# The W-2 Wage Limitation on the §199 Deduction: What are "W-2 wages" and who gets credit for them?

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## INTRODUCTION

The IRS recently issued Rev. Proc. 2006-47 [1] and temporary and proposed regulations [2] that provide methods for calculating the W-2 wage limitation under §199. Both the procedure and the regulations are effective for taxable years beginning after May 17, 2006, and incorporate changes to the wage limitation enacted as part of the Tax Increase and Prevention Act of 2005 ("TIPRA"),[3] providing that "W-2 wages" for purposes of the limitation include only wages that are properly allocable to "domestic production gross receipts" ("DPGR"). This new limitation on the amount of W-2 wages that may be taken into account under §199 may cause some taxpayers that were not constrained by the wage limitation for calendar years 2005 and 2006 to be subject to the limitation in 2007.

This article discusses the methods of computing the W-2 wage limitation for both pre- and post-TIPRA-effective-date years. In particular, we analyze the application of the W-2 wage limitation to various organizational structures and three-party employment arrangements.

## I. BACKGROUND

Section 199 [4] of the Internal Revenue Code of 1986, as amended (the "Code"),[5] permits taxpayers to claim a deduction equal to a percentage of their income attributable to domestic production activities. For taxable years beginning in 2010 and thereafter, the deduction is equal to 9% of the *lesser of* a taxpayer's "qualified production activities income" ("QPAI") or taxable income (modified adjusted gross income, in the case of individual taxpayers), determined without regard to the deduction itself. The deduction is phased in at 3% for taxable years beginning in 2005 and 2006 and increases to 6% for years beginning in 2007 through 2009. QPAI equals DPGR, less the related cost of goods and allocable below-the-line period expenses.[6]

The deduction also is limited to 50% of the taxpayer's W-2 wages paid for the calendar year ending during the taxable year ("Total W-2 Wages").[7] Total W-2 Wages equal the sum of the amounts that must be included on the Forms W-2 of employees under §6051(a)(3) (wages subject to income tax withholding) and §6051(a)(8) (elective deferrals).[8]

As originally enacted, the wage limitation included the Total W-2 Wages paid by the employer, which includes wages paid in connection with non-production activities. Consequently, the original wage limitation was unlikely to pose a meaningful constraint on the deduction for most large taxpayers, with the exception perhaps of a few lucky technology companies able to generate significant taxable income from a relatively small payroll. TIPRA rendered the wage limitation significant, however, for taxable years beginning after May 17, 2006, by providing that for purposes of the wage limitation taxpayers may take into account only that portion of the taxpayer's Total W-2 Wages that is properly allocable to DPGR.

The remainder of this article discusses the calculation of the W-2 wage limitation for both pre- and post-TIPRA-effective-date years.

## II. APPLICABLE GUIDANCE AND EFFECTIVE DATES

### A. Guidance Applicable to Taxable Years Beginning Before May 18, 2006

Final regulations under §199 (the "Final Regulations") were published on June 1, 2006,[9] effective for taxable years beginning on or after that date.[10] The Final Regulations were preceded by a notice of proposed rulemaking that appeared in the Federal Regis-

[1] 2006-45 I.R.B. 869.

[2] T.D. 9293, 71 Fed. Reg. 61662 (Oct. 19, 2006); REG-127819-06, 71 Fed. Reg. 61692 (Oct. 19, 2006).

[3] P.L. 109-222, §514, 120 Stat. 345 (May 17, 2006).

[4] Added by the American Jobs Creation Act of 2004 ("AJCA"), P.L. 108-357, §102, 118 Stat. 1418 (Oct. 22, 2004). In the Gulf Opportunity Zone Act of 2005, Congress made certain technical corrections to §199 (the "Technical Corrections"), with retroactive effect. P.L. 109-135, §403(a), 119 Stat. 25 (Dec. 21, 2005); *Id.* at Title IV (providing for retroactive effect).

[5] All section references are to the Code and to the regulations promulgated thereunder.

[6] *See generally* Granwell & Rolfes, "Musings on Selected Provisions of the Final Section 199 Regulations Applicable to Corporate Manufacturers of Tangible Property," Vol. 47, No. 18 *Tax Mgmt. Memo.* 355 (Sept. 4, 2006); Conjura, Zuber, & Breaks, Practical Considerations in Implementing the Section 199 Regulations, 105 *J. Tax'n* 68 (Aug. 2006).

[7] §199(b)(1).

[8] §199(b)(2)(A).

[9] T.D. 9263, 71 Fed. Reg. 31268.

[10] Regs. §1.199-8(i).


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ter on November 4, 2005 (the "Proposed Regulations"),[11] and Notice 2005-14 (the "Notice").[12]

For taxable years beginning before June 1, 2006, taxpayers have a choice of applying (1) the Notice, (2) a combination of the Notice and the Proposed Regulations, or (3) the Final Regulations.[13] Although the ability to choose among these three options for taxable years beginning before June 1, 2006, can be significant for other issues, the treatment of the W-2 wage limitation generally is the same under all the guidance.

As described in greater detail below, under all the applicable guidance, taxpayers can choose among three alternative methods of calculating the taxpayer's Total W-2 Wages. The three methods have remained essentially unchanged since originally appearing in the Notice. The Treasury and the IRS opted to include the three methods in a separate revenue procedure, rather than as part of the Final Regulations themselves, to make them easier to amend if Form W-2 changes. Accordingly, concurrently with the publication of the Final Regulations, the IRS issued Rev. Proc. 2006-22,[14] providing the same three methods for determining a taxpayer's W-2 wage limitation as were provided under the Notice and Proposed Regulations. Rev. Proc. 2006-22 applies to taxpayers that choose to apply the Final Regulations to taxable years beginning before May 18, 2006, the effective date of the TIPRA amendments.

### B. Guidance Applicable to Taxable Years Beginning After May 17, 2006

On October 18, 2006, the Treasury issued Regs. §1.199-2T, providing guidance for determining the portion of a taxpayer's W-2 wages that is properly allocable to DPGR, as required by TIPRA. Concurrently, the IRS published Rev. Proc. 2006-47, requiring taxpayers to apply one of the same three methods for determining Total W-2 Wages as were provided under prior guidance, but with the explicit requirement that taxpayers must then apply the rules in Regs. §1.199-2T(e) to determine the portion of those wages that is allocable to DPGR.

