Chapter 2

Fundamentals of Code Sec. 199 Deduction

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¶ 201 Introduction

This chapter discusses the fundamental requirements for the Code Sec. 199 deduction and certain elements that are embodied in its computation. Subsequent chapters will discuss other elements of this deduction.

¶ 205 Major Elements of the Deduction

Calculating the deduction can be complex because the rules that control the values or amounts used in the calculation are complex. The math is simple. The deduction for income attributable to domestic production activities is equal to the *lesser of three types of income* multiplied by a *percentage that is defined by statute*.

The three types of income are as follows:

1. The taxpayer's Qualified Production Activities Income (QPAI) for the tax year.[1]
2. Taxable income for the year in cases of taxpayers who are not individuals.[2]
3. Adjusted gross income for the year in cases of taxpayers who are individuals.[3]

[1] Code Sec. 199(a)(1)(A).
[2] Code Sec. 199(a)(1)(B).
[3] Code Sec. 199(d)(2).

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The Code Sec. 199 deduction percentage defined by the American Jobs Creation Act statute is 3 percent for tax years beginning in 2005 and 2006; 6 percent for tax years beginning in 2007, 2008 and 2009; and 9 percent for years beginning in 2010 or later.[4]

For taxpayers using a fiscal year rather than a calendar year, the date that the taxpayer's fiscal year begins is the date that will determine the statutory percentage of the Code Sec. 199 deduction.

> ***Example—Fiscal Year Taxpayer Determination of Code Sec. 199 Percentage:*** R.V. Murdell Controls Corporation has an August 1 to July 31 fiscal year. Murdell would initially be eligible for the Code Sec. 199 deduction during the taxpayer's fiscal year that begins on August 1, 2005. The statutory percentage that applies to Murdell's QPAI or taxable/adjusted gross income for that fiscal year is 3 percent. For Murdell, the following fiscal year begins August 1, 2006 and once again the statutory percentage that applies will be 3 percent. For Murdell's fiscal year beginning August 1, 2007 as well as its fiscal years beginning August 1, 2008 and August 1, 2009 the statutory percentage that applies will be 6 percent. Murdell will utilize the fully phased-in statutory percentage of 9 percent for its fiscal year that begins on August 1, 2010.

¶ 210 Basic Deduction Computation

As one might expect from legislation called the American Jobs Creation Act of 2004, jobs creation was one of its stated purposes. True to its name, the Act included provisions that do encourage job creation by several means including the Code Sec. 199 deduction itself, the subject of this book. But the Act also encourages job creation in its finer points such as the rule that limits the taxpayer's deduction for income attributable to domestic production activities to 50 percent of the W-2 wages that the taxpayer pays to employees therein tying the tax benefit to domestic employment.[5]

The example below illustrates the basic computation for the Code Sec. 199 deduction.

> ***Example—Computation of Code Sec. 199 Deduction:*** Sean Corp. is a calendar year taxpayer whose QPAI, taxable income, and W-2 wages for 2006, 2009 and 2010 are shown in the table below in bold. Sean Corp.'s deduction for income attributable to domestic production activities for 2006, 2009 and 2010 is computed as follows (all numbers are in thousands):

[4] Code Sec. 199(a)(1) and Code Sec. 199(a)(2).

[5] Code Sec. 199(b)(1) and Section 2.01(2) of Notice 2005-14.

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	2006	*2009*	*2010*
QPAI	**$100**	**$600**	**$(300)**
Taxable income	**$ 50**	**$700**	**$400**
Lesser of the above amounts	$ 50	$600	$ 0
Statutory percentage	3%	6%	9%
Tentative deduction	$2	$ 36	$ 0
W-2 wages	**$10**	**$60**	**$90**
Wage limitation %	50%	50%	50%
Wage limitation	$ 5	$30	$45
Sec. 199 deduction	$ 2	$30	$ 0

For the year 2006, Sean Corp.'s taxable income of $50,000 is less than its QPAI of $100,000. The tentative Code Sec. 199 deduction for 2006 is thus computed by multiplying 2006's statutory percentage of 3 percent by Sean Corp.'s 2006 taxable income and yields a tentative deduction of $2,000 (after rounding up to the next highest dollar amount). This amount is less than 50 percent of Sean Corp.'s 2006 W-2 wages of $5,000. Therefore, Sean Corp.'s Code Sec. 199 deduction for 2006 is $2,000.

