

2006 Instructions for Form 8903

Purpose: This is the first circulated draft of the 2006 Instructions for Form 8903 for your review and comments. See below for a discussion of the major changes.

TPCC Meeting: None, but one may be arranged if requested.

Prior Version: The 2005 Instructions for Form 8903 are available at:

<http://www.irs.gov/pub/irs-pdf/i8903.pdf>

Form: The 2006 Form 8903 was circulated earlier at:

http://taxforms.web.irs.gov/Products/Drafts/2006/06f8903_d1.pdf

Other Products: Circulations of draft tax forms, instructions, notices, and publications are posted at:

http://taxforms.web.irs.gov/draft_products.html

Comments: Please email, fax, call, or mail any comments by **December 15, 2005**.

Clarence Light

Tax Forms and Publications

SE:W:CAR:MP:T:B:C

Email: Clarence.O.Light@irs.gov

Phone: 202-283-0130

Fax: 202-283-4545

Major Changes to the 2006 Form 8903 Instructions

Note: We added references throughout the instructions to (1) the final regulations issued on June 1, 2006, and (2) the new **Additional Guidance** section discussed below.

Page 1

We added **What's New** to highlight the following changes:

- Final regulations were issued on June 1, 2006.
- An explanation of the new requirements included in section 514 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) effective for tax years beginning after May 17, 2006:
 - Only wages that are allocable to domestic production are included in the Form W-2 wage limitation.
 - The rules for determining Form W-2 wages of partners and S corporation shareholders are simplified by determining wages solely at the entity level.
- Under the final regulations, the simplified deduction method is allowed if average gross receipts are \$100 million (up from \$25 million) or less.

We added **Additional Guidance** to discuss the final regulations and some optional sources of additional guidance.

Page 3

Under **Other Deductions, Expenses, or Losses** we added a clarification that employee business expenses are excluded from other deductions, expenses, or losses.

Page 4

Under **Simplified Deduction Method** we note that the final regulations increased the average annual gross receipts threshold amount to \$100 million from \$25 million.

Under **Section 861 Method** we added a reference to Rev. Proc. 2006-42 which provides guidance on automatic approval to change certain elections relating to the apportionment of interest expense and research and experimentation expenditures.

Page 5

At the top of the 1st column, we changed the heading **Cooperatives** to **Agricultural and horticultural cooperatives** to clarify that the provision only applies to these types of cooperatives.

Under **Form W-2 Wages**, we made the following changes:

- Per IRC 199(b)(2)(C) and Treasury Decision 9293, we notify taxpayers with a tax year beginning after May 17, 2006, that only wages that are directly allocable to domestic production can be included in wages for purposes of determining the 50% of Form W-2 wages limitation.
- We notify partnerships, S corporations, and estates or trusts, that, for tax years beginning after May 17, 2006, they are no longer required to calculate the 6% of QPAI limit on allocable wages.

Under **More information**, we added references for Rev. Proc. 2006-22 and Rev. Proc. 2006-47.

Page 6

Under **Line 2** we revised the instructions to conform to the changes made to line 2 of the Form 8903.

Under **Line 3** we revised the instructions to conform to the changes made to line 3 of the Form 8903.

Under **Line 4** we revised the instructions to conform to the changes made to line 4 of the Form 8903.

Under **Line 9, Income Limitation**, we made the following changes:

- Under **Corporations**, we reference Line 30 of the Form 1120 for taxable income used in the calculation of the DPAD.
- We changed the heading **Cooperatives** to **Agricultural and horticultural cooperatives** to clarify that the provision only applies to these types of cooperatives.

Page 7

Per the suggestion of Modernized efile, at the top of the 1st column we clarify that a consolidated group generally will only file one Form 8903.

Also, per the suggestion of Modernized efile, under **EAG reporting member** under **How to Report** we clarify that the EAG chooses the reporting member for the EAG amongst all the members of the EAG.

We changed the heading **Cooperatives** to **Agricultural and horticultural cooperatives** under **Line 19, Domestic Production Activities Deduction**, to clarify that the provision only applies to these types of cooperatives.



Instructions for Form 8903

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 were issued on June 1, 2006. See *Additional Guidance*, on this page.

Form W-2 wages. For tax years beginning after May 17, 2006:

- The limit equal to 50% of Form W-2 wages is no longer based on Form W-2 wages from all businesses. Only wages properly allocable to domestic production gross receipts are included.
- The rules for determining Form W-2 wages of partners and S corporation shareholders are simplified by determining wages solely at the entity level.

See *Form W-2 Wages*, on page 5.

Simplified deduction method.

Under the final regulations, you may be able to use the simplified deduction method if your average annual gross receipts are \$100 million (up from \$25 million) or less. See *Simplified Deduction Method* on page 4.

General Instructions

Purpose of Form

Use Form 8903 to figure your domestic production activities deduction (DPAD).

Your DPAD is generally 3% 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.

