OPINION POINT

Will Section 199 Stand the Test of Time?

By Vlad Frants*

Introduced in the American Jobs Creation Act of 2004 by Congress, the section 199 domestic production deduction was created to encourage manufacturing in the United States as well as certain other "production" activity. *See* David Freeman, *Section 199 Domestic Production Deduction: Time for a Closer Look*, Metropolitan Corporate Counsel, Nov. 2010, at 22. Section 199 currently reduces the effective tax rate on U.S. manufacturing (or production) income by allowing a deduction equal to nine percent of a taxpayer's "qualified production activities income." This article begins with a brief history of earlier provisions and then delves into the definition of what is meant by qualified production activities income, the eligibility of taxpayers to take the deduction, and other issues.

In 1962, in an attempt to inhibit the movement of U.S. export profits into foreign subsidiaries in tax haven jurisdictions, Congress enacted the foreign base company rules, which limited those tax benefits. Then, in 1971, Congress enacted the domestic international sales corporation (DISC) legislation, which was determined to constitute an illegal subsidy according to a panel established under the General Agreement on Tariffs and Trade. Congress then replaced the DISC legislation with foreign sales corporation (FSC) legislation. The FSC legislation, which lasted from 1984 until late 2000, offered exporters a federal income tax subsidy for operating through foreign sales corporations. In 1999, a World Trade Organization (WTO) panel determined, and the WTO Appeals Body confirmed, that the FSC regime was an unlawful subsidy which had to be eliminated. Congress then passed the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, which significantly changed how export sales were taxed; the act introduced an extraterritorial income exclusion (ETI), which frustrated U.S. trading partners. The European Union, for example, imposed tariffs on numerous U.S. products in retaliation for the ETI export incentive. ETI was also eventually deemed to constitute an illegal subsidy and Congress ultimately repealed the ETI regime. With this background, Congress returned to the drawing board and devised another production incentive, one that was not targeted to export sales but instead incentivized domestic production irrespective of the final destination of the produced merchandise: the section 199 domestic production deduction.

Section 199 is, to say the least, extraordinarily complex. A similar provision was once part of the Canadian tax laws but was repealed because it was highly complex and difficult to administer and the numerous disputes and litigation between taxpayers and the Canadian tax authorities led Canada to reduce corporate tax rates instead. *See* Jasper L. Cummings, Jr. & Robert L. Hanson, American Jobs Creation Act of 2004: A Selective Analysis ¶ 1.03 (2005). Consider the rules for section 199 below.

Section 199 provides a qualified production activities deduction (QPAD) and applies to those taxpayers that derive income from qualified domestic production activities (QDPA). The amount of the QPAD is currently nine percent of the lesser of (1) the qualified production activities income (QPAI) of the taxpayer for the tax year or (2) taxable income (determined without regard to the effects of the deduction) for the tax year. I.R.C. § 199(a)(1). The deduction is based on a formula and not on actual outlays. However, the deduction cannot exceed 50% of the W-2 wages paid by the taxpayer. I.R.C. § 199(b)(1).

QPAI is the excess of domestic production gross receipts (DPGR) over the sum of (1) the cost of goods sold allocable to DPGR, (2) other deductions, expenses or losses directly allocable to DPGR, and (3) a ratable portion of other deductions, expenses, and losses not directly allocable to DPGR or to any other class of income. I.R.C. § 199(c)(1)–(2). DPGR consists of gross receipts derived from: (1) the lease, rental, license, sale, exchange or other disposition of (a) "qualifying production property" produced by the taxpayer in the United States (in whole or significant part), (b) any "qualified film" produced by the taxpayer, or (c) electricity, natural gas, or potable water produced by the taxpayer in the United States; (2) construction performed within the United States by taxpayers engaged in the active conduct of a construction trade or business; or (3) architectural or engineering services performed in the United States, by a taxpayer engaged in the active conduct of an engineering or architectural services trade or business, for U.S. construction projects. I.R.C. § 199(c)(4).

