COMMONWEALTH of VIRGINIA

Department of Taxation

TO: Michael Melson
Director, Appeals and Rulings

FROM: Mark C. Haskins
Director, Policy Development Division

DATE: August 5, 2011

RE: IRC Section 199 Deductions

EXECUTIVE SUMMARY

- Federal law requires that IRC § 199 deductions for members of expanded affiliated groups ("EAGs") be computed at the group level, regardless of whether the members file consolidated or separate returns, and reported on federal Form 8903. Allocation of the deduction to each member of an EAG is not related to that member's filing status.
- Certain limitations are placed on IRC § 199 deductions based on W-2 wages and taxable income. These limitations are imposed at the group level for all members of an EAG, regardless of filing status.
- Therefore, as a general rule, auditors should not adjust IRC § 199 deductions or addbacks based on amounts tied to the taxpayer's Virginia filing status, but should instead follow the federal allocations on federal Form 8903.
- There are rare exceptions to this general rule, which are described in the detailed analysis that follows. However, recalculating the deduction is extremely complex and, in most cases, is not material to Virginia tax liability. In certain cases, recalculating the deduction may actually benefit the taxpayer, rather than the state. Accordingly, it is the opinion of Policy Development that such recalculations should be undertaken by auditors only if doing so would materially affect Virginia taxable income.

ISSUE

It has been brought to our attention that Virginia auditors have been adjusting the treatment of IRC § 199 deductions in cases where taxpayers have filed consolidated federal income tax returns, but separate Virginia income tax returns, and that Appeals and Rulings has pending cases related to this issue. The purpose of this memorandum is to provide Policy Development's opinion on how IRC § 199 should be viewed for Virginia corporate income tax purposes.

Specifically, there have been questions regarding the application of the income limitations of IRC § 199(a) to these deductions. Regardless of whether a taxpayer files a separate or consolidated federal income tax return, if that taxpayer is a member of an expanded affiliated group ("EAG"), as defined in IRC § 199(d)(4), the IRC § 199 deduction is computed at the group level on federal Form 8903 and then allocated to the separate companies. Accordingly, the income and W-2 wage limitations set forth in IRC § 199(a) should be applied at the group level, rather than the individual level, regardless of whether a separate return is filed by the taxpayer.

Although filing a separate return does not affect the application of the income and W-2 wage limitations of IRC § 199(a), the rules regarding intercompany transactions between members of a consolidated group may alter the calculation of an EAG's IRC § 199 deduction, which may subsequently impact the amount of the deduction that a corporation may claim for Virginia income tax purposes. If such an impact materially changes a taxpayer's Virginia income tax liability, certain adjustments may need to be made.

To clarify these issues, a detailed analysis follows explaining Policy Development's view on the procedures for properly calculating IRC § 199 deductions for Virginia corporate income tax purposes.

ANALYSIS

Virginia's Conformity to the Internal Revenue Code

Virginia generally conforms to IRC § 199. Effective for tax years beginning on or after January 1, 2010, Virginia deconforms from the 2010 federal increase in the deduction amount from 6% to 9%. *Va. Code* §§ 58.1-402; 58.1-301(B)(5). Accordingly, beginning with the 2010 taxable year, taxpayers must add back one-third of the federal domestic production activities deduction.

<u>Federal Treatment of IRC § 199 Deductions</u>

IRC § 199(a) allows a domestic production activities deduction for taxable years 2007 through 2009 equal to 6% of the lesser of a taxpayer's qualified production activities income ("QPAI") for the taxable year or taxable income (or adjusted gross income for individuals, trusts, and estates) for the taxable year. IRC § 199(a), (d). In the 2010 taxable year, the amount of the deduction increases to 9% of QPAI. A taxpayer's QPAI for a taxable year is equal to the taxpayer's domestic production gross receipts less the sum of the cost of goods sold and other expenses, losses, or deductions (other than IRC § 199 deductions) allocable to such receipts. IRC § 199(c)(1).

