T.D. 9731 – New Rules for the Allocation of W-2 Wages in a Short Taxable Year and in an Acquisition or Disposition for Purposes of the §199 Domestic Production Activities Deduction

In Brief

Effective August 27, 2015; the IRS has issued temporary regulations modifying the W-2 wage limitation formula for the purposes of the §199 Domestic Production Activities Deduction (DPAD)[1]. The temporary regulations apply to tax years beginning on or after August 27, 2015 and they expire on August 24, 2018[2]. A taxpayer may apply these provisions to the taxable years for which the tax assessment limitations period has not expired before August, 27, 2015[3]. Given that, a taxpayer claiming a §199 deduction during the three taxable years beginning before August 27, 2015 may retroactively avail themselves to the provisions of the temporary §199 regulations for those three prior years[4].

In Detail

Taking a step back, the deduction allowed under §199 for income attributable to domestic production activities is the least of the following three amounts:

- 9% of Qualified Production Activities Income (QPAI) realized and recognized during the taxable year;
- 9% of Taxable Income realized and recognized during the tax year[5] ; or
- 50% of the W-2 wage expense paid during the tax year[6].

Given that, the amount properly deducted by a taxpayer pursuant to §199 cannot exceed, in any circumstance, 50 percent of the qualified W-2 wages paid by the taxpayer during the tax year. Qualified W-2 wages are limited to those wages that are attributable to domestic production activities[7].

T.D. 9731 amends the guidelines relating to the 50 percent wage limitation by altering the provisions of Treas. Reg. §1.199-2(c) concerning the allocation of W-2 wages during a short taxable year and in an acquisition or disposition.

Short Taxable Year Rule

Prior to the promulgation of the temporary regulations, the amounts includable as a W-2 wage were limited to those amounts paid during the calendar year ending during the taxable year of the taxpayer. Under this regime, there were some short taxable year situations under which no §199 deduction would be available to the taxpayer. To illustrate, if a taxpayer had two taxable years spanning 11/1/2012 - 3/31/2013 (year 1) and 4/1/2013 - 10/31/2013 (year 2), the amount of W-2 wages taken into account for the purposes of a §199 deduction for the 2012 tax year (year

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1) would be limited to the wages paid during November and December of that year. Further, the taxpayer would not be permitted to claim a §199 deduction during the 2013 taxable year (year 2), as no W-2 wages would be available because no calendar year ends during the short taxable year.

The temporary regulations circulated under T.D. 9731 provide relief from the stringent short taxable year rule. Under the new regulations, wages paid during a short taxable year that does not contain a calendar year ending are treated as W-2 wages for the purposes of the §199 deduction, provided that the wages otherwise meet the requirements to be W-2 wages under §199 (i.e. the wages are attributable to domestic production activities)[8].

Allocations of W-2 Wages Between Multiple Taxpayers Pursuant to an Acquisition or Disposition

In addition to modifying the short taxable year rule, T.D. 9731 also provides guidance concerning the allocation of W-2 wages paid by two or more taxpayers that are the employers of the same employees during a calendar year. This situation arises when an entity is acquired or disposed of during the taxable year.

These temporary regulations provide that W-2 wages paid during a calendar year are to be allocated between the acquirer (successor) and the seller (predecessor) based on whether the wages were incurred for employment by the successor or employment by the predecessor[9]. Put simply, wages are apportioned between the seller and the acquirer based on which party owned the entity at the time the wages were paid. To illustrate, assume Taxpayer B owned Corporation A until March 31th of the tax year, at which point the entity was sold to Taxpayer C. In this instance, for the purposes of the §199 deduction, Taxpayer B would be able to claim the W-2 wages of employees of Corporation A for the first three months of the taxable year (January, February and March). Likewise, Taxpayer C would be able to claim as §199 W-2 wages the amounts paid to employees during the remaining nine months of the taxable year.

Conclusion

While the temporary regulations promulgated by T.D. 9731 do not significantly affect the operation of the §199 deduction, they may change the equation for many taxpayers - especially those who have experienced short taxable years or a recent acquisition or disposition. Those taxpayers would be wise to familiarize themselves with the operation of the new regulations.

[1] TD 9731, 80 FR 51939.
[2] Treas. Reg. §1.199-8T(i)(10-11)
[3] Id.
[4] I.R.C. §6501(a)
[5] §199(a)(1)
[6] §199(b)(1)
[7] §199(c)(1)
[8] §1.199-2T(c)(2)
[9] §1.199-2T(c)(1)