

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 1.199-2: Wage Limitation

Methods of Determining W-2 Wages for purposes of the §199(b)(1) Limitation on the §199 Deduction for Income Attributable to Domestic Production Activities

Rev. Proc. 2006-22

SECTION 1. PURPOSE

This revenue procedure provides methods for calculating W-2 wages for purposes of §199(b)(1) of the Internal Revenue Code, which limits the amount of the §199 deduction for income attributable to domestic production activities to 50 percent of the W-2 wages of the taxpayer for the taxable year.

Section 1.199-2(e)(3) of the Income Tax Regulations provides the Internal Revenue Service with authority to issue guidance providing the methods that may be used to calculate W-2 wages. Section 1.199-2(e)(3) is only effective for taxable years beginning on or after June 1, 2006. However, pursuant to §1.199-8(i)(1), a taxpayer may apply §1.199-2(e)(3) to a taxable year beginning before June 1, 2006, provided that the taxpayer

applies all the provisions of §§1.199-1 through 1.199-9 to the taxable year (or all the provisions of §§1.199-1 through 1.199-8 for a taxable year beginning after May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005 (Public Law 109-222) (TIPRA), and before June 1, 2006). This revenue procedure provides such guidance for taxpayers who choose to apply the final regulations to taxable years beginning before June 1, 2006, but only for taxable years beginning on or after January 1, 2005, and on or before May 17, 2006.

SECTION 2. BACKGROUND

Section 199(a) provides a deduction for an amount equal to a percentage of the lesser of (A) the qualified production activities income of the taxpayer for the taxable year, or (B) taxable income (determined without regard to §199) for the taxable year (or, in the case of an individual, adjusted gross income).

Section 199(b)(1) provides that the amount of the deduction allowable under §199(a) for any taxable year shall not exceed 50 percent of the W-2 wages of the taxpayer for the taxable year.

Section 199(b)(2) provides that, for purposes of §199, the term “W-2 wages” means, with respect to any person for any taxable year of such person, the sum of the amounts described in §6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Such term shall not include any amount that is not properly included in a return filed with the

Social Security Administration (SSA) on or before the 60th day after the due date (including extensions) for such return.

This revenue procedure provides three methods for calculating W-2 wages for purposes of §199(b)(1). These methods are generally the same as were set forth in both §1.199-2 of the proposed regulations that were published in the **Federal Register** on November 4, 2005 (70 FR 67220), and in section 4.02 of Notice 2005-14, 2005-1 C.B. 498, 514. The first method (the unmodified Box method) allows for a simplified calculation while the second and third methods (the modified Box 1 method and the tracking wages method) provide greater accuracy.

Section 514(a) of TIPRA amended section 199(b)(2) by excluding from the term W-2 wages any amount that is not properly allocable to domestic production gross receipts for purposes of section 199(c)(1). This amendment made by TIPRA is effective with respect to taxable years beginning after the date of enactment, May 17, 2006. The IRS and Treasury Department plan on issuing regulations and a new revenue procedure reflecting the amendment made to section 199(b)(2) by TIPRA. It is expected that any new revenue procedure will contain methods for calculating W-2 wages similar to the three methods in this revenue procedure, but will reflect the additional limitation on W-2 wages imposed by TIPRA. Because of the amendment by TIPRA, the guidance provided by this revenue procedure does not apply to taxable years beginning after the date of enactment of TIPRA.

SECTION 3. RULES OF APPLICATION

.01 *In general.* Section 1.199-2(a)(1) of the regulations provides that, except as provided in §1.199-2(a)(3) and §1.199-2(b), the Forms W-2, “Wage and Tax Statement,” used in determining the amount of W-2 wages are those issued for the calendar year ending during the taxpayer’s taxable year for wages paid to employees (or former employees) of the taxpayer for employment by the taxpayer. For purposes of §1.199-2, §1.199-2(a)(1) provides that employees of the taxpayer are limited to employees of the taxpayer as defined in §3121(d)(1) and (2) (that is, officers of a corporate taxpayer and employees of the taxpayer under common law rules).

.02 *Wages paid by entity other than common law employer.* Section 1.199-2(a)(2) of the regulations provides that, in determining W-2 wages, a taxpayer may take into account any wages paid by another entity and reported by the other entity on Forms W-2 with the other entity as the employer listed in Box c of the Forms W-2, provided that the wages were paid to employees of the taxpayer for employment by the taxpayer. 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. 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.

