Office of Chief Counsel
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Memorandum

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subject: Treatment under section 199 of loss on sale of purchased equipment used to produce QPP

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether a loss on the sale of Equipment A purchased by a taxpayer to produce qualifying production property (QPP) reduces the taxpayer's qualified production activities income (QPAI)?

CONCLUSION

Under Treas. Reg. §1.199-4(b)(1), the adjusted basis of purchased equipment used to produce qualifying production property is considered cost of goods sold (CGS) when that equipment is sold. Under the facts and circumstances, that CGS will be allocated solely to the taxpayer's non-domestic production gross receipts (non-DPGR) received on the sale of Equipment A and therefore the loss will not reduce the taxpayer's QPAI.

FACTS

Taxpayer purchased Equipment A in Year 1 and solely used Equipment A for three years to produce QPP, the sales of which generated DPGR. Depreciation of the cost of Equipment A was properly capitalized to the QPP. In Year 3, taxpayer sold Equipment A for a sales price that was less than the adjusted basis of Equipment A at the time of

the sale. The gross receipts from the sale of Equipment A did not generate DPGR because Equipment A was not manufactured, produced, grown, or extracted (MPGE) by the taxpayer.

LAW AND ANALYSIS

The section 199 domestic production activities deduction (DPAD) is equal to the lesser of a taxpayer's QPAI or taxable income (determined without regard to the section 199 deduction) multiplied by the applicable percentage. Section 199(a)(1). The applicable percentage for current years is 9%.

Section 199(c)(1) defines QPAI as an amount equal to the excess, if any, of the taxpayer's DPGR for the taxable year over the sum of the CGS and the other expenses, losses, or deductions (other than the deduction allowed under section 199) that are properly allocable to such DPGR.

Section 199(c)(4)(A)(i)(I) defines DPGR, in part, as the gross receipts of the taxpayer that are derived from any lease, rental, license, sale, exchange, or other disposition of QPP which was MPGE by the taxpayer in whole or significant part within the United States.

Section 1.199-3(c) provides the definition of gross receipts for purposes of determining the gross receipts to characterize as DPGR or non-DPGR. In relevant part, Treas. Reg. §1.199-3(c) provides that gross receipts for this purpose are not reduced by CGS or by the cost of property sold if such property is described in section 1221(a)(1) (i.e., inventory property) or (a)(2) (i.e., depreciable property used in a trade or business).

In calculating QPAI, DPGR is reduced by CGS and the related other expenses, losses, and deductions. In determining CGS allocable to DPGR for purposes of section 199(c)(1)(B)(i), Treas. Reg. §1.199-4(b)(2) provides that a taxpayer must use a reasonable method based on all the facts and circumstances to allocate CGS between DPGR and non-DPGR. In addition, that regulation section provides that "if a taxpayer has information readily available to specifically identify CGS allocable to DPGR and can specifically identify that amount without undue burden or expense, CGS allocable to DPGR is that amount…." Further, Treas. Reg. §1.199-4(b)(1) provides, in part, that "[i]n the case of a sale, exchange, or other disposition … of non-inventory property, CGS for purposes of this section includes the adjusted basis of the property."

Prior to its sale, Equipment A was used exclusively to produce QPP, the sales of which generated DPGR. Depreciation of the cost of Equipment A was properly capitalized to the QPP. The taxpayer then allocated its CGS between DPGR and non-DPGR in accordance with Treas. Reg. §1.199-4(b)(2) (e.g., if 100% of the gross receipts recognized by taxpayer in a particular year qualified as DPGR, taxpayer should have allocated all of its CGS to DPGR in that year). Taxpayer's gross receipts from the sale of Equipment A, however, are non-DPGR, because Equipment A is not QPP that was

MPGE by the taxpayer, even though it was used to produce QPP and the gross receipts from sales of that QPP were DPGR.

Taxpayer should have information readily available to it to specifically identify Equipment A's adjusted basis, which under Treas. Reg. §1.199-4(b)(1) is treated as CGS, allocable to non-DPGR received by taxpayer on the sale of Equipment A. Accordingly, the adjusted basis of Equipment A will not reduce taxpayer's DPGR and its QPAI.[1]

Please call (202) 317-4912 if you have any further questions.

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[1] Because Treas. Reg. §1.199-4(b)(1) applies in this case, paragraph (c) and (d) of Treas. Reg. §1.199-4(c) regarding the allocation and apportionment of the taxpayer's other expenses, losses, and deductions to the taxpayer's gross income attributable to its DPGR are not applicable.