Formally, both Regs. §1.199-2T and Rev. Proc. 2006-47 apply only to taxable years beginning after October 18, 2006. Nonetheless, taxpayers will, in effect, be bound by these rules for any year beginning after May 17, 2006, the effective date of TIPRA, because Rev. Proc. 2006-47 contains the same methods for computing Total W-2 Wages as were available under prior guidance, and Regs. §1.199-2T(e) merely requires taxpayers to apply a reasonable method for allocating this amount between DPGR and non-DPGR.

The remainder of this article discusses the computation of Total W-2 Wages and the requirement for post-TIPRA years to allocate those wages between DPGR and non-DPGR. After reviewing the mechanics of the computation of the W-2 wage limitation, we consider issues regarding *whose* wages should be included in the computation, in light of the prevalence of three-party employment arrangements.

## DISCUSSION

## I. DETERMINING THE TOTAL W-2 WAGES PAID BY A TAXPAYER

*Definition of W-2 Wages.* Total W-2 Wages under §199 include only (1) wages that are subject to income tax withholding, (2) elective deferrals under §402(g)(3) (i.e., elective §401(k) contributions, including designated Roth contributions, and other qualified elective deferrals identified in §402(g)(3)), and (3) amounts deferred under §457, which deals with deferred compensation plans of state and local governments and tax-exempt organizations.[15] Importantly, Total W-2 Wages do not include any contributions or accruals under a qualified retirement plan that are not in the form of qualified elective deferrals or benefits under a §457 plan.

In addition, Total W-2 Wages include only the wages of common law employees that are actually included on a Form W-2 filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for that return.[16] Thus, compensation paid to independent contractors or other non-employees that is reported to the IRS on Form 1099 MISC is not included in Total W-2 Wages. As discussed in connection with three-party employment arrangements in Part IV, below, however, it is not necessary that the taxpayer be listed as the employer on the Form W-2; it is sufficient that the wages were paid to a common law employee of the taxpayer for employment by the taxpayer.

*Background Regarding Forms W-2.* Before delving into the mechanics of the computation of Total W-2 Wages for purposes of §199, some background regarding payments reported on a Form W-2 is helpful. Box 1 of Form W-2 ("wages, tips, other compensation") includes all wages[17] that are subject to current income tax. Examples of wages that must be included

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[11] 70 Fed. Reg. 67220.

[12] 2005-1 C.B. 498. Notice 2005-14 is obsolete for taxable years beginning on or after June 1, 2006.

[13] Regs. §1.199-8(i)(1). See Granwell & Rolfes, in note 6 above, for an extensive discussion of the ability to choose between these three options and factors to consider in making that choice. In particular, the option to forego the benefit of subsequent guidance and instead to rely solely on the Notice has been overlooked by commentators. This option may be beneficial for taxpayers with issues that were dealt with unfavorably in the subsequent guidance.

[14] 2006-23 I.R.B. 1033.

[15] §199(b)(2)(A).

[16] §199(b)(2)(C).

[17] As discussed in greater detail below, certain amounts identified in §3402(o) are treated as wages only for purposes of income tax withholding. Thus, these amounts are reported in Box 1, but technically are not within the definition of wages for purposes of §199.


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in Box 1 include cash payments of salary, bonuses, tips, commissions, and distributions of previously deferred nonqualified deferred compensation. Many noncash items also are included, such as income from the exercise of nonqualified stock options, the transfer of stock upon the vesting of restricted stock, the personal use of a company car, an employer-provided vacation, and gift certificates.

Commonly provided benefits that are not included in Box 1 include any §401(k) plan contributions, deferrals under a nonqualified deferred compensation plan, medical insurance coverage, group-term life insurance coverage up to $50,000, transit passes and parking (up to the statutory monthly dollar limit),[18] the business use of a company car, and reimbursements for substantiated business expenses. Distributions from a qualified retirement plan are not wages. They are reported on Form 1099R, not on Form W-2.

Box 5 of Form W-2 ("Medicare wages and tips") includes all wages that are subject to withholding for Medicare taxes. Because the Medicare tax statute differs slightly from the income tax withholding statute, amounts reported in Box 5 are different from those reported in Box 1 in a few important respects. For example, §401(k) plan deferrals and deferrals of vested nonqualified deferred compensation are included in Box 5 but not Box 1. Income resulting from disqualifying dispositions of stock acquired through exercise of an incentive stock option (ISO) under §422 or employee stock purchase plan (ESPP) under §423 is included in Box 1 but not in Box 5.

*Nonduplication Rule.* The rules under §199 are clear that no duplication of W-2 wages is allowed. Thus, an amount may not be treated as W-2 wages under §199 by more than one taxpayer.[19] Similarly, amounts treated as W-2 wages for one taxable year may not be treated as W-2 wages for any other taxable year.[20]

*Methods of Computation.* No single box on Form W-2 represents all of the amounts comprising Total W-2 Wages for purposes of §199. The IRS, however, has developed three alternatives for calculating a taxpayer's Total W-2 Wages: the Unmodified Box Method, the Modified Box 1 Method, and the Tracking Wages Method. For taxable years beginning before May 18, 2006, a taxpayer's Total W-2 Wages, as computed under one of the three methods, equals the taxpayer's W-2 wage limitation under §199. For taxable years beginning after May 17, 2006, a taxpayer must perform a second step to determine the portion of its Total W-2 Wages that are allocable to DPGR. The rules regarding this second step are discussed in Part III, below.

Of the three methods, the first method is the simplest because all of the numbers needed to calculate Total W-2 Wages are taken directly from the taxpayer's Forms W-2. The other two methods are more complex but more accurate.

[18] For 2007, the monthly limit for transit passes is $110, and for parking it is $215.

[19] Regs. §1.199-2(d).