.03 Requirement that wages must be reported on return filed with Social Security Administration. Section 1.199-2(a)(3) of the regulations provides that the term “W-2 wages” shall not include any amount that is not properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return. For this purpose, if a Form W-2c (or corrected return) is filed to correct a Form W-2 that was not filed with SSA on or before the 60th day after the due date (including extensions) of the Form W-2 (or to correct a Form W-2c relating to a Form W-2 that had not been filed with SSA on or before the 60th day after the due date (including extensions) of the Form W-2), then such Form W-2c (or corrected return) shall not be considered to have been filed with SSA on or before the 60th day after the due date (including extensions) for such Form W-2c (or corrected return), regardless of when such Form W-2c (or corrected return) is filed. See §1.199-2(a)(3) of the regulations for further guidance related to this requirement.

.04 No application in determining whether amounts are wages for employment tax purposes. The discussions of “wages” in this revenue procedure and in the regulations under §199 are for purposes of §199 only and have no application in determining whether amounts are wages under §3121(a) for purposes of the Federal Insurance Contributions Act, under §3306(b) for purposes of the Federal Unemployment Tax Act, and under §3401(a) for purposes of the Collection of Income Tax at Source on Wages (federal income tax withholding), or any other wage-related determination. See §1.199-2(a)(1) of the regulations.

.05 Application for a taxpayer with a short taxable year. Subject to the other rules of application of the regulations and of this revenue procedure, the W-2 wages of the taxpayer for a short taxable year shall include those wages paid during the short taxable year to employees of the taxpayer as determined under the tracking wages method described in section 5.03 of this revenue procedure. See section 6 of this revenue procedure.

.06 Acquisition or disposition of a trade or business (or major portion). Section 1.199-2(c) of the regulations provides that if a taxpayer (a successor) acquires a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business from another taxpayer (a predecessor), then, for purposes of computing the respective section 199 deduction of the successor and of the predecessor, the W-2 wages paid for that calendar year shall be allocated between the successor and the predecessor based on whether the wages are for employment by the successor or for employment by the predecessor. Thus, in this situation, the W-2 wages are allocated based on whether the wages are for employment for a period during which the employee was employed by the predecessor or for employment for a period during which the employee was employed by the successor, regardless of which permissible method for Form W-2 reporting is used.

.07 Non-duplication rule. Section 1.199-2(d) of the regulations provides that amounts that are treated as W-2 wages for a taxable year under any method of calculating W-2 wages shall not be treated as W-2 wages for any other taxable year. Thus, for

example, an amount of nonqualified deferred compensation that is treated as W-2 wages under the Unmodified Box Method described in section 5.01 of this revenue procedure shall not be treated as W-2 wages in any other taxable year. Section 1.199-2(d) of the regulations also provides that an amount shall not be treated as W-2 wages by more than one taxpayer.

.08 *Trade or business requirement.* Pursuant to §1.199-8(c)(1), the term W-2 wages only includes those wages paid to employees of the taxpayer that are attributable to the actual conduct of a trade or business of the taxpayer. For example, remuneration paid to an employee for domestic service performed in the private home of the taxpayer is not included in W-2 wages of the taxpayer.

SECTION 4. DEFINITION OF W-2 WAGES AND CORRELATION WITH BOXES ON FORM W-2

.01 *Definition of W-2 wages.* Section 199(b)(2) and §1.199-2(e) of the regulations provides that, for purposes of §199(b)(1), the term “W-2 wages” means, with respect to any person for any taxable year of such person, the sum of the amounts described in §6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Thus, the regulations provide that the term W-2 wages includes: (i) the total amount of wages as defined in §3401(a); (ii) the total amount of elective deferrals (within the meaning of §402(g)(3)); (iii) the compensation deferred under §457; and (iv) for tax years beginning after December 31, 2005, the amount of designated Roth contributions (as defined in §402A).

.02 *Correlation with Form W-2.* Under the 2005 and 2006 Forms W-2, the elective deferrals under §402(g)(3) and the amounts deferred under §457 directly correlate to coded items reported in Box 12 on Form W-2. Box 12, Code D is for elective deferrals to a §401(k) cash or deferred arrangement (plan); Box 12, Code E is for elective deferrals under a §403(b) salary reduction agreement; Box 12, Code F is for elective deferrals under a §408(k)(6) salary reduction Simplified Employee Pension (SEP); Box 12, Code G is for elective deferrals and employer contributions (including nonelective deferrals) to any governmental or nongovernmental §457(b) deferred compensation plan; and Box 12, Code S is for employee salary reduction contributions under a §408(p) SIMPLE (simple retirement account). Under the 2006 Form W-2, the amount of designated Roth contributions (as defined in section 402A) directly correlates to Box 12, Code AA for designated Roth contributions to a section 401(k) plan and Box 12, Code BB for designated Roth contributions under a section 403(b) salary reduction agreement. However, designated Roth contributions are also reported in Box 1, Wages, tips, other compensation, and Box 5, Medicare wages and tips, and are subject to income tax withholding.

