

PRACTICAL GUIDE TO
THE SEC. 199 DEDUCTION

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Chapter 9
Partnerships and S Corporations

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Chapter 9

Partnerships and S Corporations

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¶ 901 Introduction

Partners and S corporation shareholders determine their Code Sec. 199 deduction at the partner or shareholder level.¹ Generally, each partner or S corporation shareholder is required to combine that person's allocable share of Domestic Production Gross Receipts (DPGR), Cost of Goods Sold (CGS), W-2 wages and other expenses, losses and deductions from each pass-through entity owned by that taxpayer with the taxpayer's own items of DPGR, CGS, W-2 wages and other losses, expenses and deductions allocable to DPGR and any expenses incurred directly by the taxpayer that are allocated to a partnership's activities in order to compute the taxpayer's Code Sec. 199 deduction.² Other Code Sections that normally apply to items allocated to taxpayers from pass-through entities, such as the at risk rules of Code Sec. 465 and the passive loss rules of Code Sec. 469, may affect the partner/shareholder's Code Sec. 199 deduction. This chapter discusses how the rules of Code Sec. 199 are applied to partnerships, S corporations, partners and S corporation shareholders.

¶ 905 Partner's and S Corporation Shareholder's Distributive Share

One of the reasons that a partnership (this term includes Limited Liability Companies that are treated as partnerships for federal income tax purposes) is

¹ Code Sec. 199(d)(1)(A)(i) as amended by the Gulf Opportunity Zone Act of 2005. *See also* Prop. Reg. § 1.199-5(a)(1) and Prop. Reg. § 1.199-5(b)(1).

² Code Sec. 199(d)(1)(A)(ii) as amended by the Gulf Opportunity Zone Act of 2005.

chosen by business owners as the legal entity for conducting a trade or business is that the owners may make special allocations of profits and losses that are generated by the activities of the partnership. A partner's distributive share of a partnership's items is determined by the economic arrangements among the partners that are specified in the partnership agreement.³ As long as these allocations either have substantial economic effect or are in accordance with the partners' interests in the partnership, they will be respected for tax purposes.⁴ A partner's share of a partnership's Qualified Production Activities Income (QPAI), CGS allocable to DPGR, W-2 wages and other partnership expenses, losses, and deductions that are properly allocable to DPGR are also determined in accordance with the rules of Code Secs. 702 and 704.⁵ A partner then determines its Code Sec. 199 deduction by aggregating the partner's distributive share of the Code Sec. 199 items from the partnership with the partner's Code Sec. 199 items from other sources and any expenses incurred by the partner directly that are allocable to the partnership's qualified production activities.⁶

If a partnership uses the small business simplified overall method, then each partner is allocated that partner's distributive share of the partnership's QPAI and W-2 wages. The partner then combines these amounts with the partner's own QPAI and W-2 wages from other sources.⁷ A partner's distributive share of QPAI from a partnership may be less than zero.⁸

In contrast, an S corporation shareholder is allocated its pro rata share of an S corporation's share of income, gain, loss and deduction items, including the S corporation's DPGR, CGS, deductions, losses and expenses properly allocable to DPGR, in accordance with the shareholder's daily percentage of stock ownership.⁹ The shareholder then aggregates its share of Code Sec. 199 items allocated to it by the S corporation with the shareholder's own items that are attributable to qualified production activities from sources other than the S corporation.¹⁰ However, if an S corporation elects to use the small business simplified overall method, then each shareholder is allocated that shareholder's pro rata share of the S corporation's

³ Code Sec. 704(a).

⁴ See Reg. § 1.704-1(b)(1) and Reg. § 1.704-1(b)(2) for rules pertaining to substantial economic effect and a partner's interest in a partnership.

⁵ Section 4.06(1)(a)(i) of Notice 2005-14. See also Prop. Reg. § 1.199-5(a)(1).

⁶ *Id.* See also Prop. Reg. § 1.199-5(a)(1). Section 4.06(1)(a)(i) of Notice 2005-14 contains the following rule: "to determine its Code Sec. 199 deduction for the taxable year, a partner aggregates its share of the items allocated or attributable to the partnership's qualified production activities, *any expenses incurred by the partner directly that are allocated to the partnership's qualified production activities*, and those items of the partner that are allocated or attributable to qualified production activities from sources other than the partnership." Prop. Reg. § 1.199-5(a)(1) does not contain the italicized phrase. Instead, Prop. Reg. § 1.199-5(a)(1) states that "to determine its Code Section 199 deduction for the taxable year, a partner generally aggregates its distributive share of such items, to the extent they are not otherwise disallowed by the Internal Revenue Code, with those items it incurs outside the partnership (whether directly or indirectly)

for purposes of allocating and apportioning deductions to DPGR and computing its qualified production activities income (QPAI)." Presumably, the phrase in the Proposed Regulations that states that the partner is to aggregate its distributive share of the partnership items "with those items it incurs outside the partnership" includes "any expenses incurred by the partner directly that are allocated to the partnership's qualified production activities." Tax Court Summary Opinion 2004-55, *Hines v. Comm.*, states that a partner may not deduct partnership expenses paid by the partner outside of the partnership unless "there is an agreement among the partners in a partnership agreement, or in a routine partnership practice tantamount to an agreement, that calls for a partner to pay partnership expenses from his own funds." Presumably, any partnership expenses paid directly by a partner would have to meet this standard in order to be considered in the partner's QPAI computations.

