For tax years beginning in 2007, 2008, or 2009, the percentage used on line 13 of Form 8903 increases from 3% to 6%. See *Purpose of Form*.

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You can find the final regulations in T.D. 9317 on page 957 of Internal Revenue Bulletin (I.R.B.) 2007-16 at www.irs.gov/pub/irs-irbs/irb07-16.pdf.

You can find Rev. Proc. 2007-34 on page 1345 of I.R.B. 2007-23 at www.irs.gov/pub/irs-irbs/irb07-23.pdf.

You can find Rev. Proc. 2007-35 on page 1349 of I.R.B. 2007-23 at www.irs.gov/pub/irs-irbs/irb07-23.pdf.

2007

Department of the Treasury
Internal Revenue Service

Instructions for Form 8903

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Form

domestic production activities deduction (DPAD)

Domestic Production Activities Deduction

Section references are to the Internal Revenue Code unless otherwise noted.

What's New

Final regulations. Final regulations under section 199, issued on March 20, 2007, ~~in Treasury Decision 9317,~~ clarify the following.

- Generally, advertising and product-placement income are not included in domestic production gross receipts (DPGR) for purposes of determining qualified production activities income (QPAI). For more information, including exceptions to this rule, see Regulations sections 1.199-3(i)(5)(i) and (ii).
- Generally, gross receipts derived from customer and technical support, telephone and other telecommunication services, Internet access services, online banking services, and providing access to online electronic books, newspapers and journals, are not included in DPGR for purposes of determining QPAI. See Regulations section 1.199-3(i)(6)(ii) through (v) for more information, including exceptions to the above rule.
- Cooperatives ~~compute~~ QPAI without any deduction for patronage dividends, per-unit retain allocations, or non-patronage distributions under section 1382(b) or (c). See Regulations section 1.199-6(c) for more information.

figure

These regulations apply to tax years beginning on or after March 20, 2007; however, you can choose to apply them to all tax years beginning after December 31, 2004.

Qualifying in-kind partnerships. A partnership engaged solely in the extraction and processing of minerals within the United States is considered a qualifying in-kind partnership under section 199. See Rev. Rul. 2007-30. For additional information on qualifying in-kind partnerships, see page 4.

New rules for certain S corporations and partnerships. S corporations and partnerships that meet certain requirements can choose to figure QPAI and W-2 wages at the entity level and report the allocated portion of QPAI and W-2 wages to S corporation shareholders or partners. See these instructions and Rev. Proc. 2007-34 for more information.

, with tax years beginning after May 17, 2006,

Form

Statistical Sampling. For tax years beginning after December 31, 2004, you are generally allowed to use statistical sampling for purposes of calculating the domestic production activities deduction (DPAD). For details about acceptable statistical sampling methodologies, see Rev. Proc. 2007-35, ~~2007-23 I.R.B. 1349~~.

~~You can find the final regulations issued on March 20, 2007, in T.D. 9317 on page 957 of Internal Revenue Bulletin (I.R.B.) 2007-16 at *www.irs.gov/pub/irs-irbs/irb07-16.pdf.* You can find Rev. Rul. 2007-30 on page 1277 of I.R.B. 2007-21 at *www.irs.gov/pub/irs-irbs/irb07–21.pdf.* You can find Rev. Proc. 2007-34 on page 1345 of I.R.B. 2007-23 at *www.irs.gov/pub/irs-irbs/irb07-23.pdf.* You can find Rev. Proc. 2007-35 on page 1317 of I.R.B. 2007-22 at *www.irs.gov/pub/irs-irbs/irb07-22.pdf.*~~

General Instructions

Purpose of Form

Use Form 8903 to figure your DPAD.

Your DPAD is generally 6% of the smaller of:

1. Your qualified production activities income (QPAI), or
2. Your adjusted gross income for an individual, estate, or trust (taxable income for all other taxpayers) figured without the DPAD.

However, your DPAD generally cannot be more than 50% of the Form W-2 wages you paid to your employees (including Form W-2 wages allocated to you on a Schedule K-1).

Additional Guidance

These instructions cover DPAD rules from Internal Revenue Code section 199. They also cover a few rules addressing common situations from additional guidance. For more information on the DPAD rules, generally see Regulations sections 1.199-1 through 1.199-9 as well as Temporary Regulations sections 1.199-2T, 1.199-3T, 1.199-5T, 1.199-7T, and 1.199-8T.

For guidance on figuring Form W-2 wages, see *Form W-2 Wages* on page 6.

For recent guidance on computer software and computer-related services, see Regulations sections ~~1.199-5 and 1.199-6 in Treasury Decision 9317~~.

You can find Rev. Rul. 2007-30 on page 1277 of I.R.B. 2007-21 at www.irs.gov/pub/irs-irbs/irb07-21.pdf.

Who Must File

Individuals, corporations, cooperatives, estates, and trusts use Form 8903 to figure their allowable DPAD from certain trade or business activities. Shareholders of S corporations and partners use information provided by the S corporation or partnership to figure their allowable DPAD. Beneficiaries of an estate or trust use information provided by the estate or trust to figure their allowable DPAD. Patrons of certain agricultural or horticultural cooperatives may be allocated a share of the cooperative's DPAD.

However, unless you were allocated a share of a cooperative's DPAD or you are a member of an expanded affiliated group (EAG), you will not be allowed a DPAD unless you can enter on Form 8903 a positive amount for all three of the following.

- Qualified production activities income (QPAI).
- Adjusted gross income for an individual, estate, or trust (taxable income for all other taxpayers).
- Form W-2 wages you paid to your employees. If you did not pay any Form W-2 wages (or have Form W-2 wages allocated to you on a Schedule K-1), you cannot claim a DPAD.

For details, see the discussions of these three items that begin on page 3.

1.199-3

Married individuals filing a joint income tax return figure the deduction on one Form 8903 using the applicable items of both spouses.

