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Issue Contents

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Proposed Regulations Issued on New Domestic Production Deduction

-by **Neil E. Harl**[*] and **Roger A. McEowen**[**]

On October 20, 2005, the Department of the Treasury issued proposed regulations[1] for the domestic production deduction[2] enacted by the American Jobs Creation Act of 2004.[3]

The deduction, which starts out at three percent for 2005 and 2006, rises to six percent for 2007-2009 and plateaus at nine percent after 2009, is the appropriate percentage of the lesser of—(1) the "qualified production activities income" of the taxable year or (2) the taxpayer's taxable income for the year.[4] The deduction cannot exceed 50 percent of the W-2 wages of the employer for the taxable year.[5]

Trade or business requirement

The statute, as enacted, provides that "this section shall be applied by only taking into account items which are attributable to the actual conduct of a trade or business."[6] The proposed regulations failed to provide guidance on where the line is drawn among operating farmers, materially participating share rent landlords, non-materially participating share rent landlords and cash rent landlords.[7] The proposed regulations emphasize that only one taxpayer may claim a deduction with respect to any eligible activity.[8] While that has been cited in unofficial responses to queries on this issue, it is believed that a share rent lease involves a division of production and both landlord and tenant under a share-rent lease should be eligible for the deduction with the only issue being whether a non-material participation share lease landlord has sufficient involvement in management to be eligible.[9] That question remains unanswered.

The startling development is that the Chief Counsel's Office apparently has taken the position that the deduction is tied to the land so tenants, even those cash renting land, are not eligible for the deduction. This hardly seems to be an equilibrium situation and is likely to be changed in final regulations, if not before.

Qualified production activities income

Under the statute, qualified production activities income (QPAI) is the excess of domestic production gross receipts (DPGR) over the sum of (1) the cost of goods sold allocable to such receipts; (2) other deductions, expenses or losses directly allocable to such receipts; and (3) a ratable portion of deductions, expenses and losses not directly allocable to such receipts.[10] The proposed regulations clarify that, where gross receipts and expense are recognized in different taxable years, taxpayers must take receipts and expenses into account for purposes of the domestic production deduction in the taxable year the items are recognized under their method of accounting for federal income tax purposes.[11]

IRS had earlier taken the position, in Notice 2005-14,[12] that the deduction was to be applied on an item-by-item basis. The proposed regulations retain that requirement.[13] The proposed

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regulations define an "item" as the property offered for sale to customers that meets the requirements under I.R.C. § 199(c).[14] If the property offered for sale does not meet all of the requirements for the deduction, a taxpayer must treat as the item any portion of the property offered for sale that meets all of these requirements.[15]

De minimis exception

Notice 2005-14,[16] had stated that if the amount of the taxpayer's gross receipts that do not qualify as domestic production gross receipts (DPGR) equals or exceeds five percent of the total gross receipts, the taxpayer is required to allocate all gross receipts between DPGR (which is eligible for the deduction) and non-DPGR (which is not eligible for the deduction). The proposed regulations, for purposes of the five percent *de minimis* rule, provide that, in the case of an S corporation, partnership, estate, trust or other pass-through entity, the determination of whether less than five percent of the pass-through entity's total gross receipts are non-DPGR is made *at the pass-through entity level*.[17] At the same time, in the case of an owner of a pass-through entity, the determination of whether less than five percent of the *owner's* total gross receipts are non-DPGR is made at the owner level, taking into account all of the owner's gross receipts.[18]

Wage limitation

Under the statute, the deduction cannot exceed 50 percent of the W-2 wages of the employer for the taxable year with the term "W-2 wages" including amounts required to be included on statements under I.R.C. § 6051(a)(3), (8).[19] That includes wages, and elective deferrals, as the term "wages" is defined in I.R.C. § 3401(a) which, in I.R.C. § 3401(a)(2), excludes "agricultural labor" unless the remuneration paid is wages as defined in I.R.C. § 3121(a), which, in I.R.C. § 3121(a)(8)(A), excludes remuneration paid in any medium other than cash. I.R.C. § 3121(b) defines "employment" for "purposes of this chapter" to exclude "service performed by a child under the age of 18 in the employ of his father or mother" which seems to define "employment" in I.R.C. § 3121(a). That appears to exclude from eligibility under I.R.C. § 199, wages paid in kind to agricultural labor and wages paid to a child under age 18 in the employ of either parent.

