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Form 8903: Domestic Production Activities Deduction for Pass-Thrus and Other Business Entities

Mastering Complex Determinations, Calculations and Reporting Challenges for the DPAD

WEDNESDAY, FEBRUARY 25, 2015, 1:00-2:50 pm Eastern

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Feb. 25, 2015

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A Brief Commercial

- Strafford Publications
- Profit Point Tax Technologies
- The DPAD Group LLP
- John Manning
- Dan Steele

Basic §199 Mechanics And Terminology

- Domestic Production Gross Receipts (DPGR/Qualified Revenue)
- Non-DPGR (Non-Qualified Revenue)
- Cost of Goods Sold (CGS)
- Below-the-Line or Section 861 Expenses
- Qualified Production Activities Income (QPAI)
- Taxable Income (TI)
- QPAI (or TI) X 9% (or 6%)
- DPAD Capped At 50% Of Properly Allocable “W-2 Wages”

Section 199 – Initial Observations

- Observations From Significant Number Of Fortune 500 Projects
- Process-Driven DPAD Results
- 199 Regulations And IRS Pronouncements – A Significant Volume Of "Authority"
- Application Of Section 861 – A Critical Part Of DPAD Calculation
- A Surprising Number Of Taxpayer-Specific Issues
- More Complexity And Opportunity Than Meets The Eye

Complexity/Opportunity/EPS And Cash

Revenue Classification -- DPGR

- Most Taxpayers Say –
  - “We have made reasonable assumptions about the revenue that qualifies, and we collect data based on those reasonable assumptions.”
  - “We Probably Are Missing Some Opportunities, But They Can’t Be Material.”
  - “If Anything, We May Be Slightly Overstating DPGR.”

- What This Often Means –
  - “We Don’t Have The Resources To Analyze Everything, So We Just Do The Best We Can.”
  - “Our Process Was Set Up In 2005, And We Have Been Too Busy To Revisit It.”
  - “We Are Heavily Reliant On A Process That May Be Flawed.”
  - “We Think We Understand Our Business Operations, But We Really Do Not.”

A Very Imperfect Starting Point

Revenue Classification -- DPGR

- Reporting Too Little DPGR – Happens Frequently
- Understating DPAD by Reporting Too Much DPGR – Happens More Frequently Than You Might Expect
- Revenue Classification Is A Critical First Step
- Impacts Amount of DPGR (Obviously)
- Also Drives The Impact Of Cost Of Goods Sold and Expense Allocation
- Section 199 Regulations Are “Chock Full” Of DPGR Rules
- See Section 199 Outline

Revenue Classification -- DPGR

- Gross Receipts
- Directly Derived From Lease, Rental, License, Sale, Exchange, Or Other Disposition
- Of Qualifying Production Property ("QPP")
- MPGE
- By The Taxpayer
- In Whole Or In Significant Part
- Within The United States

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Revenue Classification – DPGR

- Gross Receipts Derived From Sale/Lease/License Of QPP
  - Substance Over Form
  - Item Identification
  - Shrink Back
  - Aggregate De Minimis Rule
  - Item-Specific De Minimis Rules

Revenue Classification -- DPGR

- MPGE
- MPGE By The Taxpayer
  - Who Is The Taxpayer?
  - Which Activities Are The Taxpayer's Activities?

  - Consolidated Group
  - EAG and Partnership Attribution
  - Qualifying In Kind Partnership
  - Benefits and Burdens Of Ownership
  - Government Contractors

Revenue Classification – DPGR

- MPGE By The Taxpayer In Whole Or In Significant Part
  - How Much Is Enough?
  - "We Don't Really Do Much" Or "We Don't Really Do Much In The U.S."
  - "Substantial In Nature" – Obviously, Calls For Judgment (Which Calls For An Accurate Understanding Of The Facts)
  - The Taxpayer Does Not Have To Satisfy The Safe Harbor!
  - Significant Third-Party Or Imported Content Is Not A Show Stopper
  - Within The U.S.

DPGR – Specific Industries

- Qualified Films – Motion Pictures, Videos, And Other Programming
  - See Outline For Summary Of Special Rules
- Electricity, Natural Gas, Or Potable Water
  - Generation, Extraction, And Processing; Not Transmission
  - Negative QPAI vs. Nonqualified Loss
- Construction Of Real Property
  - Inherently Permanent Structures And Infrastructure
  - Substantial Renovations
  - Support Of Oil And Gas Operations

DPGR – Specific Industries

- Engineering Or Architectural Services For A Construction Project

- Computer Software
  - Sale Or License
  - May Be An Integral Part Of Other Property
  - Video Games
  - Online Software?
  - Updates May Be Substantial In Nature
  - Does Your Client/Business Hire Programmers?

Cost Of Goods Sold

- CGS Is Equal To Beginning Inventory Plus Purchases And Production Costs Incurred During The Taxable Year And Included In Inventory Costs, Less Ending Inventory
- §1.199-4(b)(1) – "CGS Allocable To DPGR"
- Guidance (In Regulations Or Otherwise) Is Limited
- Reasonable Method . . . Based On All Facts And Circumstances
- Specific Identification?
- Apportionment?
- Indirect Costs?

