par. 2.** Section 1.199–0 is amended by:

■ 1. Adding entries in the table of contents for § 1.199–1(f).

■ 2. Revising the entry in the table of contents for § 1.199–2(c) and adding entries for § 1.199–2(c)(1), (2), and (3).

■ 3. Adding an entry in the table of contents for § 1.199–2(f).

■ 4. Redesignating the entry in the table of contents for § 1.199–3(h) as the entry for § 1.199–3(h)(1), adding introductory text for § 1.199–3(h), and adding an entry for § 1.199–3(h)(2).

■ 5. Redesignating the entry in the table of contents for § 1.199–3(i)(9) as the entry for § 1.199–3(i)(10) and adding introductory text and entries in the table of contents for § 1.199–3(i)(9).

■ 6. Redesignating the entry in the table of contents for § 1.199–3(k)(10) as the entry for § 1.199–3(k)(11) and adding an entry for § 1.199–3(k)(10).

■ 7. Adding entries in the table of contents for § 1.199–4(b)(2)(iii).

■ 8. Revising the introductory text in the table of contents for § 1.199–8(i) and adding the entries for § 1.199–8(i)(10) and (i)(11).

The additions and revision read as follows:

§ 1.199–0 Table of contents.

* * * * *

§ 1.199–1 Income attributable to domestic production activities.

* * * * *

(f) Oil related qualified production activities income.

(1) In general.

(i) Oil related QPAI.

(ii) Special rule for oil related DPGR.

(iii) Definition of oil.

(iv) Primary product from oil or gas.

(A) Primary product from oil.

(B) Primary product from gas.

(C) Primary products from changing technology.

(D) Non-primary products.

(2) Cost allocation methods for determining oil related QPAI.

(i) Section 861 method.

(ii) Simplified deduction method.

(iii) Small business simplified overall method.

§ 1.199–2 Wage limitation.

* * * * *

(c) Acquisitions, dispositions, and short taxable years.

(1) Allocation of wages between more than one taxpayer.

(2) Short taxable years.

(3) Operating rules.

(i) Acquisition or disposition.

(ii) Trade or business.

* * * * *

(f) Commonwealth of Puerto Rico.

§ 1.199–3 Domestic production gross receipts.

* * * * *

(h) United States.

* * * * *

(2) Commonwealth of Puerto Rico.

(i) * * *

(9) Engaging in production of qualified films.

(i) In general.

(ii) No double attribution.

(iii) Timing of attribution.

(iv) Examples.

* * * * *

(k) * * *

(10) Special rule for disposition of promotional films and products or services promoted in promotional films.

* * * * *

§ 1.199–4 Costs allocable to domestic production gross receipts.

* * * * *

(b) * * *

(2) * * *

(iii) Cost of goods sold associated with activities undertaken in an earlier taxable year.

(A) In general.

(B) Example.

* * * * *

§ 1.199–8 Other rules.

* * * * *

(i) Effective/applicability dates.

* * * * *

(10) Acquisition or disposition of a trade or business (or major portion).

(11) Energy Improvement and Extension Act of the 2008, Tax Extenders and Alternative Minimum Tax Relief Act of 2008, American Taxpayer Relief Act of 2012, and other provisions.

* * * * *

■ **Par. 3.** Section 1.199–1 is amended by adding paragraph (f) to read as follows:

§ 1.199–1 Income attributable to domestic production activities.

* * * * *

(f) *Oil related qualified production activity income (Oil related QPAI)*—(1) *In general*—(i) *Oil related QPAI.* Oil related QPAI for any taxable year is an amount equal to the excess (if any) of the taxpayer's DPGR (as defined in § 1.199–3) derived from the production, refining or processing of oil, gas, or any primary product thereof (oil related DPGR) over the sum of:

(A) The CGS that is allocable to such receipts; and

(B) Other expenses, losses, or deductions (other than the deduction allowed under this section) that are properly allocable to such receipts. See §§ 1.199–3 and 1.199–4.

(ii) *Special rule for oil related DPGR.* Oil related DPGR does not include gross receipts derived from the transportation or distribution of oil, gas, or any primary product thereof. However, to the extent that a taxpayer treats gross receipts derived from transportation or distribution of oil, gas, or any primary product thereof as DPGR under paragraph (d)(3)(i) of this section or under § 1.199–3(i)(4)(i)(B), then the taxpayer must treat those gross receipts as oil related DGPR.

(iii) *Definition of oil.* The term *oil* includes oil recovered from both conventional and non-conventional recovery methods, including crude oil, shale oil, and oil recovered from tar/oil sands.