⁷ Prop. Reg. § 1.199-5(a)(1).

⁸ *Id.*

⁹ Section 4.06(b)(i) of Notice 2005-14.

¹⁰ *Id.* See also Prop. Reg. § 1.199-5(b)(1).

QPAI and W-2 wages, which the shareholder then combines with that shareholder's own QPAI and W-2 wages to compute the shareholder's Code Sec. 199 deduction.¹¹ Under the small business simplified overall method, a shareholder's pro rata share of QPAI from an S corporation may be less than zero.¹²

Example—Contrast Between a Partnership and S Corporation: Coleman and DeWine form an LLC that elects to be treated as a partnership for federal income tax purposes. The LLC's purpose is to manufacture and sell appliances. Coleman contributes \$99,000 to the LLC and DeWine contributes \$1,000 to the LLC in exchange for interests in partnership capital of 99 percent and 1 percent, respectively. The LLC's operating agreement provides that the first \$98,000 of losses are to be allocated to Coleman; the next \$2,000 of losses are to be split equally; and losses in excess of \$100,000 are to be allocated 99 percent to Coleman and 1 percent to DeWine. Profits are to be allocated to each partner in proportion to each partner's share of previously allocated losses and then are to be allocated 99 percent to Coleman and 1 percent to DeWine. The first \$98,000 of distributions are to be made solely to Coleman; the next \$2,000 is to be distributed to each partner equally; distributions in excess of \$100,000 are to be made 99 percent to Coleman and 1 percent to DeWine. These provisions of the operating agreement are deemed to be in compliance with the safe harbor rules of Code Sec. 704(b). DPGR, CGS and losses, expenses and deductions properly allocable to DPGR are to be allocated to each LLC member in accordance with the provisions for the allocation of the LLC's profits and losses.

In contrast, if Coleman and DeWine had formed an S corporation, DPGR and the other items that pertain to DPGR would have to be allocated 99 percent to Coleman and 1 percent to DeWine, the proportion of each shareholder's respective ownership of the S corporation's stock. Special allocations of these items are not permissible for an S corporation.

¶ 910 Applicability of the At Risk, Basis, and Passive Loss Rules

A partner's or S corporation shareholder's deduction for its distributive share of losses generated by a partnership or for its pro rata share of losses generated by an S corporation is limited to the partner's basis before deducting the losses for the partner's partnership interest or the S corporation shareholder's basis for that shareholder's S corporation stock before deducting the losses.¹³ The loss deduction of a partner or S corporation shareholder for that person's allocable share of loss generated by a pass-through entity is also limited by Code Sec. 465 to the amount of that person's at risk basis in the pass-through entity. Finally, a partner's or S corporation shareholder's deduction for that person's share of loss from a pass-through entity may be disallowed by the passive loss rules of Code Sec. 469 if the loss is a passive loss and the partner or shareholder does not have other passive income against which to deduct that loss. In the event that any of these rules apply

¹¹ See also Prop. Reg. § 1.199(b)(1).

¹² Prop. Reg. § 1.199(b)(1).

¹³ Code Sec. 704(d) and Code Sec. 1366(d) generally.

to limit the pass-through entity owner's deduction for the loss generated by the pass-through entity, only a portion of the owner's DPGR and expenses, deductions and losses properly allocable to DPGR that is proportionate to the allowed loss is to be taken into account by the owner in computing the Code Sec. 199 deduction.¹⁴

Example—Limitation On Losses: Lamb's share of a taxable loss from a pass-through entity for 2006 is \$1,000. Lamb's share of the pass-through entity's DPGR is \$3,000 and Lamb's share of expenses and deductions properly allocable to the DPGR of the pass-through entity is \$4,000. Lamb's loss from this pass-through entity is a passive loss that is not allowed by Code Sec. 469 during 2006 because Lamb does not have sufficient passive income to deduct this loss against. Since Lamb's loss is disallowed for 2006, none of Lamb's share of DPGR or other Code Sec. 199 items may be taken into account by Lamb in computing his Code Sec. 199 deduction for 2006. The Code Sec. 199 items are suspended and carried forward to future tax years. During 2007, Lamb generates over \$2,000 of passive income from other sources and is allowed to deduct his passive loss carry forward against this income during 2007. Since Lamb's passive losses for 2006 are allowed in 2007, Lamb's share of the Code Sec. 199 items that are part of these 2006 passive losses are taken into account by Lamb in computing his QPAI for 2007.