For the year 2009, Sean Corp.'s QPAI of $600,000 is less than its taxable income of $700,000. The statutory percentage of 6 percent for 2009 is thus multiplied by Sean Corp.'s 2009 QPAI of $600,000 and results in a tentative Code Sec. 199 deduction of $36,000. However, 50 percent of Sean Corp.'s W-2 wages for 2009 equals $30,000. Since a taxpayer's Code Sec. 199 deduction is limited to 50 percent of a taxpayer's W-2 wages, Sean Corp.'s Code Sec. 199 deduction for 2009 is limited to $30,000.

For 2010, Sean Corp. has an aggregate negative QPAI of $(300,000). The base for computing the deduction is thus $0. Sean Corp. thus has no Code Sec. 199 deduction for 2010.

There are two practical observations that can be made from the above examples. First, there is a great deal of work involved in gathering the information that is necessary to perform the calculations required for a taxpayer to compute the Code Sec. 199 deduction. If the taxpayer has a minimal amount of taxable income and thus will not receive a large deduction for income attributable to domestic production activities, the taxpayer may consider foregoing the Code Sec. 199 deduction. The tax benefit derived from the Code Sec. 199 deduction may not justify the time, effort and cost that may be necessary to compute this deduction. Second, if the taxpayer has paid no W-2 wages to employees, the taxpayer will not receive a Code Sec. 199 deduction.

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¶ 215 Qualified Production Activities Income (QPAI)

A taxpayer's QPAI for a tax year is equal to the taxpayer's Domestic Production Gross Receipts (DPGR) for that tax year[6] minus the total of: 1) the cost of goods sold (CGS) allocable to DPGR[7] ; 2) other expenses, losses or deductions that are directly allocable to DPGR;[8] and 3) a ratable portion of other losses, deductions and expenses that are not directly allocable to either DPGR or to another class of gross income[9]

In general, Domestic Production Gross Receipts that are used in calculating Qualified Production Activities Income are gross receipts from qualified production activity occurring in whole or in part within the United States that are the result of a lease, rental, sale, license, exchange or other disposition of the property. Once Domestic Production Gross Receipts are determined, the taxpayer computes Qualified Production Activities Income by reducing these receipts by:

- The cost of goods sold that are allocable to such receipts,
- Other deductions that are directly allocable, and
- A ratable amount of indirect expenses.

Detailed discussion of the methods for allocating costs to QPAI, including simplified methods available to certain taxpayers, are discussed in Chapter 7. The example below illustrates the computation of QPAI by the Rant Corp. that employs the Code Sec. 861 method.

> ***Example—Computation of QPAI:*** Rant Corp. manufactures only one item of property that it sells to customers. Rant Corp. has total gross receipts of $30,000 that consist of $20,000 of DPGR and $10,000 of gross receipts that are not DPGR. Its CGS that is directly allocable to DPGR amounts to $10,000 and its CGS that is directly allocable to other gross receipts amounts to $5,000. Rant Corp. elects to use the Code Sec. 861 method for allocating its costs and deductions to DPGR and other gross receipts. The Code Sec. 861 method basically allocates deductions to the class of gross income (and apportions the deductions within that class of gross income to the statutory grouping of gross income) that the deductions are definitely related to.[10] Deductions that are either not definitely related to a class of gross income or to a statutory grouping within a class of gross income are generally, subject to special rules for interest expense, research and development expenses and certain other expenses, ratably apportioned to all classes of gross income. Rant Corp's costs that are definitely related to DPGR amount to $5,000 and its costs that are definitely related to other gross receipts amount to $3,000. Other deductions that are not definitely related to any class of gross income amount to $3,000. The ratable portion of these costs that is apportioned to DPGR totals $2,000. This amount is computed by multiplying the $3,000 of deductions that are not definitely related to DPGR or other gross receipts by the ratio of DPGR to total

[6] Code Sec. 199(c)(1)(A).
[7] Code Sec. 199(c)(1)(B)(i).
[8] Code Sec. 199(c)(1)(B)(ii).
[9] Code Sec. 199(c)(1)(B)(ii).
[10] Generally, Reg. § 1.861-8 and Reg. § 1.861-8T.