For purposes of IRC § 199, the definition of taxable income under IRC § 63 applies, except that taxable income is determined without regard to IRC § 199 and without regard to any amount excluded from gross income pursuant to IRC § 114 or pursuant to section 101(d) of the American Jobs Creation Act of 2004. Treas. Reg. § 1.199-1(b). Except as provided in Treas. Reg. § 1.199-7(c)(2) (discussed below), the IRC § 199 deduction cannot be taken into account in computing net operating losses or the amount of any net operating loss carryback or carryover. Treas. Reg. § 1.199-1(b).

In addition to the taxable income limitation, the deduction cannot exceed 50% of the W-2 wages paid by the taxpayer for the taxable year. IRC § 199(b)(1).

<u>Treatment of Expanded Affiliated Groups</u>

Special rules apply to deductions claimed by members of expanded affiliated groups. IRC § 199(d)(4). An expanded affiliated group ("EAG") is an "affiliated group" as defined in IRC § 1504(a), except that "more than 50%" is substituted for "more than 80%" and insurance companies subject to taxation under IRC § 801 and corporations making an IRC § 936 election are included as affiliated group members, where they would otherwise be excluded under IRC § 1504(b)(2) and (4). IRC § 199(d)(4)(B). An EAG is treated as a single corporation for purposes of the IRC § 199 deduction; the deduction is then allocated among the members of the EAG in proportion to each member's respective amount of QPAI. IRC § 199(d)(4)(A), (C). Such allocations are made regardless of whether the EAG member has taxable income or loss or W-2 wages for the taxable year. Treas. Reg. § 1.199-7(c)(1).

Because an EAG is treated as a single corporation for purposes of the IRC § 199 deduction, the QPAI, taxable income, and W-2 wage limitations apply at the EAG level,

not at the taxpayer level, regardless of whether the EAG members filed separate or consolidated returns. Accordingly, an EAG's domestic production activities deduction is equal to 6% of the lesser of the EAG's QPAI for the taxable year or the EAG's aggregate taxable income for the taxable year.

While IRC § 199 deductions cannot generally be taken into account in computing net operating losses, Treas. Reg. § 1.199-7(c)(2) allows an exception for members of EAGs. If a member of an EAG is allocated an IRC § 199 deduction that exceeds that member's taxable income, the deduction will create a net operating loss for the member. If a member of an EAG already has a net operating loss for the taxable year prior to allocation of a portion of the EAG's IRC § 199 deduction, the member's portion of the deduction will increase the member's net operating loss. Treas. Reg. § 1.199-7(c)(2).

Special Rules for Consolidated Group Members

Additional rules apply to EAGs that have members that are part of the same consolidated group. If all members of an EAG are members of the same consolidated group, the domestic production activities deduction is determined using the consolidated group's consolidated taxable income or loss, QPAI, and W-2 wages, rather than the separate taxable income or loss, QPAI, and W-2 wages of its members. Treas. Reg. § 1.199-7(d)(4)(ii). If the EAG includes both consolidated and non-consolidated members, the consolidated group is treated as a single member of the EAG and the taxable income or loss, QPAI, and W-2 wages of the consolidated group are aggregated with the taxable income or loss, QPAI, and W-2 wages of the other members in determining the EAG's domestic production deduction. Treas. Reg. § 1.199-7(d)(4)(i).

Treas. Reg. § 1.199-7(d)(1) provides that, when computing the QPAI of the consolidated group for purposes of the IRC § 199 deduction, the consolidated group must take intercompany transactions into account. The separate entity attributes of intercompany items must be redetermined pursuant to Treas. Reg. § 1.1502-13(c)(1)(i), which requires the consolidated group members to redetermine the separate entity attributes of the intercompany items to the extent necessary to produce the same effect on consolidated taxable income as if the consolidated members were divisions of a single corporation and the intercompany transaction was a transaction between divisions.