¶ 915 W-2 Wages Allocated to a Partner from a Partnership

An owner of an interest in a pass-through entity may include the owner's share of W-2 wages allocated to the owner by the pass-through entity in the owner's computation of W-2 wages for purposes of the owner's Code Sec. 199(b) limitation. The amount of a pass-through entity's W-2 wages that may be included in the computation of the owner's Code Sec. 199 (b) wages is an amount equal to the lesser of: 1) the owner's allocable share of the pass-through entity's W-2 wages for the tax year; or 2) two times the Code Sec. 199 statutory percentage of the QPAI computed by taking into account only the items of the partnership or S corporation allocated to the owner by the pass-through entity for the tax year.¹⁵

A partner's share of a partnership's QPAI is computed by taking into account the partner's distributive share of the partnership's items of income, gain, loss or deduction that are allocated or attributable to qualified production activities plus any expenses incurred directly by the partner that are allocated to the partnership's qualified production activities.¹⁶ An S corporation shareholder's share of the S corporation's QPAI is to be computed by taking into account only the S corporation's items that are allocated to the S corporation shareholder for the tax year.¹⁷ In general, this calculation of QPAI is performed by a partner or S corporation shareholder using the same cost allocation method that the partner or shareholder uses in calculating the partner's or shareholder's Code Sec. 199 deduction.¹⁸

¹⁴ Section 3.06(1) and Section 4.06(1)(a)(ii) and Section 4.06(1)(b)(ii) of Notice 2005-14. *See also* Prop. Reg. § 1.199-5(a)(2) and Prop. Reg. § 1.199-5(b)(2).

¹⁵ Section 4.06(1)(a)(iii) and Sec. 4.06(1)(b)(iii) of Notice 2005-14. *See also* Prop. Reg. § 1.199-5(a)(3) and Prop. Reg. § 1.199-5(b)(3).

¹⁶ Section 4.06(1)(a)(iii) of Notice 2005-14.

¹⁷ Section 4.06(1)(b)(iii) of Notice 2005-14.

¹⁸ Prop. Reg. § 1.199-5(a)(3) and Prop. Reg. § 1.199-5(b)(3).

However, if a partnership or an S corporation uses the small business simplified overall method to allocate its CGS and deductions to DPGR, the QPAI used by the partner or S corporation shareholder to determine the Code Sec. 199(d)(1)(B) limitation is the same as the share of QPAI generated by the partnership or S corporation that is allocated to the partner or shareholder.¹⁹

Each partner or shareholder must compute its share of W-2 wages from the partnership or S corporation in accordance with the provisions of Code Sec. 199(d)(1)(A)(iii) (with W-2 wages being allocated to the partner or shareholder in the same manner as is wage expense), and then add that amount to the partner's or S corporation shareholder's W-2 wages from other sources, if any.²⁰ The application of Code Sec. 199(d)(1)(A)(iii) means that if QPAI, computed by taking into account only the items of the partnership or S corporation that are allocated to the partner or S corporation shareholder for the tax year, is not greater than zero, then that partner or S corporation shareholder may not take into account any W-2 wages of the partnership or S corporation in computing the partner's or S corporation shareholder's Code Sec. 199 deduction.²¹

Example—Computation of a Partner's Share of QPAI from a Partnership: Elaine Malkin is a partner in a partnership that allocates the following items to her for 2007: DPGR of \$7,000; other gross receipts of \$7,000; CGS allocable to DPGR of \$1,750; CGS allocable to other gross receipts of \$1,750; other expenses, losses and deductions of \$3,500. These amounts net to taxable income allocated to Malkin from the pass-through entity of \$7,000 (\$14,000 of gross receipts minus \$3,500 of CGS minus \$3,500 of other deductions, expenses and losses). Included in the costs and expenses is \$2,000 that represents her share of the partnership's W-2 wages. Malkin must compute her share of QPAI from the partnership in order to determine her share of the partnership's W-2 wages. Malkin elects to use the simplified deduction method for determining the other expenses, costs and deductions that are properly allocable to the partnership's DPGR. Accordingly, \$1,750 of the other expenses, deductions and losses are allocable to Malkin's share of DPGR from the partnership (\$7,000 of DPGR/\$14,000 of total receipts times \$3,500 of other expenses, losses and deductions). Her share of QPAI from this partnership is thus \$3,500 (\$7,000 of DPGR minus \$1,750 of CGS minus \$1,750 of properly allocable expenses and deductions). Malkin's share of W-2 wages from this partnership is \$420 (the lesser of her allocable share of the partnership's W-2 wages of \$2,000 or 2 times the Code Sec. 199 statutory percentage of 6 percent times the partnership's QPAI of \$3,500).

¶ 920 Pass-through Entity Must Have Positive QPAI

In order for a taxpayer to include its share of any W-2 wages from a partnership or S corporation in the computation of the taxpayer's Code Sec. 199(b) limitation, the QPAI of the partnership or S corporation, computed by only taking

¹⁹ Prop. Reg. § 1.199-5(a)(3) and Prop. Reg. § 1.199-5(b)(3).

²⁰ Prop. Reg. § 1.199-5(a)(3) and Prop. Reg. § 1.199-5(b)(3).

²¹ *Id.*

into account the pass-through entity's items allocated to the taxpayer for the tax year, must be greater than zero.²²

Example—W-2 Wages and Negative QPAI: Hurt's share of W-2 wages from a partnership is \$6,000. However, Hurt's share of the partnership's QPAI, computed by only taking into account the partnership's items allocated to Hurt for the tax year, is negative (\$1,500). Hurt may not include the amount of any W-2 wages allocated to him by the partnership in Hurt's computation of his W-2 wages for purposes of the Code Sec. 199(b) limitation.