[20] *Id.*

**Unmodified Box Method**

Under the Unmodified Box Method, W-2 wages are the lesser of the total entries in Box 1 ("wages, tips and other compensation") or Box 5 ("Medicare wages and tips").

As explained above, §199 defines "W-2 wages" as wages subject to income tax withholding, plus elective deferrals under §402(g)(3) and amounts deferred under §457. (See the discussion of the Modified Box 1 Method immediately below for more details on these elective deferrals.) Neither Box 1 nor Box 5 corresponds exactly to this definition. Instead, both boxes are both over- and under-inclusive in certain respects:

- Both Box 1 and Box 5 are over-inclusive because both include the following amounts that are wages subject to income tax but not to income tax withholding:
  - Taxable group-term life insurance (i.e., the amount of coverage in excess of $50,000), for which withholding is not required under §3401(a)(14).
  - Vehicle fringe benefits, to the extent the employer does not elect to withhold under §3402(s).
- Both Box 1 and Box 5 are also over-inclusive because both include the following amounts identified in §3402(o) that are subject to withholding at the request of the employee but which are not "wages":
  - Payments made under a "sick pay" plan.
  - Payments of an annuity made to an employee.
- Box 1 is substantially under-inclusive because it does not include any elective deferrals under §402(g)(3) or deferred compensation under §457.
- Box 1 is over-inclusive because it includes income from an employee's disqualifying disposition of stock acquired through an exercise of an option under either an ISO plan or an ESPP (which allows employees to purchase employer stock at up to a 15% discount), even though these amounts are not subject to income tax withholding.
- Box 1 is also over-inclusive because it includes supplemental unemployment compensation benefits ("SUB pay") identified in §3402(o), which are subject to income tax withholding but are not "wages."[21]

[21] SUB pay is not included in Box 5. *See, e.g.*, Rev. Rul. 90-72, 1990-2 C.B. 211.


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- Box 5 is substantially over-inclusive because it includes certain deferrals of nonqualified deferred compensation that are no longer subject to a substantial risk of forfeiture.[22] Common examples of such nonqualified deferred compensation that—while not necessarily subject to current income taxation or withholding, are subject to Social Security and Medicare taxes—include §401(k) "excess plans" (i.e., a plan that allows the employee to elect to defer additional income over-and-above the statutory limitation) and bonus deferral plans.
  - Note that, under the nonduplication rule, taxpayers using the Unmodified Box Method that are required under the "lesser of" rule to use the amount reported in Box 5 in an earlier year and to use the amount reported in Box 1 in a later year must subtract from the amount reported in Box 1 the amount attributable to distributions from a nonqualified deferred compensation plan to the extent those distributions are of amounts that were treated as part of the taxpayer's Total W-2 Wages in the earlier year when they were earned by the employee and reported in Box 5.

We expect that, under the "lesser of" rule, many taxpayers applying the Unmodified Box Method will be required to use as Total W-2 Wages the amounts reported in Box 1. Elective deferrals under §402(g)(3) (including the substantial category of elective §401(k) deferrals) are entirely excluded from Box 1, whereas they are included in Box 5. Similarly, substantial deferrals of vested nonqualified deferred compensation would inflate the amount subject to Medicare taxes, and therefore be reported in Box 5 without adding to Box 1.

**Modified Box 1 Method**

Under the Modified Box 1 Method, a taxpayer starts with the amounts reported in Box 1 and makes the following adjustments:

- Subtract the amounts included in Box 1 of Forms W-2 that are not wages subject to withholding, which would include:
  - The amounts identified above as wages that are included in Box 1 but are not subject to income tax withholding:
    - Taxable group-term life insurance.
    - Certain vehicle fringe benefits.
    - Income from disqualifying dispositions of stock acquired through either an ISO or an ESPP.
  - The amounts identified above as subject to income tax withholding under §3402(o), but that are *not* wages:
    - Payments made under a sick pay plan and payments of an annuity made to an employee, to the extent the employee elects to subject such payments to withholding.
    - SUB pay.
- Add the elective deferrals under §402(g)(3) and the amounts deferred under §457. These amounts correlate to the amounts reported in Box 12 and properly coded as follows:
  - Code D (elective §401(k) contributions),
  - Code E (elective deferrals under a §403(b) annuity contract purchased by a charitable organization),
  - Code F (elective deferrals under a §408(k)(6) salary reduction Simplified Employee Pension (SEP),
  - Code G (elective deferrals and employer contributions (including nonelective deferrals) to any governmental or nongovernmental §457 plan), or
  - Code S (employee salary reduction contributions under a §408(p) SIMPLE retirement account).

Application of the Modified Box 1 Method should result in an amount of Total W-2 Wages that corresponds exactly to the taxpayer's W-2 wages as defined under §199(b)(2)(A).

**Tracking Wages Method**

Under the Tracking Wages Method, the taxpayer actually tracks total wages subject to Federal income tax withholding and makes appropriate modifications. Total W-2 Wages are calculated under this method as follows:

- Total the amounts of wages subject to federal income tax withholding that are paid to employees of the taxpayer for employment by the taxpayer and that are reported on Forms W-2 filed with the Social Security

[22] *See* Regs. §31.3121(v)(2)-1(b) (defining non-qualified deferred compensation for purposes of social security and Medicare taxes).


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Administration by the taxpayer for the calendar year.

- Subtract the SUB pay that was included under §3402(o)(1)(A). This adjustment would seem redundant with step 1, above, because SUB pay is not "wages" for purposes of §199.[23]
- Add amounts reported in Box 12 and properly coded D, E, F, G, or S.

The Modified Box 1 Method and the Tracking Wages Method should not produce different amounts—they merely reflect different starting points. The Tracking Wages Method is intended to implement a literal application of §199. The Modified Box 1 Method generates the same result, but begins with a specific box on Form W-2.

Although we expect the vast majority of taxpayers to apply the Unmodified Box Method, taxpayers that are constrained by the W-2 wage limitation generally will benefit from applying the Modified Box 1 Method or the Tracking Wages Method.

