

## Part III - Administrative, Procedural, and Miscellaneous

### Calculation of QPAI and W-2 wages by pass-thru entities under § 199

Rev. Proc. 2007-34

#### SECTION 1. PURPOSE

Section 199 of the Internal Revenue Code provides a deduction for income attributable to domestic production activities. This revenue procedure specifies the conditions under which certain partnerships and S corporations may choose to calculate qualified production activities income (QPAI) and W-2 wages as defined by § 1.199-2T(e)(2) of the temporary Income Tax Regulations (W-2 wages) at the entity level, as well as the manner for allocating and reporting QPAI and W-2 wages to partners or shareholders.

#### SECTION 2. BACKGROUND

Section 199(a)(1) allows a deduction equal to 9 percent (3 percent for taxable years beginning in 2005 or 2006, and 6 percent for taxable years beginning in 2007, 2008, or 2009) of the lesser of (A) the QPAI of the taxpayer for the taxable year, or (B) taxable income (determined without regard to § 199) for the taxable year (or, for an individual, adjusted gross income).

Section 199(b)(1) limits the deduction for a taxable year to 50 percent of the W-2 wages paid by the taxpayer for the taxable year. For this purpose, § 199(b)(2)(A) defines the term W-2 wages to mean, with respect to any person

for any taxable year of such person, the sum of the amounts described in § 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(c)(1) defines QPAI for any taxable year as an amount equal to the excess, if any, of the taxpayer's domestic production gross receipts (DPGR) over the sum of the cost of goods sold (CGS) allocable to DPGR and other expenses, losses, or deductions (other than the deduction allowed by § 199) (deductions) that are properly allocable to such receipts. Section 1.199-4(b) of the Income Tax Regulations provides rules for determining CGS allocable to DPGR. Section 1.199-4(c) provides rules for determining the deductions that are properly allocable to DPGR or to gross income attributable to DPGR. Section 1.199-4(a) and (d) provides that a taxpayer generally must allocate and apportion its deductions using the § 861 method, as determined under the rules of §§ 1.861-8 through 1.861-17 and §§ 1.861-8T through 1.861-14T, subject to the rules in § 1.199-4(d). Section 1.199-4(e) provides that an eligible taxpayer may use the simplified deduction method to apportion deductions between DPGR and non-DPGR. Section 1.199-4(f) provides that a qualifying small taxpayer may use the small business simplified overall method to apportion CGS and deductions between DPGR and non-DPGR.

Section 199(d)(1) provides special rules for applying § 199 to pass-thru entities. Section 199(d)(1)(A) provides that (i) § 199 shall be applied at the partner or shareholder level, (ii) each partner or shareholder shall take into

account such person's allocable share of each item described in § 199(c)(1)(A) or (B) (determined without regard to whether the items described in § 199(c)(1)(A) exceed the items described in § 199(c)(1)(B)), and (iii) each partner or shareholder shall be treated for purposes of § 199(b) as having W-2 wages for the taxable year in an amount equal to such person's allocable share of the W-2 wages of the partnership or S corporation for the taxable year (as determined under regulations prescribed by the Secretary).

Section 199(d)(1)(C) provides that the Secretary may prescribe rules requiring or restricting the allocation of items and wages under § 199(d)(1) and may prescribe such reporting requirements as the Secretary determines appropriate.

For taxable years beginning after May 17, 2006, § 1.199-2T(e)(2) provides that the term W-2 wages includes amounts described in § 1.199-2(e)(1) (paragraph (e)(1) wages) that are properly allocable to DPGR for purposes of § 199(c)(1). Under § 1.199-2(e)(1), paragraph (e)(1) wages with respect to any person for any taxable year of such person, means the sum of the amounts described in § 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 1.199-5T(b)(1)(ii) and (c)(1)(ii) provides that the Secretary may, by publication in the Internal Revenue Bulletin, permit a partnership or S corporation to calculate a partner's or shareholder's share of QPAI and W-2 wages at the entity level, instead of allocating to that partner or shareholder its share of the

entity's items and paragraph (e)(1) wages for determining the § 199 deduction at the partner or shareholder level. If a partnership or S corporation does calculate QPAI and W-2 wages at the entity level, such an entity then allocates to each partner or shareholder its share of QPAI (subject to the limitations of § 1.199-5T(b)(2) and (c)(2)) (which may be less than zero) and W-2 wages from the entity, which then are to be combined with the partner's or shareholder's QPAI and W-2 wages from other sources, if any.

