



Domestic Production Deduction

Section 199 Workbook



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Introduction

For taxable years beginning after December 31, 2004, manufacturers and producers may be entitled to a deduction relating to income from certain qualifying domestic production activities pursuant to Section 199 of the Internal Revenue Code, added by the American Jobs Creation Act of 2004. Producers of film, music and software, construction contractors, and engineers and architects may also be entitled to this deduction.

On January 19, 2005, the Treasury Department and Internal Revenue Service (IRS) issued Notice 2005-14 regarding the Section 199 deduction relating to income attributable to domestic production activities. In addition to the Notice, Treasury also issued a Fact Sheet summarizing the information contained within the Notice.

On October 20, 2005, the IRS issued proposed regulations under Section 199. The proposed regulations include a lengthy discussion of the comments received by the IRS from taxpayers and its opinion of the applicable law. For tax years beginning before June 1, 2006, taxpayers may rely on guidance in Notice 2005-14 or in the proposed regulations.

On December 16, 2005, Congress passed the Tax Technical Corrections Act of 2005 providing technical corrections to the American Jobs Creation Act, including clarification and modification to Section 199. Congress indicated its belief that the Section 199 technical corrections clarify its original intent. These corrections have been included in this Workbook.

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Introduction (con't.)

The Tax Increase Prevention and Reconciliation Act (TIPRA), passed on May 17, 2006, modified the W-2 wage limitation so that taxpayers can only include amounts allocable to domestic production gross receipts.

Final regulations under Section 199 were issued on May 24, 2006 (TD 9263). Also released on May 24, 2006 was Revenue Procedure 2006-22 which provides methods for computing W-2 wages for taxpayers who choose to apply the final regulations to tax years beginning on or after January 1, 2005 and on or before May 17, 2006.

On October 11, 2006, the IRS issued Revenue Procedure 2006-42 providing guidance for taxpayers to obtain automatic consent to change some elections under Section 861 in response to Section 199.

On October 17, 2006, the IRS issued Revenue Procedure 2006-47 which provides methods for computing W-2 wages for tax years beginning after May 17, 2006.

On October 18, 2006, the IRS issued temporary regulations addressing the changes made to Section 199 by TIPRA. Specifically, the regulations contain several safe harbor methods for determining the amount of wages allocable to domestic production gross receipts and guidance on the allocation of wages for passthrough entities. They also contain a rule on the use of losses incurred by members of an expanded affiliated group.

This Workbook illustrates the current guidance as of October 18, 2006 and is intended to be an overview of the current rules.



Qualified Production Deduction Acronyms

Listed below are technical terms that appear throughout the Workbook:

- QPAD – Qualified Production Activities Deduction
- QPAI – Qualified Production Activities Income
- DPGR – Domestic Production Gross Receipts
- CGS – Cost of Goods Sold
- QPP – Qualified Production Property
- MPGE – Manufactured, Produced, Grown, or Extracted
- EAG – Expanded Affiliated Group
- NAICS – North American Industry Classification System

Effective Dates

- General Rule - Reg. § 1.199-1 through Reg. § 1.199-8 apply for tax years beginning on or after June 1, 2006.
- Alternate Rule (Years Beginning Before 5/17/06) - For a tax year beginning on or before May 17, 2006, a taxpayer may apply Reg. § 1.199-1 through Reg. § 1.199-9 provided the taxpayer applies all provisions in the final regulations to the tax year.
- Exception - An exception allows a partnership or S corporation that uses the small business simplified overall method to apportion CGS between DPGR and non-DPGR at the entity level as allowed by the proposed regs (the final regs at Reg. § 1.199-4(f)(1) do not apply qualification for and application of this method at the entity level)
- Alternate Rule (Years Beginning After 5/17/06 and Before 6/1/06) - For a tax year beginning after May 17, 2006, and before June 1, 2006, a taxpayer may apply Reg. § 1.199-1 through Reg. § 1.199-8, provided the taxpayer applies all provisions in the final regulations to the tax year. Reg. § 1.199-9 cannot be applied to a taxable year that begins after May 17, 2006.
- Years Beginning Before 6/1/06 - For a tax year beginning before June 1, 2006, a taxpayer may choose not to rely on the final regulations, but instead may rely on guidance in Notice 2005-14 or in the proposed regulations. If Notice 2005-14 and the proposed regulations include different rules for the same issue, then a taxpayer may rely on either authority. However, if the proposed regulations include a rule that was not included in Notice 2005-14, then a taxpayer must rely on guidance in the proposed regulations.
- Effective Dates for Temporary Regulations – The temporary regulations issued on October 18, 2006 apply for tax years beginning on or after October 19, 2006. A taxpayer may apply certain provisions of the temporary regulations to tax years beginning after May 17, 2006 and before October 19, 2006 regardless of whether the taxpayer otherwise relied on Notice 2005-14, the proposed regulations, or the final regulations. A taxpayer may apply certain other provisions of the temporary regulations to tax years beginning after December 31, 2004 and before October 19, 2006 regardless of whether the taxpayer otherwise relied on Notice 2005-14, the proposed regulations, or the final regulations.

Benefit

Provides for a deduction equal to a percentage of the lesser of:

- A percentage of Qualified Production Activity Income (QPAI) or
- Taxable Income

Percentage deduction for taxable years beginning in:

- 2005 – 2006 3%
- 2007 – 2009 6%
- 2010 and after 9%

Example

For a taxpayer with \$1 million in taxable income and QPAI that derives all of its revenue from qualified production activities performed within the U.S., that would otherwise have annual federal tax of \$340,000, the benefit is as follows (assuming no limitation otherwise applies):

Years	Potential Deduction	Taxable Income after Deduction	Income Tax	Savings
2005 - 2006	\$30,000 (3% of \$1 million)	\$970,000	\$329,800	\$10,200
2007 - 2009	\$60,000 (6% of \$1 million)	\$940,000	\$319,600	\$20,400
After 2009	\$90,000 (9% of \$1 million)	\$910,000	\$309,400	\$30,600

Item-by-Item

- Notice 2005-14 and the proposed regulations state that the Section 199 deduction is calculated on an item-by-item basis and is the sum of QPAI derived by the taxpayer from each item.
- The final regulations clarify that QPAI is not computed on an item-by-item basis. The item-by-item standard applies solely for determining whether gross receipts derived from an item are DPGR.
- Additionally, the final regulations provide that a taxpayer determines whether gross receipts qualify as DPGR on an item-by-item basis using any reasonable method that is satisfactory to the IRS based on all of the facts and circumstances. (Reg. § 1.199-3(d)(1)).
- An “item” is property offered by the taxpayer for lease, rental, license, sale, exchange or other disposition to the taxpayer’s customers in the normal course of business, whether the taxpayer is a wholesaler or retailer.
- The “Shrink Back” Rule provides that if the property offered for sale does not meet all of the requirements to qualify as an item, a taxpayer must treat as the item any component of the property offered for sale that does meet the requirements.
 - Each qualifying component is treated as a separate item.
 - May not be combined with any other non-qualifying component
 - There is an exception for acquired property that may include an item sold by the taxpayer and incorporated by another taxpayer into that property.
 - An undue burden and expense standard applies to this exception.
- **Example:** Company A manufactures and sells shoes. It imports the leather upper portion of the shoes and sews the sole to the upper portion in the U.S. Assume that Company A does not meet the safe harbor test because the shoes are not manufactured in whole or in significant (discussed on page 22) part in the U.S. Company A would be able to treat the sole as QPP if this “item” within the shoe meets the safe harbor. Thus, the GR allocable to the sole would be DPGR. This is true even though Company A does not offer the sole for sale to customers separately from the shoe.



Domestic Production Basic Calculation



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For taxable year beginning 01/01/05

	All Activities Together	U.S. Production Activities Only
Gross Receipts (GR):	<u>14,000,000</u>	
Domestic Production Gross Receipts (DPGR)	<u>10,000,000</u>	<u>10,000,000</u> → See Pgs. 10-29
GR attributable to non domestic production	<u>4,000,000</u>	
Cost of Goods Sold (CGS):	<u>7,000,000</u>	
COGS attributable to domestic production	<u>5,200,000</u>	<u>5,200,000</u> → See Pgs. 31, 32 & 34
GOGS attributable to non domestic production	<u>1,800,000</u>	
Gross Margin	<u>7,000,000</u>	<u>4,800,000</u>
Selling, General & Administrative (SG&A) Expenses	<u>4,000,000</u>	
SG&A expenses directly allocable to U.S. production	<u>100,000</u>	<u>100,000</u>
Remaining SG&A expenses	<u>3,900,000</u> 69 %	<u>2,691,000</u>
Allocation percentage -- Based on:		
Relative gross receipts (DPGR/Total GR)	<u>71 %</u>	
Relative cost of goods sold (Actual COGS to U.S./total actual COGS)	<u>74 %</u>	
Relative gross margin (Actual U.S. gross margin/total gross margin)	<u>69 %</u>	
Any other reasonable method	<u>N/A</u>	
Allocation percentage (for indirect SG&A expenses)	<u>69 %</u>	
Total allocable SG&A expenses		<u>2,791,000</u> → See Pgs. 31, 32 & 36
Unadjusted Net Income	<u>3,000,000</u>	<u>2,009,000</u>
Book to Tax Differences	<u>50,000</u>	<u>40,000</u>
Taxable Income/Qualified Production Activities Income (QPAI)	(A) <u>3,050,000</u>	(B) <u>2,049,000</u>
Smallest of (A) or (B)		<u>2,049,000</u>
Qualified Production Activities Deduction (QPAD) before W-2 Limitation (3% of 2,049,000)		(C) <u>61,470</u>
W-2 Wages Per Payroll Tax Returns (only amounts allocable to DPGR)	<u>4,500,000</u>	(D) <u>2,250,000</u> → See Pg. 39 - 41
QPAD Equals the Lesser of (C) or (D)		<u>61,470</u> → See Pgs. 39-41