## II. EFFECT OF BUSINESS ENTITY STRUCTURE ON THE APPLICATION OF THE W-2 WAGE LIMITATION

### A. Rules for EAGs

For a corporate taxpayer that is a member of an Expanded Affiliated Group ("EAG"), the W-2 wage limitation is applied at the level of the EAG. An EAG is an affiliated group as defined in §1504(a), determined by substituting a "more than 50%" vote-and-value ownership test for the "at least 80%" vote-and-value ownership test for consolidation, and by including certain insurance companies and §936 corporations.[24]

Once each member of an EAG has computed its separate QPAI and W-2 wage limitation, each member's QPAI, taxable income, and W-2 wage limitation amount are aggregated in order to apply the taxable income and W-2 wage limitations at the EAG level. To compute the deduction, the EAG multiplies the applicable percentage, (e.g., 3% for taxable years beginning in 2005 and 2006), by the lesser of the EAG's aggregate QPAI and aggregate taxable income, determined without regard to the §199 deduction itself. The §199 deduction is equal to the lesser of this amount or 50% of the EAG's aggregate W-2 wage limitation. The EAG's deduction is then allocated among the members in proportion to their relative amounts of QPAI, if any.

The ability to aggregate the Total W-2 Wages paid by each member of an EAG for purposes of applying the W-2 wage limitation is another reason why the W-2 wage limitation is not expected to be significant for taxable years beginning before May 18, 2006.

For taxable years beginning after May 17, 2006, the portion of each member's Total W-2 Wages that is allocable to DPGR is determined at the individual EAG member level, and only the portion of each member's Total W-2 Wages that is allocable to DPGR earned by that member is aggregated at the EAG level for purposes of applying the W-2 wage limitation to the EAG. Application of the post-TIPRA rules for determining an EAG's W-2 wage limitation are discussed in III, below.

### B. Rules for Partnerships and Other Pass-Through Entities

Section 199 benefits are available for activities conducted through S corporations, partnerships, estates, trusts,[25] or other pass-through entities. Such entities cannot be members of an EAG, even if the EAG owns all of the interests in the entity.[26] This result is not changed for "EAG Partnerships."[27]

Instead, §199 is to be "applied at the partner . . . level" for partnerships.[28] Although this language might have been interpreted to imply that the "aggregate" approach should be taken to partnerships for purposes of §199, certain Technical Corrections and Treasury guidance indicate that the character of a partnership's items as DPGR or as relating to DPGR is to be determined at the partnership level, based solely on the activities of the partnership, and not at the level of the individual partners.[29]

Thus, the Treasury generally has interpreted the statutory directive to apply §199 at the partner level,

[23] SUB pay is subject to withholding, and therefore reportable in Box 1, as a result of its inclusion in §3402(o), entitled *Extension of withholding to certain payments other than wages.* Section 3402(o)(1)(A) provides that the amounts identified therein shall be treated as wages for purposes of Chapter 24, dealing with collection of income tax at the source, and for so much of Subtitle F, dealing with procedure and administration, as relates to Chapter 24.

[24] §199(d)(4)(B), as amended by §403(a)(10) of the Technical Corrections, note 4 above.

[25] The rules for trusts, estates, and S Corporations are beyond the scope of this article.

[26] The definition of an EAG is based on the definition of an affiliated group under §1504(a), with certain modifications. §199(d)(4)(B). Significantly, only *C corporations* are eligible for inclusion in an affiliated group. §1504(b).

[27] Even though §199 provides that, if all of the interests in the capital and profits of a partnership are owned by members of a single EAG (an "EAG Partnership"), the partnership and all members of such EAG are treated as a single taxpayer, this treatment is only for purposes of determining whether the partners' and the partnership's gross receipts qualify as DPGR. §199(c)(4)(D), as amended by §403(a)(7) of the Technical Corrections, note 4 above. Thus, the W-2 wage limitation does not apply at the level of the combined EAG and EAG Partnership as it does for purposes of determining an EAG's aggregate W-2 wage limitation.

[28] §199(d)(1)(A)(i).

[29] The Technical Corrections added more detail to the statutory directive to apply §199 at the partner level. After stating that §199


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as requiring only that the taxable income and W-2 wage limitation be applied at the partner level, after aggregating the partner and the partnership's separately determined items.

Significantly, as originally enacted, before the TIPRA amendment, §199 provided that, in applying the W-2 wage limitation at the partner level, each partner was limited in the amount of W-2 wages that it could take into account from the partnership for purposes of computing the partner's or W-2 wage limitation. Specifically, for pre-TIPRA years, a partner that is allocated QPAI from a partnership is allocated W-2 wages from such entity in an amount equal to *the lesser of* (1) such person's allocable share of the W-2 wages of the partnership for the taxable year or (2) twice the relevant percentage (i.e., 3% for 2005 and 2006) of so much of such person's QPAI that is attributable to the items earned directly by the partnership.[30] Thus, a partner in a partnership who did not pay sufficient W-2 wages directly to cover all of the QPAI earned directly by such person, with the result that the partner's §199 deduction was limited by the W-2 wage limitation could not use its allocable share of W-2 wages paid by the partnership to increase its W-2 wage limitation to cover the QPAI earned directly.

For taxable years beginning after May 17, 2006, TIPRA repealed this limitation in former §199(d)(1) on the amount of wages treated as allocated to owners of pass-through entities for purposes of computing the owners' wage limitation on the deduction. Instead, for post-TIPRA years, each partner or shareholder is treated as having W-2 wages for the tax year equal to its allocable share of the entity's W-2 wages for the taxable year.[31]

The application of the post-TIPRA rules for determining W-2 wages attributable to DPGR in the context of pass-throughs is discussed in III.D, below.

## III. DETERMINING THE PORTION OF TOTAL W-2 WAGES ALLOCABLE TO DPGR FOR TAXABLE YEARS BEGINNING AFTER MAY 17, 2006

### A. In General

For taxable years beginning after May 17, 2006, a taxpayer's W-2 wage limitation is limited to the portion of its Total W-2 Wages that are allocable to DPGR (so-called "paragraph (e)(1) wages," in reference to Regs. §1.199-2(e)(1)). Under Regs. §1.199-2T, taxpayers generally are free to use any reasonable method that satisfies the IRS for allocating Total W-2 Wages between DPGR and non-DPGR, based on all of the facts and circumstances. In addition, Regs. §1.199-2T provides safe harbors and formulas for determining the amount of wages allocable to DPGR. We applaud the Treasury for taking a common sense approach in developing the safe harbor. Furthermore, we believe that the safe harbor provides insight into what the Treasury considers a "reasonable method" for taxpayers that choose to forego the safe harbor.