(iv) *Primary product from oil or gas.* A primary product from oil or gas is, for purposes of this paragraph:

(A) *Primary product from oil.* The term *primary product from oil* means all products derived from the destructive distillation of oil, including:

(*1*) Volatile products;

(*2*) Light oils such as motor fuel and kerosene;

(*3*) Distillates such as naphtha;

(*4*) Lubricating oils;

(*5*) Greases and waxes; and

(*6*) Residues such as fuel oil.

(B) *Primary product from gas.* The term *primary product from gas* means all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including:

(*1*) Natural gas;

(*2*) Condensates;

(*3*) Liquefied petroleum gases such as ethane, propane, and butane; and

(*4*) Liquid products such as natural gasoline.

(C) *Primary products and changing technology.* The primary products from oil or gas described in paragraphs (f)(1)(iv)(A) and (B) of this section are not intended to represent either the only primary products from oil or gas, or the only processes from which primary products may be derived under existing and future technologies.

(D) *Non-primary products.* Examples of non-primary products include, but are not limited to, petrochemicals, medicinal products, insecticides, and alcohols.

(2) *Cost allocation methods for determining oil related QPAI*—(i) *Section 861 method.* A taxpayer that uses the section 861 method to determine deductions that are allocated and apportioned to gross income attributable to DPGR must use the section 861 method to determine deductions that are allocated and apportioned to gross income attributable to oil related DPGR. See § 1.199–4(d).

(ii) *Simplified deduction method.* A taxpayer that uses the simplified deduction method to apportion deductions between DPGR and non-DPGR must determine the portion of deductions allocable to oil related DPGR by multiplying the deductions allocable to DPGR by the ratio of oil related DPGR divided by DPGR from all activities. See § 1.199–4(e).

(iii) *Small business simplified overall method.* A taxpayer that uses the small business simplified overall method to apportion total costs (CGS and deductions) between DPGR and non-DPGR must determine the portion of total costs allocable to DPGR that are allocable to oil related DPGR by multiplying the total costs allocable to DPGR by the ratio of oil related DPGR divided by DPGR from all activities. See § 1.199–4(f).

■ **Par. 4.** Section 1.199–2 is amended by revising paragraph (c), adding a sentence at the end of paragraph (e)(1), and adding paragraph (f) to read as follows:

§ 1.199–2 Wage limitation.

* * * * *

(c) [The text of the proposed amendments to § 1.199–2(c) is the same as the text of § 1.199–2T(c) published elsewhere in this issue of the **Federal Register**].

* * * * *

(e) * * *

(1) * * * In the case of a qualified film (as defined in § 1.199–3(k)) for taxable years beginning after 2007, the term *W–2 wages* includes compensation for services (as defined in § 1.199–3(k)(4)) performed in the United States by actors, production personnel, directors, and producers (as defined in § 1.199–3(k)(1)).

* * * * *

(f) *Commonwealth of Puerto Rico.* In the case of a taxpayer described in § 1.199–3(h)(2), the determination of W–2 wages of such taxpayer shall be made without regard to any exclusion under section 3401(a)(8) for remuneration paid for services performed in the Commonwealth of Puerto Rico. This paragraph (f) only applies as provided in section 199(d)(8).

■ **Par. 5.** Section 1.199–3 is amended by:

■ 1. In paragraph (d)(4):

■ a. Redesignating *Example 6, Example 7, Example 8, Example 9, Example 10, Example 11,* and *Example 12* as *Example 7, Example 8, Example 9, Example 10, Example 11, Example 12,* and *Example 13,* respectively;

■ b. In newly-designated *Example 10,* removing the language ''*Example 8''* and adding ''*Example 9''* in its place; and

■ c. Adding *Example 6* and *Example 14.*

■ 2. Revising the last sentence in paragraphs (e)(1) and (3).

■ 3. In paragraph (e)(5):

■ a. Revising the third sentence in *Example 1,* the second sentence in *Example 4,* and *Example 5.*

■ b. Adding *Example 9.*

■ 4. Revising the last sentence in paragraph (f)(1).

■ 5. Revising *Example 1,* removing *Example 2,* and redesignating *Example 3* as *Example 2* in paragraph (f)(4).

■ 6. Removing the second and third sentences in paragraph (g)(1).

■ 7. Revising paragraph (g)(4)(i).

■ 8. Redesignating paragraph (h) as paragraph (h)(1), adding paragraph (h) heading and adding paragraph (h)(2).

