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Maximizing the Section 199 Deduction

Starting this year, the domestic manufacturing deduction increases to 9% of income from eligible activities.

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Every business in the manufacturing sector, whether small or large, should consider the manufacturing deduction under IRC § 199. While section 199 comes with a complex set of rules, it nonetheless represents a valuable tax break for businesses that perform domestic manufacturing and certain other production activities. However, businesses should weigh its benefit against the cost of calculating and supporting it. For tax years beginning in 2010 and thereafter, the benefit is fully phased in at 9% of income from qualified production activities, so more businesses may now find the effort worthwhile.

This article provides an introduction to the deduction, with an overview of its rationale, background and applicability to a range of domestic production enterprises. It provides some tips and implications for claiming the deduction that might not otherwise be readily apparent to business owners and managers and their CPA advisers, and gives an overview of how the deduction is calculated. For a more detailed treatment of applying and calculating the deduction, see "Sec. 199: Domestic Production Activities Deduction" in *The Tax Adviser*, May 2010, page 322.

This deduction, sometimes also referred to as the "domestic manufacturing deduction," "U.S. production activities deduction" or "domestic production deduction," was instituted by the American Jobs Creation Act of 2004 (PL 108-357) effective for tax years beginning after 2004.

Previously, the Tax Code provided for an "extraterritorial income exclusion," but the World Trade Organization ruled that the provision violated its agreements concerning export subsidies. In response, Congress repealed that provision (former IRC § 114) and enacted section 199 in its place. Since the biggest beneficiaries of the former provision were manufacturers, Congress appeared in the new one to be looking for another way to provide an incentive for employment in domestic manufacturing. The law defined "domestic production activities" expansively, to include mining, oil extraction, farming, construction, architecture, engineering and the production of software, recordings and films. Companies can even claim the break for products only partially produced in the U.S. (According to a safe harbor in the regulations, if the manufacturing activities performed in the U.S. account for 20% of the costs, the companies may be eligible for the manufacturing deduction.)

The deduction is allowed for both the regular tax and the alternative minimum tax for individuals; C corporations; farming cooperatives; and estates, trusts and their beneficiaries. The deduction is allowed to partners and the owners of S corporations (not to partnerships or the S corporations themselves). Note that, unlike the former extraterritorial income exclusion and representing a significant advantage for a broader range of businesses, the domestic production deduction is available to taxpayers that do not export.

The deduction equals a percentage of the net income from eligible activities: 3% in 2005–2006; 6% for 2007–2009; and 9% after 2009. However, the amount of the deduction for any tax year may not exceed the taxpayer's taxable income or, in the case of individuals, adjusted gross income. There is also a limitation of 50% of certain wages reported on Form W-2 that are attributable to domestic production. Fully phased in, the deduction is designed to be economically equivalent to approximately a 3-percentage-point reduction in the tax rate on eligible activities conducted in the U.S.

The deduction might not apply at the state level, however. As of the start of 2010, 22 states had decoupled from the section 199 deduction (tinyurl.com/337brrk).

ELIGIBLE MANUFACTURING AND PRODUCTION ACTIVITIES

Among the more common eligible categories of activities are:

- Manufacture, production, growth or extraction (MPGE) of tangible personal property, in whole or in significant part within the U.S. (which for tax years beginning before Jan. 1, 2010, could in some circumstances include Puerto Rico—see section 199(d)(8));
- Construction of real property in the U.S.; and
- Performance of engineering or architectural services in the U.S. in connection with real property construction projects in the U.S.

Within those categories, a broad range of types of activities are eligible. Raw materials and finished products may be either new or made from scrap, salvage or junk material. Manufacturing or producing components used by another party in later manufacturing or production activities are eligible activities, as are manufacturing or producing finished items from components manufactured or produced by others. Processing and preparation of food products for sale at wholesale is an eligible production activity, but preparation of food and beverages for sale at retail is not.

Generally, the taxpayer must own the property that it is manufacturing or producing. Manufacture or production of property under contract for someone else who owns the property generally is not an eligible activity. (Exceptions apply for some federal government contractors—and this requirement does not apply to construction, architecture or engineering businesses.)

Activities that are purely sales are not eligible for the deduction, nor are activities that are purely services, except for those in construction, engineering and architecture.