Allocations to EAG Members

If the EAG contains only consolidated group members, the domestic production activities deduction is simply allocated to the consolidated group members in proportion to each member's QPAI. Treas. Reg. § 1.199-7(d)(5). If a member of the consolidated group has negative QPAI, the QPAI of the member shall be treated as zero. Treas. Reg. § 1.199-7(d)(5). In allocating the deduction among consolidated group members, any redetermination of a corporation's receipts, cost of goods sold, or other deductions from an intercompany transaction under Treas. Reg. § 1.1502-13(c)(1)(i) or (c)(4) is not taken into account. Treas. Reg. § 1.199-7(d)(5).

If the EAG contains both consolidated group members and separate members, then the consolidated group is treated as a single member of the EAG and the domestic production activities deduction is allocated to the separate members and consolidated group in proportion to each EAG member's QPAI. The domestic production activities deduction that is allocated to the consolidated group is then allocated to the consolidated group members in proportion to each member's QPAI, as described above. Treas. Reg. § 1.199-7(d)(5). Accordingly, the percentage of the total EAG deduction allocated to a consolidated group member would be the same regardless of whether it was treated as a separate or consolidated taxpayer.

Federal Filing Requirements

Taxpayers claiming an IRC §199 deduction must file Form 8903. Because members of an EAG are treated as a single corporation for purposes of determining the IRC § 199 deduction, different reporting requirements apply to these taxpayers. The EAG must choose a reporting member to figure the deduction amount for all members. 2009 Instr. for Form 8903, pp.9-10. The reporting member must then complete Form 8903 and attach a schedule showing how the deduction was figured for the group and identifying each member's share of the deduction. 2009 Instr. for Form 8903, p. 10. The non-reporting members must each complete Lines 21 and 23 of Form 8903, reporting their respective shares of the deduction, and attach a copy of the group deduction computation schedule. 2009 Instr. for Form 8903, p. 10.

In the case of corporations that are members of an EAG, the method of computing the IRC § 199 deduction can be determined by reviewing federal Form 8903 and the attached schedules. The amount reported as the EAG's IRC § 199 deduction (Line 20 of the reporting member's federal Form 8903) cannot exceed 6% (for tax years 2007 through 2009) of the lesser of the aggregate QPAI (Line 10 of the reporting

member's federal Form 8903) or aggregate taxable income (Line 11 of the reporting member's federal Form 8903). IRC § 199(a), (d). The amount allocated to each taxpayer must be computed according to the taxpayer's QPAI, pursuant to IRC § 199(d)(4)(C).

Adjustments to Form 8903 Calculations for Virginia Income Tax Purposes

Certain adjustments may be required in cases where a taxpayer files a consolidated federal income tax return but a separate Virginia income tax return. The Virginia Administrative Code requires a taxpayer that files a consolidated federal return, but a separate Virginia return to compute the federal taxable income of each member of the group as if separate federal returns had been filed. 23 *Va. Admin. Code* § 10-120-320(D)(1)(b).

Treating a corporation as a separate taxpayer for federal income tax purposes would not require adjustments in the percentage allocated to each corporation. This is because the percentage of QPAI allocated to each corporation is determined using the same formula, without regard to any intercompany transactions, regardless of whether the corporations are filing consolidated or separate returns.

The taxable income and W-2 wage limitations of IRC § 199 apply at the EAG level, rather than at the individual member level. Accordingly, no adjustments should be made for a domestic production activity deduction on the basis that it exceeds 6% of an EAG member's taxable income or W-2 wages. This is true even if the taxpayer has filed a consolidated return at the federal level, because the IRC § 199 deduction for an EAG member is computed on Federal Form 8903 and allocated to the company regardless of whether it is filing separately or as part of a consolidated group.