While these basic rules may seem mechanical, the deduction can have a counterintuitive effect, is full of interpretive issues, and is replete with computational complexity. Consider even the most basic premise: section 199 is supposed to provide a *domestic*

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production deduction. Yet, nearly 80% of the cost of a finished product could be produced overseas (*non-domestic*) and still meet a safe harbor to qualify as domestic production, and 80% or more could be produced overseas if the taxpayer could successfully argue that the U.S. production was nonetheless "substantial" in nature. Services (*not production*) that are "embedded" in the products can also qualify for the deduction. *See* David Freeman, *supra*, at 23. Consider two examples of the interpretive difficulties. First, section 199(c)(4)(A)(i)(I) states that qualifying production property gives rise to domestic production gross receipts to the extent that the property is "manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States." The term "by the taxpayer" is addressed by neither the statute nor legislative history and, although some guidance has been issued, it has historically been a gray area. *See*, *e.g.*, Notice 2005-14, 2005-7 I.R.B. 498. Second, the meaning of "[produced] in whole or in significant part [within the United States]" has also been an area involving some uncertainty. Guidance on this matter has made this issue somewhat simpler, though by no means simple. *See* Cummings & Hanson, *supra*, at ¶ 2.03. These are only two of a multitude of interpretive issues related to section 199.

In addition to the statute's counterintuitive consequences and interpretive issues, there are also special rules and other computation issues that add an additional level of complexity. These special rules address particular taxpayer situations and "include the application of the deduction to individuals, pass-through entities (such as partnership, S corporation, estates, trusts, and similar entities), cooperatives, and the timber industry. Section 199 adopts the concept of an 'expanded affiliated group' both to compute the deduction and then to allocate the deduction to the members of the expanded affiliated group." Cummings & Hanson, *supra*, at ¶ 2.03. As David Freeman aptly points out in his article, *supra*, at 24, the correct application of section 199 can be difficult for taxpayers whose business models involve one or more of the following:

- [Accounting systems that track revenue and expenses based on divisions, product lines and other broad criteria (as opposed to the "item" approach required in the [Section 199] computation);
- Shared production responsibilities through sub-contractor arrangements, whether acting as the sub-contractor or the customer of a sub-contractor;
- Provision of delivery services, installation services or warranties in connection with the produced property;
- Production of products with multiple components with only some produced by the taxpayer;
- Unusual or non-recurring types of income including Subpart F inclusions, litigation settlements, gains on the disposition of capital assets;
- Unusual or non-recurring types of expenses and expenses that may relate to the stewardship of or allocation of costs and revenue among subsidiary and affiliated businesses.]

"In a testament to the broad reach and complexity of [Section 199], the IRS had designated [Section 199] a "Tier I Issue." Additionally, the Service "has admitted that the complexity of the rules related to [Section 199] might lead to substantial audit resources being expended during examination of any deduction claimed by the taxpayer." Beth Benko, *Section 199: Deduction Relating to Income Attributable to Domestic Production Activities*, 510-2nd T.M., at 2. While section 199 was moved from active to monitoring status in 2010, the likelihood of a Service audit of the deduction remains high today.

Recently, House Ways and Means Committee leaders have suggested that they are willing to consider eliminating the section 199 manufacturing deduction as part of a wider effort to reduce the corporate tax rate. Brett Ferguson & Heather M. Rothman, *Lawmakers Open to Trading R&D Credit, Section 199 Deduction to Lower Corporate Rates*, June 3, 2011, at http://www.bnasoftware.com/News/Tax_News/Articles/Lawmakers_Open_to_Trading_R_and_D_Credit_Section_199_Deduction_for_Lower_Corporate_Rates.asp. Practically speaking, eliminating the deduction would save the government money as well. One estimate of the ten-year budget impact related to the enactment of section 199 would be a decrease in tax revenue of approximately $76.5 billion. *See* Staff of Joint Comm. on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress 546 (App. Table) (JCS-5-05) (2005), *available at* http://jct.gov. In addition, the Treasury Department has indicated that, had the provision been repealed in 2008, revenues would have increased by $258 billion through 2017. Office of Tax Policy, U.S. Department of Treasury, Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century 48 (Table 3.1) (2007), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/Approaches-to-Improve-Business-Tax-Competitiveness-12-20-2007.pdf.

To the extent that it could be argued that the high cost (and complexity) is justified because it keeps manufacturers producing in the United States, perhaps a reduction in corporate tax rates would fulfill the same objective at a lower overall cost. It will be interesting to see if section 199 survives the test of time or whether the U.S. follows in the steps of Canada and replaces the deduction with a reduction in corporate tax rates. ■