Note: Example detail is located on pages 48 - 50



Industry Specific Guidelines



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Industry Specific Guidelines

- Specific rules must be taken into account in calculating DPGR by taxpayers in the following industries:
 - computer software (page 12-13);
 - sound recordings (page 14);
 - qualified film (page 15);
 - engineering & architectural services (page 16);
 - electricity, natural gas, or potable water producers (page 17);
 - food & beverage producers (page 18); and
 - construction (page 19).
- If you are a manufacturer or producer in an identified industry you will need to locate your industry specific section in the next few pages and apply the rules specific to your industry before you begin the DPGR methodology, beginning on page 22.
- If you are a manufacturer or producer not in an identified industry, proceed to the DPGR methodology on page 22.

Computer Software

Is the computer software you produce classified in one or more of the following categories:

- Machine-readable code (includes video games and similar programs)
- Documentation required to describe or maintain that routine or program
- Routine
- Program
- Operating system
- Executive systems
- Markers
- Compilers and translators
- Assembly routines
- Utility programs

No

No QPAD is available for your programming activities

Yes

Does the software contain databases?

Yes

Is the data/information base in the public domain* and incidental to a computer program?

No

Is not part of QPAD

No

Are gross receipts from Internet access services, online services, customer support, telephone services, games played through a website or provider - controlled software online access services?

Yes

Are the revenues derived from software provided for customers' direct use while connected to the internet?

No

Is not part of QPAD

Yes

No

Go to DPGR Methodology Section.

Yes

Do you meet either safe harbor test?
(1) Sell same software on tangible medium or;
(2) unrelated third party sells substantially identical** software on tangible medium.

No

Is not part of QPAD

* **Public Domain:** Data/information must not contribute significantly to the cost of the program to be considered public.

****Substantially Identical:** From customers prospective has same functional result and significant overlap features or purpose.

Note 1: Merely requiring a terms and conditions agreement to be signed before using online service does not qualify it as leased.

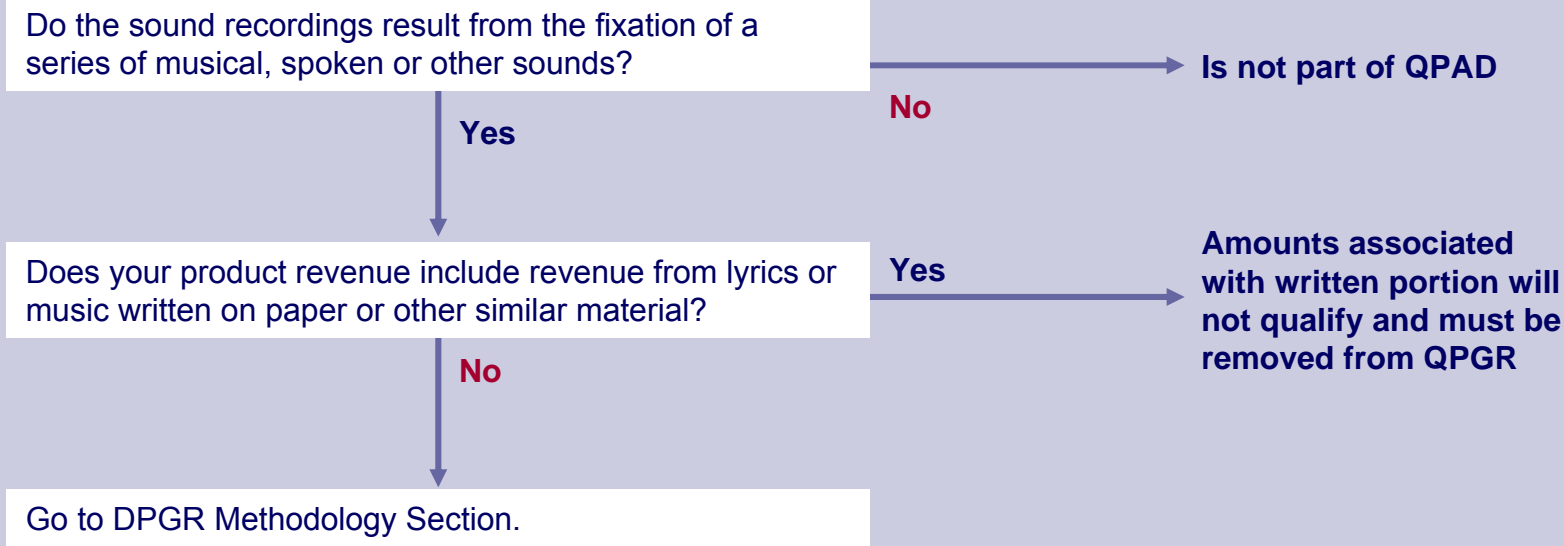


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Computer Software

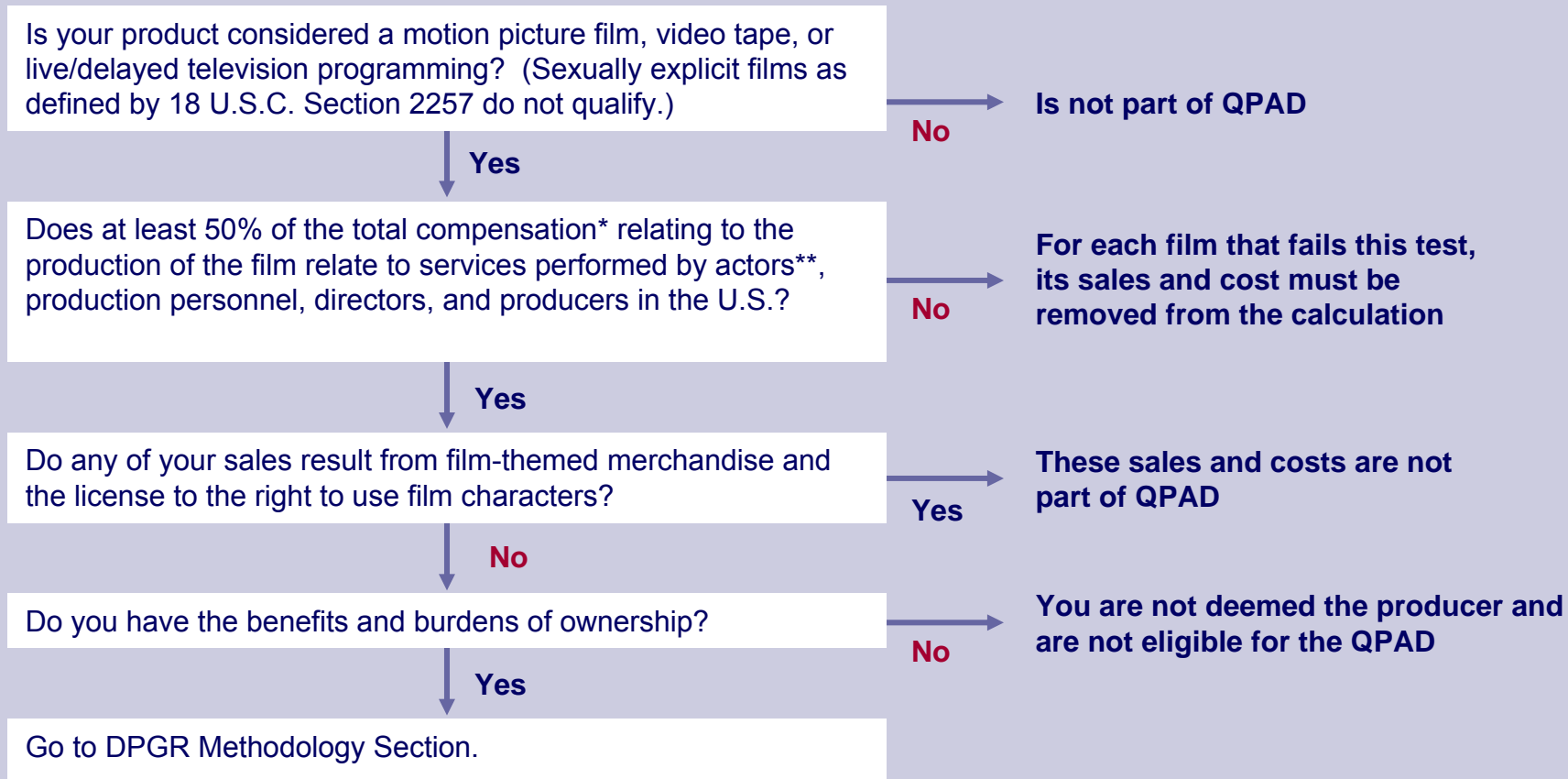
- If a taxpayer MPGE in whole or significant part computer software within the United States that is affixed or added to tangible personal property, whether or not the taxpayer MPGE such tangible personal property in whole or significant part within the United States, the computer software and the tangible personal property may be treated by the taxpayer as computer software.
- If the taxpayer treats the computer software and the tangible personal property as computer software, activities the cost of which are described in Rev. Proc. 2000-50, activities giving rise to research and experimental expenditures under Section 174, and the creation of intangible assets for computer software are considered in determining whether the taxpayer's MPGE activity is substantial in nature under Reg. Sec 1.199-3(g)(2).
- However, any costs under section 174, and the costs to create intangible assets, attributable to the tangible personal property are not considered in determining whether the taxpayer's activity is substantial in nature and are not direct labor and overhead.