■ 9. Revising paragraph (i)(3).

■ 10. Removing *Example 3;* redesignating *Example 5* as *Example 3;* and revising *Example 4* in paragraph (i)(5)(iii).

■ 11. In paragraph (i)(6)(iv)(D)(*2*), removing the language ''§ 1.199–3T(i)(8)'' and adding ''§ 1.199–3(i)(8)'' in its place.

■ 12. Redesignating paragraph (i)(9) as paragraph (i)(10) and adding paragraph (i)(9).

■ 13. Adding three sentences after the first sentence in paragraph (k)(1),

revising paragraph (k)(2)(ii) introductory text, and adding a sentence at the end of paragraph (k)(3)(i).
■ 14. Removing the first, second, and fifth sentences in paragraph (k)(3)(ii).
■ 15. Adding one sentence at the end of paragraph (k)(6).
■ 16. Adding two sentences before the last sentence in paragraph (k)(7)(i).
■ 17. Revising the last sentence in paragraph (k)(8).
■ 18. Redesignating paragraph (k)(10) as paragraph (k)(11) and adding paragraph (k)(10).
■ 19. In newly redesignated paragraph (k)(11):
■ a. Revising *Example 3;*
■ b. Removing *Example 4;* redesignating *Example 5* and *Example 6* as *Example 4* and *Example 5,* respectively; and adding *Example 6, Example 7, Example 8, Example 9, Example 10,* and *Example 11;* and
■ c. Revising the third sentence in newly redesignated *Example 4.*
■ 20. Adding one sentence at the end of paragraph (m)(2)(i).
■ 21. Revising paragraph (m)(5).

The revisions and additions read as follows:

§ 1.199–3 Domestic production gross receipts.

* * * * *

(d) * * *

(4) * * *

Example 6. The facts are the same as *Example 3* except that R offers three-car sets together with a coupon for a car wash for sale to customers in the normal course of R's business. The gross receipts attributable to the car wash do not qualify as DPGR because a car wash is a service, assuming the de minimis exception under paragraph (i)(4)(i)(B)(6) of this section does not apply. In determining R's DPGR, under paragraph (d)(2)(i) of this section, the three-car set is an item if the gross receipts derived from the sale of the three-car sets without the car wash qualify as DPGR under this section.

* * * * *

Example 14. Z is engaged in the trade or business of construction under NAICS code 23 on a regular and ongoing basis. Z purchases a piece of property that has two buildings located on it. Z performs construction activities in connection with a project to substantially renovate building 1. Building 2 is not substantially renovated and together building 1 and building 2 are not substantially renovated, as defined under paragraph (m)(5) of this section. Z later sells building 1 and building 2 together in the normal course of Z's business. Z can use any reasonable method to determine what construction activities constitute an item under paragraph (d)(2)(iii) of this section. Z's method is not reasonable if Z treats the gross receipts derived from the sale of building 1 and building 2 as DPGR. This is because Z's construction activities would not have substantially renovated buildings 1 and 2 if they were considered together as one item. Z's method is reasonable if it treats the construction activities with respect to building 1 as the item under paragraph (d)(2)(iii) of this section because the proceeds from the sale of building 1 constitute DPGR.

(e) * * *

(1) * * * Pursuant to paragraph (f)(1) of this section, the taxpayer must be the party engaged in the MPGE of the QPP during the period the MPGE activity occurs in order for gross receipts derived from the MPGE of QPP to qualify as DPGR.

* * * * *

(3) * * * Notwithstanding paragraph (i)(4)(i)(B)(*4*) of this section, if the taxpayer installs QPP MPGE by the taxpayer, then the portion of the installing activity that relates to the QPP is an MPGE activity.

* * * * *

(5) * * *

Example 1. * * * A stores the agricultural products. * * *

* * * * *

Example 4. * * * Y engages in the reconstruction and refurbishment activity and installation of the parts. * * *

Example 5. The following activities are performed by Z as part of the MPGE of the QPP: Materials analysis and selection, subcontractor inspections and qualifications, testing of component parts, assisting customers in their review and approval of the QPP, routine production inspections, product documentation, diagnosis and correction of system failure, and packaging for shipment to customers. Because Z MPGE the QPP, these activities performed by Z are part of the MPGE of the QPP. If Z did not MPGE the QPP, then these activities, such as testing of component parts, performed by Z are not the MPGE of QPP.