Generally, treating a corporation as a separate, rather than a consolidated, taxpayer would not affect the computation of the EAG's deduction. One exception is in cases where intercompany transactions were taken into account when computing a consolidated group's QPAI because this may impact the amount of the EAG's deduction. Treating a corporation as a separate taxpayer for purposes of filing a separate Virginia return would prohibit the redetermination of any intercompany transactions pursuant to Treas. Reg. § 1.199-7(d). This may have an impact on the total amount of QPAI at the EAG level, which in turn flows through to the taxpayer. However, it would not impact the percentage of the total EAG QPAI allocated to the taxpayer because the percentage of allocation is calculated without reference to any intercompany transactions.

In cases where taxpayers file consolidated federal returns, but separate Virginia returns, auditors should first examine whether the EAG's QPAI has been redetermined to take into account any intercompany transactions. If the EAG's QPAI is affected by intercompany transactions, auditors should then determine whether the impact of intercompany transactions on the consolidated group's QPAI is material and, if the impact is material, the deduction should be adjusted accordingly. It should be noted that, in some cases, treating a corporation as a separate taxpayer may actually increase the amount of the EAG's IRC § 199 deduction.

Examples

The following examples are adopted in part from Treas. Reg. § 1.199-7(e). Examples 1 and 2 demonstrate how an EAG's total amount of QPAI may differ if the EAG members are also members of the same consolidated group. Notice that, although the overall EAG limits may change, the percentage of the deduction allocated to each member does not change.

Assume for both examples that X and Y are the only members of the EAG; that both corporations use the IRC § 861 method of allocating and apportioning deductions; and that all events take place in the same taxable year. Also assume that the events described take place during the 2009 taxable year.

Example 1:
Corporations X and Y are members of the same EAG, but are not members of a consolidated group. X incurs $5,000 in costs in manufacturing a machine, all of which are capitalized. X is entitled to a $1,000 depreciation deduction in the current taxable year. X rents the machine to Y for $1,500 and Y uses the machine in manufacturing qualifying production property ("QPP") within the United States. Y incurs $1,400 of cost of goods sold ("CGS") in manufacturing the QPP. Y sells the QPP to unrelated persons for $7,500.

Calculating QPAI: QPAI is equal to domestic production gross revenues ("DPGR") less CGS attributable to DPGR and any other expenses attributable to DPGR.

Because X and Y are considered related persons for purposes of IRC § 199(c)(7) and Treas. Reg. § 1.199-3(b), X's rental income is non-DPGR and its related costs are not attributable to DPGR. Accordingly, X's QPAI is $0.

Y's QPAI is $4,600, which is equal to its DPGR less its CGS attributable to DPGR and its rental expenses attributable to DPGR. Y's QPAI is calculated as follows:

$DPGR_Y$	$7,500
$(CGS_Y$	$1,400)
$(EXPENSES_Y$	$1,500)
$QPAI_Y$	$4,600

The EAG's QPAI is equal to the aggregate QPAI of its members:

$QPAI_x$	$ 0
$QPAI_Y$	$4,600
$QPAI_{EAG}$	$4,600

This amount is then used to calculate the EAG's total deduction.

Allocating the Deduction: The deduction is allocated amongst EAG members in proportion to their QPAI. X is allocated 100% ($4,600/$4,600) of the deduction and Y is allocated 0% ($0/$4,600) of the deduction. Accordingly, assuming that the EAG has met the taxable income and W-2 wage limitations, X's deduction would be calculated as follows:

($4,600 x 6%) x 0% = $0

Again, assuming that the taxable income and W-2 wage limitations are met at the EAG level, Y's deduction would be calculated as follows:

($4,600 x 6%) x 100% = $276

Calculating the Deduction for Virginia Purposes: Because X and Y are filing separate returns for both federal and Virginia income tax purposes, the entire amount of the deduction would flow through for Virginia income tax purposes. Accordingly, no adjustments to the deduction should be made.

Example 2:
Same facts as Example 1, except that X and Y are members of the same federal consolidated group.

Calculating QPAI: X's rental income would not ordinarily be considered DPGR and its related costs would not be allocable to DPGR. However, because X and Y are members of the same consolidated group, the separate entity attributes of X's intercompany items and Y's corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income as if X and Y were divisions of a single corporation and the intercompany transaction were a transaction between divisions, pursuant to Treas. Reg. § 1.1502-13(c)(1)(i).