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gross receipts ($20,000 of DPGR divided by $30,000 of total gross receipts). Rant Corp.'s Qualified Production Activities Income is computed as follows:

Domestic Production Gross Receipts		$20,000
CGS directly allocable to DPGR	$10,000	
Other costs directly allocable to DPGR	5,000	
Other costs ratably apportioned to DPGR	2,000	
Total		17,000
Qualified Production Activities Income		$3,000

The Gulf Opportunity Zone Act of 2005 amended Code Sec. 199(c)(1)(B) by striking the clauses contained in that subparagraph that stated that QPAI is to be reduced by other deductions, expenses or losses directly allocable to such receipts and a ratable portion of other deductions, expenses and losses that are not directly allocable to such receipts or to another class of gross income. The Act then inserted as Code Sec. 199(c)(1)(B)(ii) the statement that QPAI is to be reduced by "other expenses, losses, or deductions (other than the deduction allowed under this section), which are properly allocable to such receipts."[11] Apparently, Congress wanted to convey that QPAI had to be reduced by the portion of a taxpayer's deductions that are "properly allocable" to DPGR regardless of whether those deductions are "directly allocable" to DPGR or are "not directly allocable to DPGR." The Gulf Opportunity Zone Act of 2005, by amending this subparagraph, is allowing the Treasury Department flexibility in prescribing those deductions that are "properly allocable" to DPGR.

¶ 220 Definition of the Term "Item"

Under current rules, QPAI is to be "determined on an item-by item basis"[12] rather than on a transaction-by-transaction basis, a division-by-division basis or a product line-by-product line basis.[13] The Preamble to the Code Sec. 199 Proposed Regulations stated that, even though some commentators indicated that applying Code Sec. 199 on an item-by-item basis could be unduly burdensome, the Proposed Regulations retained the requirement that QPAI is to be determined on an item-by-item basis because the IRS and the Treasury Department believe that applying any other basis may allow taxpayers to receive a Code Sec. 199 deduction with gross receipts that should not constitute DPGR.[14] As a result, Prop. Reg. § 1.199-1(c)(1) retained the requirement that QPAI is to be determined on an item-by-item basis.

The Preamble to the Proposed Regulations also noted that many commentators asked whether an "item" may constitute one or more of a finished product's component parts that meets all of Code Sec. 199's requirements even if the entire final product does not satisfy those requirements.[15] The Preamble to the Proposed

[11] Section 2(a)(3)(ii) of the Gulf Opportunity Zone Act of 2005.

[12] Section 4.03(1) of Notice 2005-14.

[13] *Id.*

[14] *See* ¶ 1200, Preamble to Prop. Reg. §§ 1.199-0—1.199-8.

[15] *Id. See also* Granwell, A. W. and D.E. Rolfes. "The Code Sec. 199 Domestic Production Activities Deduction: Opportunities, Pitfalls, & Ambiguities for Domestic Man-

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Regulations states that Footnote 27 to the Conference Committee Report[16] indicated that a component of a finished product may be treated as property that qualifies for the Code Sec. 199 deduction even if the fully finished final product does not satisfy Code Sec. 199's requirements.[17] Based on this indication of Congressional intent, Prop. Reg. § 1.199-1(c)(2) defines an *item* as "property offered for sale to customers that meets all of" Code Sec. 199's requirements.[18] However, if the fully finished property offered for sale to customers does not meet all of Code Sec. 199's requirements, but components of the finished product do fulfill Code Sec. 199's requirements, then a taxpayer must treat as an item the portion of the property offered for sale that does meet Code Sec. 199's requirements.[19] An item cannot consist of two or more properties offered for sale unless those multiple properties are packaged and sold together as one item.[20] If the property is customarily sold by volume or by weight, then the item is determined by using the custom of the particular industry (e.g., barrels of oil).[21] Some commentators inquired, in the case of construction, engineering, or architectural services, as to whether the *item* is the construction project itself or whether the *item* can consist of "a task or subtask that is performed as part of the construction project."[22] The Proposed Regulations allow a taxpayer to determine what architectural or engineering services or what construction activities constitute an item by using any reasonable method that takes "into account all of the facts and circumstances. [23]

> ***Example—Rubber Sole Shoes:*** Libby manufactures leather and rubber shoe soles entirely in the United States. Libby imports the components of the shoe above the shoe sole and manufactures shoes for sale by attaching the sole to the other components of the shoe. If the entire shoe does not meet Code Sec. 199's requirements, then Libby must treat the manufactured sole as an item if the sole meets Code Sec. 199's requirements.[24]
>
> Libby also buys some shoes from unrelated persons and resells those shoes along with the manufactured shoes in individual pairs. Libby ships these shoes in boxes that contain 50 individual pairs of shoes in each box. Since the box of shoes in which the 50 pairs of shoes are shipped is not sold at retail and since each box contains shoes that Libby has manufactured as well as shoes that Libby has purchased, Libby is prohibited from treating a box of 50 pairs of shoes as an item.[25]
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> ***Example—Toy Car Manufacturer:*** Blackwell manufactures toy cars entirely within the United States and also purchases toy cars from unrelated persons. Blackwell sells some of these toy cars individually and also packages these cars in sets of three. Some of the cars in the sets of three may have been

(Footnote Continued)

ufacturers: Part I," *Tax Management Memorandum,* (2005) Vol. 45, no. 14: 262-264.