The proposed regulations state that payments to independent contractors and self-employment income, including guaranteed payments made to partners, are not included in determining W-2 wages.[20] The term "employees" is defined as including only common law employees of the taxpayer and officers of a corporate taxpayer.[21]

The proposed regulations authorize the same three methods for calculating W-2 wages as are outlined in Notice 2005-14[22] making it clear that the methods are all subject to the non-duplication rule.[23] The three methods are—(1) the unmodified box method (taking into account the lesser of the entries in Box 1 of all Forms W-2 filed with the Social Security Administration or the entries in Box 5 of all Forms W-2 filed with the SSA with respect to employees of the taxpayer for employment by the taxpayer);[24] (2) the modified box 1 method (with reduction for amounts included in Box 1 that are not wages for federal income tax withholding purposes and amounts included in Box 1 that are treated as wages under I.R.C. § 3402(o) (such as supplemental employment benefits) and adding in amounts reported in Box 12 coded D, E, F, G or S);[25] and (3) the tracking wages method which involves actually tracking total wages subject to federal income tax withholding with modifications comparable to those in the modified box 1 method.[26]

Hedging transactions

The proposed regulations require that gains or losses on hedges are to be taken into account in determining domestic production gross receipts if the hedge involves the purchase of supplies used in the business,[27] the hedge involves sales of stock in trade of the taxpayer or other property of a kind that would be included in inventory if on hand at the close of the taxable year, or property held for sale to customers in the ordinary course of the trade or business.[28] If the hedge involves the *purchase* of stock in trade, inventory property or property held for sale, gains and losses are taken into account in determining the cost of goods sold.[29]

Minerals

Under the regulations, gross receipts from mineral royalties and net profits interests, other than those derived from operating mineral interests, are treated as returns on passive interests in mineral properties, with the owner making no expenditure for operation or development, and are not treated as domestic production gross receipts.[30]

Related person

The statute makes it clear that the term "domestic production gross receipts" does not include gross receipts derived from property leased, licensed or rented by the taxpayer for use by a related person.[31] A person is treated as related if both are treated as a single employer under either I.R.C. § 52(a) or (b) (without regard to I.R.C. § 1563(b)) or I.R.C. § 414(m) or (o).[32]

The proposed regulations include exceptions—(1) for situations where the property is leased to a related person if the property is held for sublease or is subleased to an *unrelated* person for the ultimate use of the unrelated person and (2) to a license to a related person for reproduction and sale, exchange, lease, rental or sublicense to an unrelated person for the ultimate use of the unrelated person.[33]

Trusts or estates

Under the regulations, for grantor trusts[34] a person is treated as owning all or part of the trust and reports qualified production activities income as if the income had been generated by activities performed directly by the owner.[35] For a non-grantor trust or estate, all income and expense items must be allocated among the trust or estate and its beneficiaries based on the proportion of distributable net income deemed to be distributed to that beneficiary for the taxable year.[36]

Thus, a trust or estate may claim the deduction to the extent that qualified production activity income is allocated to the trust or estate but the deduction applies at the beneficiary level.[37]

Agricultural cooperatives

The proposed regulations clarify that a cooperative may, at its discretion, pass through some, all or none of the allowable deduction to its patrons.[38] In order for a patron to qualify for the deduction, the cooperative must designate the patron's portion of the deduction in a written notice mailed by the cooperative to its patrons not later than the 15th day of the ninth month following the close of the cooperative's taxable year.[39] The amount of the patron's deduction is to be reported on Form 1099-PATR issued to the patron.[40] A cooperative patron of a federated cooperative may pass the deduction to its member patrons.[41]