*Wage Expense Safe Harbor.* The new rules include a wage expense safe harbor for those using the §861 method of cost allocation under Regs. §1.199-4(d) or the simplified deduction method under Regs. §1.199-4(e). Under this safe harbor, the calculation of wages qualifying for the deduction is made by multiplying Total W-2 Wages by the ratio of the taxpayer's "wage expense" included in calculating QPAI for the taxable year to the taxpayer's total wage expense used to calculate taxable income for the taxable year.[32] The remainder of this section discusses the computation of this "wage expense" fraction.

For purposes of the safe harbor, "wage expense" is defined as "compensation paid by the employer in the active conduct of a trade or business to its employees" that is properly taken into account under the taxpayer's method of accounting.[33] Thus, the regulations do not require taxpayers to allocate their Total W-2 Wages using factors based solely on "W-2 wages" as defined under §199. Instead, taxpayers are able to allocate their Total W-2 Wages based on the amount of "compensation expense" that is included in the com-

should be applied at the partner level, the statute now provides:

> [E]ach partner or shareholder shall take into account such person's allocable share of each item described in subparagraph (A) [referring to DPGR] or (B) [referring to cost of goods sold and other expenses, losses or deductions that are properly allocable to such receipts] of subsection (c)(1) (determined without regard to whether the items described in such subparagraph (A) exceed the items described in such subparagraph (B)) . . . .

§199(d)(1), as amended by §403(a)(8) of the Technical Corrections, note 4 above.

Treasury officials have suggested that Congress added this provision to reinforce Treasury's position that §199 is to be applied to partnerships using the "entity" approach. Thus, Treasury officials have asserted that the requirement for a partner to take into account, in computing its QPAI, its share of the *partnership's* DPGR and related costs is inconsistent with the assertion that a partnership's DPGR should be determined at the partner level.

Regardless of the validity of this line of reasoning, the Technical Corrections also added the concept of EAG Partnerships to §199 (see note 27, above), which seems to foreclose any argument for the application of the aggregate approach to partnerships under §199. §199(c)(4)(D), as amended by §403(a)(7) of the Technical Corrections. The Joint Committee explanation of the effect of qualifying as an EAG Partnership implies that, absent the application of this provision, a partnership would not be treated as having conducted the activities conducted by a partner (or vice versa) for purposes of determining whether the partnership's gross receipts qualify as DPGR or the partnership's expenses should be treated as related to DPGR. *See* Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of H.R. 4440, The "Gulf Opportunity Zone Act of 2005," JCX-88-05 (Dec. 16, 2005).

[30] §199(d)(1)(a)(iii), before amendment by TIPRA.

[31] §199(d)(1)(A)(iii).

[32] Regs. §1.199-2T.

[33] Regs. §1.199-2T(e)(2)(ii)(A).


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putation of their taxable income. For example, compensation expense would seem to include all deductible compensation expenses, including payments made to a qualified plan or for medical benefits that are not included within the definition of W-2 wages because they are not subject to withholding tax and are not elective deferrals. This makes sense because taxpayers are unlikely to track the components of Total W-2 Wages in their accounting systems. That is, taxpayers are unlikely to have any idea of the amount of "W-2 wages" included in their cost of goods sold.

*Application of Safe Harbor to COGS.* Under the safe harbor, a taxpayer may determine the portion of its wage expense included in cost of goods sold (COGS) that is allocable to DPGR using any reasonable method that is satisfactory to the IRS based on all of the facts and circumstances. A reasonable method would include using direct labor included in COGS as wage expense. A reasonable method also would include using the §263A labor costs used by the taxpayer in applying the simplified service cost method with a labor-based allocation ratio under Regs. §1.263A-1(h)(4)(ii) as wage expense included in COGS.

The preamble to Regs. §1.199-2T acknowledges that COGS frequently includes the cost of goods manufactured in prior years, and thus frequently would include W-2 wages from prior years that are allocable to DPGR.[34] Nonetheless, under the safe harbor, no adjustment is required and taxpayers are permitted to use the wage expense included in COGS in developing the overall wage expense fraction used to allocate Total W-2 Wages between DPGR and non-DPGR. The preamble requests comments on appropriate safe harbors for determining the amount of paragraph (e)(1) wages in COGS that are properly allocable to DPGR.[35]

*Application of Safe Harbor to Below-the-Line Expenses.* The safe harbor requires taxpayers that use the §861 method of cost allocation or the simplified deduction method to use the same expense allocation and apportionment methods that it uses to allocate below-the-line expenses in order to allocate and apportion any wage expense that is included in each of the taxpayer's below-the-line items. For example, if a taxpayer uses square footage to allocate headquarters expenses between DPGR and non-DPGR, the taxpayer must use square footage to determine the portion of any wage expense that is included in headquarters expenses that is attributable to DPGR.

Once a taxpayer has determined the portion of the "wage expense" included in each deduction (whether cost of goods sold or each below-the-line expense), that amount is divided by the total wage expense included in each deduction. Total W-2 Wages are then apportioned between DPGR and non-DPGR based on this fraction.

Small business simplified overall method safe harbor. Taxpayers that use the small business simplified overall method of cost allocation can use a simplified overall method safe harbor. Under this safe harbor, the portion of Total W-2 Wages that is properly allocable to DPGR is based on the same proportion of Total W-2 Wages that the amount of DPGR bears to the taxpayer's total gross receipts.[36]

## B. Application to EAGs

As discussed in Part II, above, each member of an EAG first separately calculates its own QPAI, taxable income, and W-2 wage limitation amount, which are then aggregated at the EAG level for purposes of applying the taxable income and W-2 wage limitation before they are aggregated by the EAG.[37] Because each member of an EAG separately calculates its own items before they are aggregated by the EAG, the temporary regulations provide that a member having Total W-2 Wages must itself have DPGR to which the wages are properly allocable in order for those wages to qualify as W-2 wages allocable to DPGR at the level of the EAG.[38] As a result, if a member has substantial Total W-2 Wages but no DPGR, none of the member's Total W-2 Wages will be allocable to DPGR, even if the member used all of its employees to provide services to another member that were attributable to the other member's DPGR activities.