SECTION 5. METHODS FOR CALCULATING W-2 WAGES

For any taxable year, a taxpayer generally must calculate W-2 wages for purposes of §199(b)(1) using one of the three methods described in section 5.01, 5.02, and 5.03 of this revenue procedure. These three methods are subject to the non-duplication rule provided in §1.199-2(d). For a taxpayer with a short taxable year, see Section 6 of this

revenue procedure. In calculating W-2 wages for a taxable year under the methods below, the taxpayer includes only Forms W-2 that are for the calendar year ending with or within the taxable year of the taxpayer and that meet the rules of application described in section 3 of this revenue procedure.

.01 Unmodified box method. Under the unmodified box method, W-2 wages are calculated by taking, without modification, the lesser of—

- (A) The total entries in Box 1 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer; or
- (B) The total entries in Box 5 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer.

.02 Modified Box 1 method. Under the Modified Box 1 method, the taxpayer makes modifications to the total entries in Box 1 of Forms W-2 filed with respect to employees of the taxpayer. W-2 wages under this method are calculated as follows—

- (A) Total the amounts in Box 1 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer;
- (B) Subtract from the total in paragraph .02(A) of this section amounts included in Box 1 of Forms W-2 that are not wages for Federal income tax withholding purposes and amounts included in Box 1 of Forms W-2 that are treated as wages for purposes of income tax withholding under §3402(o) (for example, supplemental unemployment compensation benefits); and

(C) Add to the amount obtained after paragraph .02(B) of this section the total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.

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

(A) 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 SSA by the taxpayer for the calendar year;

(B) Subtract from the total in paragraph .03(A) of this section the supplemental unemployment compensation benefits (as defined in §3402(o)(2)(A)) that were included in the total in paragraph .03(A) of this section; and

(C) Add to the amount obtained after paragraph .03(B) of this section the total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.

SECTION 6. APPLICATION IN CASE OF SHORT TAXABLE YEAR

.01 Special rule for taxpayers with a short taxable year. Section 1.199-2(b) of the regulations provides that, in the case of a taxpayer with a short taxable year, subject to the rules of §1.199-2(a), the W-2 wages of the taxpayer for the short taxable year shall include

only those wages paid during the short taxable year to employees of the taxpayer, only those elective deferrals (within the meaning of §402(g)(3)) made during the short taxable year by employees of the taxpayer, and only compensation actually deferred under §457 during the short taxable year with respect to employees of the taxpayer.

.02 Method required for a short taxable year and modifications required in application of method. The W-2 wages of a taxpayer with a short taxable year shall be determined under the tracking wages method described in section 5.03 of this revenue procedure. In applying the tracking wages method in the case of a short taxable year, the taxpayer must apply the method as follows—

- (A) For purposes of section 5.03(A), the total amount of wages subject to Federal income tax withholding and reported on Form W-2 must include only those wages subject to Federal income tax withholding that are actually paid to employees during the short taxable year and reported on Form W-2 for the calendar year ending with or within that short taxable year;
- (B) For purposes of section 5.03(B), only the supplemental unemployment compensation benefits paid during the short taxable year that were included in the total in section 5.03(A) as modified by section 6.02(A) are required to be deducted; and
- (C) For purposes of section 5.03(C), only the portion of the total amounts reported in Box 12, Codes D, E, F, G, and S on Forms W-2, that are actually deferred or

contributed during the short taxable year are included in W-2 wages.

SECTION 7. EFFECTIVE DATE

A taxpayer must apply this revenue procedure to a taxable year beginning on or before May 17, 2006, if the taxpayer applies §§1.199-1 through 1.199-9 to the taxable year. For a taxpayer who chooses not to rely on §§1.199-1 through 1.199-9 and this revenue procedure for a taxable year beginning on or before May 17, 2006, the guidance on W-2 wages under section 199 that applies to such taxable year is contained in Notice 2005-14 or §1.199-2 of the proposed regulations. If Notice 2005-14 and §1.199-2 of the proposed regulations include different rules for the same particular issue, then a taxpayer may rely on either the rule set forth in Notice 2005-14 or the rule set forth in §1.199-2 of the proposed regulations. However, if §1.199-2 of the proposed regulations includes a rule that was not included in Notice 2005-14, then a taxpayer is not permitted to rely on the absence of a rule to apply a rule contrary to §1.199-2 of the proposed regulations. For taxable years beginning after May 17, 2006, and before June 1, 2006, a taxpayer may not apply Notice 2005-14, the proposed regulations, or any other guidance under section 199 in a manner inconsistent with amendments made to section 199 by section 514 of TIPRA.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is A. G. Kelley of the Office of Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this revenue procedure contact Mr. Kelley at (202) 622-6040 (not a toll free call).