Whether a partnership or S corporation is an eligible entity (as defined in section 3.01 of this revenue procedure), and thus able to calculate QPAI and W-2 wages on behalf of some or all of its partners or shareholders, is determined at the entity level. Similarly, the determination as to what cost allocation method an eligible entity may use (specifically, the § 861 method, the simplified deduction method, or the small business simplified overall method) is determined and applied at the entity level (subject to any additional conditions, rules, and procedures as may be provided by publication in the Internal Revenue Bulletin).

### SECTION 3. CALCULATION AND ALLOCATION OF QPAI AND W-2 WAGES AT THE ENTITY LEVEL

#### .01 Entities eligible to calculate QPAI and W-2 wages at the entity level.

Pursuant to § 1.199-5T(b)(1)(ii) and (c)(1)(ii), each of the following entities (eligible entity) may calculate QPAI and W-2 wages on behalf of its partners or shareholders:

(a) an eligible § 861 partnership (as defined in section 5.01 of this revenue procedure), but only on behalf of qualifying partners;

(b) an eligible widely-held pass-thru entity (as defined in section 5.02 of this revenue procedure); and

(c) an eligible small pass-thru entity (as defined in section 5.03 of this revenue procedure).

.02 Ineligible entities. Qualifying in-kind partnerships (under § 1.199-3T(i)(7)) and EAG partnerships (as described in § 1.199-3T(i)(8)) may not compute a partner's share of QPAI and W-2 wages at the entity level.

.03 Cost allocation methods for calculating QPAI and W-2 wages at the entity level. An eligible entity may choose to calculate QPAI and W-2 wages at the entity level (subject to the limitations and requirements set forth in this revenue procedure) for any taxable year in which it qualifies as an eligible entity. The cost allocation methods available to an eligible entity choosing to report under this revenue procedure are as follows.

(a) Section 861 method. An eligible § 861 partnership (as defined in section 5.01 of this revenue procedure) choosing to calculate QPAI and W-2 wages at the entity level must use the § 861 method of § 1.199-4(d), subject to section 3.03(d) of this revenue procedure. A partnership using this method may use the wage expense safe harbor under § 1.199-2T(e)(2)(ii), or another reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, to calculate W-2 wages at the entity level.

(b) Simplified deduction method. An eligible widely-held pass-thru entity (as defined in section 5.02 of this revenue procedure) choosing to calculate QPAI and W-2 wages at the entity level must use the simplified deduction method of

§ 1.199-4(e), subject to section 3.03(d) of this revenue procedure. A partnership or S corporation using this method may use the wage expense safe harbor under § 1.199-2T(e)(2)(ii), or another reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, to calculate W-2 wages at the entity level.

(c) Small business simplified overall method. An eligible small pass-thru entity (as defined in section 5.03 of this revenue procedure) choosing to calculate QPAI and W-2 wages at the entity level must use the small business simplified overall method of § 1.199-4(f), subject to section 3.03(d) of this revenue procedure. A partnership or S corporation using this method also may use the small business simplified overall method safe harbor under § 1.199-2T(e)(2)(iii), or another reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, to calculate W-2 wages at the entity level.

(d) Entities eligible to use more than one allocation method. A partnership or S corporation meeting the qualifications of more than one type of eligible entity may choose to use any one of the methods, as described in section 3.03(a) through (c) of this revenue procedure, for calculating QPAI and W-2 wages at the entity level for which it is eligible for the taxable year. For example, an entity that qualifies as both an eligible widely-held pass-thru entity and an eligible small pass-thru entity for a taxable year may choose to use either the simplified deduction method of § 1.199-4(e) or the small business simplified overall method of § 1.199-4(f) for calculating QPAI. If the entity uses the simplified deduction method, then it may calculate W-2 wages using either the

wage expense safe harbor or another reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances. If the entity uses the small business simplified overall method, then it may calculate W-2 wages using either the small business simplified overall method safe harbor or another reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances.