For example, if one member houses all of an EAG's production workers and contracts out the services of those workers to other members of the EAG who earn all of the EAG's DPGR, none of the first member's W-2 wages will be considered allocable to DPGR. As discussed below, this conclusion assumes that the first member is in fact the common law employer of the workers. If it were possible to assert instead that the EAG members that earn the DPGR in fact are the common law employers, the wages paid to the workers by the first member would be treated for purposes of the W-2 wage limitation as being wages of the other members and could be allocated to their DPGR.

This type of structure is common in the construction industry, where the line employees are often housed in a separate legal entity from the operating affiliates for various business reasons, including minimizing the taint of these employees' relatively high turnover and injury rates on the unemployment and disability insurance rates applicable to the non-construction workers. If the separate legal entity housing the employees does not earn any DPGR directly, then none of the construction workers' wages will be included in the EAG's W-2 wage limitation.

Another example is that of a "Shared Services" organization ("S") that provides accounting, tax, and other headquarters type services to the operating entities in a group of affiliated companies. If S were a separate taxable entity, then, subject to the consolidated return rules discussed below, none of the wages

[34] Preamble to T.D. 9293, 71 Fed. Reg. 61662 (Oct. 19, 2006).

[35] *Id.*

[36] Regs. §1.199-2T(e)(2)(iii).

[37] Regs. §1.199-7(b).

[38] Regs. §1.199-2T(e)(2)(iv), *Ex. 5.*


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paid to the employees of S would be allocable to DPGR, even though, on a combined basis, a portion of such wages would be allocable to DPGR. Furthermore, this result holds even though the operating entities must apportion the services fee they pay to S between their DPGR and non-DPGR.

## C. Application to Consolidated Groups

The structures illustrated in the foregoing examples would not be problematic if the individual EAG members joined in the filing of a consolidated return. Under the single-entity concept of a consolidated group, Regs. §1.1502-13(c) (the "matching rule") generally redetermines the timing, character, and other attributes of intercompany items and corresponding items as if the members participating in the transaction were divisions of a single corporation.[39] Accordingly, if the companies comprising each of the foregoing examples were members of a consolidated group, the amount of the aggregate Total W-2 Wages allocable to DPGR in each example would equal that which it would have been if in fact the member companies in each example were merely divisions of a single corporation.[40]

## D. Application to Partnerships

As part of the same regulations package that included Regs. §1.199-2T, the Treasury issued Regs. §1.199-5T, providing guidance on the application of §199 to pass-thru entities for taxable years beginning after May 17, 2006.

As discussed above, although the statute provides that §199 is to be applied at the partner level, the guidance generally provides that only the computational aspects of §199 are performed at the partner level.[41] Accordingly, as in the case of the EAG, a partner and its partnership must each separately determine its respective Total W-2 Wages. However, after the partnership has determined its Total W-2 Wages, the new temporary regulations provide that the partnership must allocate its Total W-2 Wages among its partners in the same manner that wage expense is allocated among those partners.[42] The partner must then add its share of the Total W-2 Wages from the partnership to the partner's Total W-2 Wages from other sources, if any. A partner then must calculate its W-2 wage limitation by determining the amount of the aggregate Total W-2 Wages (including both those earned directly by the partner and those allocated from the partnership) that are properly allocable to DPGR.[43]

In light of the Treasury's past insistence on taking the entity approach to partnerships, it is a welcome surprise that the Treasury took the aggregate approach to the allocation of Total W-2 Wages between DPGR and non-DPGR, by allowing the allocation to take place at the partner level, presumably based on the partner's aggregate DPGR from both the partner's own activities and those of the partnership. Presumably, the fact that the §861 allocations take place at the partner level was at least a factor in this decision.

# IV. SPECIAL PROBLEMS WITH THREE-PARTY EMPLOYMENT ARRANGEMENTS

Total W-2 Wages include only those wages that are paid to the common law employees of the taxpayer. This Part describes various types of three-party employment arrangements and considers which party to such arrangements will be treated as the employer for purposes of §199.

## A. The Common Law Test

Whether a worker is a common law employee—and, if he is, of whom—has been heavily litigated over the years for tax and other purposes. The inquiry begins with an analysis of the Supreme Court's decision in *Nationwide Ins. Co. v. Darden*.[44] The opinion describes the common law employment test as follows:

> In determining whether a hired party is an employee under the general common law of agency, we consider the hiring party's right to control the manner and means by which the product is accomplished. Among the other factors relevant to this inquiry are the skill required; the source of the instrumentalities and tools; the location of the work; the duration of the relationship between the parties; whether the hiring party has the right to assign additional projects to the hired party; the extent of the hired party's discretion over when and how long to work; the method of payment; the hired party's role in hiring and paying assistants; whether the work is part of the regular business of the hiring party; whether the hiring party is in business; the provision of employee benefits; and the tax treatment of the hired party.[45]

Rev. Rul. 87-41,[46] which has been cited favorably by numerous courts, lists 20 factors relevant to the determination of whether an individual is an employee and of whom: (1) whether instructions are provided; (2) whether training is provided; (3) whether a worker's services are integrated into the business; (4)

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[39] Regs. §1.1502-13(a)(2).

[40] Regs. §1.199-2T(e)(2)(iv), *Ex. 6*.

[41] *See* Regs. §1.199-5T(b)(1)(i).

[42] Regs. §1.199-5T(b)(3).

[43] *Id.*

[44] 503 U.S. 318 (1992).

[45] *Id.* at 323-24.

[46] 1987-1 C.B. 296.