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Definitions and Special Rules

Trade or business. QPAI and Form W-2 wages are figured by only taking into account items that are attributable to the actual conduct of a trade or business. An activity qualifies as a trade or business if your primary purpose for engaging in the activity is for income or profit and you are involved in the activity with continuity and regularity. For example, a sporadic activity or a hobby does not qualify as a trade or business.

Coordination with other deductions. Expenses that otherwise would be taken into account for purposes of figuring the DPAD are only taken into account if and to the extent the losses and deductions from all of your activities are not disallowed by any of the following provisions.

- Basis limits on a partner's share of partnership losses.
- Basis limits on a shareholder's share of S corporation losses.
- At-risk rules.
- Passive activity rules.
- Any other provision of the Internal Revenue Code.

If only a portion of your losses or deductions are allowed in the current tax year, a proportionate share of the losses or deductions that reflect expenses allocated to your gross receipts from qualified production activities, after applying the provisions listed above, is taken into account for purposes of figuring the DPAD for the current tax year. If any of the losses or deductions disallowed for tax years beginning after 2004 are allowed in a later tax year, a proportionate share of the expenses reflected in those losses or deductions is taken into account in figuring the DPAD in the later tax year.

A net operating loss under section 172 is figured without the section 199 deduction.

Form

S corporations and partnerships. The DPAD is applied at the shareholder or partner level. ~~For tax years beginning after May 17, 2006,~~ certain S corporations and partnerships can figure QPAI and W-2 wages at the entity level and allocate and report these amounts to shareholders and partners. See *Qualified Production Activities Income (QPAI)* and *Form W-2 Wages* for more information.

All other S corporations and partnerships need to provide each shareholder or partner with information the shareholder or partner needs to figure the DPAD.

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Estates and trusts. Generally, an estate or trust will figure its:

- QPAI (which may be less than zero), and
- Form W-2 wages it paid to its employees (including Form W-2 wages allocated to it on a Schedule K-1).

These items are then allocated among the estate or trust and its beneficiaries based on the relative proportion of the estate's or trust's distributable net income (DNI) for the tax year that is distributed or required to be distributed to the beneficiary or retained by the estate or trust. If the estate or trust has no DNI for the tax year, QPAI and Form W-2 wages are allocated entirely to the estate or trust.

Although estates and trusts actually allocate their QPAI and Form W-2 wages to beneficiaries as discussed above, when completing Form 8903 they must reduce the amounts reported on lines 8 and 16 to reflect the portion of those amounts that were allocated to beneficiaries as QPAI or Form W-2 wages. For details, see *Specific Instructions* on page 8.

Agricultural and horticultural cooperatives. Generally, an agricultural or horticultural cooperative can choose to allocate all, some, or none of its allowable DPAD (but not QPAI) to its patrons. For this purpose, an agricultural or horticultural cooperative is an organization described in section 1381 that is engaged in ~~the~~:

- Manufacturing, production, growth, or extraction (MPGE) in whole or significant part of any agricultural or horticultural product, or
- Marketing of agricultural or horticultural products.

ing

An organization engaged in marketing agricultural or horticultural products is treated as ~~having~~ MPGE in whole or significant part any qualifying production property marketed by the organization that its patrons have MPGE. For this purpose, agricultural or horticultural products include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production.

Allocation of cooperative DPAD. A patron who receives a patronage dividend or qualified per-unit retain certificate can be allocated any portion of the DPAD allowed with respect to the portion of the QPAI to which such payment is attributable. The cooperative must identify the portion of its DPAD allocated to a patron in a written notice mailed to the patron no later than the 15th day of the 9th month following the close of the cooperative's tax year. The allocated DPAD will also be reported to patrons that are not corporations on Form 1099-PATR, Taxable Distributions Received From Cooperatives.

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Note. Patrons of agricultural or horticultural cooperatives cannot include any distributions of qualified payments from the cooperative in the computation of their DPAD.

Expanded affiliated groups (EAGs). All members of an EAG are treated as a single corporation to figure their DPAD. The DPAD is allocated among the members of the group in proportion to each member's respective amount (if any) of QPAI. See the instructions for line 22 before completing Form 8903.

An EAG is an affiliated group as defined in section 1504(a) determined:

- By substituting "more than 50 percent" for "at least 80 percent" each place it appears, and
- Without regard to paragraphs (2) and (4) of section 1504(b).

A corporation's status as a member of an EAG is determined on a daily basis. Also, if a corporation joins or leaves an EAG, its status as a member of the EAG is determined at the end of the day on which it joins or leaves the EAG.

If all the capital and profits interests of a partnership are owned by members of a single EAG at all times during the partnership's tax year, the partnership and all members of the group are treated as a single taxpayer to figure their domestic production gross receipts (DPGR) for that tax year.

Alternative minimum tax (AMT). For taxpayers other than corporations, the DPAD used to determine regular tax is also used to determine alternative minimum taxable income (AMTI). Corporations use AMTI (instead of taxable income) figured without the DPAD to figure the alternative minimum DPAD used to determine AMTI.

For details, see the Instructions for Form 4626, Alternative Minimum Tax—Corporations.

generally Style Guide p. 8

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for patronage dividends, per-unit retain allocations, or non-patronage distributions

Qualified Production Activities Income (QPAI)

Your allowable DPAD generally cannot be more than 6% of your QPAI. If you do not have QPAI, you generally are not allowed a DPAD. However, you do not need QPAI to claim a DPAD you are allocated as a patron of an agricultural or horticultural cooperative.

S corporations and partnerships. S corporations and partnerships~~, with tax years beginning after May 17, 2006,~~ that meet specific requirements, can choose to figure QPAI at the entity level and allocate QPAI to shareholders or partners. The shareholder or partner then combines the allocated portion with QPAI from other sources on Form 8903 to determine the DPAD. S corporations or partnerships that are not eligible to figure QPAI at the entity level must report each shareholder's or partner's share of deductions, expenses, or losses on Schedule K-1 with other information the shareholder or partner needs to figure their DPAD.

QPAI from an estate or trust. An estate or trust will figure its QPAI and report each beneficiary's share on Schedule K-1 (Form 1041).