* * * * *

Example 9. X is in the business of selling gift baskets containing various products that are packaged together. X purchases the baskets and the products included within the baskets from unrelated third parties. X plans where and how the products should be arranged into the baskets. On an assembly line in a gift basket production facility, X arranges the products into the baskets according to that plan, sometimes relabeling the products before placing them into the baskets. X engages in no other activity besides packaging, repackaging, labeling, or minor assembly with respect to the gift baskets. Therefore, X is not considered to have engaged in the MPGE of QPP under paragraph (e)(2) of this section.

* * * * *

(f) * * *

(1) * * * If a qualifying activity under paragraph (e)(1), (k)(1), or (l)(1) of this section is performed under a contract, then the party to the contract that is the taxpayer for purposes of this paragraph (f) during the period in which the qualifying activity occurs is the party performing the qualifying activity.

* * * * *

(4) * * *

Example 1. X designs machines that it sells to customers. X contracts with Y, an unrelated person, for the manufacture of the machines. The contract between X and Y is a fixed-price contract. To manufacture the machines, Y purchases components and raw materials. Y tests the purchased components. Y manufactures the raw materials into additional components and Y physically performs the assembly of the components into machines. Y oversees and directs the activities under which the machines are manufactured by its employees. X also has employees onsite during the manufacturing for quality control. Y packages the finished machines and ships them to X's customers. Pursuant to paragraph (f)(1) of this section, Y is the taxpayer during the period the manufacturing of the machines occurs and, as a result, Y is treated as the manufacturer of the machines.

* * * * *

(g) * * *

(4) * * *

(i) *Contract with an unrelated person.* If a taxpayer enters into a contract with an unrelated person pursuant to which the unrelated person is required to MPGE QPP within the United States for the taxpayer, the taxpayer is not considered to have engaged in the MPGE of that QPP pursuant to paragraph (f)(1) of this section, and therefore, for purposes of making any determination under this paragraph (g), the MPGE or production activities or direct labor and overhead of the unrelated person under the contract are only attributed to the unrelated person.

* * * * *

(h) *United States* * * *

(2) *Commonwealth of Puerto Rico.* The term *United States* includes the Commonwealth of Puerto Rico in the case of any taxpayer with gross receipts for any taxable year from sources within the Commonwealth of Puerto Rico, if all of such receipts are taxable under section 1 or 11 for such taxable year. This paragraph (h)(2) only applies as provided in section 199(d)(8).

(i) * * *

(3) *Hedging transactions*—(i) *In general.* For purposes of this section, provided that the risk being hedged relates to property described in section 1221(a)(1) giving rise to DPGR or relates to property described in section 1221(a)(8) consumed in an activity giving rise to DPGR, and provided that the transaction is a hedging transaction within the meaning of section 1221(b)(2)(A) and § 1.1221–2(b) and is properly identified as a hedging transaction in accordance with § 1.1221–2(f), then—

(A) In the case of a hedge of purchases of property described in section 1221(a)(1), income, deduction, gain, or loss on the hedging transaction must be taken into account in determining CGS;

(B) In the case of a hedge of sales of property described in section 1221(a)(1), income, deduction, gain, or loss on the hedging transaction must be taken into account in determining DPGR; and

(C) In the case of a hedge of purchases of property described in section 1221(a)(8), income, deduction, gain, or loss on the hedging transaction must be taken into account in determining DPGR.

(ii) *Effect of identification and nonidentification.* The principles of § 1.1221–2(g) apply to a taxpayer that identifies or fails to identify a transaction as a hedging transaction, except that the consequence of identifying as a hedging transaction a transaction that is not in fact a hedging transaction described in paragraph (i)(3)(i) of this section, or of failing to identify a transaction that the taxpayer has no reasonable grounds for treating as other than a hedging transaction described in paragraph (i)(3)(i) of this section, is that deduction or loss (but not income or gain) from the transaction is taken into account under paragraph (i)(3) of this section.

(iii) *Other rules.* See § 1.1221–2(e) for rules applicable to hedging by members of a consolidated group and § 1.446–4 for rules regarding the timing of income, deductions, gains or losses with respect to hedging transactions.

* * * * *

(5) * * *

(iii) * * *

Example 4. X produces a live television program that is a qualified film. In 2010, X broadcasts the television program on its station and distributes the program through the Internet. The television program contains product placements and advertising for which X received compensation in 2010. Because the methods and means of distributing a qualified film under paragraph (k)(1) of this section do not affect the availability of the deduction under section 199 for taxable years beginning after 2007, pursuant to paragraph (i)(5)(ii) of this section, all of X's product placement and advertising gross receipts for the program are treated as derived from the distribution of the qualified film.