Example—Applying Code Sec. 861 Method to a Partner's Share of a Partnership's Items: Mort and Mindy are unrelated 50 percent partners in Crystal Partnership, a partnership that generates both DPGR and non-DPGR. Crystal Partnership is not able to identify from its books and records the CGS that is allocable to DPGR and Non-DPGR. CGS is definitely related to all of Crystal's income and apportionment based on gross receipts is thus appropriate. For 2010, the adjusted basis of Crystal's business assets is \$5,000; \$4,000 of those assets generates DPGR and \$1,000 of those assets generates gross receipts that are not DPGR. For 2010, Crystal Partnership has the following tax items:

	Total	DPGR	Non-DPGR
Gross receipts	\$6,000	\$3,000	\$3,000
CGS-Wages	(200)	(100)	(100)
Other CGS	<u>(3,040)</u>	<u>(1,520)</u>	<u>(1,520)</u>
Gross Profit	<u>\$2,760</u>	<u>\$1,380</u>	<u>\$1,380</u>
Selling expenses			
W-2 wages	300		
Other selling expenses	900		
Interest expense	300		

Mort's QPAI—For 2010, Mort does not have any Code Sec. 199 items other than those passed thru to him by Crystal Partnership. The adjusted basis of Mort's assets, which are investment assets, is \$10,000. Mort's only gross receipts are those gross receipts allocated to Mort by Crystal Partnership. Mort allocates and apportions its deductible items to gross income attributable to DPGR under the Code Sec. 861 method. In this situation, the Code Sec. 162 selling expenses are definitely related to all of Crystal Partnership's gross receipts. Under these circumstances, apportionment of the Code Sec. 162 selling expenses between DPGR and gross receipts that are not DPGR on the basis of Crystal Partnership's gross receipts is appropriate. Therefore, \$300 (\$600 × 50%) of selling expenses are allocated to DPGR based on the ratio of the amount of DPGR (\$1,500) to the amount of total gross receipts (\$3,000).

²² Section 4.06(1)(a)(iii) and Section 4.06(1)(b)(iii) of Notice 2005-14.

Mort elects to apportion its distributive share of interest expense using the tax book value method. Mort's QPAI for 2010 is \$366, computed as follows:

DPGR	\$1,500
CGS allocable to DPGR, including \$50 of W-2 wages	(810)
Selling expenses, including \$75 of W-2 wages	(300)
Interest expense ($\$150 \times \$2,000$ (Mort's share of Crystal's assets) / $\$12,500$ (Mort's non-Crystal assets plus Crystal's assets))	<u>(24)</u>
Mort's QPAI	<u>\$ 366</u>

Mindy's QPAI—Mindy also has non-Crystal Partnership activities that generate DPGR. The adjusted basis of Mindy's non-Crystal assets attributable to DPGR activities is \$8,000; the adjusted basis of Mindy's assets attributable to Mindy's other activities that generate gross receipts that are not DPGR is \$2,000. Mindy has the following items relating to its non-Crystal Partnership activities:

DPGR	\$1,500
W-2 wages that are in CGS	(70)
Other CGS	<u>(830)</u>
Gross Profit from DPGR	<u>\$ 600</u>
Gross receipts that are not DPGR	\$3,000
W-2 wages that are not DPGR	(150)
Other CGS allocable to non-DPGR gross receipts	<u>(1,470)</u>
Gross Profit from Non-DPGR sales	<u>\$1, 380</u>
Section 162 W-2 wages	30
Other Section 162 expenses	510
Interest expense	90

Mindy must aggregate its share of Crystal Partnership's Code Sec. 199 items with its other Code Sec. 199 items. Apportionment of Mindy's Code Sec. 162 selling expenses between DPGR and non-DPGR on the basis of Mindy's gross receipts is appropriate under Code Sec. 861. Mindy elects to apportion its interest expense using the tax book value method described in Reg. §1.861-9T(g). Mindy has \$1,290 of gross profit attributable to DPGR (\$3,000 DPGR [\$1,500 from Crystal Part. plus \$1,500 from Mindy's own activities] minus \$1,710 CGS (\$810 from Crystal Partnership and \$900 from Mindy's other activities). Mindy's QPAI for 2010 is \$642, computed as follows:

DPGR- \$1,500 from Crystal Part. plus \$1,500 from other activities	\$3,000
CGS allocable to DPGR- includes \$120 of W-2 wages	(1,710)
Section 162 selling expenses (includes \$180 of W-2 wages):	
Total Section 162 expenses from Crystal Part. of \$600 plus \$540 of Mindy's own Code Sec 162 expenses equals \$1,140. This amount is multiplied by 40 percent, the ratio of Mindy's total DPGR of \$3,000 divided by Mindy's total gross receipts of \$7,500 (\$3,000 DPGR plus \$3,000 of Mindy's other gross receipts that are non-DPGR plus \$1,500 of Crystal Part.'s non-DPGR)	
	(456)
Interest expense- \$240 (\$150 from Crystal Part. and \$90 from non-Crystal activities) multiplied by the ratio of Mindy's DPGR assets of \$10,000 (\$2,000 Crystal Part. assets plus \$8,000 of Mindy's other assets) divided by \$12,500 of total assets (Mindy's \$10,000 of DPGR assets plus Mindy's \$2,000 of non-DPGR assets plus Mindy's share of Crystal Part.'s non -DPGR assets of \$500)	
	(192)
Mindy's QPAI	<u>\$642</u>