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whether the worker's services must be rendered personally; (5) whether the firm or the worker hires and pays assistants for the worker; (6) whether there is a continuing relationship between the firm and the worker; (7) whether the firm sets the worker's hours of work; (8) whether the worker is required to work full-time for the firm; (9) whether the work must be performed on the firm's premises; (10) whether the firm establishes an order or sequence for performing services; (11) whether the worker must provide oral or written reports to the firm; (12) whether the worker is paid by the hour, week, or month (rather than by commission or by the job); (13) whether the firm pays the workers business or traveling expenses; (14) whether the firm furnishes tools and materials; (15) whether the worker significantly invests in facilities used to perform the services; (16) whether the worker has the opportunity for profit or loss; (17) whether the worker performs services for more than one firm at a time; (18) whether the worker's services are made available to the general public; (19) whether the firm has a right to discharge the worker; and (20) whether the worker has a right to terminate the relationship with the firm without incurring any liability.

Although some courts continue to apply those factors, the IRS itself has changed its analytical framework in an effort to accommodate modern arrangements. The IRS Publication entitled "Employee or Independent Contractor?" [47] focuses simply on the right to direct and control the worker, both as to the result to be accomplished and as to the means and details by which the result is to be accomplished. The Training Materials frame the inquiry into three broad categories: (1) behavioral control; (2) financial control; and (3) intent of the parties. Some of the factors listed in Rev. Rul. 87-41 may be relevant within this framework, but the Training Materials emphasize that the IRS does not view the test as a simple tabulation of the various factors, but rather bases the determination on an overall evaluation of the business operation.

All businesses make a decision—whether conscious or subconscious—about whether their workers are employees when they pay the workers: Employee compensation generally is subject to federal and state income tax withholding, Social Security taxes, and Medicare taxes, and is reported to the Social Security Administration on Form W-2. Non-employee compensation generally is not subject to withholding and is reported to the IRS on Form 1099.[48] Whether a business has actually analyzed its relationship with its workers under the common law test is, of course, another matter. Accordingly, businesses for which the §199 deduction is constrained by the W-2 wage limitation may benefit from taking a fresh look at their relationships with their workers to determine who among them are common law employees, and whether the business might benefit from shifting some of its domestic production activities to common law employees from other types of workers.

## B. Three-Party Arrangements

Most businesses engage a third party to assist them in the complex task of managing a payroll. The degree of third-party involvement can range from clerical tasks (payroll services) to actually exercising the degree of control necessary to become the common law employer of the workers (some employee leasing arrangements). The §199 regulations permit taxpayers to take into account wages paid by a third party and reported by that party on Forms W-2 only if the wages were paid to common law employees of the taxpayer for employment by the taxpayer.[49] Accordingly, the structure of a business's payroll and its relationships with its workers can significantly affect the business's Total W-2 Wages. The remainder of this section discusses common three-party arrangements in this context.

*Payroll Services.* Many employers hire payroll services to process paychecks, deposit withheld taxes, and file associated tax and information returns. Payroll services file those returns under the name and taxpayer identification number of the employer, not of the payroll service. Payroll service companies clearly could not apply the wages paid to employees of its client companies to its own Total W-2 Wages because it is not the common law employer of those employees. Only the common law employer—the party hiring the payroll service in this instance—can apply those wages to its limit.

*Pay Agents.* A pay agent performs many of the same functions as a payroll service, but it does so under its own name and taxpayer identification number, after filing IRS Form 2678, Employer Appointment of Agent Under Section 3504 of the Internal Revenue Code. Members of an affiliated group of corporations often appoint one member of the affiliated group to serve as pay agent for all the members of the group. Unrelated entities may also be appointed as pay agents. This often occurs in connection with the disposition of a business, where the transferred business appoints a former parent or other affiliate to continue to handle its payroll for a transition period.

Similar to a payroll service, a pay agent exercises no control over the employees and, thus, is not the common law employer. Unlike a payroll service, however, a pay agent assumes liability under the Code to make deposits and file the required IRS forms. But the agent's assumption of these liabilities does not relieve the common law employer of liability.[50] The §199 regulations make it clear that if "the taxpayer is paying wages as an agent of another entity to individuals who are not employees of the taxpayer, the wages may not be included in determining the W-2 wages of the taxpayer." [51]

*Section 3401(d)(1) Employers and Leasing Companies.* A variety of arrangements are generically referred to as "employee leasing." The term may refer

[47] Training Materials, 3320-102 (Rev. 10-96).

[48] Non-employee compensation could be subject to backup withholding in certain circumstances.

[49] Regs. §1.199-2(a)(2).

[50] §3504.

[51] *Id.*


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to a §3401(d)(1) employer or a common law employer, or even a payroll service [52] or pay agent.[53] A leasing company may be an independent entity or a "captive" leasing company that simply provides workers to other entities within the same affiliated group. A §3401(d)(1) employer is not necessarily a leasing company, however.

*Section 3401(d)(1) Employers.* Briefly, a "section 3401(d)(1) employer" is an employer not because of a formal appointment to that status, but by operation of law because that party has "legal control" over the payment of the wages.[54] When a leasing company merely acts as an agent of the employer, providing payroll and other services without legal responsibility for payment of the wages, the leasing company is not the §3401(d)(1) employer,[55] nor is it a common law employer. Several court cases have addressed what constitutes "control of the payment of wages" under §3401(d)(1).[56] Based on those cases, the IRS's position is that a taxpayer is not in control of the payment of wages if the payment of wages is contingent upon, or proximately related to, the taxpayer having first received funds from its clients.[57]

The §199 regulations provide that, "if the taxpayer is treated as an employer described in §3401(d)(1) because of control of the payment of wages (that is, the taxpayer is not the common law employer of the payee of the wages), the payment of wages may not be included in determining W-2 wages of the taxpayer." [58] Thus, the regulations are clear that a §3401(d)(1) employer is not an employer for purposes of the wage limitation.

*Leasing Companies as Common Law Employers.* Despite numerous court cases holding that leasing companies were not common law employers,[59] leasing companies will be recognized as common law employers when they exercise the requisite level of control over the workers. Therefore, it is not safe to assume that workers hired through a leasing company are always common law employees of the recipient of the workers' services.