.04 Changes in method. For purposes of § 199, the following changes will not constitute changes in method of accounting to which the statutory and regulatory provisions of §§ 446 and 481 apply:

(a) A change in an eligible entity's method for calculating QPAI at the entity level among those methods described in section 3.03 of this revenue procedure; and

(b) A change from calculating QPAI and W-2 wages at the entity level to calculating such amounts at the partner or shareholder level, or vice versa.

.05 Rules for calculating QPAI at the entity level. Solely for calculating QPAI and W-2 wages at the entity level in accordance with its applicable cost allocation method for the taxable year, an eligible entity as described in section 3.01 of this revenue procedure must apply the following rules:

(a) A partnership must take into account any separately stated items described in § 702(a)(1) through (7) and any nonseparately stated items described in § 702(a)(8);

(b) An S corporation must take into account any separately stated items described in § 1366(a)(1)(A) and any nonseparately stated items described in § 1366(a)(1)(B);

(c) Income items, the inclusion of which ordinarily is determined at the partner or shareholder level, must be included by the partnership or S corporation;

(d) Expense items, the deduction or capitalization of which is determined at the partner or shareholder level, must be subtracted by the partnership or S corporation;

(e) Any limitation on the deduction of expense items that is ordinarily applied at the partner or shareholder level must be disregarded by the partnership or S corporation;

(f) Any expenditure described in § 59(e)(2), regarding the optional writeoff provided for certain tax preferences, must be taken into account by the partnership or S corporation without regard to any election by the partner or shareholder;

(g) Any expenditure which, at the election of the partner or shareholder, may be taken into account as a deduction or as a credit, must be disregarded by the partnership or S corporation;

(h) Any depletion deduction described in § 613A must be computed and taken into account by the partnership or S corporation without regard to any limitations at the partner or shareholder level;



(i) Any increase or decrease in the bases of partnership assets pursuant to § 743 must be taken into account by the partnership;

(j) Any partnership items allocated by an eligible § 861 partnership to a partner that is not a qualifying partner (including items allocated to such a partner pursuant to § 704(c)) must be excluded by the partnership for purposes of calculating the QPAI and W-2 wages to be allocated to its qualifying partners (see section 4.03 of this revenue procedure); and

(k) The QPAI computed at the entity level (and thus the QPAI allocated to each partner or shareholder) will be less than zero if the entity's DPGR does not exceed the sum of the entity's items to be deducted in computing QPAI.

.06 Allocation of QPAI and W-2 wages calculated at the entity level.

(a) QPAI. Generally, an eligible entity that calculates QPAI at the entity level for a taxable year must allocate its QPAI for that taxable year among its partners or shareholders in the same proportion as gross income is allocated to its partners or shareholders for that taxable year. However, if such an entity has no gross income for a taxable year, then it must allocate QPAI in that year among its partners or shareholders in proportion to its partners' profits interests or shareholders' ownership interests.

(b) W-2 wages. An eligible entity that calculates QPAI at the entity level for the entity's taxable year also must calculate W-2 wages for that taxable year by determining the amount of paragraph (e)(1) wages that is properly allocable to DPGR for purposes of § 199(c)(1). The eligible entity then allocates its W-2

wages among its partners or shareholders in the same manner as it allocates wage expense among its partners or shareholders for that taxable year.