If X and Y were divisions of a single corporation, X and Y would have QPAI of $5,100, which is calculated by subtracting cost of goods sold and the depreciation deduction from DPGR. To obtain this same result for the consolidated group, X's rental income is redetermined as DPGR, which results in both the rental income being included as DPGR and the accompanying depreciation deduction being included as an expense allocated to DPGR. The calculation for the QPAI of the consolidated group is as follows:

$DPGR_{CG}$	$9,000
(CGS_{CG}	$1,400)
($EXPENSES_{CG}$	$2,500)
$QPAI_{CG}$	$5,100

Because the consolidated group is the only member of the EAG, this is also the QPAI for the EAG.

Allocating the Deduction: The deduction is allocated to the members of the consolidated group in proportion to QPAI. For purposes of determining how the deduction is allocated to X and Y, the redetermination of X's rental income as DPGR is not taken into account, pursuant to Treas. Reg. § 1.199-7(d)(5). Accordingly, X's QPAI for purposes of allocating the deduction is $0 and Y's QPAI for purposes of allocating the deduction is $4,600. Just as in Example 1, X is allocated 0% ($0/$4,600) of the deduction and Y is allocated 100% ($4,600/$4,600) of the deduction.

Calculating the Deduction for Federal Purposes: Assuming that the EAG has met the taxable income and W-2 wage limitations, X's deduction would be calculated as follows:

($5,100 x 6%) x 0% = $0

Again, assuming that the taxable income and W-2 wage limitations are met at the EAG level, Y's deduction would be calculated as follows:

($5,100 x 6%) x 100% = $306

Calculating the Deduction for Virginia Purposes: If X and Y file a consolidated Virginia income tax return, no adjustments to the deduction would be made because a consolidated return was filed at both the federal and state levels.

If X and Y file separate Virginia income tax returns, Y must recompute its federal taxable income as if a separate federal return were filed. This is necessary in this instance because intercompany transactions were taken into account when computing the consolidated group's QPAI.

First, QPAI must be calculated without accounting for intercompany transactions between X and Y, as it was computed in Example 1:

$DPGR_Y$	$7,500
$(CGS_Y$	$1,400)
$(EXPENSES_Y$	$1,500)
$QPAI_Y$	$4,600

The EAG's QPAI is equal to the aggregate QPAI of its members:

$QPAI_x$	$ 0
$QPAI_Y$	$4,600
$QPAI_{EAG}$	$4,600

Next, the deduction is allocated amongst EAG members in the same proportion as on the federal return. Accordingly, and X would be allocated 0% of the deduction and Y would be allocated 100% of the deduction.

X's deduction would still be $0.

Y's deduction would be calculated as follows:

($4,600 x 6%) x 100% = $276

Y would then increase its federal taxable income by $30, or the difference between the federal deduction claimed on the consolidated federal return and the federal deduction that would have been allowed on a separate federal return.

These examples demonstrate how the amount of the deduction may change if a corporation is treated as a separate, rather than consolidated, taxpayer for Virginia purposes. While no adjustment is typically needed, a recalculation of the QPAI may be necessary in cases involving intercompany transactions. In such cases, auditors should determine whether the intercompany transactions result in a material impact on the calculation of QPAI and, if so, the amount of the deduction should be adjusted accordingly.

It is important to note that no adjustments should be made due to an EAG member's taxable income or W-2 limitations. Regardless of whether a separate or consolidated federal return is filed, these limitations are determined at the EAG level, not at the taxpayer level.

Similarly, no adjustments should be made to the percentage of QPAI allocated to an EAG member. This is because the percentage of QPAI allocated to a corporation is determined without regard to intercompany transactions and, accordingly, this calculation would not be impacted by a change in filing status from consolidated to separate.

If you have any questions, do not call me, call Kristin Collins at (804) 371-2341.

cc: Bill White