Mort and Mindy must calculate the amount of Crystal Partnership's W-2 wages that are allocated to them for purposes of the Code Sec. 199(d)(1)(B) wage limitation by taking into account only the allocated items from Crystal Partnership. In making this calculation, Mort and Mindy must use the same allocation and apportionment methods that they use to determine their own QPAI. Mort and Mindy must apportion their Code Sec. 162 selling expenses that include W-2 wages on the basis of gross receipts and apportion interest expense using the tax book value method. QPAI of Mort and Mindy is determined by allocating each partner's share of Crystal's expenses to each partner's share of Crystal's gross income. This calculation is as follows:

Mort & Mindy's shares of DPGR from Crystal Part.	\$1,500
CGS from Crystal allocable to Crystal's DPGR	(810)
Selling expenses from Crystal Part. allocable to DPGR	(300)
Interest expense allocable to DPGR- each partner's share of interest expense of \$150 multiplied by the ratio of 80 percent, the ratio of each Partner's share of Crystal's DPGR assets of \$2,000 divided by each Partner's share of Crystal's total assets of \$2,500	
	(120)
QPAI for Mort & Mindy solely from Crystal Part.'s items	<u>\$270</u>

Mort and Mindy's respective share of W-2 wages from Crystal is \$49. This is the lesser of each partner's allocable share of Crystal Part.'s W-2 wages of \$250 (partner's allocable share of Crystal Partnership's W-2 wages (\$100 of wages included in CGS plus \$150 of wages included in selling expenses) or \$49 ($2 \times [\$270 \times 9\%]$)).

Mort's tentative Code Sec. 199 deduction is \$33 ($9\% \times \366). However, this deduction is subject to the wage limitation of 25-50 percent of the W-2 wages of \$49. Accordingly, Mort's Code Sec. 199 deduction for 2010 is \$25.

Mindy's tentative Code Sec. 199 deduction is \$58 ($9\% \times \642, QPAI determined at the partner level subject to a wage limitation of \$150). This wage limitation is computed by multiplying the sum of Mindy's W-2 wages of \$49 from Crystal partnership plus \$250 of W-2 wages from Mindy's non-Crystal Partnership activities by 50 percent. This amount equals \$150. Therefore, Mindy's Code Sec. 199 deduction for 2010 is \$58.²³

Example—Partnership Elects to Use the Small Business Simplified Overall Method: Ray and Bernie are each 50 percent partners in KGO partnership. KGO partnership engages in activities that generate gross receipts that are DPGR and gross receipts that are not DPGR. In 2010, KGO has total gross receipts of \$2,000, of which \$1,000 are DPGR, CGS of \$800 (including \$400 of W-2 wages) and deductions of \$800. Ray and KGO both use the small business simplified overall method to allocate CGS and deductions to DPGR while Bernie uses the Code Sec. 861 method. KGO's CGS and deductions apportioned to DPGR total \$800. This amount is computed by multiplying KGO's total CGS (\$800) and deductions (\$800) of \$1,600 by the 50 percent ratio of DPGR (\$1,000) to total gross receipts of \$2,000. KGO's QPAI is \$200, \$1,000 of DPGR minus deductions of \$800. This QPAI is allocated \$100 to Ray and \$100 to Bernie. Ray's share of KGO's W-2 wages is \$18, the lesser of \$200 (Ray's 50 percent share of KGO's W-2 wages of \$400) or \$18 ($9\% \times [\$100 \text{ QPAI} \times 2]$). Ray's tentative Code Sec. 199 deduction is \$9 ($\$100 \text{ QPAI} \times 9\%$) subject to the wage limitation of \$9 ($50\% \times \18). Assuming that Ray engages in no other activities generating DPGR, Ray's total Code Sec. 199 deduction for 2010 is \$9. Bernie must use \$100 of QPAI from KGO and \$18 of W-2 wages from KGO to determine his Code Sec. 199 deduction using the Code Sec. 861 method.²⁴

¶ 925 Wages Paid by More Than One Entity

The results in the above examples would be the same if the pass-through entity involved was an S corporation rather than a partnership. There is no rule that treats partnerships and S corporations that are owned by the same persons as a single entity. As a result, pass-through entities that conduct qualifying production activities in one pass-through entity and pay the wages applicable to those activities through another entity may not be able to include any of the W-2 wages paid by the wage paying entity in their Code Sec. 199(b) wage limitation because the wage paying entity may not have positive QPAI.²⁵ Owners of multiple businesses frequently use only one entity to pay W-2 wages in order to minimize their payroll tax expense for FICA taxes and federal and state unemployment taxes.

Example—Wages Paid by One Partnership: Lugar and Martinez own several businesses that they conduct through Limited Liability Companies

²³ This example is based on Example 1 of Prop. Reg. § 1.199-5(a)(4).

²⁴ This example is based on Example 4 of Prop. Reg. § 1.199-5(a)(4).

²⁵ For a discussion of the occurrence of this situation in the construction industry, see Grunberger, Armand (Bud), "The Code Sec. 199 Deduction-Its Application to Real Property Construction and Open Issues," *Tax Management Real Estate Journal*, (2005) Vol. 21, no. 8: 231-233, 8/9/05.