[16] *See* H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. 272.

[17] *Id.*

[18] Prop. Reg. § 1.199-1(c)(2)(i).

[19] *Id.*

[20] *Id.*

[21] *Id.*

[22] *See* ¶ 1200, *supra*, note 14.

[23] *Id.*

[24] This example is based on Example 1 of Prop. Reg. § 1.199-1(c)(2)(ii).

[25] This example is based on Example 2 of Prop. Reg. § 1.199-1(c)(2)(ii).

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manufactured by Blackwell and some of the cars may have been purchased by Blackwell. The three-car packages are customarily sold by the toy stores at retail. Blackwell must treat each package of three cars as the individual item because the three car package is customarily sold to customers as a package. However, if this package does not satisfy the requirements of Code Sec. 199 but individual toy cars contained in the package do satisfy Code Sec. 199's requirements, then Blackwell must treat an individual toy car in the package that does satisfy Code Sec. 199's requirements as the item.[26]

Assume that the toy store Blackwell sells these toy cars to follows Blackwell's suggested pricing arrangement and offers these toy cars for sale to customers at a retail price of three cars for $15. Retail customers usually purchase three individual cars in one transaction. Blackwell must treat each individual toy car as an item. Blackwell is prohibited from treating three individual cars as one item since those three cars are not packaged together for retail sale.[27]

Example—Ingredient for Pharmaceutical Product: Assume that Diane produces an active ingredient for a pharmaceutical product entirely in the United States and that she sells that ingredient in bulk form to a foreign corporation. Gross receipts derived from these sales qualify as Domestic Production Gross Receipts (DPGR). The foreign corporation uses the active ingredient purchased from Diane to produce a finished dosage form drug. The foreign corporation then sells the finished dosage form drug to Diane, who in turn sells this finished dosage drug to customers. If the finished dosage form drug does not meet the requirements of Code Sec. 199, then Diane must treat the active ingredient portion of the finished dosage form drug as the item if this ingredient meets Code Sec. 199's requirements.[28]

The Proposed Regulations are beneficial to taxpayers in the sense that they permit a portion of a product to be treated as an item in cases where the finished product taken as a whole does not satisfy Code Sec. 199's requirements. To gain this benefit, taxpayers must be able to determine the portion of gross receipts derived from the sale of the finished product that are applicable to the components of the final product that do meet Code Sec. 199's requirements. For this allocation to be convincing, the taxpayer perhaps may allocate gross receipts from sales of the finished product to the portion of the product that satisfies Code Sec. 199's requirements using one of the methods contained in Code Sec. 482.

Prop. Reg. § 1.199-1(c)(1) and Notice 2005-14 both state that QPAI generated by an individual item may be either positive or negative.[29] A taxpayer's QPAI for each individual item is then aggregated with the taxpayer's QPAI from other individual items to determine the taxpayer's total QPAI.[30] The taxpayer then computes the Code Sec. 199 deduction based on the taxpayer's total QPAI.

[26] This example is Example 3 of Prop. Reg. § 1.199-1(c)(2)(ii).

[27] This example is Example 4 of Prop. Reg. § 1.199-1(c)(2)(ii).

[28] This example is based on Example 5 of Prop. Reg. § 1.199-1(c)(2)(ii).

[29] Notice 2005-14, Section 3.03; Section 4.03(1) and Prop. Reg. § 1.199-1(c)(1).

[30] *Id.*

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Example—Taxpayer's Aggregate Qualified Production Activities Income: O'Mouth Corp. manufactures a shirt and a hat within the United States. The QPAI derived from sales of the shirt is positive $3; the QPAI derived from sales of the hat is negative $(2). The shirt and the hat are individual items. The QPAI from each of these items is then added to the QPAI from the other item to determine the taxpayer's total QPAI of $1. The taxpayer's Code Sec. 199 deduction will be based on the taxpayer's aggregate QPAI of $1.[31]