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Treatment Of “Below The Line” Expenses

- Expenses Not In CGS (Lines 12-26 on Form 1120)
- Simplified Deduction Method
  - Gross Receipts Ratio
  - Average Gross Receipts Of $100M Or Less, Or $10M Or Less Of Assets
- Small Business Simplified Overall Method
  - Gross Receipts Ratio Applied To “Total Costs”
  - Average Gross Receipts Of $5M Or Less, And Certain Cash Basis Taxpayers
- Section 861 Method
  - §§1.861-8 Through 1.861-17, and 1.861-8T Through 1.861-14T
  - With A Few Modifications In The §199 Regulations

Section 861 Method

- Can Be A Major Driver Of DPAD Results
- Requires Careful Application Of A Complex Set Of Rules
- Expenses Directly Related To DPGR (Or Non-DPGR) Should Be Allocated To Those Receipts
- Other Expenses Require Apportionment
  - Under A Reasonable Method
  - Or Pursuant To Specific Rules (Interest; Taxes; R&D; Charitable Contributions)
  - “Feels About Right” Or “Seems Reasonable”?

If Taxable Income > QPAI, Revisit Your Section 861 Methodologies

Prior Period Expenses

- Can Be A Significant Opportunity
- Expenses That Relate To Pre-2005 Activities, But Are Deductible In A Post-2004 Tax Year
- Qualified Pension Plan Funding
- Non-Qualified Pension Plan Payouts
- Stock Option Expense
- Judgments/Settlements
- Environmental Claims and Remediation

Prior Period Expenses

- Amounts Subject To Section 861 Method
  - Post-2004 Deductions That Factually Relate To Pre-2005 Gross Receipts Are Not Properly Allocable To DPGR
  - IRS May Challenge Your Methodology, But They Have Accepted The Concept

- Amounts Includible In CGS
  - See CCA 200946037 – IRS Contends That Amounts In CGS May Not Be Treated As Prior Period Expenses
  - And, Of Course, IRS Interprets §263A Rather Expansively
  - Very Good Arguments For Why IRS Position Is Wrong

Pass-Thru Entities

- Focusing On Partnerships, But Regulations Also Have Similar Rules For S Corps, Trusts, And Estates
- General Rule – Partnership Reports Information To Partners; Then Each Partner Does Its Own Partner-Level QPAI Calculation
  - Form K-1, Line 13 – DPGR, Non-DPGR, Q COS, NQ COS, Expenses Subject To Section 861 Method, and Wages
  - Section 861 Method Is Applied At Partner Level
- Rev. Proc. 2007-34 – Certain Eligible Partnerships May Calculate QPAI And W-2 Wages At Partnership Level
  - At Least 100 Partners Or Total Costs Of $100M Or Less
  - Partners Simply Add The Results To Non-Partnership Results
  - Partnership Items And Attributes Are Ignored

Pass-Thru Entities

- Trap For The Unwary – Generally, Activity Attribution Does Not Apply Between Partners And Partnerships
  - Use Of Partnership Could Disqualify Certain Revenue
  - But See Qualifying-In-Kind Partnership And EAG Rules
  - Also A Special Attribution Rule For Qualified Films

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Expanded Affiliated Groups

- Consolidated Group, Plus More-Than-50%-Owned Subsidiaries
- All "Members" Generally Are A Single Corporation
- Each "Member" Computes TI, QPAI, And W-2 Wages
- "Disposing Member" Generally Is Treated As Conducting The Activities Of Other Members
- Attribution Generally Does Not Apply For Construction, Engineering, Or Architectural Services, Except Within A Consolidated Group

EAG DPAD Calculation

- Consolidated Group Is One Member
- Each Member Determines Its Own TI, QPAI, And W-2 Wages
- Then Aggregate The Separate Determinations To Apply Limitations And Calculate The EAG's DPAD
- Then Allocate The EAG's DPAD Based On Each Member's Share Of EAG QPAI

Other Rules -- §1.199-8

- Allocations May Be Made Under Any Reasonable Method Based On All Facts And Circumstances, Unless Regulations Specify A Method
- Coordination With AMT
- Attribution Generally Does Not Apply In Connection With Non-recognition Transactions (§§351/721/731/1031), But See Exceptions For EAGs, EAG Partnerships, And §381(a) Transactions
- Treatment Of §481 Adjustments
- Pre-2005 Disallowed Losses And Deductions Do Not Impact DPAD If Allowed Post-2004

Taxable Income Limitation

- Form 1120, Line 30 Plus DPAD On Line 25
- A "Moving Target"
  - Obviously, A Very Long List Of Items Impact Taxable Income
  - Gain On Asset And Stock Dispositions
  - Cash Repatriations
  - NOL Carry Forwards And Carry Backs
  - Bonus Depreciation
  - Pension Funding Decisions (Late In Return Prep Season)
  - IRS Audit Adjustments

Maximize Cash And EPS

W-2 Wages Limitation

- For Most Taxpayers This Limitation Is Not A Problem
- DPAD Is Capped At 50% Of "W-2 Wages" Allocable To DPGR
- Are The Wages (CGS And Below-The-Line) In The QPAI Calculation At Least 200% Of DPAD?
- If Not, Consider The Wage Expense Safe Harbor (§1.199-2(e)(2)(ii))
- See Rev. Proc. 2006-47 For W-2 Wages Guidance
- Special Rules Apply To Qualified Films, Short Taxable Years, And Acquisition/Disposition Of A Trade Or Business

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