Figuring QPAI. QPAI is the excess (if any) of:

1. Domestic production gross receipts (DPGR), over
2. The sum of:

a. Cost of goods sold allocable to DPGR, and

b. Other expenses, losses, or deductions (other than the DPAD) allocable to DPGR.

figure 19

Cooperatives. For tax years beginning ~~on or~~ after March ~~20~~, 2007, cooperatives ~~calculate~~ QPAI without any deduction under section 1382(b) or (c). However, you can choose to apply this rule to tax years beginning after December 31, 2004.

Domestic Production Gross Receipts (DPGR)

Generally, your gross receipts (defined below) derived from the following activities are DPGR.

1. Construction of real property you perform in the United States in your construction trade or business.
2. Engineering or architectural services you perform in the United States in your engineering or architectural services trade or business for the construction of real property in the United States.
3. Any lease, rental, license, sale, exchange, or other disposition of the following.

a. Qualifying production property you manufacture, produce, grow or extract in whole or in significant part in the United States. See *Qualifying Production Property* and *Manufacturing, Producing, Growing, or Extracting,* below for details.

b. Any qualified film you produce.

c. Electricity, natural gas, or potable water you produce in the United States.

In general, gross receipts derived from the following activities are not DPGR.

- Activities not attributable to the actual conduct of a trade or business.
- The sale of food and beverages you prepare at a retail establishment.
- The lease, rental, or license of property between certain persons treated as a single employer.
- The lease, rental, license, sale, exchange, or other disposition of land.
- The transmission or distribution of electricity, natural gas, or potable water.
- Advertising and product-placement; however, see Regulations section 1.199-3(i)(5)(ii) for exceptions.
- Customer and technical support, telephone and other telecommunications services, online services (including Internet access services, online banking services, providing access to online electronic books, newspapers, and journals) and other similar services; however, see Regulations section 1.199-3(i)(6)(iii) for exceptions.

Gross receipts. Gross receipts include the following amounts from your trade or business activities.

- Total sales (net of returns and allowances).
- Amounts received for services, not including wages received as an employee.
- Income from incidental or outside sources (including sales of business property).

Gross receipts are generally not reduced by the:

- Cost of goods sold, or
- Adjusted basis of property (other than capital assets) sold or otherwise disposed of if such property is described in section 1221(a)(1) through (5).

Allocation of gross receipts. You generally must allocate your gross receipts between DPGR and non-DPGR. Allocate gross receipts using a reasonable method that accurately identifies gross receipts that are DPGR. However, if less than 5% of your gross receipts are non-DPGR, you can treat all of your gross receipts as DPGR. Also, ~~under the final regulations,~~ if less than 5% of your gross receipts are DPGR, you can treat all of your gross receipts as non-DPGR.

For details, see Regulations section 1.199-1(d).

Qualifying Production Property

The following are qualifying production property.

- Tangible personal property.
- Computer software.
- Sound recordings.

Tangible personal property. Tangible personal property includes any tangible property other than land, buildings (including structural components), computer software, sound recordings, qualified films, electricity, natural gas, or potable water. Tangible personal property also includes any gas (other than natural gas), chemical, and similar property, such as steam, oxygen, hydrogen, or nitrogen.

Machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs that are contained in or attached to a building constitute tangible personal property.

Note. Local law does not control whether property is tangible personal property.

See Regulation section 1.199-3(j)(2) for more information.

Computer software. In general, computer software includes the following:

- Any program, routine, or sequence of machine-readable code that is designed to cause a computer to perform a desired function or set ~~of~~ functions, and the documentation required to describe or maintain that program or routine. An electronic book online or for download does not constitute computer software.
- Machine-readable code for (1) video games or similar programs, (2) equipment that is an integral part of other property, and (3) typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, even if the program is not designed to operate on a computer as defined in section 168(i)(2)(B).
- Computer programs including, but not limited to, operating systems,

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executive systems, monitors, compilers and translators, assembly routines, utility programs, and application programs.

- Any incidental and ancillary rights that are necessary for the acquisition of the title to, the ownership of, or the right to use computer software, and that are used only in connection with that specific software. These incidental and ancillary rights are not included in the definition of a trademark or trade name under Regulation section 1.197-2(b)(10)(i).

Exception. Computer software does not include any data or information base unless the data or information base is in the public domain and is incidental to a computer program.

Example. If a word processing program includes a dictionary feature that may be used to spell-check a document then the entire program (including the dictionary feature) is a computer software regardless of the form in which the dictionary feature is maintained or stored.

See Regulation section 1.199-3(j)(3) for more information.

Sound Recordings. Sound recordings include any works that result from the fixation of a series of musical, spoken, or other sounds. The definition of sound recordings is limited to the master copy of the recordings (or other copy from which the holder is licensed to make and produce copies), and if the medium (such as compact discs, tapes, or other phonorecordings) in which the sounds may be embodied, is tangible, then the medium is considered tangible personal property.

Exception. Sound recordings do not include the creation of copy-righted material in a form other than a sound recording, such as lyrics or music composition.

See Regulation section 1.199-3(j)(4) for more information.

Manufacturing, Producing, Growing, or Extracting

Manufacturing, producing, growing, and extracting (MPGE) generally include the following trade or business activities.

- Activities related to manufacturing, producing, growing, extracting, installing, developing, improving, and creating qualifying production property.
- Making qualifying production property out of scrap, salvage, or junk material, or 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.
- Storage, handling, or other processing activities (other than transportation activities) in the United States related to the sale, exchange, or other disposition of agricultural products, provided the products are consumed in connection with, or incorporated into, manufacturing, producing, growing, or extracting qualifying production property whether or not by the taxpayer.

For details, see Regulations section 1.199-3(e).

Qualifying in-kind partnerships. In general, partners of qualifying in-kind partnerships are treated as having MPGE the property they receive as a distribution from the partnership. For purposes of section 199, a qualifying in-kind partnership is a partnership engaged in any of the following activities.