* * * * *

(9) *Partnerships and S corporations engaging in production of qualified films*—(i) *In general.* For taxable years beginning after 2007, in the case of each partner of a partnership or shareholder of an S corporation who owns (directly or indirectly) at least 20 percent of the capital interests in such partnership or the stock of such S corporation, such partner or shareholder shall be treated as having engaged directly in any qualified film produced by such partnership or S corporation, and such partnership or S corporation shall be treated as having engaged directly in any qualified film produced by such partner or shareholder.

(ii) *No double attribution.* When a partnership or S corporation is treated as having engaged directly in any qualified film produced by a partner or shareholder, any other partners of the partnership or shareholders of the S corporation who did not participate directly in the production of the qualified film are treated as not having engaged directly in the production of the qualified film at the partner or shareholder level. When a partner or shareholder is treated as having engaged directly in any qualified film produced by a partnership or S corporation, any other partnerships or S corporations in which that partner or shareholder owns an interest (excluding the partnership or S corporation that produced the film), are treated as not having engaged directly in the production of the qualified film at the partnership or S corporation level.

(iii) *Timing of attribution.* A partner or shareholder is treated as having engaged directly in any qualified film produced by the partnership or S corporation, regardless of when the qualified film was produced by the partnership or S corporation, during any period that the partner or shareholder owns (directly or indirectly) at least 20 percent of the capital interests in the partnership or stock of the S corporation (attribution period). During any period that a partner or shareholder owns less than a 20 percent of the capital interests in such partnership or the stock of such S corporation, that partner or shareholder is not treated as having engaged directly in the qualified film produced by the partnership or S corporation for purposes of this paragraph (i)(9). A partnership or S corporation is treated as having engaged directly in a qualified film produced by a partner or shareholder during any period the partner or shareholder owns (directly or indirectly) at least 20 percent of the capital interests in such partnership or the stock of S corporation (attribution period). During any period that the partner or shareholder owns less than 20 percent of the capital interests in such partnership or stock of such S corporation, the partnership or S corporation is not treated as having engaged directly in the qualified film produced by the partner or shareholder for purposes of this paragraph (i)(9). The attribution period under this paragraph (i)(9) may be shorter or longer than a taxpayer's taxable year, depending on the length of the attribution period.

(iv) *Examples.* The following examples illustrate an application of this paragraph (i)(9). Assume that all taxpayers are calendar year taxpayers.

Example 1. In 2010, Studio A and Studio B form an S corporation in which each is a 50-percent shareholder to produce a qualified film. Studio A owns the rights to distribute the film domestically and Studio B owns the rights to distribute the film outside of the United States. The production activities of the S corporation are attributed to each shareholder, and thus each shareholder's revenue from the distribution of the qualified film is treated as DPGR during the attribution period because Studio A and Studio B are treated as having directly engaged in any film that was produced by the S corporation.

Example 2. The facts are the same as *Example 1* except that, in 2011, after the S corporation's production of the qualified film, Studio C becomes a shareholder that owns at least 20 percent of the stock of the S corporation. Studio C is treated as having directly engaged in any film that was produced by the S corporation during the attribution period, as defined in paragraph (i)(9)(iii) of this section.

Example 3. In 2010, Studio A and Studio B form a partnership in which each is a 50-percent partner to distribute a qualified film. Studio A produced the film and contributes it to the partnership and Studio B contributes cash to the partnership. The production activities of Studio A are attributed to the partnership, and thus the partnership's revenue from the distribution of the qualified film is treated as DPGR during the attribution period, as defined in paragraph (i)(9)(iii) of this section, because the partnership is treated as having directly engaged in any film that was produced by Studio A.

Example 4. The facts are the same as *Example 3* except that Studio B receives a distribution of the rights to license an intangible associated with the qualified film produced by Studio A. Any receipts derived from the licensing of the intangible by Studio B are non-DPGR because Studio A's production activities are attributed to the partnership, and are not further attributed to Studio B.

Example 5. The facts are the same as *Example 3* except that, at some point in 2011, Studio A owns less than a 20-percent capital interest in the partnership. During the period that Studio A owns less than a 20-percent capital interest in the partnership between Studio A and Studio B, the partnership is not treated as directly engaging in the production of a qualified film. Therefore, any future receipts the partnership derives from the film after the end of the attribution period, as defined in paragraph (i)(9)(iii) of this section, are non-DPGR. Studio A, however, is still treated as having engaged directly in the production of the qualified film.