Sound Recordings



Note: If a taxpayer MPGE in whole or significant part sound recordings within the United States that is affixed or added to tangible personal property, whether or not the taxpayer MPGE such tangible personal property in whole or significant part within the United States, the sound recordings and the tangible personal property may be treated by the taxpayer as sound recordings. If the taxpayer treats the sound recordings and the tangible personal property as sound recordings, activities giving rise to research and experimental expenditures under Section 174 and the creation of intangible assets for sound recordings are considered in determining whether the taxpayer's MPGE activity is substantial in nature under Reg. Sec 1.199-3(g)(2).

Qualified Film



* The final regulations provide that the total compensation requirement is calculated using a fraction.

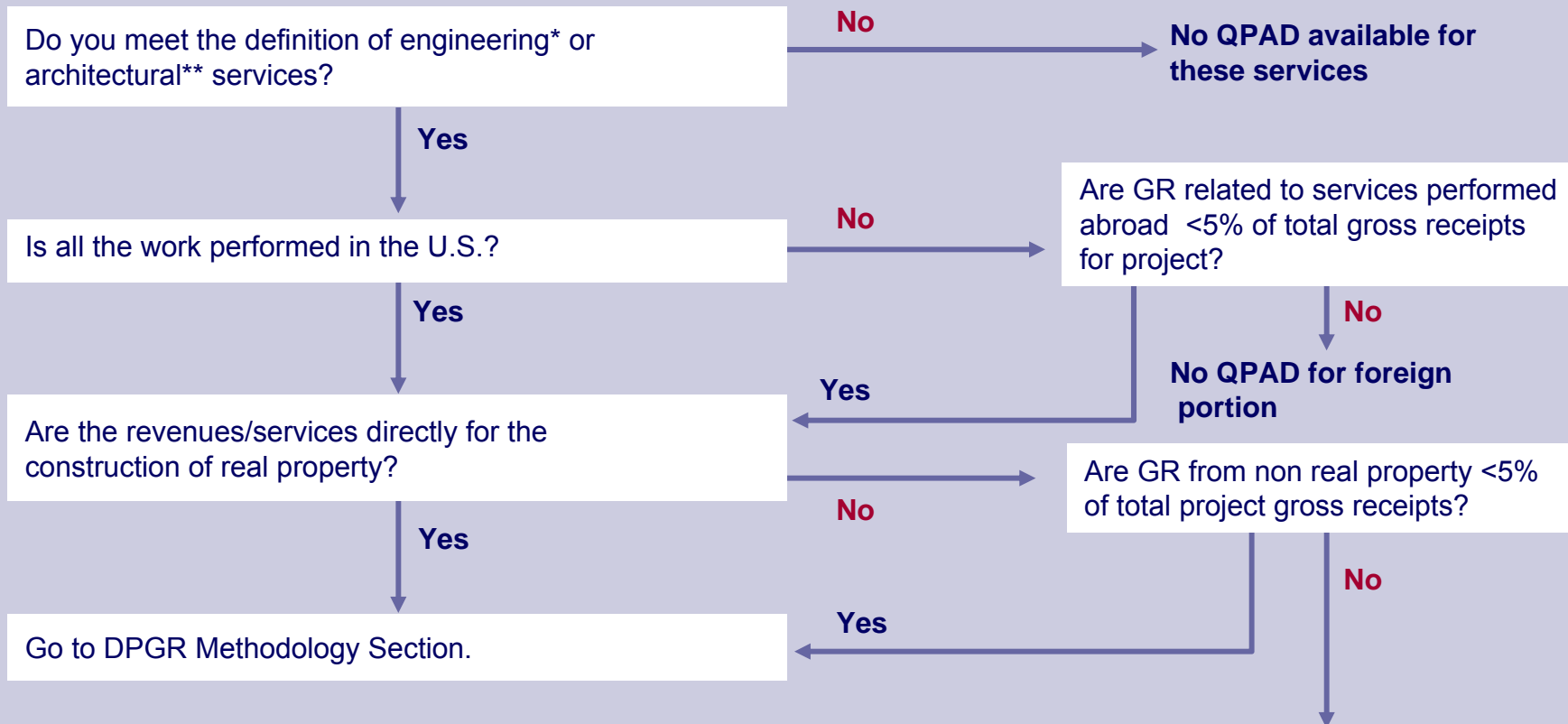
** The final regulations clarify that the term “actors” includes players, newscasters, or any other persons performing in a qualified film.

•**Note:** If a taxpayer MPGE tangible personal property (for example, a DVD) in whole or significant part in the United States and a film not produced by a taxpayer is affixed to the tangible personal property, then the taxpayer may treat the tangible personal property with the affixed film as tangible personal property, regardless of whether the film is a qualified film.



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Engineering & Architectural Services



* **Engineering Services:** Professional services requiring engineering education, training and experience, and the application of special knowledge of the mathematical, physical or engineering sciences such as consultation, investigation, evaluation, planning, design, or responsible supervision of construction for the purpose of assuring compliance with plans, specifications, and design.

** **Architectural Services:** Consultation, planning, aesthetic and structural design drawing and specifications or responsible for supervision of construction or erection in connection with any construction project.

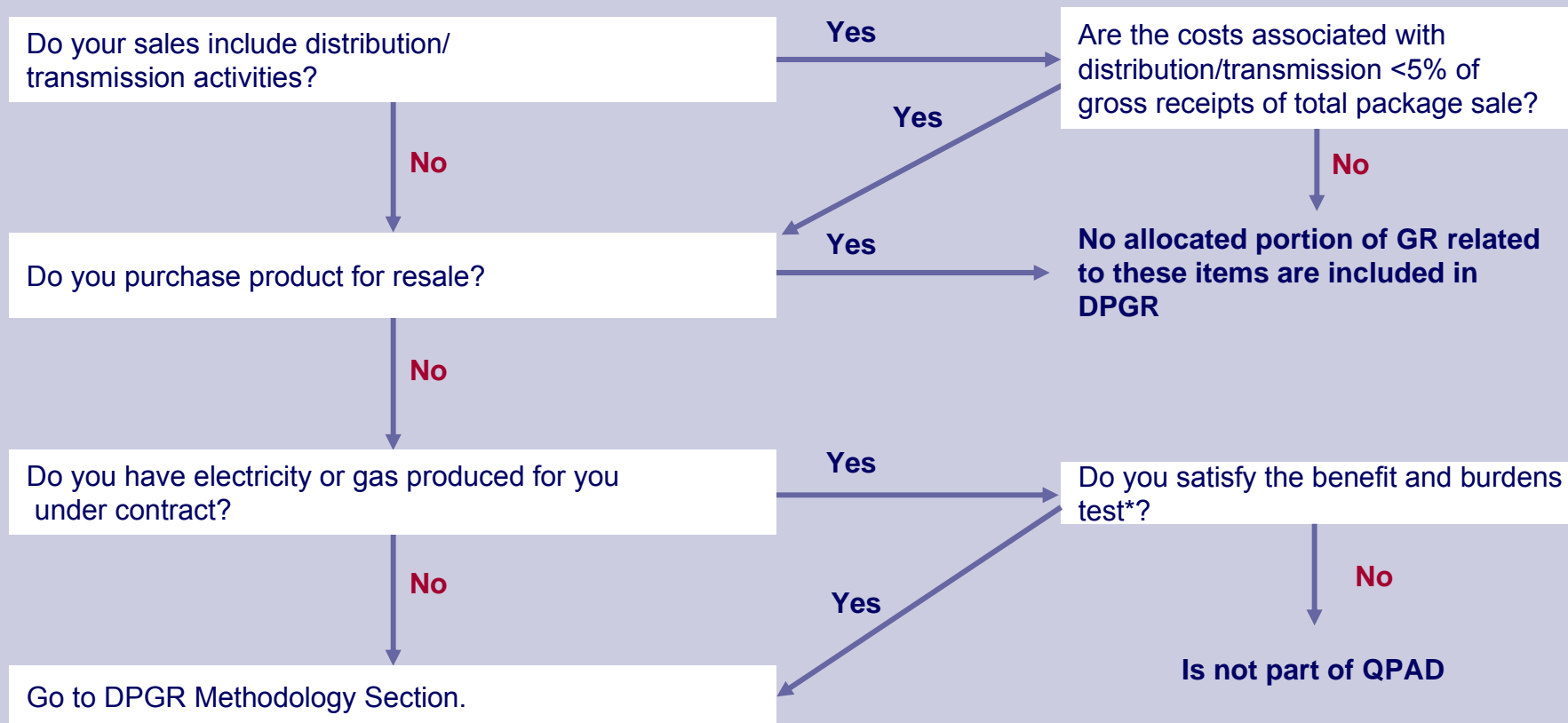
Note1: The final regulations provide that if the taxpayer performing engineering or architectural services also provides administrative support services incidental and necessary to such engineering or architectural services, then these administrative support services are considered engineering or architectural services.