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 Final Regulations sections 1.199-1 through 1.199-9. However, for tax years beginning before June 1, 2006, you can choose not to rely on any part of the final regulations and rely instead on guidance provided in 2005 by Notice 2005-14 and Proposed Regulations sections 1.199-1 through 1.199-8. But, for tax years beginning after May 17, 2006, you must figure Form W-2 wages with the changes discussed above under *Form W-2 Wages*.

For guidance on computer software provided to customers over the Internet, also see Treasury Decision 9262 and Announcement 2006-56.

You can find the final regulations on page 1063 of Internal Revenue Bulletin (I.R.B.) 2006-25 at www.irs.gov/pub/irs-irbs/irb06-25.pdf. You can find Notice 2005-14 on page 498 of I.R.B. 2005-7 at www.irs.gov/pub/irs-irbs/irb05-07.pdf. You can find the proposed regulations on page 987 of I.R.B. 2005-47 at www.irs.gov/pub/irs-irbs/irb05-47.pdf. You can find Treasury Decision 9262 on page 1040 of I.R.B. 2006-24 at www.irs.gov/pub/irs-irbs/irb06-24.pdf. You can find Announcement 2006-56 on page 342 of I.R.B. 2006-35 at www.irs.gov/pub/irs-irbs/irb06-35.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, 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 wages (or have 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 2.

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

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.

- Partnership basis limit on losses.
- S corporation basis limit on 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 qualified production activities, after applying the provisions listed above, can be taken into account for purposes of figuring the DPAD for the current tax year. If any of the disallowed losses or deductions are allowed in a later tax year, you can take into account a proportionate share of the expenses reflected in those losses or deductions in figuring QPAI in the later tax year.

S corporations and partnerships.

The DPAD is applied at the shareholder or partner level.

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

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.

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 for the tax year that is distributed or required to be distributed to the beneficiary or retained by the estate or trust.

Agricultural and horticultural cooperatives.

Generally, an agricultural or horticultural cooperative can choose to allocate all, some, or none of its allowable DPAD 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 in whole or significant part of any agricultural or horticultural product, or
- Marketing of agricultural or horticultural products.

An organization engaged in marketing agricultural or horticultural products is treated as having manufactured, produced, grown, or extracted in whole or significant part any qualifying production property marketed by the organization that its patrons have so manufactured, produced, grown, or extracted. 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 on 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.

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 18 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.

Qualified Production Activities Income (QPAI)

Your allowable DPAD generally cannot be more than 3% 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.

QPAI from an S corporation or partnership. QPAI is generally figured by the shareholder or partner using information provided by the S corporation or partnership on Schedule K-1. However, certain small S corporations and partnerships can use the small business simplified overall method (discussed on page 3) to figure their QPAI and report each shareholder's or partner's positive or negative share on Schedule K-1. Others must give shareholders or partners the information they need to separately figure QPAI. If you must separately figure QPAI with information provided by an S corporation or partnership, see *Figuring QPAI*, below.

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.

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 page 3 for details.

b. Any qualified film you produce.

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

However, 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.

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.

For details, see Final Regulations section 1.199-1(d) or see section 4.03 of Notice 2005-14 and Proposed Regulations section 1.199-1(d) as discussed under *Additional Guidance* on page 1.

Qualifying production property.

The following are qualifying production property.

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

Manufacturing, producing, growing, or extracting.

Manufacturing, producing, growing, and extracting 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 Final Regulations section 1.199-3(e) or see section 4.04(3) of Notice 2005-14 and Proposed Regulations section 1.199-3(d) as discussed under *Additional Guidance* on page 1.

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 below), 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 Final Regulations section 1.199-4 or see section 4.05 of Notice 2005-14 and Proposed Regulations section 1.199-4 as

discussed under *Additional Guidance* on page 1.

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. However, you cannot 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.

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

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 Revenue Procedure 2002-28. You can find Revenue Procedure 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 can subtract \$300 ($\$400 \times .75$) 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. The following entities cannot use the small business simplified overall method.

- Estates and trusts.
- Qualifying oil and gas partnerships.
- Certain partnerships owned by expanded affiliated groups.

For details, see Final Regulations section 1.199-4(f) or see Proposed Regulations section 1.199-4(f)(4) as discussed under *Additional Guidance* on page 1.

S corporations and partnerships. If eligible under the above rules, an S corporation or partnership can use the small business simplified overall method to figure QPAI, which it can then allocate to shareholders or partners on Schedule K-1. A shareholder or partner who is allocated QPAI from an S corporation or partnership must report that QPAI on line 7. However, the shareholder or partner may figure QPAI from other sources using any method for which the shareholder or partner is eligible.

Expanded affiliated groups. For additional rules that apply to expanded affiliated groups, see Final Regulations section 1.199-4(f)(4) or see section 4.05(5) of Notice 2005-14 and Proposed Regulations section 1.199-4(f)(3) as discussed under *Additional Guidance* on page 1.

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 on page 3) are \$100 million or less (\$25 million or less if you choose not to rely on any part of the final regulations as discussed under *Additional Guidance* on page 1).

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 can subtract \$240 ($\$400 \times .60$) of your total other trade or business deductions, expenses, or losses from your DPGR to figure your QPAI.

S corporations and partnerships.