***Construction*.** Construction of real property in the U.S. is eligible for the manufacturing deduction. The real property may consist of residential or commercial buildings; permanent structures (such as docks and wharves); permanent land improvements (such as swimming pools and parking lots); oil and gas wells, platforms and pipelines; and infrastructure (such as roads, sewers, sidewalks and power lines). Real property does not include machinery unless it is a "structural component"—for example, an elevator. Examples of businesses conducting eligible construction activities are residential remodelers; commercial and institutional building construction contractors; foundation, structure and building exterior contractors; structural steel and precast concrete contractors; and electrical, plumbing, heating and air-conditioning contractors.

Eligible construction activities do not include tangential services such as hauling trash and debris and delivering materials, even if the tangential services are essential for construction. Construction also includes "substantial renovation," but not decoration (or redecoration).

***Engineering and architecture*.** Engineering and architectural services are eligible for the manufacturing deduction only if they are performed in the U.S. for real property construction projects also in the U.S. Eligible engineering services include consultation, investigation, evaluation, planning, design and supervision of construction. Eligible architectural services include consultation, planning, aesthetic and structural design, and supervision of construction.

COMPLICATION IN APPLYING THE RULES

Many taxpayers can benefit from their CPAs' help to understand and determine whether they perform qualified activities. Where a company both produces a product and sells it in its own retail outlets, the retail sale can qualify as part of the production process. But in what might seem at first glance an arbitrary distinction, it breaks the chain of qualifying production if within those retail outlets it further processes the product immediately prior to sale—especially if it thereby prepares a food or beverage for consumption.

This was illustrated by the so-called "Starbucks footnote" in the House-Senate conference committee report on the legislation enacting section 199. In it, Congress noted that food processing is generally a qualified production activity but does not include activities carried out at retail establishments. Congress then noted that a taxpayer "may own facilities at which the predominant activity is domestic production ... and other facilities at which [the taxpayer] engage[s] in the retail sale of the taxpayer's produced goods and also sell[s] food and beverages." Congress then gave an example of a taxpayer that buys coffee beans and at the taxpayer's facility roasts and packages those beans. The taxpayer then sells the roasted coffee through unrelated third-party vendors and at the taxpayer's own retail establishments. Congress concluded that gross receipts from the sale of the roasted coffee are qualified domestic production gross receipts.

As a result, roasting and packaging coffee beans qualifies the taxpayer for the manufacturing deduction. In addition, the taxpayer, at its retail establishments, sells brewed coffee and other foods. Congress concluded that gross receipts from the sale of brewed coffee and other foods did not qualify as qualified domestic production gross receipts; however, the taxpayer may allocate part of the gross receipts from the sale of the brewed coffee as qualified domestic production gross receipts to the extent of the value of the roasted coffee beans used to brew the coffee.

CALCULATION STEPS

In general, the computation involves the following steps:

1. ***Identify areas of potential qualified production activities.*** Determine whether the manufacture, production of tangible personal property and/or development of computer software occurred in the U.S. Then evaluate whether a product is held for sale, lease or license, or involves a hosting service.

2. ***Calculate domestic production gross receipts (DPGR).*** Allocate gross receipts between qualified and nonqualified production activities. The starting point of these reconciliations is usually the sales detail contained in the trial balance. The gross receipts should be allocated and/or apportioned at the item level.

3. ***Allocate cost of goods sold to DPGR.*** Allocate production costs between qualified and nonqualified activities. The starting point of these reconciliations is usually the cost-of-goods-sold detail contained in the trial balance.

4. ***If necessary, determine, allocate and apportion below-the-line expenses.*** Unless the taxpayer is eligible for the simplified deduction method described in Treas. Reg. § 1.199-4(e)(1) or the small business simplified overall method described in Treas. Reg. § 1.199-4(f)(1), it must use the principles of section 861 (specifies apportionment of certain items of gross income and deductions to sources within the U.S.) to allocate and apportion deductions that support or otherwise are related to a class of gross income. Expenses so allocated and apportioned include charitable contributions, research and development expenses, selling, general and administrative expenses, corporate/stewardship expenses and interest.

5. ***Calculate the deduction.*** Use sales and cost-of-sales data derived in steps 2 and 3, and taxable income data derived in step 4. The net taxable income of the qualified products should be aggregated and presented on the consolidated calculation by entity schedule. The lesser of the qualified production activities income (QPAI) or taxable income is then multiplied by the applicable percentage to determine the deduction, which is limited to 50% of wages paid to the taxpayer's employees reported on Form W-2 during the calendar year ending during the tax year and that are allocable to DPGR.

PRACTICE TIPS

The complicated nature of the section 199 deduction presents numerous pitfalls for taxpayers, and in many cases, taxpayers fail to obtain the full benefit to which they are entitled. In addition, many taxpayers' calculation methods were instituted when the section 199 deduction was at 3%, and therefore amounts might have not been considered material. It is all too common to see calculations that have been rolled forward over several years and have not been updated to reflect changes, including the higher deduction amount.