- The extraction, refining, or processing of oil, natural gas (as defined in Regulations section 1.199-3(l)(2)), petrochemicals, or products derived from oil, natural gas, or petrochemicals, in whole or significant part within the United States.
- The production or generation of electricity in the United States.
- The extraction and processing of minerals (as defined in Regulations section 1.611-1(d)(5)) within the United States.
- Any other industry or activity designated as an industry or activity of a qualifying in-kind partnership by publication in the Internal Revenue Bulletin.

For more information on qualifying in-kind partnerships, see Regulations section 1.199-9(i), and Temporary Regulations section 1.199-3T(i)(7). For qualifying in-kind partnerships engaged solely in the extraction and processing of minerals, see Rev. Rul. 2007-30 on page 1277 of I.R.B. 2007-21 at *www.irs.gov/pub/irs-irbs/irb07-21.pdf*.

EAG Partnerships. A partnership is an EAG partnership if a single EAG owns all the interests in the capital and profits of the partnership at all times during the tax year. If the requirements are met, the EAG partnership and all members of the EAG are treated as a single taxpayer for purposes of section 199(c)(4).

Special rules apply to the attribution of gross receipts (1) to a member of the EAG from the disposition of property ~~MPGE by~~ an EAG partnership, and (2) to an EAG partnership from the disposition of property ~~MPGE by~~ another EAG partnership, both of which are members of the same EAG. See Regulations section 1.199-3T(i)(8) for more information, exceptions, and other rules.

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Cost of Goods Sold

For purposes of the DPAD, cost of goods sold includes the:

- Cost of goods sold to customers, and
- Adjusted basis of ~~other~~ property you sold or otherwise disposed of in your trade or business.

Allocation of cost of goods sold. Generally, you must allocate your cost of goods sold between DPGR and non-DPGR using a reasonable method. If you use a method to allocate gross receipts between DPGR and non-DPGR, the use of a different method to allocate cost of goods sold will not be considered reasonable, unless it is more accurate. However, if you qualify to use the small business simplified overall method (discussed on page 5), you can use it to apportion both cost of goods sold and other deductions, expenses, and losses between DPGR and non-DPGR.

For details, see Regulations section 1.199-4.

W-2 Wages. To determine the amount of W-2 wages to include in cost of goods sold, see *Wage expense included in cost of goods sold,* on page 7.

Other Deductions, Expenses, or Losses

Other deductions, expenses, or losses include all deductions, expenses, or losses (other than cost of goods sold and employee business expenses) from a trade or business.

Allocation and apportionment of other deductions, expenses, or losses. You can generally use one of the following three methods to allocate and apportion other trade or business deductions, expenses, or losses between DPGR and non-DPGR.

- Small business simplified overall method.
- Simplified deduction method.
- Section 861 method.

However, do not allocate and apportion a net operating loss deduction or deductions not attributable to the conduct of a trade or business to DPGR under any of the methods.

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<insert>", which is $450 ($750 minus $300)."

You have $240 of cost of goods sold allocable to DPGR.

S corporations and partnerships. S corporations and partnerships, ~~with a tax year beginning after May 17, 2006,~~ that meet specific requirements, can choose to figure QPAI at the entity level and allocate the QPAI to shareholders or partners. S corporations or partnerships that are not eligible to figure QPAI under those rules, must report each shareholder's or partner's share of its deductions, expenses, or losses on Schedule K-1 with other information the shareholder or partner needs to figure their DPAD.

Estates and trusts. An estate or trust allocates directly allocable trade or business deductions, expenses, or losses between DPGR and non-DPGR under Regulations section 1.652(b)-3. An estate or trust that is eligible must use the simplified deduction method to allocate indirectly allocable trade or business deductions, expenses, or losses between DPGR and non-DPGR. Otherwise, the estate or trust uses the section 861 method to allocate these indirect items.

Small Business Simplified Overall Method

You generally can use the small business simplified overall method to apportion cost of goods sold and other deductions, expenses, and losses between DPGR and non-DPGR if you meet any of the following tests.

- You are engaged in the trade or business of farming and are not required to use the accrual method of accounting (see section 447).
- Your average annual gross receipts (defined below) are $5 million or less.
- You are eligible to use the cash method of accounting under Rev. Proc. 2002-28. You can find Rev. Proc. 2002-28 on page 815 of I.R.B. 2002-18 at *www.irs.gov/pub/irs-irbs/irb02-18.pdf*.

Under the small business simplified overall method, your total cost of goods sold and other deductions, expenses, and losses are ratably apportioned between DPGR and non-DPGR based on relative gross receipts.

Example. Your total cost of goods sold and other trade or business deductions, expenses, or losses are $400 and do not include a net operating loss deduction. You have $1,000 total gross receipts and $750 DPGR. Your DPGR equal 75% of your total gross receipts. Under the small business simplified overall method, you subtract $300 ($400 × .75) of your total cost of goods sold and other trade or business deductions, expenses, or losses from your DPGR to figure your QPAI.

Average annual gross receipts. For this purpose, your average annual gross receipts are your average annual gross receipts for the preceding 3 tax years. If your business has not been in existence for 3 tax years, base your average on the period it has existed. Include any short tax years by annualizing the short tax year's gross receipts by (a) multiplying the gross receipts for the short period by 12 and (b) dividing the result by the number of months in the short period.

Excluded entities. Estates and trusts cannot use the small business simplified overall method. Also, certain oil and gas partnerships and certain partnerships owned by expanded affiliated groups cannot use the small business simplified overall method.

For details, see Regulations section 1.199-4(f).

S corporations and partnerships. An S corporation or partnership can choose to use the small business simplified overall method to figure QPAI at the entity level and allocate that QPAI to shareholders or partners if it meets the requirements of an eligible small pass-through entity. A shareholder or partner who is allocated QPAI from an eligible small pass-through entity must report that QPAI on line 7. An S corporation or partnership is an eligible small pass-through entity if it meets each of the following requirements for the current tax year.