¶ 225 Taxable Income

For a taxpayer who is not an individual, the amount of the taxpayer's Code Sec. 199 deduction is limited by the amount of the taxpayer's taxable income, computed without regard to the Code Sec. 199 deduction, for the taxpayer's tax year.[32] For purposes of this limitation, the definition of taxable income in Code Sec. 63 applies.[33] Code Sec. 63(a) defines taxable income as a taxpayer's "gross income minus the deductions allowed by this chapter (other than the standard deduction)."[34] The "chapter" referred to in this definition of taxable income is Chapter 1 of the Internal Revenue Code and includes Section 1 through Section 1400. Based on this definition, a corporation's taxable income, for purposes of this taxable income limitation, is to be determined after all other deductions with a limitation based on taxable income have been taken into account. For a C corporation, these deductions include the deduction for charitable contributions[35] and the dividends received deduction.[36]

.01 C Corporation's Charitable Contributions Limit

A C corporation's deduction for charitable contributions was limited to 10 percent of the C corporation's taxable income computed without regard to the charitable contribution deduction, the dividends received deduction, the deduction for net operating loss carrybacks allowed by Code Sec. 172 and the deduction for capital loss carrybacks allowed by Code Sec. 1212(a)(1).[37] This meant that a C corporation's taxable income limitation for charitable deductions is its taxable income determined after taking into account the Code Sec. 199 deduction. The Gulf Opportunity Zone Act of 2005 amended Code Sec. 170 (b)(2), the section of the Code that imposes the 10 percent taxable income limitation on C corporations, to state that a C corporation's taxable income limitation on its deduction for charitable contributions is to be computed without regard to the deduction allowed by Code Sec. 199.[38] A C corporation is to compute its deduction for charitable contributions before it computes its Code Sec. 199 deduction.

Example—C Corporation with a Charitable Contribution and a Code Sec. 199 Deduction: For its calendar tax year 2010, Greta Corp. has made a charitable contribution of $100 and has QPAI and taxable income of $1,000

[31] This example is based on the example found in Section 4.03 (1) of notice 2005-14 and the example contained in the last sentence of Prop. Reg. § 1.199-1(c)(1).

[32] Code Sec. 199(a)(1)(B).

[33] Prop. Reg. § 1.199-1(b) among other authoritative sources.

[34] Code Sec. 63(a).

[35] Code Sec. 170.

[36] Code Secs. 243 through 247.

[37] Code Sec. 170(b)(2).

[38] Section 2(a) of the Gulf Opportunity Zone Act of 2005.

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before computing its charitable contribution deduction and its Code Sec. 199 deduction. Under the Gulf Opportunity Zone Act of 2005, Greta Corp.'s limitation on its deduction for charitable contribution is to be computed without regard to the Code Sec. 199 deduction. Greta Corp's taxable income limitation for purposes of computing its deduction for charitable contributions is $1,000. After Greta Corp. deducts $100 of charitable contributions, Greta Corp.'s taxable income for purposes of the Code Sec. 199 deduction will be $900 ($1,000 minus charitable contribution of $100) and its Code Section 199 deduction will be $81 (9% × $900).

.02 Corporate Dividends Received Deduction

There is no ambiguity concerning the taxable income limitation for the corporate dividends received deduction because Code Sec. 246 (b)(1) states that taxable income, for purposes of limiting the corporate dividends received deduction, is to be determined without regard to the Code Sec. 199 deduction.[39] Code Sec. 246 (b)(2) states that, for purposes of the corporate dividends received deduction, the taxable income limitation described in Code Sec. 246 (b) (1) is not to apply for any tax year that the corporation has a net operating loss deduction.[40] There is no exception of this nature for the taxable income limitation of Code Sec. 199.

For purposes of Code Sec. 199, the term "taxable income" means taxable income after taking into account the deduction allowed for net operating loss carryovers and net operating loss carrybacks.[41] This could result in a corporation that subsequently carries back a net operating loss sustained in a year subsequent to the tax year that it took a Code Sec. 199 deduction losing its Code Sec. 199 deduction for the earlier year.

Example—C Corporation with Carryback of Net Operating Loss to Year of Code Sec. 199 Deduction: Greta Corporation has taxable income and QPAI for its calendar tax year 2010 of $1,000 and takes a Code Sec. 199 deduction of $90. For its calendar tax year 2011, Greta Corporation sustains a loss of $1,000 that it carries back to the year 2010 (assume that Greta Corporation had taxable income of $0 for 2009). For purposes of determining the amount of a net operating loss carryback under Code Sec. 172(b)(2), taxable income is to be determined without regard to the Code Sec. 199 deduction.[42] Therefore, Greta Corporation's taxable income before deducting the net operating loss carryback from 2011 is $1,000. After carrying back its net operating loss in the amount of $1,000 from 2011, Greta Corporation has taxable income of $0 before computing its Code Sec. 199 deduction. Greta Corporation will thus receive no Code Sec. 199 deduction for 2010. Moreover, Greta Corporation's Net Operating Loss carryover to future years is $0.[43]

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[39] Code Sec. 246 (b)(1).
[40] Code Sec. 246(b)(2).
[41] Prop. Reg. § 1.199-1(b)(1).
[42] Prop. Reg. § 1.199-1(b)(1).
[43] *See* Example 2 of Prop. Reg. § 1.199-1(b)(2).