(LLCs) that are treated as partnerships for federal income tax purposes. Lugar and Martinez use one of these LLCs as the employer of all their employees. The LLC that pays the wages receives reimbursement payments from the other LLCs. However, Lugar and Martinez may not be able to include their shares of W-2 wages paid by the wage paying LLC in their individual computations of W-2 wages for purposes of the Code Sec. 199(b) limitation if the wage paying LLC does not have positive QPAI. Since the activities of one commonly controlled pass-through entity are not attributed to other commonly controlled pass-through entities, the only way that Lugar and Martinez may avoid the application of this rule is by contending that the W-2 wages are wages of the LLCs that generate QPAI because the wage paying LLC is in reality an agent for these entities. Otherwise, if the wages are necessary for Lugar and Martinez to individually avoid the Code Sec. 199(b) limitation, then Lugar and Martinez may have to restructure their operations so that the wages are paid by the entities that generate QPAI.

This rule may result in owners restructuring their business operations so that each pass-through entity that has QPAI also has W-2 wages. The restructuring of an owner's business in this manner may result in several entities preparing W-2s and employees receiving multiple W-2s from several entities that are part of the same overall business organization as well as higher costs to that overall business organization for payroll taxes and other administrative costs.

¶ 930 Tiered Structures

A tiered pass-through entity structure is an arrangement where one pass-through entity (the "upper tier") owns an interest in another pass-through entity (the "lower tier"). Normally, the upper tier reports its distributive share of items from the lower tier on its income tax return and then passes those items through to its individual owners or beneficiaries. It is possible for an upper tier pass-through entity to have its own negative QPAI in excess of the positive QPAI that is passed through to the upper tier by the lower tier. In these cases, Prop. Reg. § 1.199-5(f)(1) states that the Code Sec. 199(d)(1)(A)(iii) limitation must be applied separately at each tier (i.e., separately for each entity).²⁶ At each tier, a pass-through entity owner calculates its allocable share of W-2 wages from the pass-through entity as determined by the rules of Code Sec. 199(d)(1)(A)(iii) separately with respect to its interest in that pass-through entity.²⁷ The W-2 wages of the owner of the upper tier entity that owns an interest in one or more pass-through entities is equal to the total of the owner's allocable share of W-2 wages of the upper tier entity, subject to the wage limitation of Code Sec. 199(d)(1)(A)(iii), plus the owner's own W-2 wages.²⁸ An upper tier entity's W-2 wages is the sum of the upper tier entity's allocable share of W-2 wages from each of the next lower tier entities, as limited by Code Sec. 199(d)(1)(A)(iii), plus the W-2 wages of the upper tier entity.²⁹ Each lower tier entity in a tiered structure computes its W-2 wages in the manner described in the

²⁶ Prop. Reg. § 1.199-5(f)(1).

²⁷ *Id.*

²⁸ Prop. Reg. § 1.199-5(f)(2).

²⁹ *Id.*

preceding sentence.³⁰ Even though all wages paid during a tax year are factored into the computation of QPAI, only W-2 wages as defined in Prop. Reg. § 1.199-2 are considered in computing the W-2 wage limitation.³¹

Example—Upper and Lower Tier Partnerships: In 2010, Gallagher, an individual, owns a 50 percent interest in a partnership, No Serve Part., which in turn owns a 50 percent interest in another partnership, Draft Dodge Part. All items from both partnerships are allocated to the partners in accordance with the ownership percentages of the partners. Both partnerships qualify for and use the small business simplified overall method. The pertinent Code Sec. 199 items for each partnership are as follows:

Type of Item	Draft Dodge Part	No Serve's share	No Serve's Own Items
DPGR	\$900	\$450	\$500
CGS-W-2 wages	(\$100)	(\$ 50)	(\$200)
Other CGS	(\$350)	(\$175)	(\$300)
Other deductions	(\$ 50)	(\$ 25)	(\$500)
QPAI	\$400	\$200	(\$500)

No Serve's share of Draft Dodge's W-2 wages, for purposes of its own W-2 Code Sec. 199(d)(1)(B) wage limitation, is the lesser of: 1) \$50, its allocable share of No Serve's W-2 wages; 2) \$36, ($2 \times (9\% \times \$200)$), the Code Sec. 199(d)(1)(A)(iii) limitation. No Serve Part. has QPAI of (\$300) after combining its own QPAI of (\$500) with its share of QPAI passed through to it from Draft Dodge in the amount of \$200. No Serve's W-2 wages are \$236, the sum of its W-2 wages from Draft Dodge Part. of \$36 plus its own W-2 wages of \$200. Gallagher's share of No Serve's QPAI is (\$150). Since Gallagher's share of No Serve's QPAI is negative, Gallagher's W-2 wage limitation under Code Sec. 199(d)(1)(A)(iii) is \$0.³² Thus no W-2 wages are passed through to Gallagher from No Serve Part. This example is an illustration of the fact that the amount of wages of a lower tier partnership that ultimately pass through to a partner in the upper tier partnership is dependent upon the QPAI in the upper tier partnership.

¶ 935 Lack of Attribution of Activities

Except for certain oil and gas partnerships described in Prop. Reg. § 1.199-3(h)(7) and certain EAG partnerships described in Prop. Reg. § 1.199-3(h)(8), a pass-through entity owner is not treated as conducting the pass-through entity's qualified production activities and vice versa.³³ This includes those partnerships that have elected out of Subchapter K under the provisions of Code Sec. 761(a). If a partnership MPGE an item of QPP within the United States or

³⁰ *Id.*

³¹ *Id.*

³² This example is based on the Example contained in Prop. Reg. § 1.199-5(f)(3).