- ~~Satisfies~~ one of the following requirements: (a) it has average annual gross receipts for the three tax years preceding the current tax year of $5 million or less, (b) it is engaged in the trade or business of farming and is not required to use the accrual method of accounting, or ~~(3)~~ it is eligible to use the cash method of accounting under Rev. Proc 2002-28, 2002-1 C.B. 815 (that is, it has average annual gross receipts of $10 million or less and is not excluded from using the cash method under Section 448 of the Internal Revenue Code).
- It has total cost of goods sold and deductions added together of $5 million or less.
- It has DPGR.
- If a partnership, it does not have a partner that is an ineligible partnership (qualifying in-kind partnerships or expanded affiliated group partnerships as defined in Temporary Regulations section 1.199-3T(i)(7) and (8)).

Expanded affiliated groups. For additional rules that apply to expanded affiliated groups, see Regulations section 1.199-4(f)(4).

Simplified Deduction Method

You generally can use the simplified deduction method to apportion other deductions, expenses, and losses (but not cost of goods sold) between DPGR and non-DPGR if you meet either of the following tests.

- Your total trade or business assets at the end of your tax year are $10 million or less.
- Your average annual gross receipts (defined above) are $100 million or less.

Under the simplified deduction method, your other trade or business deductions, expenses, or losses are ratably apportioned between DPGR and non-DPGR based on relative gross receipts.

Example. Your total other trade or business deductions, expenses, or losses are $400 and do not include a net operating loss. You have $1,000 total gross receipts and $600 DPGR. Your DPGR equal 60% of your total gross receipts. Under the simplified deduction method, you subtract $240 ($400 × .60) of your total other trade or business deductions, expenses, or losses from your DPGR to figure your QPAI.

S corporations and partnerships. An S corporation or partnership can choose to use the simplified deduction method to figure QPAI at the entity level and allocate that QPAI to shareholders or partners if it meets the requirements of an eligible widely-held pass-through entity. A shareholder or partner who is allocated QPAI from an eligible widely-held pass-through entity must report that QPAI on line 7. An S corporation or partnership is an eligible widely-held pass-through entity if it meets each of the following requirements for its current tax year.

- Either of the two tests discussed earlier under *Simplified Deduction Method*.
- It has total cost of goods sold and deductions added together of $100 million or less.
- It has DPGR.
- On every day during the current tax year, all of its shareholders or partners are individuals, estates, or

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trusts described (or treated as described) in section 1361(c)(2).

- On every day during the current tax year, no shareholder or partner owns, alone or combined with the ownership interests of all related persons, more than 10% of (a) total shares of the S corporation or (2) the profits or capital interests in the partnership.

Estates and trusts. If eligible under the above rules, an estate or trust must use the simplified deduction method to allocate its indirectly allocable trade or business deductions, expenses, or losses between DPGR and non-DPGR. All estates and trusts must allocate directly allocable deductions, expenses, or losses between DPGR and non-DPGR under Regulations section 1.652(b)-3.

Expanded affiliated groups. For additional rules that apply to expanded affiliated groups, see Regulations section 1.199-4(e).

Section 861 Method

You do not have to meet any tests to use the section 861 method. Under the section 861 method, you generally must apply the rules of the section 861 regulations to allocate and apportion other trade or business deductions, expenses, or losses between DPGR and non-DPGR. Section 199 is treated as an "operative section" described in Regulations section 1.861-8(f).

For details, see Regulations section 1.199-4(d).

For guidance on automatic approval to change certain elections relating to the apportionment of interest expense and research and experimentation expenditures, see Rev. Proc. 2006-42. You can find Rev. Proc. 2006-42 on page 931 of I.R.B. 2006-47 at *www.irs.gov/pub/irs-irbs/irb06-47.pdf*.

S corporations. An S corporation cannot use the section 861 method to figure QPAI. Unless it is eligible to use the small business simplified overall method or simplified deduction method, an S corporation must report each shareholder's share of its deductions, expenses, or losses on Schedule K-1 that the shareholder needs to figure their DPAD.

Partnerships. A partnership can choose to use the 861 method to figure QPAI at the entity level and allocate that QPAI to qualifying partners (defined below) if it meets the requirements of an eligible 861 partnership. A partner who is allocated QPAI from an eligible 861 partnership must report that QPAI on line 7. An eligible 861 partnership must meet the following requirements for its current tax year.

- It has at least 100 partners on any day during the partnership's tax year.
- At least 70% of the partnership is owned, at all times during its tax year, by qualifying partners (defined next).
- It has DPGR.

Qualifying partner. A qualifying partner is a partner that, on each day during the partnership's tax year that the partner owns an interest in the partnership:

- Is not a general partner or a managing member of a partnership organized as a limited liability company,
- Does not materially participate (discussed later) in the activities of the partnership,
- Does not own, alone or combined with the interests of all related persons (defined next), 5% or more of the profits or capital interests in the partnership,
- Is not an ineligible partnership (qualifying in-kind partnership or expanded affiliated group partnership as defined in Temporary Regulations section 1.199-3T(i)(7) and (8)).

Related persons. For purposes of determining whether a partner is a qualifying partner, persons are related if they meet the requirements of sections 267(b) or 707(b), disregarding sections 267(e)(1) and (f)(1)(A).

Material participation. A qualifying partner cannot materially participate in the activities of the partnership. See section 5.05 of Rev. Proc. 2007-34 for the definition of material participation.

Non-qualifying partners. An eligible 861 partnership cannot allocate QPAI to non-qualifying partners (see *Qualifying partner,* earlier). Instead, the partnership must report each non-qualifying partner's share of deductions, expenses, or losses on Schedule K-1 that the partner needs to figure their DPAD. The partnership items allocated to non-qualifying partners must be excluded for purposes of computing QPAI at the partnership level.

Estates and trusts. An estate or trust that cannot use the simplified deduction method must use the section 861 method to allocate and apportion its indirectly allocable trade or business deductions, expenses, or losses between DPGR and non-DPGR. All estates and trusts must allocate directly allocable deductions, expenses, or losses between DPGR and non-DPGR under Regulations section 1.652(b)-3.