To avoid duplication of benefits, the proposed regulations specify that the patronage dividends and per-unit allocations received by a patron from a cooperative that are taken into account as part of the cooperative's computation of qualified production activities income, may not be taken into account in computing the patron's QPAI from its own activities.[42]

The W-2 wage limitation is to be applied only at the cooperative level whether or not the cooperative chooses to pass through some or all of the deduction.[43] Patrons may claim the deduction without regard to the taxable income limitation.[44]

If an audit determines (or an amended return reports) that the amount of the deduction passed through to the patrons exceeded the amount allowable, recapture occurs *at the cooperative level*.[45]

Costs

In order to determine its qualified production activities income for the taxable year, a taxpayer must subtract from its domestic production gross receipts the cost of goods sold which is allocable to the DPGR, other expenses and deductions directly allocable to DPGR and a ratable portion of other deductions not directly allocable to DPGR or another class of income.[46] A taxpayer's costs must be determined using the taxpayer's method of accounting for federal income tax purposes.[47]

The proposed regulations specify that, for purposes of determining the cost of goods sold allocable to domestic production gross receipts, "cost of goods sold" includes the costs that would have been included in ending inventory if the goods sold during the year were on hand at the end of the year.[48] However, any reasonable method may be used to allocate indirect costs between DPGR and non-DPGR if the taxpayer's books do not or cannot, without undue burden or expense, identify the cost of goods sold allocable to DPGR.[49]

The proposed regulations provide three methods for allocating and apportioning deductions[50]—

• The so-called "Section 861" method is required to be used unless the taxpayer is eligible for and chooses to use either the "simplified deduction" method or the "small business simplified" method.[51] Deductions are allocated to DPGR by applying the regulations under I.R.C. § 861.[52]

• Under the simplified deduction method, deductions are apportioned between DPGR and other receipts based on relative gross receipts.[53] A taxpayer may use the simplified deduction method if the taxpayer has average annual gross receipts of $25,000,000 or less or total assets at the end of the taxable year of $10,000,000 or less.[54]

• The small business simplified overall method may be used by taxpayers with average annual gross receipts of $5,000,000 or less or be a taxpayer eligible to use the cash method of accounting.[55] The use of this method is further limited by specifying that a small business taxpayer is a taxpayer with gross receipts of $5,000,000 or less and cost of goods sold and deductions (excluding NOL deductions and deductions not attributable to the conduct of a trade or business) for the current year of $5,000,000 or less.[56] Also, taxpayers engaged in the trade or business of farming can use this method if not required to use the accrual method of accounting under I.R.C. § 447.[57]

Under this method, the ***total*** costs are apportioned based on relative gross receipts.[58] For pass-through entities eligible to use this method, the small business simplified overall method is applied at the pass-through entity level.[59]

Pass-through entities

The deduction is available at the owner level for pass-through entities.[60] Each owner computes its deduction by taking into account its proportionate share of the pass-through entity's items, cost of goods sold and gross receipts.[61] The owner of a pass-through entity need not be engaged directly in the entity's trade or business in order to claim a deduction on the basis of that owner's share of the pass-through items.[62]

In determining its deduction, an owner of a pass-through entity is to aggregate items of income and expense of the entity (including W-2 wages) with its own items of income and expense (including W-2 wages) for purposes of apportioning deductions to DPGR.[63] The wage limitation must be applied at each level in a tiered entity.[64]

Footnotes

[1] Prop. Treas. Reg. §§ 1.199-1 through 1.199-8.

[2] I.R.C. § 199.

[3] See generally, 4 Harl, *Agricultural Law* § 28.05[21] (2005); Harl, *Agricultural Law Manual* § 4.03[15] (2005). See also Harl, "Guidance on New Domestic Production Deduction," 16 *Agric. L. Dig*. 25 (2005).

[4] I.R.C. § 199(a).

[5] I.R.C. § 199(b)(1).

[6] I.R.C. § 199(d)(5).

[7] See Prop. Treas. Reg. § 1.199-8(b).