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¶ 230 Unrelated Business Taxable Income Limitation

Code Sec. 511 (a) states that certain not-for-profit orgaizations that are exempt from federal income taxation under the provisions of Code Sec. 501(a) must pay the tax imposed on C corporations by Code Sec. 11 on any “unrelated business taxable income”.[44] Prop. Reg. § 1.199-1(b) indicates that a tax-exempt organization that generates unrelated business taxable income may be allowed a Code Sec. 199 deduction in the computation of that unrelated business taxable income.[45] In computing its Code Sec. 199 deduction, a tax-exempt organization is to use “unrelated business taxable income” as its Code Sec. 199 (a)(1)(B) taxable income limitation.[46]

¶ 235 Adjusted Gross Income Limitation

For an individual, adjusted gross income is defined as gross income minus a series of deductions that are contained in Code Sec. 62.[47] This definition is important because, in the case of an individual, the Code Sec. 199 deduction is limited to a statutory percentage of the individual’s adjusted gross income.[48] Adjusted Gross Income, for purposes of computing the Code Sec. 199 deduction, is to be determined without regard to the Code Sec. 199 deduction and after applying the following Code Sections:[49]

> *Code Section 86*—this Code Section contains the rules for determining the amount of social security benefits that must be included in a taxpayer’s gross income. The computation of the amount of social security benefits includible in an individual’s gross income considers the individual’s modified adjusted gross income, as defined by Code Section 86. The Code Sec. 199 deduction is not taken into consideration in the computation of modified adjusted gross income for purposes of Code Section 86.[50]
>
> *Code Section 135*—this Code Section provides that gross income does not include any proceeds from the redemption of qualified U. S. savings bonds that are used to pay qualified higher education expenses. This exclusion is reduced if a taxpayer’s modified adjusted gross income exceeds certain amounts.[51] For this purpose, modified adjusted gross income does not include any deduction allowed by Code Sec. 199.[52]
>
> *Code Section 137*—this Code Section allows qualified adoption expenses to be excluded from an individual’s gross income. This exclusion is eliminated for taxpayers whose adjusted gross income exceeds certain limits.[53] The Code Sec. 199 deduction is not taken into account for purposes of determining whether an individual’s adjusted gross income exceeds these limits.[54]
>
> *Code Section 219*—This Code Section permits individuals to receive deductions for IRA payments. The IRA deduction is phased out if the taxpayer’s adjusted gross income exceeds certain amounts.[55] For purposes of these phase-out rules,

[44] Code Sec. 511 (a).
[45] Prop. Reg. § 1.199-1(b)(1).
[46] *Id.*
[47] Code Sec. 62.
[48] Code Sec. 199(d)(2).
[49] Prop. Reg. § 1.199-1(b)(1).
[50] Code Sec. 86(b)(2)(A).
[51] Code Sec. 135(b)(2)(A).
[52] Code Sec. 135(c)(4)(A).
[53] Code Sec. 137(b)(2)(A).
[54] Code Sec. 137(b)(3)(A).
[55] Code Sec. 219(g)(2)(A).

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adjusted gross income is determined without regard to the Code Sec. 199 deduction.[56]

Code Section 221—This Code Section allows an individual to deduct up to $2,500 of interest paid on qualified education loans. This deduction is reduced to the extent a taxpayer's modified adjusted gross income exceeds certain amounts.[57] For purposes of this rule, modified adjusted gross income does not include any deduction that a taxpayer is permitted to take under Code Sec. 199.[58]

Code Section 222—for a tax year beginning in 2005, this Code Section allows a taxpayer a deduction of either $4,000 or $2,000 for qualified tuition and related expenses depending on the amount of that individual's adjusted gross income. For purposes of determining the amount of this individual's adjusted gross income, an individual does not include the Code Sec. 199 deduction in the computation.[59]