* * * * *

(k) * * *

(1) * * * For taxable years beginning after 2007, the term *qualified film*

includes any copyrights, trademarks, or other intangibles with respect to such film (intangibles). For purposes of this paragraph (k), other intangibles include rights associated with the exploitation of a qualified film, such as endorsement rights, video game rights, merchandising rights, and other similar rights. See paragraph (k)(10) of this section for a special rule for disposition of promotional films. * * *

(2) * * *

(ii) *Film produced by a taxpayer.* Except for intangibles under paragraph (k)(1) of this section, if a taxpayer produces a film and the film is affixed to tangible personal property (for example, a DVD), then for purposes of this section—

* * * * *

(3) * * *

(i) * * * For taxable years beginning after 2007, the methods and means of distributing a qualified film shall not affect the availability of the deduction under section 199.

* * * * *

(6) * * * Production activities do not include transmission or distribution activities with respect to a film, including the transmission of a film by electronic signal and the activities facilitating such transmission (such as formatting that enables the film to be transmitted).

(7) * * *

(i) * * * Paragraph (g)(3)(ii) of this section includes all costs paid or incurred by a taxpayer, whether or not capitalized or required to be capitalized under section 263A, to produce a live or delayed television program, and also includes any lease, rental, or license fees paid by a taxpayer for all or any portion of a film, or films produced by a third party that taxpayer uses in its film. License fees for films produced by third parties are not included in the direct labor and overhead to produce the film for purposes of applying paragraph (g)(3) of this section. * * *

* * * * *

(8) * * * If one party performs a production activity pursuant to a contract with another party, then only the party that is considered the taxpayer pursuant to paragraph (f)(1) of this section during the period in which the production activity occurs is treated as engaging in the production activity.

* * * * *

(10) *Special rule for disposition of promotional films and products or services promoted in promotional films.* A promotional film is a film produced to promote a taxpayer's particular product or service and the term includes, but is not limited to, commercials, infomercials, advertising films, and sponsored films. A product or service is promoted in a promotional film if the product or service appears in, is described during, or is in a similar way alluded to by such film. If a promotional film meets the requirements to be treated as a qualified film produced by the taxpayer, then a taxpayer derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of a qualified film, including any copyrights, trademarks, or other intangibles when the promotional film's disposition is distinct (separate and apart) from the disposition of the promoted product or service. Gross receipts are not derived from the disposition of a qualified film, including any copyrights, trademarks, or other intangibles when gross receipts are derived from a disposition of the promoted product or service.

(11) * * *

Example 3. X produces live television programs that are qualified films. X shows the programs on its own television station. X sells advertising time slots to advertisers for the television programs. Because the methods and means of distributing a qualified film under paragraph (k)(1) of this section do not affect the availability of the deduction under section 199 for taxable years beginning after 2007, the advertising income X receives from advertisers is derived from the lease, rental, license, sale, exchange, or other disposition of the qualified films and is DPGR.

Example 4. * * * Y is considered the taxpayer performing the qualifying activities pursuant to paragraph (f)(1) of this section with respect to the DVDs during the MPGE and duplication process. * * *

* * * * *

Example 6. X produced a qualified film and licenses the trademark of Character A, a character in the qualified film, to Y for reproduction of the Character A image onto t-shirts. Y sells the t-shirts with Character A's likeness to customers, and pays X a royalty based on sales of the t-shirts. X's qualified film only includes intangibles with respect to the qualified film in taxable years beginning after 2007, including the trademark of Character A. Accordingly, any gross receipts derived from the license of the trademark of Character A to Y occurring in a taxable year beginning before 2008 are non-DPGR, and any gross receipts derived from the license of the trademark of Character A occurring in a taxable year beginning after 2007 are DPGR (assuming all other requirements of this section are met). The royalties X derives from Y occurring in a taxable year beginning before 2008 are non-DPGR because the royalties are derived from an intangible (which is not within the definition of a qualified film under paragraph (k)(1) of this section for taxable years beginning before 2008).

Example 7. Y, a media company, acquires all of the intangible rights to Book A, which was written and published in 2008, and all of the intangible rights associated with a qualified film that is based on Book A. The qualified film based on Book A is produced in 2009 by Y. Y owns the copyright and trademark to Character B, the lead character in Book A and the qualified film based on Book A. Y licenses Character B's copyright and trademark to Z for $50,000,000. For 2009, without taking into account the payment from Z, Y derives 40 percent of its gross receipts from the qualified film based on Book A, and 60 percent from Book A. Z's payment is attributable to both Book A and the qualified film based on Book A. Therefore, Y must allocate Z's payment, and only the gross receipts derived from licensing the intangible rights associated with the qualified film based on Book A, or 40 percent, are DPGR.