[8] Prop. Treas. Reg. § 1.199-3(e)(1).

[9] For a discussion on the numerous standards imposed in the Internal Revenue Code of the management required to achieve trade or business status, see Harl, "Guidance on New Domestic Production Deduction," 16 *Agric. L. Dig*. 25, 26 (2005).

[10] I.R.C. § 199(c)(1).

[11] Prop. Treas. Reg. § 1.199-1(e).

[12] Sec. 4.03(1), I.R.B. 2005-7, 498.

[13] Prop. Treas. Reg. § 1.199-1(c)(2)(i).

[14] *Id.*

[15] *Id.*

[16] Sec. 4.03(2), I.R.B. 2005-7, 498.

[17] Prop. Treas. Reg. § 1.199-1(d)(2).

[18] *Id.*

[19] I.R.C. § 199(b)(1).

[20] Prop. Treas. Reg. § 1.199-2(a)(1).

[21] *Id.*

[22] I.R.B. 2005-7, 498.

[23] Prop. Treas. Reg. § 1.199-1(f)(2).

[24] Prop. Treas. Reg. § 1.199-1(f)(2)(i).

[25] Prop. Treas. Reg. § 1.199-1(f)(ii).

[26] Prop. Treas. Reg. § 1.199-1(f)(iii).

[27] Prop. Treas. Reg. § 1.199-3(h)(3)(i)(C).

[28] Prop. Treas. Reg. § 1.199-3(h)(3)(i)(B).

[29] Prop. Treas. Reg. § 1.199-3(h)(3)(i)(A).

[30] Prop. Treas. Reg. § 1.199-3(h)(9).

[31] I.R.C. § 199(c)(7).

[32] Prop. Treas. Reg. § 1.199-3(b)(1).

[33] Prop. Treas. Reg. § 1.199-3(b)(2).

[34] I.R.C. §§ 671-679.

[35] Prop. Treas. Reg. § 1.199-5(c).

[36] Prop. Treas. Reg. § 1.199-5(d).

[37] Prop. Treas. Reg. § 1.199-5(d)(1).

[38] Prop. Treas. Reg. § 1.199-6(d).

[39] Prop. Treas. Reg. § 1.199-6(d).

[40] Prop. Treas. Reg. § 1.199-6.

[41] Prop. Treas. Reg. § 1.199-6(d).

[42] Prop. Treas. Reg. § 1.199-6(h).

[43] Prop. Treas. Reg. § 1.199-6(e).

[44] Prop. Treas. Reg. § 1.199-6(d).

[45] Prop. Treas. Reg. § 1.199-6(f).

[46] I.R.C. § 199(c)(1).

[47] Prop. Treas. Reg. § 1.199-4(b)(1).

[48] Prop. Treas. Reg. § 1.199-4(b)(1).

[49] Prop. Treas. Reg. § 1.199-4(b)(2).

[50] Prop. Treas. Reg. § 1.199-4(d), (e), (f).

[51] Prop. Treas. Reg. § 1.199-4(d)(1).

[52] *Id.*

[53] Prop. Treas. Reg. § 1.199-4(e)(1).

[54] Prop. Treas. Reg. § 1.199-4(e)(1).

[55] Rev. Proc. 2002-28, 2002-1 C.B. 815.
[56] Prop. Treas. Reg. § 1.199-4(f).
[57] Prop. Treas. Reg. § 1.199-4(f)(2).
[58] Prop. Treas. Reg. § 1.199-4(f)(1).
[59] *Id.*
[60] Prop. Treas. Reg. § 1.199-5.
[61] Prop. Treas. Reg. § 1.199-5(a)(1).
[62] See Prop. Treas. Reg. § 1.199-5.
[63] Prop. Treas. Reg. § 1.199-5(a)(1).
[64] Prop. Treas. Reg. § 1.199-5(f).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

ANIMALS

HORSES. The defendant was charged with cruelty to animals after two of the defendant's horses were found in a starved condition without access to food or water. The horses were initially observed by an electrician working on neighboring farms who called the sheriff. The sheriff observed the horses in an open pasture on an abandoned farmstead. The defendant claimed that the pasture was rented by the defendant but failed to provide any evidence of the lease or its terms. The defendant challenged the evidence of the condition of the horses as obtained by an illegal search by the sheriff. The court held that the "open pasture" rule allowed the evidence to be considered by the trial court in that the defendant had no expectation of privacy for horses kept in an open field. **Nebraska v. Ziemann, 2005 Neb. App. LEXIS 248 (Neb. Ct. App. 2005)**.