Note 2: The IRS and Treasury Department believe that the determination of what constitutes an item for purposes of construction and architectural or engineering services should be made on a case-by-case basis taking into account all of the facts and circumstances. Taxpayers may use any reasonable method to determine an item.



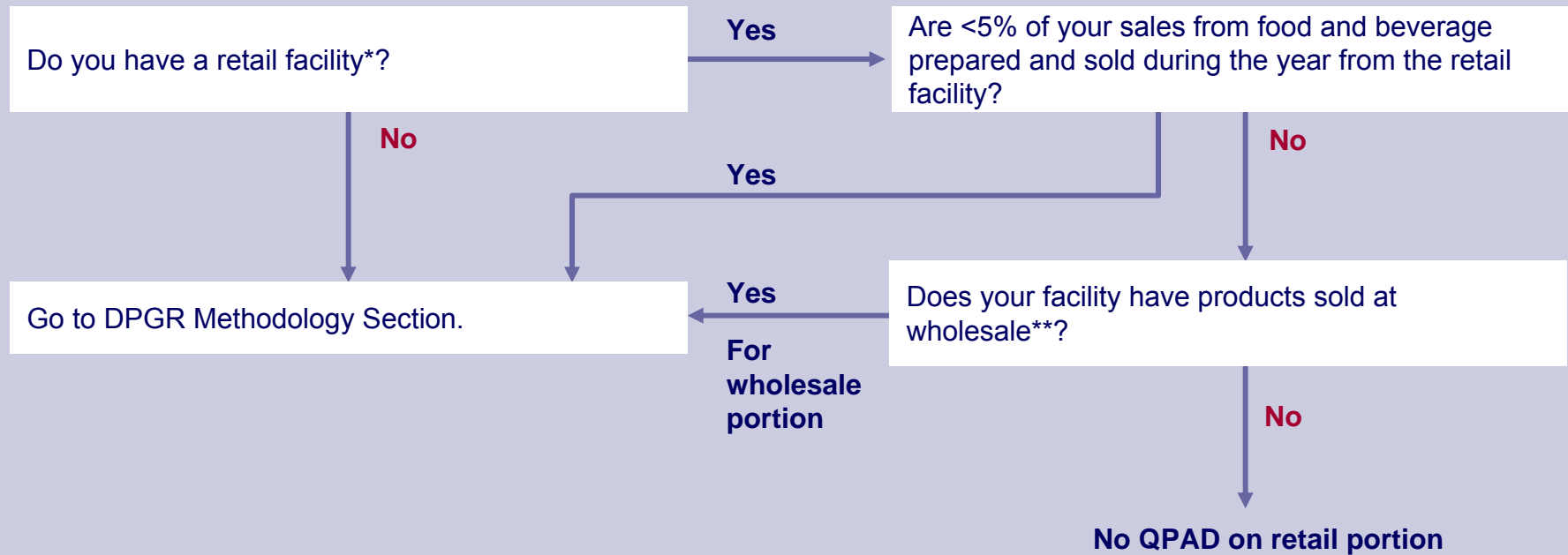
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Electricity, Natural Gas, or Potable Water Producers



* **Benefits and Burden Test:** Taxpayer will need to examine each contract for gas or electricity produced by a third party to determine who has “ownership” of the product while in production. Taxpayer will meet this test if it is determined to own the product while in production.

Food & Beverage Producers

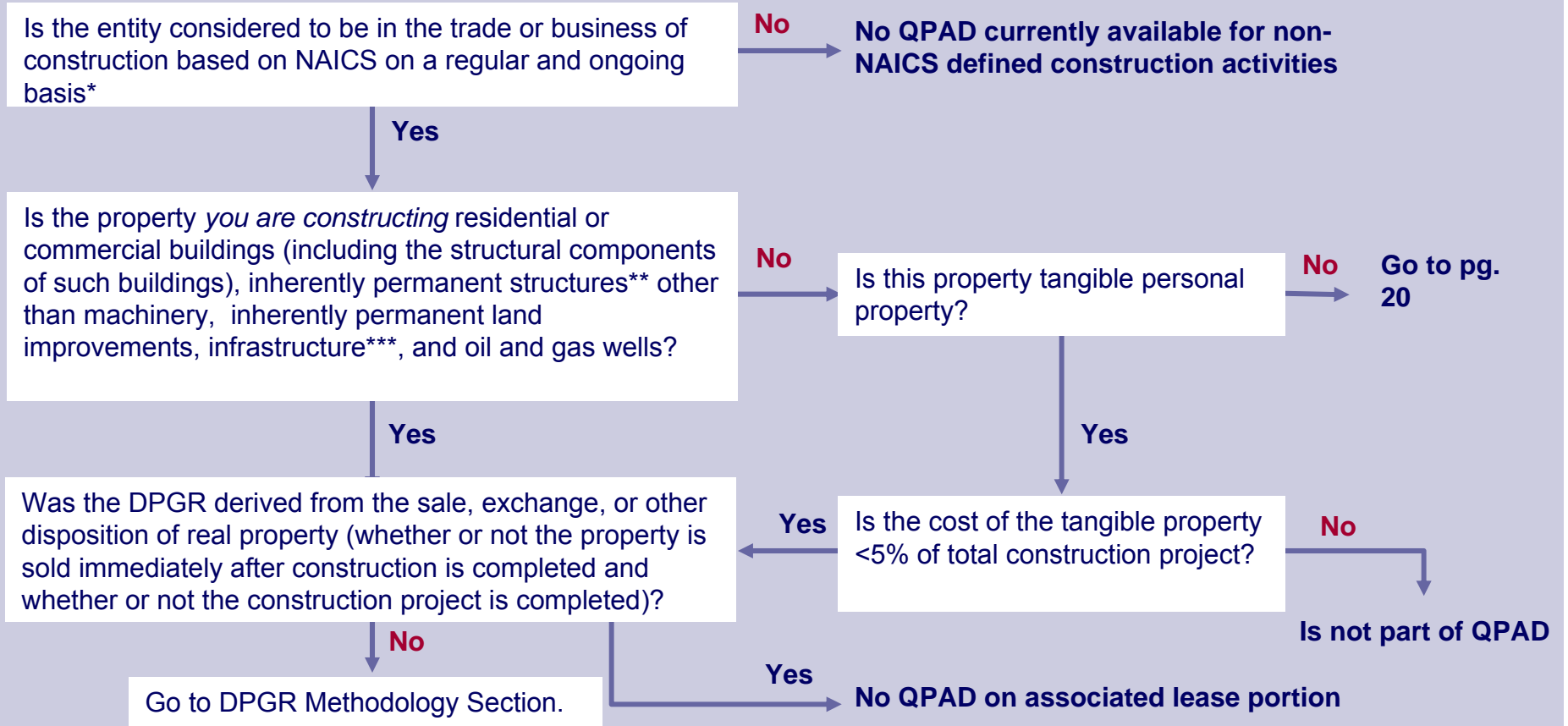


* Retail establishment is intended to be interpreted broadly to include any facility at which the taxpayer prepares food or beverages and makes retail sales of the food or beverage to the public.

- Includes establishments at which customers dine on premises or are engaged primarily in dining trade.
- Includes establishment where food and beverage are prepared solely for take out services or delivery.
- Includes both real and personal property.
- For portion of distilled spirits plant, bonded winery, or brewery that is restricted to production activities, including processing and blending, will not be treated as a retail facility.

** DPGR includes GR from wholesale sales of food and beverage produced at retail establishments, e.g., in-store bakery sales to restaurants.

Construction



* NAICS: North American Industry Classification System (land development, land subdivision, general contracting, infrastructure consolidation, and many subcontracting trades). Tested on a entity-by-entity basis (even for EAG). The final regulations provide that the regular and ongoing business requirement is satisfied if the taxpayer sells or exchanges constructed real property within 60 months of when construction is completed. In the case of a newly-formed business or a taxpayer in its first tax year, the requirement is met if the taxpayer reasonably expects that it will engage in a construction trade or business on a regular and ongoing basis.

** Structural components and inherently permanent structures include walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property.

*** Infrastructure includes but is not limited to roads, power lines, water systems, railroad, communication facilities, sewers, sidewalks, cable and wiring.



Construction (con't.)