Adjusted Gross or Taxable Income

Your allowable DPAD generally cannot be more than 6% of your adjusted gross income if you are an individual, estate, or trust (taxable income for all other taxpayers) figured without the DPAD. If you do not have adjusted gross or taxable income, you generally are not allowed a DPAD. However, you do not need adjusted gross or taxable income to claim a DPAD you are allocated as a:

- Patron of an agricultural or horticultural cooperative, or
- Member of an expanded affiliated group.

Agricultural and horticultural cooperatives. For this purpose, figure taxable income without taking into account any allowable deduction for patronage dividends, per-unit retain allocations, or nonpatronage distributions.

Estates and trusts. See the instructions for line 11 on page 8 to figure adjusted gross income.

Unrelated business taxable income (UBTI). The allowable DPAD of an organization taxed on its UBTI under section 511 generally cannot be more than 6% of its UBTI figured without the DPAD.

Form W-2 Wages

Your allowable DPAD generally cannot be more than 50% of the Form W-2 wages you paid to your employees (including Form W-2 wages allocated to you on a Schedule K-1). If you did not pay Form W-2 wages, you generally are not allowed a DPAD. However, you do not need Form W-2 wages to claim a DPAD you are allocated as a:

- Patron of an agricultural or horticultural cooperative, or
- Member of an expanded affiliated group.

Note. When figuring your DPAD, the limit equal to 50% of Form W-2 wages is based only on Form W-2 wages properly allocable to DPGR.

Form W-2 wages from an S corporation or partnership. S corporations and partnerships, with tax years beginning after May 17, 2006, that meet specific requirements, can choose to figure Form W-2 wages at the entity level and report the allocated portion of W-2 wages on Schedule K-1 to the S corporation shareholder or partner

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Form

who then combines the allocated portion with W-2 wages from other sources on Form 8903 to determine the DPAD.

If the S corporation or partnership meets the requirements to be classified as one of the eligible entities listed below, it can figure Form W-2 wages at the entity level and allocate Form W-2 Wages to S corporation shareholders or partners.

- Eligible small pass-through entity. See *S corporations and partnerships,* under *Small Business Simplified Overall Method,* on page 5 for the requirements.
- Eligible widely-held pass-through entity. See *S corporations and partnerships,* under *Simplified Deduction Method,* on page 5 for the requirements.
- Eligible 861 partnership. See *Partnerships,* under *Section 861 Method,* on page 6 for the requirements.

Form W-2 wages from an estate or trust. An estate or trust generally will figure its Form W-2 wages and apportion them between the beneficiary and the fiduciary (and among the beneficiaries) and report each beneficiary's share on Schedule K-1 (Form 1041).

Figuring the 50% of Form W-2 Wages Limit

You figure the 50% of Form W-2 Wages limit in two steps. First, you must determine the amount of wages to classify as Form W-2 Wages under Regulations section 1.199-2(e)(1). See *Figuring Form W-2 Wages,* below. Second, you must figure Form W-2 Wages that are properly allocable to DPGR.

You can figure Form W-2 wages that are properly allocable to DPGR using one of the safe harbor methods discussed later under *Form W-2 Wages Allocable to DPGR.* Also, you can use any reasonable method based on all the facts and circumstances.

Figuring Form W-2 Wages

You can use one of the following three methods to figure your Form W-2 wages.

- Unmodified box method.
- Modified box 1 method.
- Tracking wages method.

After you figure Form W-2 wages, see *Form W-2 Wages Allocable to DPGR* to determine the 50% of Form W-2 wages limit to report on line 14 of Form 8903.

Relevant Forms W-2. To figure your Form W-2 wages, generally use the sum of the amounts you properly report for each employee on Form W-2, Wage and Tax Statement, for the calendar year ending with or within your tax year. However, do not use any amounts reported on a Form W-2 filed with the Social Security Administration more than 60 days after its due date (including extensions).

Non-duplication rule. Amounts that are treated as Form W-2 wages for a tax year under any method cannot be treated as Form W-2 wages for any other tax year. Also, an amount cannot be treated as Form W-2 wages by more than one taxpayer.

Unmodified box method. Under the unmodified box method, Form W-2 wages are the **smaller** of:

1. The sum of the amounts reported in box 1 of the relevant Forms W-2, or
2. The sum of the amounts reported in box 5 of the relevant Forms W-2.

Form

Modified box 1 method. Under the modified box 1 method, Form W-2 wages are figured as follows.

1. Add the amounts reported in box 1 of the relevant Forms W-2.
2. Add all the amounts described below and included in box 1 of the relevant Forms W-2.

"S"

a. Amounts not considered wages for federal income tax withholding purposes.
b. Supplemental unemployment compensation benefits.
c. Sick pay or annuity payments from which the recipient requested federal income tax withholding.

3. Subtract (2) from (1).
4. Add any amounts reported in box 12 of the relevant Forms W-2 that are properly coded D, E, F, G, or S.
5. Add (3) and (4).

Tracking wages method. Under the tracking wages method, Form W-2 wages are figured as follows.

1. Add the amounts reported in box 1 of the relevant Forms W-2 that are also wages for federal income tax withholding purposes.
2. Add any amounts reported in box 1 of the relevant Forms W-2 that are both:

a. Wages for federal income tax withholding purposes, and
b. Supplemental unemployment compensation benefits.

3. Subtract (2) from (1).
4. Add any amounts reported in box 12 of the relevant Forms W-2 that are properly coded D, E, F, G, or S.
5. Add (3) and (4).

Form W-2 Wages Allocable to DPGR

After you calculate Form W-2 Wages, as discussed above, you must figure Form W-2 Wages that are properly allocable to DPGR. You report the Form W-2 wages that are properly allocable to DPGR on line 14 of Form 8903 as the 50% of Form W-2 wages limit.