#### SECTION 4. REPORTING AND EFFECT ON PARTNERS AND SHAREHOLDERS

.01 In general. If an eligible entity calculates QPAI and W-2 wages at the entity level, then each partner (except for a partner that is not a qualifying partner with respect to an eligible § 861 partnership) or shareholder is allocated (in accordance with section 3.06 of this revenue procedure) its share of QPAI (which may be less than zero) and W-2 wages from the eligible entity, and the partner or shareholder then must combine those amounts with the partner's or shareholder's QPAI and W-2 wages from other sources, if any. See § 1.199-5T(b)(1)(ii) and (c)(1)(ii). If an eligible entity computes QPAI and W-2 wages at the entity level, no partner or shareholder receiving an allocation of the entity's QPAI and W-2 wages may recalculate its share of QPAI or W-2 wages from the entity using another cost allocation method (although the partner or shareholder must adjust its share of QPAI from the entity to account for certain disallowed losses or deductions, and for the allowance of suspended losses or deductions). In addition, no partner or shareholder of such an eligible entity that receives an allocation of the entity's QPAI and W-2 wages may take into account any of the items from that entity that go into the computation of the partner's or shareholder's share of QPAI and W-2 wages from that entity in calculating its QPAI and W-2 wages from any other source (for example, in allocating and apportioning deductions from another source or in determining whether a

threshold or de minimis rule applies). If a partnership or S corporation, whether by ineligibility or choice, does not compute QPAI and W-2 wages at the entity level, then each partner or shareholder is allocated (in accordance with §§ 702 and 704, or § 1366, respectively) its share of the entity's items (including items of income, gain, loss, and deduction, CGS allocated to such items of income, gross receipts included in such items of income, and paragraph (e)(1) wages), for purposes of calculating the § 199 deduction at the partner or shareholder level. See § 1.199-5T(b) and (c).

.02 Reporting exception. Section 199(d)(5) provides that § 199 is applied by only taking into account items that are attributable to the actual conduct of a trade or business. For example, a securities partnership (as defined in § 1.704-3(e)(3)(iii)) not engaged in a trade or business need not include on its Schedule K-1 (or other relevant form) any items required solely for § 199, unless a partner requests this information.

.03 Partners in eligible § 861 partnerships. Pursuant to § 6031(b), an eligible § 861 partnership that chooses to calculate QPAI and W-2 wages at the entity level reports allocable shares of QPAI and W-2 wages directly to those partners that were qualifying partners (as defined in section 5.04 of this revenue procedure) at all times during the partnership's taxable year (or, if such partners were partners for less than the entire taxable year, for the portion of the partnership's taxable year during which they were partners). A qualifying partner must use its share of QPAI and W-2 wages as reported by the partnership in calculating its § 199 deduction. If an eligible § 861 partnership has partners that

are not qualifying partners (as defined in section 5.04 of this revenue procedure), it must allocate (in accordance with §§ 702 and 704) and report to each such partner that partner's allocable share of the partnership's items of income, gain, loss, and deduction, CGS allocated to such items of income, gross receipts included in such items of income, and paragraph (e)(1) wages, so that the partner is able to calculate its § 199 deduction. To the extent that any partner that is not a qualifying partner is allocated its share of the partnership's items (rather than a share of the partnership's QPAI and W-2 wages), such items shall not be taken into account for purposes of calculating the QPAI and W-2 wages to be allocated to the qualifying partners.

.04 Partners or shareholders in eligible widely-held pass-thru entities or eligible small pass-thru entities. Pursuant to § 6031(b) or § 6037(b), an eligible widely-held pass-thru entity or an eligible small pass-thru entity that chooses to calculate QPAI and W-2 wages at the entity level reports allocable shares of QPAI and W-2 wages directly to its partners or shareholders. Each partner or shareholder must use its reported share of QPAI and W-2 wages (subject to section 4.05 of this revenue procedure) in calculating its § 199 deduction.

.05 Adjustment for disallowed losses or deductions and for the allowance of suspended losses or deductions. An eligible entity that calculates QPAI at the entity level also must report to each partner (except for a partner that is not a qualifying partner with respect to an eligible § 861 partnership) or shareholder its allocable share (as determined under §§ 702 and 704, or § 1366, respectively) of the aggregate amount of losses or deductions attributable to the entity's qualified

production activities. A partner or shareholder to which an allocation of QPAI and W-2 wages is made must increase its reported share of QPAI by its allocable share of losses or deductions attributable to the entity's qualified production activities that reduced QPAI for the entity level calculation but that are disallowed by the application of § 465, 469, 704(d), or 1366(d) for the taxable year. Such a partner or shareholder also must decrease its reported share of QPAI by its allocable share of any previously suspended losses or deductions attributable to the entity's qualified production activities that are currently allowed by application of § 465, 469, 704(d), or 1366(d) for the taxable year. However, losses or deductions of a partnership or S corporation that are disallowed for taxable years beginning on or before December 31, 2004, are not taken into account in a later taxable year for purposes of computing the partner's or shareholder's QPAI for that later taxable year, whether or not those losses or deductions are allowed for other purposes.