BANKRUPTCY

GENERAL

EXEMPTIONS

HOMESTEAD. The debtor had raised feeder pigs in the past but had ceased doing so for three years when the bankruptcy petition was filed. The debtor intended to resume farming after the bankruptcy. The debtor's estate included a one-half interest in $8,000 in corn which was to be liquidated and a shed which was used to store farm equipment, a truck and property relating to the debtor's electrical business. The debtor claimed an exemption in the corn and included the shed in the exempt homestead. A creditor objected to both exemptions because the property was not necessary for the farm. The court held that the corn was not eligible for the feed exemption of Iowa Code § 627.6(11)(b) because the debtor had no animals to feed. The court also held that the shed was included in the homestead because the shed was used in the farm operation. The court held that the concurrent use of a portion of the shed for the electrical business was not sufficient to prohibit the exemption. ***In re* Sadler, 327 B.R.654 (Bankr. N.D. Iowa 2005)**.

FEDERAL TAX

DISCHARGE. The debtor filed joint income tax returns with the debtor's spouse for 1999, 2000 and 2001, with all returns filed within three years of the debtor's filing for bankruptcy. The taxes for those years were assessed within 240 days of the bankruptcy filing. In each tax year, the debtor's income was small enough to not require the debtor individually to file an income tax return but the addition of the spouse's income was sufficient to require the joint return. The debtor argued that, because the debtor was not required to file a return in each year, Sections 507(a)(8)(A), (B), 523(a)(1)(A) allow the discharge of the debtor's tax liability for those years. The court held that Section 507(a)(8)(B) (taxes assessed within 240 days before the bankruptcy filing) did not apply to taxes for which a return was "required;" therefore, it was irrelevant whether or not the debtor was required to file a return in order for Section 507(a)(8)(B) to apply to make the taxes nondischargeable. The court also held that the Section 507(a)(8)(A) provision for required returns applied not to whether a taxpayer was required to file a return but whether the tax involved required a return to be filed. Because a return is required for income taxes, the debtor's 1999, 2000 and 2001 income tax liability was nondischargeable. ***In re* Carlin, 328 B.R. 221 (D. Kan. 2005), *aff'g*, 318 B.R. 556 (Bankr. D. Kan. 2004)**.

CONTRACTS

FRAUD. The plaintiff had purchased hog feed from the defendant and the plaintiff claimed that the feed was contaminated with dioxin because the pigs were rejected by a purchaser for that reason. The plaintiff, however, failed to present any direct evidence from the purchaser that the pigs were rejected because of dioxin contamination from the feed. The court held that indirect evidence of the reason for the rejection was inadmissable hearsay and left the plaintiff without any evidence of the cause of the rejection. The court held that the case was to be dismissed for lack of an essential element of fraud. **Archer-Daniels-Midland Co. v. Beadles Enterprises, Inc., 2005 Ark. App. LEXIS 738 (Ark. Ct. App. 2005)**.

FEDERAL AGRICULTURAL PROGRAMS

MEAT, POULTRY AND EGGS. The FSIS has announced the availability on its web site of information regarding new technologies for use in the production of meat, poultry, and egg products that the FSIS has received and for which FSIS has written a "No Objection" letter. The web site includes brief descriptions of the new technologies in order to increase public and industry awareness of new technologies and foster their use by small and very small plants. **70 Fed. Reg. 60784 (Oct. 19, 2005)**.

TUBERCULOSIS. The APHIS has adopted as final regulations