- The determination of what constitutes an item for purposes of construction and architectural or engineering services should be made on a case-by-case basis taking into account all of the facts and circumstances.
 - Taxpayers may use any reasonable method to determine an item.
- Construction includes activities performed by a general contractor or that constitute activities typically performed by a general contractor (e.g., activities relating to management and oversight of the construction processes such as approvals, periodic inspection of the progress of the construction project, and required job modifications).
 - A taxpayer does not have to be a licensed contractor to benefit from Section 199.
- Construction DPGR includes:
 - Compensation from construction services,
 - Proceeds from qualified construction warranties,
 - GR derived from materials and supplies consumed in the construction project or that become part of the constructed real party, and
 - GR derived from administrative support services (i.e., billing and secretarial services) incidental and necessary to construction activities performed by the taxpayer.
- Property produced by a taxpayer that is not real property in the hands of that taxpayer, but may be incorporated into real property by another taxpayer, is not treated as real property by the producing taxpayer (e.g., bricks nails, paint, and windowpanes).

Construction (con't.)

- Construction DPGR does not include lease or rental of real property or GR attributable to the sale of land (including zoning, planning, entitlement costs and other costs capitalized to the land).
 - Services such as grading, demolition, clearing, and excavating are activities constituting construction for DPAD purposes if performed in connection with other activities that constitute building or substantial renovation of realty.
- Pursuant to a safe harbor, a taxpayer may allocate GR between the proceeds from the sale of real property constructed by the taxpayer and GR attributable to the sale of land by reducing its costs related to DPGR by costs of the land (and any other costs capitalized to the land) and by reducing its DPGR by those land costs plus a specified percentage. This percentage is based on the number of months that elapse between the date the taxpayer acquires the land and the date the taxpayer sells each item of real property on the land. The percentage is:
 - 5% for land held not more than 60 months;
 - 10% for land held more than 60 but not more than 120 months; and
 - 15% for land held more than 120 but not more than 180 months.

Land held by the taxpayer more than 180 months is not eligible for the safe harbor. The final regulations provide that the holding period begins on the date the taxpayer enters into the first option to acquire the land if the purchase price under the option does not approximate fair market value (i.e., a below-market loan).



Domestic Production Gross Receipts

General Methodology Section



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Are any of your sales revenues derived from foreign manufacturing?

No

Are any of your sales revenues derived from services (direct or embedded - service costs that are not separately stated in the sale price) - (see page 27 for discussion of embedded costs)?

No

Do you have the benefits and burdens* of ownership for these goods (i.e., do you have economic risk of loss)?

Yes

Do you manufacture or produce these goods in whole or in significant part by meeting one of the two following tests:

1. Cost Safe Harbor Test – Conversion cost** (direct labor and overhead/CGS) in US of QPP \geq 20% of total cost of property or in transactions without CGS (lease, rental, license, etc) \geq 20% of the depreciable basis of the property; or
2. Facts and Circumstances Test: Determine if MPGE of QPP by the taxpayer within the US is substantial in nature by taking into account all of the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer's MPGE activity within the US, the nature of the QPP, and the nature of the MPGE activity the taxpayers performs within the US.

Yes

Are the remaining gross receipts derived from lease, rental, license, sale, exchange or other disposition of the property?***

No

Yes

Are your total DPGR/total GR > 95% at the entity level?

Yes

No

Go to of COGS Allocation Section.

No QPGR for these items

No

Are these sales and services <5% of total sales for the company?

Yes

Include de minimis sales and services in DPGR.

No

No QPGR for these items except for certain government contracts

No

You will need to separately examine these items

STOP: Entity's taxable income will be your QPAI.

* Other Factors to consider: title, control over manufacturing process, rights to accept or reject goods, right to market or sell the property, responsibility to insure the property, responsibility to pay tax on the property, right to intellectual property associated with the property, etc.

** The final regulations dropped the concept of "related factory burden" and replaced it with the concept of "overhead."

*** Passive income is not included in your DPGR and thus will reduce your QPAI.



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Consistency Requirement with Section 263A

- For taxpayers subject to Section 263A, overhead is all costs required to be capitalized under Section 263A except direct materials and direct labor.
- For taxpayers not subject to Section 263A, overhead may be computed using any reasonable method based on all the facts and circumstances, but may not include any cost that would not be capitalized under Section 263A.
- R&E expenditures under Section 174 and the costs of creating intangible assets are not taken into account in determining direct labor or overhead for any tangible personal property (see special rule regarding computer software (Page 13) and sound recordings).

Examples of DPGR

- Proceeds derived from the sale of QPP manufactured in whole or in significant part in the US
- Business interruption insurance, governmental subsidies, and governmental payments *not to produce* to the extent they are substitutes for GR that would otherwise be DPGR
- GR derived from US developed software that is purchased through a download via the world wide web
- GR derived by newspapers and magazines including advertising income if the newspapers, magazines, telephone directories, periodicals, or other similar printed materials are DPGR (in other words advertising income does not automatically qualify, but may in certain circumstances)
- GR from advertising in newspapers, magazines, or films, qualify as DPGR as long as the qualifying medium carrying the advertising *could have* generated DPGR, even if there is no revenue stream from the medium
- GR from certain in-kind partnerships that are from the sale of oil and gas, petrochemical products, and electricity generation
- GR derived from certain contracts to manufacture or produce property for the Federal government would be treated as derived from the sale of such property and, therefore, would qualify as DPGR

Examples of DPGR (con't.)

- GR derived from activities relating to:
 - Manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP;
 - Making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles;
 - Cultivating soil, raising livestock, fishing, and mining minerals; and
 - Storage, handling, or other processing activities (other than transportation activities) within the U.S. related to agricultural products.
- Advanced payments for QPP will be included as DPGR in the year the income is included in taxable income under the taxpayer's method of accounting for federal income tax purposes
 - For items that span multiple years, historical data may be used to allocate between DPGR and non-DPGR
- Repair parts that are manufactured by the taxpayer and the taxpayer retains benefits and burdens during installation process
- Interest component of lease payments
- Gain/loss on hedging transactions on inventory that is QPP or supplies consumed in DPGR activities or risk of currency

Examples of Non-Qualifying GR

- Non-de minimis* GR from embedded service software license fee that includes help desk service (see exception in final regulations for qualified computer software maintenance agreements)
- GR originating from computer software offered online for a fee
 - Customer support
 - Internet access service fees
 - Telephone services
 - Fees for playing video games online
 - Online services
 - Provider controlled online access services
- GR from ticket sales for viewing qualified films
- GR derived from the sale of food and beverages prepared at a retail establishment
- GR derived from property leased or licensed by the taxpayer for use by a related person
- Repair labor where customer retains benefits and burdens with respect to the property
- Broker's fees
- Mineral royalties, including net profits interests (passive interest) other than operating interests
- License of a network produced show to a related affiliate

* If the amount of gross receipts from embedded services is less than 5 percent of the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the property, the amount of gross receipts from embedded services would qualify as DPGR.

Embedded and Non-Qualified Services

- GR from embedded revenue related to “qualified” warranty
 - Must be done in the normal course of its business*; the charge for the warranty is included in the price charged for lease, rental, license, sale, exchange, or other disposition of the qualifying production property
 - The warranty is neither separately offered by the taxpayer nor separately bargained for with any customer in the normal course of its business; that is, the customer cannot purchase the qualifying production property without the warranty
- Installation/minor assembly services
 - Generally not DPGR
 - Exceptions where taxpayer makes and installs the property and:
 - The taxpayer maintains benefits and burdens of ownership at time of installation;
 - The charge is included in the selling price and installation is not separately offered; or
 - The gross receipts from the installation are separately stated but are less than five percent of the total gross receipts (de minimis rule).
- Delivery services
 - Generally not DPGR
 - Exception where charge is included in the selling price and item not separately offered (“embedded cost”); they qualify for de minimis test

*The Preamble to the final regulations clarifies that whether a taxpayer separately offers or states the price for an item in the normal course of its trade or business depends on the facts and circumstances. Thus, potentially allowing some deviations based on limited nature.

Embedded and Non-Qualified Services (con't.)

- Operating manuals
 - Generally not DPGR
 - Cannot be provided in connection with a training course for a customer
 - Exception where charge is included in the selling price and item not separately offered (“embedded cost”); they qualify for de minimis test
- Qualified Computer Software Maintenance Agreements
 - Provided in connection with the qualified disposition of computer software that entitles the customer to receive future updates, cyclical releases, rewrites of the underlying software, or customer support services for the computer software
 - In general this exclusion does not apply to qualified online software
- De minimis rule applied on an item-by-item basis
 - May operate to treat receipts attributable to embedded services or embedded non-qualified service property as DPGR
 - Not applicable where price is separately stated or property may be acquired without embedded service
- Other service-type activities
 - Certain other service type activities will be included in related QPP and taxpayer will not be required to separately allocate GR for these activities while the taxpayer is engaged in an MPGE activity with respect to property and retains the benefits and burdens of ownership of the property
 - Example of these activities include non-construction engineering, materials analysis and selection, subcontractor inspections and approval, routine production inspections, product testing and documentation, and assistance with certain regulatory approval



Allocation and Apportionment of Deductions Section



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Deductions from DPGR – Specific Rules

- There are four rules that apply to the allocation and apportionment of deductions to DPGR regardless of which method is selected by the taxpayer for purposes of allocating COGS and other costs to DPGR:
 - **First**, losses allowed by Section 165 that are generated by a sale or other disposition of property, including a loss from theft, casualty, or abandonment of property, are required to be allocated to DPGR only if the proceeds from the sale of that property either are or would have been included in DPGR.
 - **Second**, a deduction under IRC Section 172 for a net operating loss is not allocated or apportioned to DPGR or gross income attributable to DPGR.
 - **Third**, deductions which are not attributable to the actual conduct of a trade or business are not to be apportioned to any gross income which consists of DPGR.
 - In the case of individuals, these types of deductions are the deduction for personal exemptions under IRC Section 151 and the standard deduction allowed by Section 63
 - In the case of taxpayers other than individuals that make charitable contributions and that choose to allocate deductions to DPGR using the Section 861 method, these entities are required to ratably apportion the deduction for charitable contributions between DPGR and non-DPGR according to the relative amounts of each type of gross income
 - **Fourth**, any deductions attributable to either GR for embedded services or non-DPGR that the taxpayer is permitted to treat as DPGR because of the 5 percent de minimis rules must be apportioned to DPGR.