One such case, *In re Critical Care Support Services, Inc.*,[60] provides a helpful list of factors that the court considered in holding that nurses were common law employees of a nursing agency. The court noted that: (1) the agency screened the nurses before sending them to any hospital to ascertain that the nurse had a valid license, adequate skills for the job, and malpractice insurance; (2) the agency told the nurses what shift to fill, what hours to work, and where to report; (3) the nurses were paid by the agency by the shift regardless of whether the agency collected from the hospital; (4) the nurses had no financial investment in the agency and bore no meaningful risk of profit or loss from the jobs taken; (5) if a nurse was assigned to a shift, the nurse was not reassigned to a different shift by the hospital; (6) if a hospital was not satisfied with a nurse's performance, it notified the agency that it did not want the nurse reassigned to it; (7) the nurse could not hire a replacement or substitute for the assignment; and (8) the agency decided whether to send a particular nurse to a particular hospital, whether to assign that nurse to different duties at the hospital, and whether to withhold assignments from the nurse for any period of time.

*Co-employment Theory.* Typically, each individual who is classified as an employee has only one common law employer under the tax law. But under the common law doctrine of co-employment, a worker may have the status of an employee with respect to more than one employer if service to one does not involve abandonment of service to the other. Therefore, two employers may employ a worker simultaneously.[61] A few select tax authorities do refer to this theory.[62]

Rev. Rul. 66-162 deals with payments made to sales clerks by a department store and by a concessionaire hired by the department store to run the departments. The salary paid by the department store was wages and not at issue. The question presented was whether the commission payments made by the concessionaire directly to the sales clerks were wages for employment tax purposes. The ruling holds that, because the concessionaire controlled the clerks inde-

[52] *See, e.g., Professional & Executive Leasing, Inc. v. Comr.*, 89 T.C. 225 (1987), *aff'd*, 862 F.2d 751 (9th Cir. 1988) ("petitioner merely performs a bookkeeping and payroll service function"). *See also U.S. v. Garami*, 184 B.R. 834 (D.C. Fla. 1995) (leasing company not the 3401(d)(1) employer of cleaners; contractual agreement with leasing company did not relieve employer of FICA responsibility); *In re Professional Sec. Servs., Inc.*, 162 B.R. 901 (Bankr. M.D.Fla. 1993) (leasing company not the 3401(d)(1) employer of security guards; contractual agreement with leasing company did not relieve employer of FICA responsibility).

[53] *See, e.g.*, FSA 199932002.

[54] Regs. §31.3401(d)-1(f).

[55] CCA 200103070.

[56] *See Winstead v. U.S.*, 109 F.2d 989 (4th Cir. 1997); *In re Earthmovers, Inc.*, 199 B.R. 62 (Bankr. M.D. Fla. 1996); *Alexander Drilling Inc. v. U.S.*, 98-1 USTC ¶50,225 (W.D. Ark. 1997).

[57] *See, e.g.*, 1998 FSA LEXIS 259 (April 9, 1998). *See also In re Professional Sec. Servs., Inc.*, 162 B.R. 901 (Bankr. M.D. Fla. 1993) (holding that because the leasing company did not issue payroll checks unless it first received payment from the client company, the leasing company was not in control of the payment of wages under §3401(d)(1).)

[58] Regs. §1.199-2(a)(2).

[59] *See, e.g., Dains v. Comr.*, 149 F.3d 1182 (6th Cir. 1998); *U.S. v. Total Employment Co., Inc.*, 305 B.R. 333, 2004-1 USTC ¶50,177 (M.D. Fla. 2004); *Beech Trucking Co., Inc. v. Comr.*, 118 T.C. 428 (2002).

[60] Lexis Doc. No. 92-1421 (Bankr. E.D. N.Y. 1992).

[61] *See Restatement (Second) of Agency* §226 (1958).

[62] *See, e.g.*, Rev. Rul. 66-162, 1966-1 C.B. 234. *See also* CCA 200415008 (recommending pursuit of a co-employment theory in collecting unpaid employment taxes from a leasing company when the client company is insolvent); *In re Earthmovers, Inc. v. U.S.*, 199 B.R. 62 (Bankr. M.D. Fla. 1996) (leasing company not the §3401(d)(1) employer of construction workers; court held that construction company and leasing company were "co-employers" because Florida law placed responsibility for paying employment taxes on leasing company).


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pendently of the control exerted by the department store, the clerks were the employees of the concessionaire and the commissions paid by the concessionaire were wages for employment. An ERISA case, *Vizcaino v. Microsoft*,[63] suggests that a similar result is possible in the employee leasing context for employee benefit plan purposes: "Even if for some purposes a worker is considered an employee of the agency, that would not preclude his status of common law employee of Microsoft."

The §199 regulations preclude the possibility that the same wages could be counted twice, once by each of two common law employers.[64] But if one entity qualified for the deduction and the other did not, there is an argument under co-employment theory that some or all of the wages paid to employees of the co-employers could be applied to the Total W-2 Wages of the common law employer who qualified for the deduction. Thus, the argument would be that, even though a leasing company is a common law employer of employees engaged in domestic production activities for another company, and the leasing company itself does not qualify for the §199 deduction, the production company, as a co-employer, could apply wages paid to those employees to its §199 deduction limit.

## V. CONCLUSION

The amount of a taxpayer's §199 deduction depends, in part, on how the taxpayer has structured its operations and its relationships with its workers, including the components of their pay. For example, housing employees in a legal entity that is separate from the entity that generates DPGR may cause a group of related companies to be constrained by the wage limitation despite having a substantial aggregate payroll. In addition, taxpayers who use employee leasing companies and whose deduction is constrained by the wage limitation should consider whether restructuring their relationships with some of their workers may prove cost-effective. Historically, the financial incentives tended to favor hiring independent contractors or workers who were common law employees of another entity. The W-2 wage limitation under §199 may tilt the balance for some taxpayers in favor of using more of their own common law employees for domestic production activities.

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[63] 173 F.3d 713 (9th Cir. 1999).

[64] Regs. §1.199-2(d) ("an amount shall not be treated as W-2 wages by more than one taxpayer").


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