S corporations and partnerships cannot use the simplified deduction method to figure QPAI. Instead, they must include on Schedule K-1 the information shareholders or partners need to separately figure QPAI (unless the S corporation or partnership is using the small business simplified overall method).

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 Final Regulations section 1.199-4(e) or see section 4.05(3)(d) of Notice 2005-14 and Proposed Regulations section 1.199-4(e)(2) as discussed under *Additional Guidance* on page 1.

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 Final Regulations section 1.199-4(d) or see section 4.05(3)(c) of Notice 2005-14 and Proposed Regulations section 1.199-4(d) as discussed under *Additional Guidance* on page 1.

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 and partnerships.

S corporations and partnerships cannot use the section 861 method to figure QPAI. Instead, they must include on Schedule K-1 the information shareholders or partners need to separately figure QPAI (unless the S corporation or partnership is using the small business simplified overall method).

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 3% 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 9 on page 6 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 3% 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. 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.

Form W-2 Wages for tax years beginning after May 17, 2006.

When figuring your DPAD for a tax year beginning after May 17, 2006, the limit equal to 50% of Form W-2 wages is no longer based on Form W-2 wages from all businesses. Only wages properly allocable to domestic production gross receipts are included. For more information, see Treasury Decision 9293. You can find Treasury Decision 9293 on page 1013 of I.R.B. 2006-48 at www.irs.gov/pub/irs-irbs/irb06-48.pdf.

Form W-2 wages from an S corporation or partnership. An S corporation or partnership generally will figure its Form W-2 wages and report each shareholder's or partner's share on Schedule K-1. However, when figuring your DPAD for an S corporation or partnership with a tax year beginning before May 18, 2006, your allocable share of Form W-2 wages from the S corporation or partnership is limited to 6% of your share of any QPAI derived from the S corporation or partnership.

The S corporation or partnership should have applied the 6% limit for Form W-2 wages you report on line 13. However, you must apply the 6% limit to Form W-2 wages you report on line 12. If your share of QPAI

derived from an S corporation or partnership is zero or less, you cannot use any of its Form W-2 wages to figure your DPAD.

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). However, when figuring your DPAD for an estate or trust with a tax year beginning before May 18, 2006, your allocable share of Form W-2 wages from the estate or trust is limited to 6% of your share of any QPAI derived from the estate or trust. The estate or trust should have applied the 6% limit.

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.

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.

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.

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).

More information. Additional guidance provides rules that apply to short tax years and the acquisition or disposition of a trade or business. If you need more information to figure your Form W-2 wages, see Final Regulations section 1.199-2 and Rev. Proc. 2006-22 (for tax years beginning before May 18, 2006) or Rev. Proc. 2006-47 (for tax years beginning after May 17, 2006) or see section 4.02 of Notice 2005-14 and Proposed Regulations section 1.199-2 as discussed under *Additional Guidance* on page 1.

You can find Rev. Proc. 2006-22 on page 1033 of I.R.B. 2006-23 at www.irs.gov/pub/irs-irbs/irb06-23.pdf. You can find Rev. Proc. 2006-47 on page 869 of I.R.B. 2006-45 at www.irs.gov/pub/irs-irbs/irb06-45.pdf.

Specific Instructions

Line 1

Domestic Production Gross Receipts (DPGR)

Enter your DPGR (defined on page 2).

Estates and trusts. Estates and trusts must reduce the amounts on lines 1 through 4 by the percentage of any QPAI allocated to beneficiaries.

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 3).

Line 3

Estates and trusts must allocate directly allocable deductions or losses between DPGR and non-DPGR under Regulations section 1.652(b)-3 and enter the total on line 3.

Line 4

If you are using the small business simplified overall method (discussed on page 3), enter the amount of cost of goods sold and other deductions or losses you ratably apportion to DPGR.

If you are using the simplified deduction method (discussed on page 4), enter the other deductions or losses you ratably apportion to DPGR.

Line 9 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 18 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 12 Form W-2 Wages

Enter your Form W-2 wages (discussed on page 5). Do not include Form W-2 wages you must report on line 13.

Estates and trusts. Estates and trusts must reduce the amount on line 12 by the percentage of any Form W-2 wages allocated to beneficiaries.

Line 18 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* on page 7.

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 Final or Proposed Regulations section 1.199-7(h)(2) as discussed under *Additional Guidance* on page 1.

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 Final or Proposed Regulations section 1.199-7(d)(4) as discussed under *Additional Guidance* on page 1.

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 Final Regulations section 1.199-7(d)(4) or see section 4.09(4) of Notice 2005-14 and Proposed Regulations section 1.199-7(d)(4) as discussed under *Additional Guidance* on page 1.

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

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 with the same tax year. The reporting member completes lines 8 through 12 and lines 14 through 16 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 18.
2. Completes lines 17 and 19.
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 1-16, and enters its share of the group deduction on line 18 as a positive number.
2. Completes lines 17 and 19.
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.

Line 19 Domestic Production Activities Deduction

Combine lines 16 through 18 and enter the result on line 19 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 19, which includes any amount allocated to patrons, is deductible under section 199 by the cooperative.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

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 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.