Small Business Simplified Overall Method

Do you meet one of the following:

- (1) Your average annual GR (over the three prior years) and total deductions for the current year are \$5M or less
- (2) You are engaged in farming and are eligible to use the cash method (under Section 447); or
- (3) You are on the cash method of accounting (under Revenue Procedure 2002-28)

Yes

The small business simplified overall method* can be utilized

No

Go to Cost of Goods Sold Allocation Section.

*** Small business simplified overall method:**

- All costs are allocated on the basis of the ratio of DPGR to total GR derived from all sources (included CGS and other costs).



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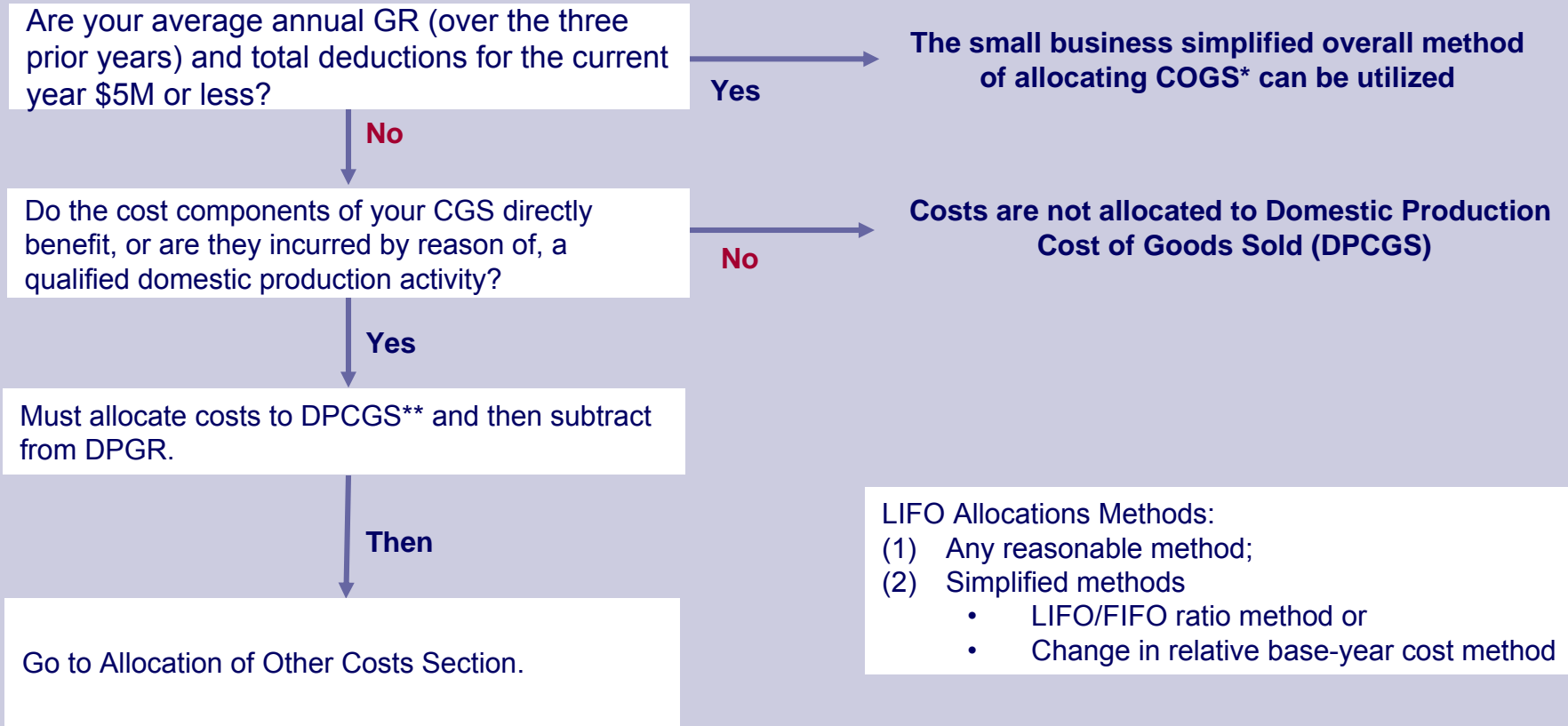


Cost of Goods Sold Allocation Section



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Cost of Goods Sold Allocation



- LIFO Allocations Methods:
- (1) Any reasonable method;
 - (2) Simplified methods
 - LIFO/FIFO ratio method or
 - Change in relative base-year cost method

*** Simplified method of allocating CGS:**

- Costs are allocated on the basis of the ratio of DPGR to total GR derived from all sources.

**** Methods of allocating CGS:**

- Any reasonable method to identify direct material, direct labor, factory overhead and general/administrative cost properly allocated to CGS (mixed service cost).
- Method must be consistent with the approach used to determine DPGR.
- The principles under Sections 263A (Inventory Capitalization) and 861 (Income from Sources within the U.S.) should be utilized to determine if the allocation method is reasonable, e.g., if using simplified method, apply absorption ratio to Section 471 CGS.

Note 1: This must be tested at the EAG level.

Note 2: In a consolidated groups each company must use the same allocation method.

Note 3: Must include inventory valuation adjustments (e.g., LCM or LIFO).



Allocation of Other Costs



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Other Cost Allocation

Is your three-year prior GR average \$100M or less or your end of year total assets are \$10M or less?

No

The Section 861 method** must be utilized to allocate all other costs associated with QPGR.

Yes

Simplified Deduction Method* may be utilized to allocate all other costs associated with DPGR.

*** Simplified Deduction Method of Allocating Other Costs:**

- Costs are allocated on the basis of the ratio of DPGR to total GR derived from all sources. Can switch between Section 861 method and simplified method at any time.

****Section 861 Method:**

- This method applies the principles of determining taxable income within and outside the U.S. to other costs attributed to DPGR. (Coordination with the foreign tax credit computation is key to maximize both the deduction and the credit.)
- Charitable contributions are ratably apportioned between DPGR and other gross income.
- Research and experimentation expenditures are allocated and apportioned in accordance with Section 1.861-17 without taking into account the exclusive apportionment rule of Section 1.861-17(b).
- If non-DPGR is treated as DPGR, deductions related to such receipts must be allocated or apportioned to gross income attributable to DPGR.



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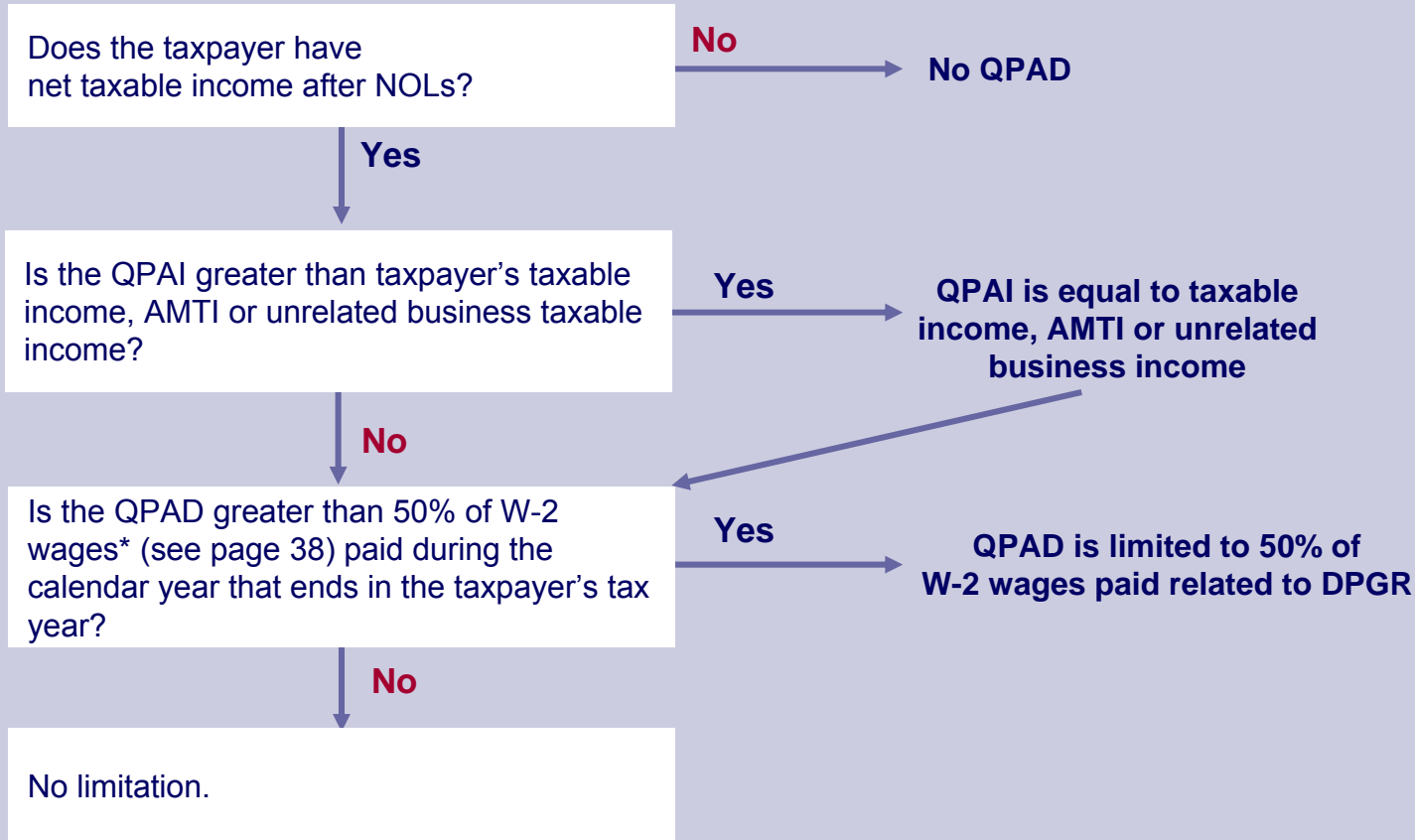