## SECTION 5. DEFINITIONS

.01 Eligible § 861 partnership. An eligible § 861 partnership is a partnership that, for the current taxable year--

(a) has at least 100 partners on any day during the partnership's taxable year,

(b) is composed at all times during the taxable year of interests, at least 70 percent of which are held by qualifying partners (as defined in section 5.04 of this revenue procedure), and

(c) has DPGR.

.02 Eligible widely-held pass-thru entity. An eligible widely-held pass-thru entity is a partnership or S corporation that, for the current taxable year--

(a) satisfies the requirements of § 1.199-4(e)(2) (definition of eligible taxpayer), determined as though the partnership or S corporation were the taxpayer,

(b) has total CGS and deductions, the sum of which is \$100 million or less,

(c) has DPGR,

(d) for every day of the current taxable year, is composed entirely of partners, or S corporation shareholders, that are individuals, estates, or trusts described (or treated as described) in § 1361(c)(2), and

(e) for every day of the taxable year, is--

(i) a partnership in which no partner has a profits or capital interest exceeding 10 percent (determined after aggregating the interests of any related persons as defined in section 5.06 of this revenue procedure) of the total profits or capital interests of the partnership, or

(ii) an S corporation with a shareholder described in § 1361(c)(6) in which no shareholder owns shares exceeding 10 percent (determined after aggregating the interests of any related persons as defined in section 5.06 of this revenue procedure) of the total shares of the S corporation.

.03 Eligible small pass-thru entity. An eligible small pass-thru entity is a partnership or S corporation that, for the current taxable year--

(a) satisfies the requirements of § 1.199-4(f)(2) (definition of qualifying small taxpayer), determined as though the partnership or S corporation were the taxpayer,

(b) has total costs (as defined in § 1.199-4(f)(3)) of \$5 million or less,

(c) has DPGR, and

(d) in the case of a partnership, does not have an ineligible entity (as described in section 3.02 of this revenue procedure) as a partner.

.04 Qualifying partner. A qualifying partner is a partner in an eligible § 861 partnership that, on each day during the partnership's taxable year that such person is a partner of the partnership, such person--

(a) is not a general partner or a managing member of a partnership organized as a limited liability company under state law,

(b) does not materially participate in the activities of the partnership as determined in section 5.05 of this revenue procedure,

(c) does not hold a profits or capital interest in the partnership of 5 percent or greater (determined after aggregating the partner's interests with those of any related persons as defined in section 5.06 of this revenue procedure), or

(d) is not an ineligible entity under section 3.02 of this revenue procedure.

.05 Material participation. (a) Individual partners. For purposes of section 5.04(b) of this revenue procedure, whether an individual partner materially participates in the activities of the partnership (treating all the partnership's activities as a single activity) is determined under § 1.469-5(f)(1);

§ 1.469-5T(a)(1) through (3) and (7), (b)(2)(ii) and (iii), (f)(2) through (4), and (k) Examples 1 through 3, 7 and 8; and section 5.05(b) of this revenue procedure.

(b) Partners that are not individuals. For purposes of section 5.04(b) of this revenue procedure, a partner that is not an individual is treated as materially participating in the activities of the partnership if the partner's owners, directors, officers, employees, or fiduciaries are treated collectively as materially participating in the activities of the partnership under the rules described in section 5.05(a) of this revenue procedure. The activities of the partner's owners, directors, officers, employees, and fiduciaries must be combined and treated as the activities of the partner for this purpose. For example, assume that X, a corporation, is a limited partner in a partnership. A, an employee of X, and B, an officer of X, participate in the activities of the partnership for 300 hours and 201 hours, respectively, during the partnership's taxable year. Under these facts, X is treated as materially participating in the partnership for the taxable year.