You can figure Form W-2 wages that are properly allocable to DPGR under one of the following methods.

- Small business simplified overall method safe harbor.
- Wage expense safe harbor.
- Any other reasonable method based on all the facts and circumstances.

Small business simplified overall method safe harbor. If you use the small business simplified overall method to allocate costs between DPGR and non-DPGR (see *Small Business Simplified Overall Method* on page 5), you can use the small business simplified overall method safe harbor to determine the amount of W-2 wages allocable to DPGR. Under this safe harbor method, the amount of W-2 wages that is properly allocable to DPGR equals the proportion of DPGR to total gross receipts.

Wage expense safe harbor. If you are using either the section 861 method of cost allocation under Reg. Section 1.199-4(d) or the simplified deduction method under Regulation Section 1.199-4(e), you determine the amount of wages properly allocable to DPGR by multiplying the amount of wages for the tax year by the ratio of your wage expense included in calculating QPAI for the tax year to your total wage expense used in calculating your taxable income (or adjusted gross income) for the tax year without regard to any wage expenses disallowed by Sections 465, 469, 704(d), or 1366(d).

If you use the section 861 method or the simplified deduction method, you must use the same expense allocation and apportionment methods that you use to determine QPAI to allocate and apportion wage expense for purposes of the safe harbor.

Wage expense included in cost of goods sold. After you determine the amount of wages under the wage expense safe harbor, discussed earlier, you can allocate a portion of those wages to cost of goods sold by any reasonable method based on the facts and circumstances. For

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You can find Rev. Proc. 2006-47 on page 851 of I.R.B. 2006-45 at www.irs.gov/pub/irs-irbs/irb06-45.pdf.

b a

example, you can include wage expense in cost of goods sold in proportion to (1) the amount of direct labor included in cost of goods sold, or (2) section 263A labor costs (as defined in Regulations section 1.263A-1(h) (4)(ii)) included in cost of goods sold. See Temporary Regulations section 1.199-2T(e)(2)(ii)(B) for more information.

More information. For more information on figuring your Form W-2 wages, see Regulations section 1.199-2 and Rev. Proc. 2006-47.

For more information on figuring Form W-2 wages properly allocable to DPGR, see Temporary Regulations section 1.199-2T(e)(2).

Specific Instructions

Line 1 Domestic Production Gross Receipts (DPGR)

Enter your DPGR (defined on page 3).

<insert>"allocable to DPGR"

Line 2 Allocable Cost of Goods Sold

If you are not using the small business simplified overall method, enter your ~~allocable~~ cost of goods sold (discussed on page 4).

Line 3

If you are using the simplified deduction method (discussed on page 5) or the section 861 method (discussed on page 6), enter the other deductions or losses you ratably apportion to DPGR.

Line 4

If you are using the small business simplified overall method (discussed on page 5), enter the amount of cost of goods sold and other deductions or losses you ratably apportion to DPGR.

Line 7

Beneficiaries of estates and trusts, partners, and S corporation shareholders report the QPAI distributed from estates or trusts, and certain partnerships or S corporations on line 7. The QPAI should be reported to you on Schedule K-1 for Forms 1041, 1065, or 1120S. See the related Schedule K-1 and its instructions for more information.

Line 9

Estates and trusts must use Regulations section 1.652(b)-3 to allocate QPAI to beneficiaries if DNI is distributed or required to be distributed to beneficiaries. Report the amount of QPAI allocated to beneficiaries on line 9. See *Estates and trusts* on page 2.

Line 11 Income Limitation

Individuals. Enter your adjusted gross income from line 37 of Form 1040 figured without the DPAD.

Corporations. Enter your taxable income from the applicable line of your tax return (for example, line 30 of Form 1120) figured without the DPAD.

Members of EAGs. See the instructions for line 22 ~~for exceptions.~~

Agricultural and horticultural cooperatives. Enter your taxable income figured without the DPAD or the deductions for patronage dividends, per-unit retain allocations, and nonpatronage distributions under section 1382(b) or (c).

Estates and trusts. Enter your adjusted gross income figured without the DPAD. See the Instructions for Form 1041 to figure adjusted gross income. Use the method discussed under *How to figure AGI for estates and trusts,* under *Line 15b—Allowable Miscellaneous Itemized Deductions Subject to the 2% Floor.*

Unrelated business taxable income (UBTI). An organization taxed on its UBTI under section 511 enters its UBTI from line 34 of Form 990-T figured without the DPAD.

Line 14 Form W-2 Wages

Enter your Form W-2 wages that are properly allocable to DPGR (discussed on page 7). Do not include Form W-2 wages you must report on line 15.

Form

Line 15

Beneficiaries of estates and trusts, partners, and S corporation shareholders report the W-2 wages distributed from estates or trusts, and certain partnerships or S corporations on line 15. The W-2 wages should be reported to you on the Schedule K-1 for Forms 1041, 1065, or 1120S. See the related Schedule K-1 and its instructions for more information.

Form "required"

Line 17

Estates and trusts must use Regulations section 1.652(b)-3 to allocate W-2 wages to beneficiaries if DNI is distributed or required to be distributed to beneficiaries. Report the amount of the W-2 wages allocated to beneficiaries on line 17. See *Estates and trusts* on page 2.

Line 22 Expanded Affiliated Group Allocation

The instructions below explain how expanded affiliated groups (EAGs) (defined on page 2) figure and report the DPAD. Certain members of an expanded affiliated group may not be required to complete the entire Form 8903. See *How to Report* below.

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Computation of the EAG's DPAD

In general, the DPAD for an EAG is determined by aggregating each member's taxable income or loss, QPAI, and Form W-2 wages. A member's QPAI may be positive or negative. Also, a member's taxable income or loss and QPAI are determined under the member's method of accounting.

Members with different tax years. If members of an EAG have different tax years, in determining the DPAD of a member, the reporting member must take into account the taxable income or loss, QPAI, and Form W-2 wages of each group member that are both:

- Attributable to the period that the member of the EAG and the reporting member are both members of the EAG, and
- Taken into account in a tax year that ~~begins after 2004 and~~ ends with or within the tax year of the reporting member with respect to which the DPAD is figured.