With the deduction rate rising permanently to 9% this year, the section 199 deduction may become material. Taxpayers should note, however, that the IRS has designated the deduction as a Tier 1 issue, and we have seen a corresponding rise in IRS audits. Thus, businesses must also ensure that proper supporting documentation is in place and audit-ready.

The following are just a few examples of problems, solutions and planning opportunities that may help companies maximize the section 199 deduction:

1. ***Improperly reviewed gross receipts causing a reduction in DPGR.*** Companies may fail to identify which production items should qualify, and it is common to see tax departments not understand the revenue stream generated by various business lines within their respective companies.

2. ***Direct expenses improperly matched to DPGR***. Companies may, for a variety of reasons, fail to match direct expenses to DPGR, which in turn may cause an incorrect amount of expenses assigned to QPAI-producing items and, consequently, a reduction in QPAI.

3. ***Improperly matched indirect expenses.*** This is the most common limiter to a potential section 199 deduction. The companies may have difficulties with assigning the indirect expenses, especially the corporate and selling and administrative expenses, to QPAI-producing items, which in many cases may reduce or even eliminate the section 199 deduction.

4. ***Maximizing deductions in 2009 and deferring revenue to 2010.*** Companies may consider maximizing the benefit of an increased section 199 deduction percentage in 2010 (9%). As such, it may be beneficial to accelerate deductions into 2009 and defer revenue into 2010.

5. ***Contract manufacturing arrangements.*** Taxpayers that either rely on contract manufacturers or outsource a portion of their MPGE activities to an unrelated third party should be prepared to analyze which portions of their MPGE processes qualify for the section 199 deduction. Failure to comply with this requirement could result in situations in which neither the taxpayer nor the contract manufacturer benefits from section 199.

6. ***NOL carryback and section 199 interplay.*** For 2008 or 2009 tax years, companies may elect to carry back net operating losses (NOLs) up to five years, which may affect their taxable income and consequently their section 199 deduction. The companies should evaluate whether recomputing the section 199 deduction for the carryback year is required—for example, if the amount of the deduction depends on whether it was based on taxable income or QPAI.

    a. If taxable income is less than QPAI, then the NOL carryback would reduce taxable income and the amount of the section 199 deduction in the carryback year.
    b. If QPAI is less than taxable income, the section 199 deduction would not change in the carryback year, unless QPAI exceeds taxable income after applying the NOL carryback.

7. ***Allocation of noncompensatory expenses under section 861.*** Examples of noncompensatory expenses may include warranties, bad debts, legal settlements and environmental remediation.

8. ***Section 481(a) adjustments.*** A taxpayer that changes its method of accounting must properly allocate the resulting section 481(a) adjustment (to prevent omission or duplication of items) between DPGR and non-DPGR in determining its section 199 deduction. Common examples of a section 481(a) adjustment may include changes in accounting in regard to depreciation, amortization and repairs.

It is clear that focusing on the section 199 calculation and understanding the business-specific facts and circumstances can pay big dividends in the resulting deduction. Consider the steps outlined above and ensure that a proper methodology is in place; and you will be on your way to maximizing this deduction for years to come.

EXECUTIVE SUMMARY

- **The domestic manufacturing deduction under IRC § 199** became fully phased in for tax years beginning in 2010, at 9% of income from qualified production activities. Thus, more businesses may find it worthwhile to calculate and substantiate the deduction than in previous years, when the percentage was lower. However, they must take care to properly identify and substantiate qualifying activities and allocation of income and expenses.

- **The deduction is available** for a range of production activities performed in the U.S. in mining; oil extraction; farming; production of software, recordings and films; and construction of real property and related architectural and engineering services. However, products need not be wholly produced in the U.S., nor must they be finished goods. The taxpayer usually must own the property being produced, however.

- **Preparation of food and beverages for retail sale** is not eligible for the deduction, nor are activities that are purely services, outside the fields of construction, engineering and architecture.

- **Once a taxpayer identifies qualified production activities**, it calculates domestic production gross receipts (DPGR) and allocates them between qualified and nonqualified production activities. Then the taxpayer similarly allocates cost of goods sold and below-the-line expenses.

- **The resulting qualified production activities income** (or taxable income, if lower) is multiplied by the applicable percentage. The resulting deduction is further limited to 50% of Form W-2 wages allocable to DPGR.

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