³³ Prop. Reg. § 1.199-5(g).

produces a qualified film or utilities within the United States, and either distributes or otherwise transfers that property to a partner who subsequently engages in a disposition of that property described in Code Sec. 199(c)(4)(A)(i), the partner's gross receipts from this latter lease, rental, license, sale, exchange or other disposition of this property are not DPGR.³⁴ If a partner MPGE an item of QPP within the United States or produces utilities or a qualified film in the United States and contributes or otherwise transfers that property to a partnership that subsequently engages in a disposition of that property that is described in Code Sec. 199(c)(4)(A)(i), the partnership's gross receipts derived from this latter lease, rental, sale, exchange, license or other disposition of this property are not DPGR.³⁵

Example—Construction of Property: Balog and George each own a 50 percent interest in the capital and profits of Building Construction, LLC and a 50 percent interest in the capital and profits of Balog-George, LLC. Building Construction, LLC erects a building in the United States and sells that building to Balog-George, LLC. Since Building Construction, LLC is engaged in the active conduct of a construction trade or business, its gross receipts from the sale of the constructed building to Balog-George, LLC should constitute DPGR. However, if Balog-George, LLC resells this building, its receipts are not DPGR because Balog-George, LLC did not engage in the active conduct of a construction trade or business and the activities of Building Construction, LLC are not attributed to Balog-George, LLC or its partners.³⁶

¶ 940 Gain or Loss from Sale of Partnership Interest

A pass-through entity owner's DPGR does not generally include any gain or loss recognized by that owner on the sale, exchange or other disposition of an interest in a pass-through entity.³⁷ There is one exception to this rule in the case of a seller of a partnership interest that recognizes ordinary income due to the sale of certain hot assets under Code Sec. 751(a) or Code Sec. 751(b).³⁸ If the Code Sec. 751 gain is attributable to partnership assets that would have given rise to DPGR if those assets had been sold by the partnership, then the portion of the partner's gain attributable to those assets may be treated as QPAI. To the extent that a distribution of property to a partner generates gain under Code Sec. 751(b) because it is considered a sale or exchange of property between the partnership and the partner, and the property deemed to be sold or exchanged would have generated DPGR if sold or exchanged by the partnership, this deemed sale or exchange of property must be taken into account in determining the partnership's and the partner's DPGR.³⁹

Example—Sale of Partnership Interest: Gilchrest sells his interest in a partnership that manufactured light bulbs. Gilchrest has a gain on the sale of \$15,000, of which \$3,000 of gain is ordinary income under Code Sec. 751 because it is attributable to Gilchrest's interest in the partnership's inventory.

³⁴ *Id.*

³⁵ *Id.*

³⁶ Section 3.04(11)(e)(ii) of Notice 2005-14.

³⁷ Section 4.06(2) of Notice 2005-14. *See also* Prop. Reg. § 1.199-5(e).

³⁸ *Id.* *See also* Prop. Reg. § 1.199-5(e).

³⁹ *Id.*

If this inventory had been sold by the partnership, gross receipts derived from its sale would have constituted DPGR. Gilchrest may include \$3,000 in determining Gilchrest's DPGR for the tax year.

¶ 945 Effective Date of Code Sec. 199 Regarding Pass-through Entities

Code Sec. 199 does not apply to a tax year of a pass-through entity that begins before January 1, 2005.⁴⁰ For example, assume that a pass-through entity has a tax year that begins on October 1, 2004 and ends on September 30, 2005. The owners of this entity all have calendar tax years. Since Code Sec. 199 is not effective for tax years that begin before January 1, 2005, the owners of the pass-through entity can not include any of the pass-through entity's items in the computation of their Code Sec. 199 deduction for 2005. The provisions of Code Sec. 199 will apply to this pass-through entity for its tax year that begins on October 1, 2005 and ends on September 30, 2006. The owners will be able to include their allocable share of items attributable to the pass-through entity's qualified production activities in their computations of the Code Sec. 199 deduction for 2006.⁴¹

Example—Code Sec. 199 Deduction for Partner: Sean is a partner in Elk Partnership. Sean's distributive share of Code Sec. 199 items that are allocated to him for the year 2010 by Elk Partnership consist of the following: \$3,000 of DPGR, which constitute all of the partnership's gross receipts that are allocated to Sean; \$1,000 of CGS allocable to DPGR; and \$1,000 of other deductions, including Sean's allocable share of Elk's W-2 wages for 2010 of \$600. Sean also produces widgets through an entity named Sean LLC, which is a disregarded entity for federal income tax purposes. Sean's DPGR from this business is \$3,000, which is all of the gross receipts of this business; the CGS of this DPGR amounts to \$1,000; this LLC's other deductions, including W-2 wages of \$700, total \$2,400. Sean's adjusted gross income for 2010 is \$12,000, computed without regard to the Code Sec. 199 deduction. None of Sean's losses from Elk Partnership are disallowed by the Code Sec. 465 at risk rules, the Code Sec 469 passive loss rules, the basis rules of Code Sec. 704(d) or any other provision of the Code. Sean's share of QPAI from Elk Partnership, computed only by taking into account the items allocated to him by Elk Partnership, is \$1,000.