.06 Related persons. For purposes of this revenue procedure, persons are related if they bear a relationship to each other that is described in § 267(b) or § 707(b), disregarding § 267(e)(1) and (f)(1)(A).

## SECTION 6. EXAMPLE

The following example illustrates an application of the rules in this revenue procedure. Assume that each partner has sufficient adjusted gross income or taxable income so that the § 199 deduction is not limited by § 199(a)(1)(B), and that the partnership and each of its partners (whether individual or corporate) are calendar year taxpayers.



Example. Small business simplified overall method. A, an individual, and X, a corporation, are partners in PRS. PRS engages in manufacturing activities that generate both DPGR and non-DPGR. X, but not A, has other manufacturing activities that generate DPGR and W-2 wages. A and X share all items of income, gain, loss, deduction, and credit equally. For the 2010 taxable year, PRS has total costs of no more than \$5 million, and it qualifies and chooses to calculate QPAI and W-2 wages at the entity level under section 3.03(c) of this revenue procedure for the 2010 taxable year. For 2010, PRS has total gross receipts of \$2,000x (\$1,000x of which is DPGR), CGS of \$900x (including \$400x of wage expenses), and deductions of \$700x (including \$50x of R&E expenditures under § 174(a) and \$100x of § 179 expenses). In this example, the paragraph (e)(1) wages are equal to the \$400x of wage expenses. PRS uses the safe harbor under § 1.199-2T(e)(2)(iii) to calculate W-2 wages. Accordingly, PRS's W-2 wages equal \$200x (\$400x of wages described in § 1.199-2(e)(1) multiplied by (\$1,000x DPGR divided by \$2,000x total gross receipts)). Pursuant to section 3.05(f) of this revenue procedure, PRS disregards A's election under § 59(e) to write off A's share of R&E expenditures over 10 years. In addition, pursuant to section 3.05(e) of this revenue procedure, PRS disregards any limitation under § 179(b) on A's ability to deduct A's share of the § 179 expenses. Under the small business simplified overall method, PRS's CGS and deductions apportioned to DPGR equal \$800x ((\$900x CGS plus \$700x of other deductions) multiplied by (\$1,000x DPGR divided by \$2,000x total gross receipts)). Accordingly, PRS's QPAI is \$200x (\$1,000x DPGR minus \$800x CGS and other deductions). Under section 3.06(a) of this revenue procedure, PRS's QPAI is allocated \$100x to A and \$100x to X. Under section 3.06(b) of this revenue procedure, PRS's W-2 wages are allocated \$100x to A and \$100x to X. Because A engages in no other activities generating DPGR, A's tentative deduction is \$9x (its \$100x share of QPAI from PRS multiplied by .09), subject to the § 199(b)(1) wage limitation (50% of A's \$100x share of W-2 wages from PRS, as defined by § 1.199-2T(e)(2)). Because X does engage in other production activities generating DPGR, X must combine its \$100x share of QPAI and its \$100x share of W-2 wages from PRS with its QPAI and W-2 wages from all other sources, and X is not permitted to recompute its share of QPAI from PRS using another cost allocation method.

## SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for taxable years beginning on or after May 11, 2007. However, taxpayers may apply this revenue procedure to taxable years beginning after May 17, 2006.

## SECTION 8. REQUEST FOR COMMENTS

Comments on all aspects of this revenue procedure are welcome. The IRS specifically requests comments on the clarity of these rules and how they can be made easier to understand and to implement. All comments will be available for public inspection and copying. Send comments to: CC:PA:LPD:PR (Rev. Proc. 2007-34), room 5203, Internal Revenue Service, PO 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 (Rev. Proc. 2007-34), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Submissions may also be sent electronically via the Internet to the following e-mail address:

[Notice.comments@irs.counsel.treas.gov](mailto:Notice.comments@irs.counsel.treas.gov). Include the revenue procedure number (Rev. Proc. 2007-34) in the subject line. Comments must be received on or before August 9, 2007.

#### DRAFTING INFORMATION

The principal author of this revenue ruling is Martin Schäffer, formerly of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact William Kostak at (202) 622-3060 (not a toll-free call).