Limitations on Domestic Production Deduction



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Limitations on Domestic Production Deduction



* **Qualified Wages:** The proposed regulations state that wages for the limitation are only W-2 wages and do not include such items as:

- guaranteed payments to partners;
- self-employment income of proprietors; and
- amounts paid to independent contractors.
- For tax years beginning after May 17, 2006, W-2 wages include only amounts that are allocable to DPGR.

Note: Only one taxpayer may claim Section 199 deduction with respect to the same function performed with respect to the same property.

- **Unmodified Box Method**

- W-2 wages are calculated by taking, without modification, the lesser of:
 - The total entries in Box 1 (Wages, Tips and Other Compensation) from all Forms W-2 filed with the Social Security Administration (SSA)
 - The total entries in Box 5 (Medicare Wages and Tips) from all Forms W-2 filed with the SSA

- **Modified Box 1 Method**

- W-2 wages are calculated by taking the total entries in Box 1 of Forms W-2, subtracting amounts that are not wages for federal income tax withholding purposes and amounts that are merely treated as wages for withholding purposes (e.g., supplemental unemployment compensation benefits and certain forms of sick pay)
- This amount is then increased by employee salary reduction contributions to 401(k) arrangements and similar plans (amounts that are reported in Box 12 of Forms W-2, Coded D, E, F, G, or S)

- **Tracking Wages Method**

- Wages are calculated by actually tracking total wages subject to federal income tax withholding, subtracting supplemental unemployment compensation benefits, and adding employee salary reduction contributions to 401(k) arrangements and similar plans (amounts that are reported in Box 12 of Forms W-2, Coded D, E, F, G, or S)
- If a taxpayer acquires a major portion of a separate trade or business or unit thereof, the successor employer's portion of qualified W-2 wages are only those that relate to wages earned under its ownership despite the fact that the successor may issue W-2s that include services provided to the predecessor
- Taxpayer may only take into account wages paid to common law employees of the taxpayer



Calculating W-2 Wages

- The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) made significant changes to the W-2 wage limit. Under pre-TIPRA law, W-2 wages were the sum of the aggregate amounts that must be included on the Forms W-2 of employees (i.e., wages subject to withholding and elective deferrals). Wages did not have to be allocable or attributable to activities that gave rise to a DPAD. Therefore, if a taxpayer had employees in a business that generated DPAD as well as in another business that did not, the wages of both businesses counted for purposes of the 50 percent of W-2 wage limit.
- Additionally, under pre-TIPRA law, when applying the 50 percent of W-2-wage limit available to an S corporation shareholder or partner, each was treated as having W-2 wages for the tax year in an amount equal to the lesser of that person's allocable share of the W-2 wages of the entity or two times the specified percentage (3 percent for tax years beginning in 2005 or 2006) of the QPAI allocated to that person for the tax year.
- Under TIPRA, for tax years beginning after May 17, 2006, W-2 wages only include amounts that are properly allocable to DPGR. Additionally, for tax years beginning after May 17, 2006, TIPRA repeals the special limitation on wages treated as allocated to partners or shareholders of pass-through entities for purposes of the W-2 wage limit. Instead, each partner or shareholder is treated as having W-2 wages for the tax year equal to his allocable share of the partnership's or S corporation's W-2 wages for the tax year.
- Final Section 199 regulations provide additional changes to the W-2 wage limitation:
 1. Payments to domestic servants in a taxpayer's private home are not attributable to the actual conduct of a trade or business of the taxpayer and can not be included in W-2 wages.
 2. For married taxpayers filing jointly, one spouse may take into account wages paid to employees of the other spouse in determining the amount of W-2 wages, provided the wages are paid in a trade or business of the spouse and the other requirements of the final regulations are met. A separate filer, however, can not use the other spouse's wages in determining W-2 wages for DPAD purposes.



Wage Expense Safe Harbors

- After TIPRA a taxpayer may determine the allocation of W-2 wages that are properly allocable to DPGR using any reasonable method based on all of the facts and circumstances.
- Taxpayers who use either the Section 861 method of cost allocation or the simplified deduction method can use the wage expense safe harbor.
 - Under this safe harbor, the amount of wages properly allocable to DPGR is determined by multiplying the employer's W-2 wages by the ratio of the taxpayer's wage expense included in calculating QPAI for the tax year to the taxpayer's total wage expense used in calculating the taxpayer's taxable income (or AGI, if applicable) for the tax year.
 - Under this safe harbor, a taxpayer may determine its wage expense included in CGS using any reasonable method based on all of the facts and circumstances.
- A taxpayer that uses the small business simplified overall method of cost allocation can use the small business simplified overall method safe harbor for determining the amount of wages properly allocable to DPGR.
 - Under this safe harbor, the amount of wages properly allocable to DPGR is the same proportion of wages that the amount of DPGR bears to the taxpayer's total gross receipts.



Issues to Consider



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Issues to Consider

Consistency Rule

- The Notice specifically states that the consistency rules of Reg. Section 1.861-8(f)(2) must be followed. These rules require taxpayers that apply Section 861 apportionment and allocation methods to be consistent in application between tax calculations, e.g., apportionment and allocation methods used in calculation of your foreign tax credit, Extraterritorial Income Exclusion (ETI/EIE) and Section 199 apportionment should be the same. Other examples include the treatment of:
 - Research and Development Expenditures – based on either sales or gross income
 - Interest – based on FMV, TBV or alternative TBV method
 - State Taxes
 - Factual Nexus Application

Transfer Pricing Coordination

- Since different allocation methodologies could taint transfer pricing methodology, taxpayers need to ensure that their Section 199 allocation methodology for costs is consistent with their current transfer pricing methodology

Tax Section Harmony

- Taxpayers need to understand the interplay when implementing strategies for maximizing or minimizing foreign sales income/expenses. Maximizing a Section 199 deduction could have a potential negative effect on a taxpayer's Section 904 foreign tax credit limitation and vice versa
- Consideration needs to be given to the impact of international tax planning to ensure the maximization of tax benefits among all affected tax sections

Reverse De-Minimis Rule

- Taxpayers who have a small amount of DPGR can avoid the complexities of Section 199. All of a taxpayer's gross receipts may be treated as non-DPGR if less than 5% of its total gross receipts are DPGR.

Issues to Consider (continued)

Foreign Tax Credit

- Taxpayers must coordinate the benefits of their Section 199 deduction with their FTC. Specifically, when determining your cost allocation strategy, thought should be given to the FTC limitations that may be created versus a lost deduction for Section 199 purposes.

FAS 109 Implications

- FASB states that they believe the QPAD should be accounted for as a special deduction and not a tax rate reduction (FSP FAS 109-1).

NOL Limitation

- NOL carryforwards have a negative impact on the Section 199 deduction as the mechanics of the calculation limit the benefit to taxable income after NOLs.
- The temporary regulations issued on October 18, 2006 provide that to the extent an NOL was used in the year it was sustained in determining any EAG's Section 199 taxable income limitation the NOL is not treated as an NOL carryover or carryback to any tax year in determining that year's Section 199 taxable income limitation.

AMT

- The computation of a company's Section 199 deduction in computing the Alternative Minimum Taxable Income (AMTI) is the same as in computing the regular tax, except that, in the case of a corporation, the taxable income limitation is the corporation's AMTI.
- The guidance suggests that the 199 deduction appears to be available for taxpayers with taxable income sheltered by NOL carryforwards who are in AMT positions due to the 90% AMTI limitation on the AMT NOL deduction.

Accounting Method

- Section 199 methodologies do not constitute an accounting method. As such, taxpayers may modify/change their methodologies annually based on facts and circumstances without being required to file a change in accounting method request.