Example 8. Z produces a commercial in the United States that features Z's shirts, shoes, and other athletic equipment that all have Z's trademarked logo affixed (promoted products). Z's commercial is a qualified film produced by Z. Z sells the shirts, shoes, and athletic equipment to customers at retail establishments. Z's gross receipts are derived from the disposition of the promoted products and are not derived from the disposition of Z's qualified film, including any copyrights, trademarks, or other intangibles with respect to Z's qualified film.

Example 9. X produces a commercial in the United States that features X's services (promoted services). X's commercial is a qualified film produced by X. The commercial includes Character A developed to promote X's services. Gross receipts that X derives from providing the promoted services are not derived from the disposition of X's qualified film, including any copyrights, trademarks, or other intangibles with respect to X's qualified film. X also licenses the right to reproduce Character A developed to promote X's services to Y so that Y can produce t-shirts featuring Character A. This license is distinct (separate and apart) from a disposition of the promoted services and the gross receipts are derived from the license of an intangible with respect to X's qualified film produced by X. X's gross receipts derived from the license to reproduce Character A are DPGR.

Example 10. Y produces a qualified film in the United States. Y purchases DVDs and affixes the qualified film to the DVDs. Y purchases gift baskets and sells individual gift baskets that contain a DVD with the affixed qualified film in its retail stores in the normal course of Y's business. Under § 1.199–3(k)(2)(ii)(A), Y may treat the DVD as part of the qualified film produced by taxpayer, but Y cannot treat the gift baskets as part of the qualified film produced by taxpayer. The gross receipts that Y derives from the sale of the DVD are DPGR derived from a qualified film, but the gross receipts that Y derives from the sale of the gift baskets are non-DPGR.

Example 11. The facts are the same as in *Example 10* except that the individual gift baskets that Y sells also contain boxes of popcorn and candy manufactured by Y within the United States. Under § 1.199–3(k)(2)(ii)(A), Y cannot treat the gift baskets including the boxes of popcorn and candy manufactured by Y as part of the qualified

film produced by taxpayer. Gross receipts from the sale of the DVD are still treated as DPGR derived from a qualified film. Y must separately determine whether the gross receipts from the tangible personal property it sells qualify as DPGR. Thus, Y must determine whether the gift basket, including the boxes of popcorn and candy but excluding the qualified film, is an item for purposes of § 1.199–3(d)(1)(i).

* * * * *

(m) * * *

(2) * * *

(i) * * * 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.

* * * * *

(5) *Definition of substantial renovation.* The term *substantial renovation* means activities the costs of which would be required to be capitalized by the taxpayer as an improvement under § 1.263(a)–3, other than an amount described in § 1.263(a)–3(k)(1)(i) through (iii). If not otherwise defined under § 1.263(a)–3, the unit of property for purposes of § 1.263(a)–3 is the real property, as defined in paragraph (m)(3) of this section, to which the activities relate.

* * * * *

Par. 6. Section 1.199–4 is amended by adding a sentence after the seventh sentence in paragraph (b)(1) and adding paragraph (b)(2)(iii) to read as follows:

§ 1.199–4 Costs allocable to domestic production gross receipts.

* * * * *

(b) * * *

(1) * * * In the case of a long-term contract accounted for under the percentage-of-completion method described in § 1.460–4(b) (PCM), or the completed-contract method described in § 1.460–4(d) (CCM), CGS for purposes of this section includes the allocable contract costs described in § 1.460–5(b) (in the case of a contract accounted for under PCM) or § 1.460–5(d) (in the case of a contract accounted for under CCM). * * *

(2) * * *

(iii) *Cost of goods sold associated with activities undertaken in an earlier taxable year*—(A) *In general.* A taxpayer must allocate CGS between DPGR and non-DPGR under the rules provided in paragraphs (b)(2)(i) and (ii) of this section, regardless of whether certain costs included in CGS can be associated with activities undertaken in an earlier taxable year (including a year prior to the effective date of section 199). A taxpayer may not segregate CGS into component costs and allocate those component costs between DPGR and non-DPGR.