Sean's share of Elk Partnership's W-2 wages is the lesser of: 1) \$600 or 2) two times 9 percent (the statutory Code Sec. 199 percentage for 2010) of Sean's share of Elk Partnership's QPAI of \$1,000. This amount is \$180 ($2 \times [9\% \times \$1,000]$).

⁴⁰ Section 4.06(3) of Notice 2005-14.

⁴¹ This example is based on the Example contained in Section 4.06(3) of Notice 2005-14.

Sean's tentative Code Sec. 199 deduction is computed as follows:

DPGR from Elk partnership	\$3,000
DPGR from disregarded entity	<u>3,000</u>
Total	\$6,000
Sean's CGS from Elk partnership	(\$1,000)
Sean's CGS for disregarded entity	(\$1,000)
Other deductions from partnership	(\$1,000)
Other deductions for disregarded entity	<u>(\$2,400)</u>
Total QPAI	<u>\$ 600</u>

Since 100 percent of Sean's gross receipts are DPGR, all of Sean's deductions are properly allocable to DPGR. Sean's tentative Code Sec. 199 deduction is \$54 (9% × \$600). Sean's Code Sec. 199(b) wage limitation is computed based on the following totals of W-2 wages:

Sean's W-2 wages from the disregarded entity	\$700
Share of wages from Elk partnership	<u>\$180</u>
Total	<u>\$880</u>

The wage limitation is \$440 (50% × \$880). This is greater than the computed Code Sec. 199 deduction of \$54.

The last limitation to be considered is the taxable income limitation. Since Sean is an individual, the limitation is the Code Sec. 199 statutory percentage of 9 percent multiplied by Sean's adjusted gross income of \$12,000. This amount is \$1,080 (9% × \$12,000).

Sean's Code Sec. 199 deduction is \$54 because this amount is less than the Code Sec. 199(b) limitation of \$440 and the Code Sec. 199(a) (1) (B) taxable limitation of \$1,080.

¶ 950 Conclusion

Many partnerships eligible to use the small business simplified overall method for allocating CGS and deductions to DPGR may consider electing to use that method. These partnerships would compute each partner's share of QPAI and W-2 wages, taking into account only the partnership's amounts of DPGR, related CGS and properly allocable deductions, and communicate those calculated amounts to the partners on Form 1065 (Schedule K-1). Each partner's share of QPAI would be reported in box 13, Code U of Form 1065 (Schedule K-1). Each partner's share of W-2 wages would be reported in box 13, Code V of Form 1065 (Schedule K-1). An eligible partnership that elects to use the small business simplified overall method may relieve its partners from the necessity of making the computations of QPAI and W-2 wages that consider only the partner's share of the partnership's pertinent items. Use of this method may also reduce the supplemental information that the partnership would otherwise be required to furnish to its partners. The partners,

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the partnership and their tax advisors will have to decide if use of the small business simplified overall method by a partnership to allocate its CGS and other deductions is prudent.

In a similar vein, S corporations that are eligible to use the small business simplified overall method for allocating CGS and deductions to DPGR may also consider electing to use that method. These S corporations would compute each shareholder's pro rata share of QPAI and W-2 wages by taking into account only the S corporation's amounts of DPGR, related CGS and properly allocable deductions. The S corporation would then communicate these amounts to its shareholders on Form 1120S (Schedule K-1). Each shareholder's share of QPAI would be reported in box 12, Code Q of Form 1120S (Schedule K-1). Each shareholder's portion of W-2 wages would be reported in box 12, Code R of Form 1120S (Schedule K-1). The factors that an eligible S corporation would have to take into consideration in deciding whether to elect to utilize the small business simplified overall method are the same factors stated in the preceding paragraph concerning partnerships.

The Code Sec. 199 Proposed Regulations did clarify that an owner of a pass-through entity does not have to be engaged directly in the pass-through entity's trade or business in order to claim the Code Sec. 199 deduction.⁴² However, with the exception for certain EAG partnerships and oil and gas partnerships, the Proposed Regulations rejected the suggestion by certain commentators that MPGE activities of a pass-through entity be attributed to that entity's partners and vice versa. This lack of aggregation rules for commonly controlled pass-through entities may raise structuring and planning issues for many businesses that conduct their activities through various pass-through entities and use one of these entities to pay the payroll. These businesses may have to alter their organizational structures so that each pass-through entity that pays W-2 wages also generates QPAI. Instead of using an entity that generates either no QPAI or a minimum amount of QPAI to perform the payroll functions, each entity that generates QPAI will have to pay its own payroll and file its own W-2s. This may cause these commonly controlled businesses to incur additional payroll taxes and administrative costs.

The rules applicable to tiered structures may cause certain owners to restructure their activities so that W-2 wages of lower tier entities are passed through to owners without having to pass through the upper tier entities. This could involve liquidating some upper tier partnerships and distributing the interests in the lower tier partnerships directly to the upper tier's partners.

The Proposed Regulations clarified many issues with respect to pass-through entities. However, they have also added a level of compliance that may be significant in the case of many pass-through entities.

⁴² See ¶ 1200, Preamble to Prop. Reg. §§ 1.199-0—1.199-8.