Consolidated Group

- QPAD allocated based on proportion to each member QPAI.



Issues to Consider (continued)

Affiliated Group

- Taxpayers that are members of an expanded affiliated group will be treated as a single corporation for determining the deduction.
- Each member of EAG calculates its own separate QPAI, taxable income or loss, and W-2 wages
- Transactions between members of an EAG may result in DPGR (does not include related party transactions)
- To be a member of an expanded affiliated group for Section 199 the common ownership is more than 50%
- The deduction for the group is allocated to each member based on their respective QPAI contributed
- In general, activities of one EAG member are attributed to other members (not applicable in construction, architectural or engineering, but is applicable to EAG partnership)
- A partnership may be part of an EAG if it is owned entirely by members of the EAG
- Partnerships can be part of EAG; however, the Section 199 partnership rules still apply for allocation
- Anti-avoidance rule: If a transaction between EAG member is principally engaged in or structured to receive or increase Section 199 deduction, the benefit will be eliminated

Leased Employees

- For employees leased from a third party, common law employee definitions will determine who can apply the W-2 wages of the leased employees for Section 199
- For employees leased through non-corporate related parties, there are issues as to whom may utilize the W-2 wages for Section 199

Related Party Transactions

- Generally not treated as DPGR
- Exception where related party (1) subleases the property to an unrelated person or (2) reproduces the property pursuant to a license and disposes of such property to an unrelated person

State and Local Impact

- You must look at each individual state to determine if it allows the QPAD (see page 45) and how the deduction is allocated in the case of a federal expanded affiliated group
- Changes to presentation of embedded and other services (moving from separately stated to “embedding” in price) may result in additional sales and use taxes

Pass Through Entities

(S Corporations, Limited Liability Companies, Partnerships, Estates, Trusts)

- QPAI is calculated at the partner level; as such DPGR, CGS, W-2 wages and related expenses must be allocated to each partner
- For tax years beginning before May 18, 2006, the W-2 wages allocated are capped at the lesser of 2 times the applicable percentage of the partner's share of QPAD (3% X QPAI) or partner's allocable share of such wages (without regard to this rule). For tax years beginning after May 17, 2006, an owner's share of W-2 wages of a pass through entity is the owner's allocable share of the pass through entity's W-2 wages.
- Partner/owner may add their own wages related to the entity generating QPAI
- In tiered partnerships the direct partnership owner calculates the wage limitation (each tier does calculation)
- There are special rules for oil and gas, petrochemical, and electricity generation partnerships
- Special allocations are available to partners as long as they meet the substantial economic effect requirement of Section 704(b)
- To the extent partners lack basis or the application of the at-risk rules disallow losses or deductions, a proportionate share of the losses or deductions reflecting expenses allocable to qualified activities are suspended as well. In the year the loss is utilized the suspended QPADs will be taken into account. The final regulations clarify that disallowed losses of the taxpayer that are disallowed for tax years beginning on or before December 31, 2004 are not taken into account in a later tax year for purposes of computing the taxpayer's QPAI for that later tax year regardless of whether the disallowed losses are allowed for other purposes.
- Structural planning that has been done or is being contemplated should be examined to determine what impact it would have on the company's production deduction. There may be planning opportunities to maximize the production deduction as part of the restructuring
- >95% DPGR to total GR safe harbor is applied at the pass through entity level
- **Trap** – A partnership employee leasing company's W-2 wages may not pass W-2 amounts to partner unless they were a 100 percent member of an EAG for the entire tax year.



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State Treatment

The following states do not allow the Section 199 deduction either because their law specifically disallows the deduction or because the state's laws have not adopted or incorporated the American Jobs Creation Act:

- Arkansas
- California
- Georgia
- Hawaii
- Indiana
- Maine
- Maryland
- Massachusetts
- Minnesota
- Mississippi
- New Hampshire
- New Jersey (*Partially Decoupled*)
- North Carolina
- North Dakota
- Rhode Island
- Oregon
- South Carolina
- Tennessee
- Texas
- West Virginia
- Washington D.C.

**This list will be updated as further information becomes available.*

Example – Facts

Facts:

- Production Company (Company) is a manufacturer of carburetors
- They have one plant in the U.S. and one plant in China.
- The China facility is a check-the-box entity (taxed in U.S.)
- Included in the contract price is an embedded warranty cost. This cost is part of normal business practices, is not bargained for with customers, and represents on average 4% - 5% of the overall contract price
- Company has three major customers: one in the United Kingdom, one in U.S. and one in Canada.
- Sales personnel are located in Canada, U.S., United Kingdom and China
- Company financial information is located on Page 7
- Company average three-year GR \$10,250,000

Example – Steps to Compute Production Deduction

Step 1

Determine Company DPGR

- Company has total sales of \$14,000,000
- Determined that \$4,000,000 of sales related to China-produced parts.
- Company has service revenue related to warranty
 - Warranty revenue is <5% of total sales
 - Other embedded service requirements are satisfied (see pages 19 & 22)
- No contracted goods, so Company has benefits and burdens of ownership
- No GR derived from disposition of property outside of normal course of business

DPGR = \$10,000,000

Step 2

Determine Company DPGS

- Since the Company's prior three-year average gross receipts are greater than \$5M, it cannot use the small business simplified overall method for allocating CGS.
- Company determined domestic production cost allocation based on Section 263(A) UNICAP methodology
- Cost for China products are \$1.8M

DPCGS = \$5.2M

Example – Steps to Compute Production Deduction

Step 3

Determine Company Allocation of Other Cost

- Company's prior three-year average gross receipts are \$100M or less; thus, Company can use simplified deduction method for allocating other costs
- Company may use Section 861 Method
- Section 861 Method provides lower expense allocation
 - Simplified Method (71% of total other cost) = \$2,840,000
 - Section 861 Method (\$100,000 of direct other costs + 69% of remaining SG&A costs) = \$2,791,000

U.S. Allocation of Other Costs = \$2,791,000

Step 4

Determine if Limitations Apply

- Taxable Income Limitation
 - Taxable income after NOL > QPAI
 - \$3,050,000 > \$2,049,000

No Limitation

- W-2 Limitation
 - 50% of W-2 > DPAD
 - \$2,250,000 > \$61,470

No Limitation

DPAD = \$61,470 will reduce taxable income

Form 8903, Domestic Production Activities Deduction

Form 8903		Domestic Production Activities Deduction	CMB No. 1545-1984
Department of the Treasury Internal Revenue Service		▶ Attach to your tax return. ▶ See separate instructions.	2005 Attachment Sequence No. 143
Name(s) as shown on return		Identifying number	
1	Domestic production gross receipts	1	
2	Allocable cost of goods sold	2	
3	Directly allocable deductions, expenses, or losses	3	
4	Indirectly allocable deductions, expenses, or losses	4	
5	Add lines 2 through 4	5	
6	Subtract line 5 from line 1	6	
7	Qualified production activities income from— If you are a— Then enter the total qualified production activities income from— a Shareholder Schedule K-1 (Form 1120S), box 12, code Q b Partner Schedule K-1 (Form 1065), box 13, code U c Beneficiary Schedule K-1 (Form 1065-B), box 9, code S2 Schedule K-1 (Form 1041), box 14, code C	7	
8	Qualified production activities income. Add lines 6 and 7. If zero or less, enter -0- here, skip lines 9 through 15, and enter -0- on line 16	8	
9	Income limitation (see instructions): • Individuals, estates, and trusts. Enter your adjusted gross income figured without the domestic production activities deduction • All others. Enter your taxable income figured without the domestic production activities deduction (tax-exempt organizations, see instructions)	9	
10	Enter the smaller of line 8 or line 9. If zero or less, enter -0- here, skip lines 11 through 15, and enter -0- on line 16	10	
11	Enter 3% of line 10	11	
12	Form W-2 wages (see instructions)	12	
13	Form W-2 wages from pass-through entities: If you are a— Then enter the total Form W-2 wages from— a Shareholder Schedule K-1 (Form 1120S), box 12, code R b Partner Schedule K-1 (Form 1065), box 13, code V c Beneficiary Schedule K-1 (Form 1065-B), box 9, code S3 Schedule K-1 (Form 1041), box 14, code D	13	
14	Add lines 12 and 13	14	
15	Form W-2 wage limitation. Enter 50% of line 14	15	
16	Enter the smaller of line 11 or line 15	16	
17	Domestic production activities deduction from cooperatives. Enter deduction from Form 1099-PATR, box 6	17	
18	Expanded affiliated group allocation (see instructions)	18	
19	Domestic production activities deduction. Combine lines 16 through 18 and enter the result here and on Form 1040, line 35; Form 1120, line 25; Form 1120-A, line 21; or the applicable line of your return	19	

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 37712F

Form 8903 (2005)



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What needs to be done?

- Identify qualified activities
 - Have costing/pricing detail run for product groups to test for overall 95% safe harbor
 - Examine “sub-items” for qualification
- Allocate and apportion CGS and other expenses
 - Determine if simplified methods apply
 - Review for coordination with company’s current tax methodologies (e.g., Sections 263A and 861)
- Document methodology, calculation and conclusions
- Examine FAS 109 implications
- File tax return

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