(B) *Example.* The following example illustrates an application of paragraph (b)(2)(iii)(A) of this section:

Example. During the 2009 taxable year, X manufactured and sold Product A. All of the gross receipts from sales recognized by X in 2009 were from the sale of Product A and qualified as DPGR. Employee 1 was involved in X's production process until he retired in 2003. In 2009, X paid $30 directly from its general assets for Employee 1's medical expenses pursuant to an unfunded, self-insured plan for retired X employees. For purposes of computing X's 2009 taxable income, X capitalized those medical costs to inventory under section 263A. In 2009, the CGS for a unit of Product A was $100 (including the applicable portion of the $30 paid for Employee 1's medical costs that was allocated to cost of goods sold under X's allocation method for additional section 263A costs). X has information readily available to specifically identify CGS allocable to DPGR and can identify that amount without undue burden and expense because all of X's gross receipts from sales in 2009 are attributable to the sale of Product A and qualify as DPGR. The inventory cost of each unit of Product A sold in 2009, including the applicable portion of retiree medical costs, is related to X's gross receipts from the sale of Product A in 2009. X may not segregate the 2009 CGS by separately allocating the retiree medical costs, which are components of CGS, to DPGR and non-DPGR. Thus, even though the retiree medical costs can be associated with activities undertaken in prior years, $100 of inventory cost of each unit of Product A sold in 2009, including the applicable portion of the retiree medical expense cost component, is allocable to DPGR in 2009.

* * * * *

■ **Par. 7.** Section 1.199–6 is amended by adding *Example 4* to paragraph (m) to read as follows:

§ 1.199–6 Agricultural and horticultural cooperatives.

* * * * *

(m) * * *

Example 4. (i) The facts are the same as *Example 1* except that Cooperative X's payments of $370,000 for its members' corn qualify as per-unit retain allocations paid in money within the meaning of section 1388(f) and Cooperative X reports the per-unit retain allocations paid in money on Form 1099–PATR.

(ii) Cooperative X is a cooperative described in paragraph (f) of this section. Accordingly, this section applies to Cooperative X and its patrons and all of Cooperative X's gross receipts from the sale of its patrons' corn qualify as domestic production gross receipts (as defined in § 1.199–3(a)). Cooperative X's QPAI is $1,370,000. Cooperative X's section 199 deduction for its taxable year 2007 is $82,200 (.06 × $1,370,000). Because this amount is more than 50% of Cooperative X's W–2 wages (.5 × $130,000 = $65,000), the entire amount is not allowed as a section 199 deduction, but is instead subject to the wage limitation section 199(b), and also remains subject to the rules of section 199(d)(3) and this section.

■ **Par. 8.** Section 1.199–8 is amended by revising the heading of paragraph (i) and adding paragraphs (i)(10) and (11) to read as follows:

§ 1.199–8 Other rules.

* * * * *

(i) *Effective/applicability dates* * * *

* * * * *

(10) [The text of the proposed amendments to § 1.199–8(i)(10) is the same as the text of § 1.199–8T(i)(10) published elsewhere in this issue of the **Federal Register**].

(11) *Energy Improvement and Extension Act of the 2008, Tax Extenders and Alternative Minimum Tax Relief Act of 2008, Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, and other provisions.* Section 1.199–1(f); the last sentence in § 1.199–2(e)(1) and paragraph (f); § 1.199–3(d)(4) *Example 6* and *Example 14,* the last sentence in paragraph (e)(1), the last sentence in paragraph (e)(3), the third sentence in paragraph (e)(5) *Example 1,* the second sentence in paragraph (e)(5) *Example 4,* paragraph (e)(5) *Example 5* and *Example 9,* the last sentence in paragraph (f)(1), paragraph (f)(4) *Example 1,* paragraph (g)(4)(i), paragraphs (h)(2), (i)(3), (i)(5) *Example 4,* and (i)(9), the second, third, and fourth sentences in paragraph (k)(1), paragraph (k)(2)(ii), the second sentence in paragraph (k)(3)(i), the last sentence in paragraph (k)(6), the second sentence from the last sentence in paragraph (k)(7)(i), the last sentence in paragraph (k)(8), paragraph (k)(10), the third sentence in paragraph (k)(11) *Example 4,* paragraph (k)(11) *Example 3, Example 6, Example 7, Example 8, Example 9, Example 10,* and *Example 11,* the last sentence in paragraph (m)(2)(i), paragraph (m)(5); the eighth sentence in § 1.199–4(b)(1) and paragraph (b)(2)(iii); and § 1.199–6(m) *Example 4* apply to taxable years beginning on or after the date the final regulations are published in the **Federal Register**.

John M. Dalrymple,

Deputy Commissioner for Services and Enforcement.

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