For an example that explains the above requirements, see Regulations section 1.199-7.

Net operating losses. The net operating loss (NOL) of a member of an EAG that is used in the computation of the EAG's taxable income ~~cannot also be used as a~~ NOL carryback or carryover to determine the taxable income ~~of that member~~ in a prior or subsequent year for purposes of section 199(a)(1)(B). See Regulations section 1.199-7T(b)(4) for more information.

<insert>"is not treated as an"

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Allocation of the DPAD to Members of the EAG

The EAG's DPAD is allocated among members of the EAG based on the ratio of each member's QPAI to the total QPAI of the EAG. The allocation is made regardless of whether the EAG member has taxable income or loss or Form W-2 wages for the tax year. If a member has negative QPAI, that member's QPAI is treated as zero for purposes of the allocation.

Section 199 closing of the books method. Under the section 199 closing of the books method, a corporation's taxable income or loss, QPAI, and Form W-2 wages for the period during which the corporation was a member of the EAG are figured by treating the corporation's tax year as two separate tax years. The first tax year is treated as ending on the close of the day on which the corporation's status as a member of the EAG changes. The second tax year is treated as beginning on the day after the corporation's status as a member of the EAG changes.

Making the section 199 closing of the books election. A corporation makes the section 199 closing of the books election by attaching the following statement to the corporation's timely filed (including extensions) federal income tax return for the tax year that includes the periods that are subject to the election: "The section 199 closing of the books election is hereby made with respect to [insert name of corporation and its employer identification number] with respect to the following periods [insert dates of two periods between which items are allocated pursuant to the closing of the books method]."

If you filed your original return on time without making the election, you can make the election on an amended return filed no later than 6 months after the due date of your tax return (excluding extensions). Enter "Filed pursuant to section 301.9100-2" at the top of the amended return.

Once made, the election is irrevocable.

Consolidated Groups

Under section 199, a consolidated group is treated as a single member of the EAG. If all members of an EAG are members of the same consolidated group, the DPAD of the consolidated group is determined based on the consolidated taxable income or loss, QPAI, and Form W-2 wages of the group and not the separate taxable income or loss, QPAI, and Form W-2 wages of its members. The consolidated group will generally file only one Form 8903. For details, see Regulations section 1.199-7.

If an EAG includes both consolidated and non-consolidated members, the consolidated (not separate) taxable income or loss, QPAI, and Form W-2 wages of the consolidated group are aggregated with the taxable income or loss, QPAI, and Form W-2 wages of the non-consolidated group members to determine the DPAD. For details, see Regulations section 1.199-7(d)(4).

A consolidated group's DPAD (or the DPAD allocated to a consolidated group that is a member of an EAG) is allocated to the members of the consolidated group in proportion to each member's QPAI, if any, regardless of whether the consolidated group member has:

- Separate taxable income or loss for the tax year, and
- Form W-2 wages for the tax year.

For purposes of allocating the DPAD of a consolidated group among its members, if a consolidated group member has negative QPAI, the member's QPAI is treated as zero.

Simplified deduction and small business simplified overall methods. For purposes of applying the simplified deduction method and the small business simplified overall method, a consolidated group determines its QPAI by reference to its members' DPGR, non-DPGR, cost of goods sold, and all other deductions, expenses, or losses, determined on a consolidated basis.

How to Report

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All members of an EAG are treated as a single corporation for purposes of determining the DPAD. However, the DPAD is allocated to each member.

EAG reporting member. The EAG chooses a reporting member from amongst all members of the EAG to figure the DPAD for all EAG members. The reporting member completes lines 10 through 14 and lines 16 through 20 of the Form 8903 for the group.

The reporting member also does the following.

1. Enters the portion of the deduction allocated to the other members of the EAG as a negative number on line 22.
2. Completes lines 21 and 23.
3. Attaches a schedule showing how the reporting member figured its own QPAI.
4. Attaches a schedule that shows how the DPAD was figured for the group and each member's name, EIN, and share of the DPAD.
5. Provides a copy of the group DPAD computation schedule to the other members of the group.

EAG member other than the reporting member. An EAG member other than the reporting member does the following.

1. Completes a separate Form 8903, skips lines 1-20, and enters its share of the group deduction on line 22 as a positive number.
2. Completes lines 21 and 23.
3. Attaches a schedule that shows how its QPAI was figured.
4. Attaches a copy of the group DPAD computation schedule provided by the reporting member.

Consolidated groups. If the EAG is comprised of a single consolidated group, the common parent of the consolidated group completes lines 1 through 23 for the group. If the EAG is comprised of more than just the members of a single consolidated group, the common parent files a Form 8903 for the consolidated group as either the reporting member or as an EAG member other than the reporting member, whichever is appropriate. In all events, the common parent attaches a schedule that shows the amount of the consolidated group's DPAD allocated to each member of the consolidated group, and how the allocated amount was calculated.

<insert>"(computing members)."

Line 23 Domestic Production Activities Deduction

Combine lines 20 through 22 and enter the result on line 23 and the appropriate line of your tax return.

Agricultural and horticultural cooperatives. Reduce the amount the cooperative deducts under section 1382 by the portion of the cooperative's DPAD allocated to its patrons. However, the entire amount on line 23, which includes any amount allocated to patrons, is deductible under section 199 by the cooperative. See *Agricultural and horticultural cooperatives* on page 2 for more information on this subject.

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<insert>"(including non-computing members)"

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You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated burden for individual taxpayers filing this form is approved under OMB control number 1545-0074 and is included in the estimates shown in the instructions for their individual income tax return. The estimated burden for all other taxpayers who file this form is shown below:

Recordkeeping	5 hr., 1 min.
Learning about the law or the form	13 hr., 6 min.
Preparing, copying, assembling, and sending the form to the IRS	13 hr., 46 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the instructions for the tax return with which this form is filed.