An individual's adjusted gross income, for purposes of limiting the Code Sec. 199 deduction, is also computed after application of the passive activity loss rules contained in Code Sec. 469[60]. Generally, Code Sec. 469 provides that losses of certain taxpayers generated by activities that those taxpayers do not materially participate in are deductible only to the extent of passive income from those activities.[61] Individuals are allowed to deduct up to $25,000 of losses generated by rental real estate activities that they actively participate in if their adjusted gross income, as defined by Code Sec. 469, is less than $100,000.[62] Some commentators have stated that clarification is needed as to whether the Code Sec. 199 deduction itself is a passive activity deduction.[63] An individual computes QPAI by reducing the individual's DPGR by deductions that are properly allocable to DPGR. If these deductions are generated by a passive activity, they are passive activity deductions subject to the Code Sec. 469 limitation. If the Code Sec. 199 deduction is a passive activity deduction, then it is subject to the passive activity limitation rules and may be suspended[64] until an event, such as a complete disposition of the taxpayer's entire interest in the passive activity, occurs that allows the taxpayer to deduct the passive activity deductions. After the Code Sec. 199 deduction has survived the gauntlet of tests imposed by Code Sec. 469, it then becomes subject to the adjusted gross income and other limitations contained in Code Sec. 199.[65]

¶ 240 Alternative Minimum Tax

The Code Sec. 199 deduction is also allowed for purposes of computing the alternative minimum tax imposed by Code Sec. 55.[66] For taxpayers that are C corporations, the deduction is Code Sec. 199's applicable statutory percentage multiplied by the lesser of: 1) QPAI, as determined without regard to any adjustments under Code Secs. 56 through 59; or 2) the taxpayer's alternative minimum taxable income (AMTI) for the year computed without regard to the Code Sec. 199 deduction.[67] For an individual, the limit specified in item (2) of the preceding

[56] Code Sec. 219(g)(3)(A)(ii).

[57] Code Sec. 221(b)(2).

[58] Code Sec. 221(b)(2)(C)(i).

[59] Code Sec. 222(b)(2)(C)(i).

[60] Code Sec. 199(d)(2)(A).

[61] Code Sec. 469(a).

[62] Code Sec. 469(i).

[63] *American Jobs Creation Act of 2004—Law, Explanation and Analysis* (CCH 2004), ¶ 210.

[64] *Id.*

[65] *Id.*

[66] Code Sec. 199(d)(6).

[67] Code Sec. 199(d)(6)(A) and Code Sec. 199(d)(6)(B).

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sentence is the individual's adjusted gross income, as determined under Code Sec. 199(d)(2), rather than the individual's alternative minimum taxable income.[68]

The Proposed Regulations provide that, for purposes of computing AMTI, QPAI is to be determined without regard to: 1) any adjustments made in computing AMTI under Code Sec. 56; 2) any items of tax preference contained in Code Sec. 57; 3) any denial of certain losses specified by Code Sec. 58; or 4) the alternative minimum tax foreign tax credit.[69] If the taxpayer is a trust or an individual, that individual's adjusted gross income and taxable income are to be calculated without regard to the adjustments specified by Code Section 56 through Code Section 59.[70]

It is conceivably possible for a C corporation to be allowed a Code Sec. 199 deduction for regular tax purposes and not to be allowed the same deduction for alternative minimum tax purposes or vice versa. This may not be a problem for certain C corporations that have less than $5,000,000 of average annual gross receipts for their first taxable 3 year period and that have average annual gross receipts that are less than $7,500,000 for each subsequent taxable 3 year period[71] because these small corporations are not subject to the alternative minimum tax.[72] A C corporation should not experience this anomaly during the first year of its existence because a C Corporation's alternative minimum tax for its first year of existence is zero.[73] Larger C corporations that have been in existence for several years, however, may be allowed a Code Sec. 199 in the computation of one type of tax without being allowed a deduction in the computation of the other type of tax.

¶ 245 Actual Conduct of a Trade or Business

Code Sec. 199(d)(5) states that the provisions of Code Sec. 199 "shall be applied by *only* taking into account items which are attributable to the actual conduct of a trade or business."[74] What does the term "trade or business" mean and why is it important with respect to the deduction for income attributable to domestic production activities? It is easier to answer the second part of the question first. The concept of trade or business is important because, as Code Sec. 199(c)(4) mandates, DPGR and QPAI must be derived from manufacturing, production, growing, extraction, or construction activities or from the performance of architectural or engineering services that are regularly conducted by a taxpayer as a trade or business. If the activity that generates the DPGR or QPAI is not a trade or business, then the receipts and deductions generated by that activity do not qualify for the Code Sec. 199 deduction.

.01 Concept of Trade or Business

The Supreme Court has discussed the meaning of "trade or business" in several cases. In a case decided in 1941, the Supreme Court held that expenses incurred for managing one's investments, even if the investment management activity is a full–time occupation, are not deductible as expenses incurred in a trade

[68] Code Sec. 199(d)(6).
[69] Prop. Reg. § 1.199-8(c).
[70] *Id.*
[71] Code Sec. 55(e)(1).
[72] *Id.*
[73] Code Sec. 55(e)(1)(C).
[74] Code Sec. 199(d)(5).

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or business activity.[75] In a prior case, Justice Frankfurter made a comment that was discussed at length in subsequent cases.[76] This comment was that "carrying on any trade or business . . . involves holding one's self out to others as engaged in the selling of goods or services."[77] The latest Supreme Court case to discuss the "trade or business" concept was *Commissioner v. Groetzinger.*[78] The issue in that case was whether a full-time gambler was engaged in a trade or business. The Supreme Court discussed the holding of the *Higgins* case and Justice Frankfurter's comment in the *Deputy v. DuPont* case. The Supreme Court stated that "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit."[79] The Supreme Court held that the full-time gambler was engaged in a full-time business because the gambling activity was engaged in for a profit and because the taxpayer's involvement in the activity was regular and continuous.[80] It was not necessary for the taxpayer to be engaged in selling goods or services to the public in order to be engaged in a trade or business.[81] How do these holdings apply to Code Sec. 199?

.02 Trade or Business Activity

For purposes of Code Sec. 199, the activity itself must be engaged in for profit and must be conducted as a business on a regular and continuous basis in order to satisfy the trade or business definition. Activities that constitute hobbies, as defined by Code Sec. 183 and its regulations, cannot generate QPAI that qualifies for the Code Sec. 199 deduction.[82] Code Sec. 199(d)(5)'s phrase that the Code Sec. 199 items must be "attributable to the actual conduct of a trade or business" implies that the taxpayer personally does not have to be involved in the conduct of the trade or business as long as the activity itself constitutes a trade or business. This would allow a limited partner or a limited liability company member that does not materially participate in an entity's activity to obtain a Code Sec. 199 deduction provided that Code Sec. 199's other requirements are satisfied and provided that the activity itself involves the conduct of a trade or business.

.03 Active vs. Actual Conduct of Trade or Business

It should be noted that other Code Sections, such as Code Sec. 179 and 355, refer to the "active" conduct of a trade or business rather than the "actual" conduct of a trade or business. For example, Code Sec. 179(b)(3)(A) limits the amount of a taxpayer's Code Sec. 179 deduction for a tax year to the amount of a taxpayer's taxable income "derived from the active conduct by the taxpayer of any trade or business during such tax year."[83] The effect of this rule is to prevent a taxpayer from using the Code Sec. 179 deduction for any business that the taxpayer personally does not actively conduct. If the term "actual" means "active", then the

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[75] *E. Higgins,* SCt, 4101 USTC ¶ 9233, 312 US 212, 61 SCt 475.

[76] *P.S.. Du Pont,* SCt, 40-1 USTC ¶ 9161, 308 US 488, SCt 363.

[77] *Id.*

[78] *R.P. Groetzinger,* SCt, 87-1 USTC 9191, 480 US 23, 107 SCt 980.

[79] *Id.*

[80] *Id.*

[81] *Id.*

[82] Code Sec. 183. For a good article that discusses the hobby loss regulations, *see* Paul J. Brennan, "The Tax Court's Interpretation of the Hobby Loss Factors- A Score Sheet with Analysis," *TAXES—The Tax Magazine,* Vol. 87, no. 7: July 2005.

[83] Code Sec. 179(b)(3)(A).

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taxpayer would have to personally participate in the trade or business in order to receive the Code Section 199 deduction. In effect, a taxpayer could never receive a Code Sec. 199 deduction that constituted a passive activity deduction because a taxpayer that is passive with respect to an activity is, by definition, not "active" in the conduct of that activity. Fortunately, it does not appear that it was Congress' intent to limit the Code Sec. 199 deduction to trades or businesses that the taxpayer actively conducts.

¶ 250 Conclusion

This chapter addressed the fundamental composition of the Code Sec. 199 deduction. The chapter showed that the Code Sec. 199 deduction can require substantial information gathering, burdensome accounting, accurate interpretion of complex requirements, and a disciplined compliance effort.

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