

American Jobs Creation Act of 2004

The American Jobs
Creation Act of 2004

A magnifying glass with a wooden handle and a metal frame is positioned over the text. The lens of the magnifying glass is centered over the words 'American Job' and 'Act of 2004', making them appear larger and sharper than the surrounding text.

Section 199: Deduction for
Qualified Production Activity Income

Industrial Manufacturing

This Whitepaper sets forth certain thoughts, observations, insights and views on issues relating to the application of section 199 to industrial manufacturing.

The analysis herein takes into account the interim guidance on section 199 recently issued by Treasury and the IRS in Notice 2005-14 (the “Notice”). The interim guidance is intended to provide “comprehensive rules and definitions to assist taxpayers in implementing” section 199. Taxpayers may rely on the interim guidance until regulations are issued in the future.

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Nothing in this Whitepaper represents an opinion, or should be construed as an opinion, of PwC, and should not be relied upon for any purpose. The purpose of this Whitepaper is merely to provoke thought relating to the application of section 199.

It is anticipated that the analysis contained in this Whitepaper will be revised and updated from time to time, in particular as regulatory and other additional guidance is issued by Treasury and the IRS relating to the application of section 199. In this regard, we understand that the goal of Treasury and the IRS is to issue proposed regulations under section 199 sometime late this summer. It is anticipated that such regulations will incorporate the interim guidance and will be effective for taxable years beginning after December 31, 2004.

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Section 199: Deduction for Qualified Production Activity Income

Industrial Manufacturing

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This Whitepaper addresses the extent to which the new deduction for qualified production activities under Code section 199 may be available to industrial manufacturing companies. The potential tax benefit to industrial manufacturing companies is estimated to be approximately \$6.3 billion.

Taxpayers need to consider immediate phase-in planning and understand the impact that the section 199 deduction will have on their financial statements. Companies should consider what disclosures should be made to address the impact of the deduction on their effective tax rate, cash flows and estimated future tax benefits for accounting periods ending in 2005 and beyond. In addition, companies must take into account the impact of the deduction as a special deduction under FASB Staff Position (FSP) FAS 109-1. Companies also need to put a plan in place to develop and maintain substantial record keeping and/or documentation necessary to support their deduction. Finally, companies may be required to look internally to determine whether their existing reporting systems are capable of generating the information necessary to calculate the deduction.

As a general matter, it would appear that industrial manufacturing companies have many opportunities to benefit from section 199. Such opportunities, however, will, in part, be shaped by how section 199 is interpreted by Treasury and the IRS, and applied in practice.

There are several open questions of key importance to industrial manufacturing companies. Accordingly, the industry needs to move quickly to analyze the language of section 199 and the Notice in light of their business operations, identify the critical interpretive questions and take action where appropriate to seek a favorable outcome, either in the pending Technical Corrections bill, or in the ongoing administrative guidance process underway by Treasury and the IRS.

It should be noted that the wording of section 199 and the Notice draw heavily on terminology that has appeared in other areas of the tax law. Treasury has said that they will consider those precedents in preparing new guidance. We see a strong need for immediate industry awareness and, where needed, involvement in the rulemaking process.

Issues

The following are some of the key issues under section 199 for industrial manufacturing companies:

1. How is the term “manufacture” defined?
2. Special industry concerns with the definition of “qualifying production property” in relation to tangible personal property.
3. Special industry concerns with the definition of “qualifying production property” in relation to computer software.
4. Special industry concerns with the definition of “derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property.”
5. When considered separately, the provision of some services, such as extended warranties or transportation, do not qualify under section 199. However, can any portion of the services be included in qualified production activities? When are service costs, such as warranty or transportation costs, integrated into the product?
6. Are packaging, design, development, minor assembly, and testing activities taken into account in applying the “in significant part” test for tangible personal property?
7. For purposes of determining qualification for the deduction, how should “taxpayer” be defined? More specifically, how should contract manufacturing arrangements be treated?
8. How is “in whole or in significant part within the United States” defined?
9. What methodology should be used for the allocation of expenses?
10. What methodology should be adopted for determining qualified production activities income (i.e., at which level should testing be done)? More specifically, how should testing be done on an item-by-item basis? How does this testing differ from testing on a transaction-by-transaction basis or product-line-by-product-line basis?
11. How does the availability of the ETI deduction impact the availability and use of the section 199 deduction?
12. What is the proper application of the deduction where equipment is sold to a dealer and then the dealer enters into a lease of the equipment with the customer? Essentially this results in a sale back to the manufacturer followed by a lease arrangement by the leasing entity of the manufacturer.
13. What is the proper treatment of the deduction where there is a net operating loss carryover?
14. To what extent can industrial manufacturing companies benefit from section 199 with respect to the construction of their own stores or franchisee outlets?
15. How should joint ventures or other activities undertaken by the industry be treated under section 199, including those that are meant to establish standards or establish means of meeting standards? Will such joint ventures contribute gross receipts or expenses that will be included in the calculation of the deduction? Will manufactured items that are sold by an affiliate of a partner in the manufacturing partnership have the activity attributed to the selling affiliate?
16. Are there special industry concerns with the definition and qualification of “qualified films” and sound recordings?

Analysis

The American Jobs Creation Act of 2004 (the “Act”) was designed to stimulate the growth of manufacturing jobs in the United States by granting a reduced rate of tax for income from qualified “production activities” carried out in the United States. This is accomplished by introducing a special deduction under new section 199. The deduction will be 3% of qualified production income for 2005-2006; 6% for 2007, 2008, 2009 and 9% for 2010 and years thereafter.

For corporate taxpayers, this will mean a Federal income tax rate of 33.95%, 32.90% and 31.85%, respectively, for the years in question. The deduction cannot exceed 50 percent of a taxpayer’s W-2 wages paid to employees, and does not apply if the taxpayer does not have taxable income (determined after net operating loss carryovers). Importantly, the deduction also applies in calculating alternative minimum tax.

Special rules apply to corporate members of an “expanded affiliated group.” Such members are treated as a single taxpayer for purposes of applying the rules. Under other special rules, royalty revenue from “related persons” is excluded from qualifying gross receipts.

1. Computation of the QPA deduction

QPA gross receipts

Less the sum of:

- Cost of goods sold allocable to such receipts
- Other deductions directly allocable to such receipts
- A ratable portion of other deductions not directly allocable to another class of income

QPA income

Multiplied by 3% (effective for tax years beginning in 2005)

QPA deduction

2. “Qualified production activities income”

The benefit will apply to “qualified production activities income.”

Qualified production activities income equals the excess, if any, of the taxpayer’s domestic production gross receipts over the sum of:

- (a) the cost of goods sold that are allocable to such receipts,
- (b) other deductions, expenses, or losses directly allocable to such receipts, and
- (c) a ratable portion of other deductions, expenses, and losses that are not directly allocable to such receipts or to any other class of income.

Domestic production gross receipts are gross receipts “derived from” –

- a. Any “lease, rental, license, sale, exchange, or other disposition” of

- tangible personal property
- any computer software
- certain films

that have been “manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States;”

- b. Construction performed in the United States; and

- c. Engineering or architectural services performed in the United States for construction projects performed in the United States.

The Notice provides that a taxpayer’s qualified production activities income is determined on an “item-by-item” basis (and not, for example on a division-by-division, product-line-by-product-line, or transaction-by-transaction basis) and is the sum of the qualified production activities income derived by the taxpayer from each item. For purposes of this determination, qualified production activities income from each item may be positive or negative. It is not entirely clear from the Notice what constitutes an “item-by-item” basis. Elsewhere in the Notice, the term “property” is used in instances where the term “item” would appear more appropriate based on the requirements in the Notice. Based on recent comments made by Treasury officials, it is anticipated that Treasury and the IRS will provide more detailed guidance in the future with regard to computing qualified production activities income on an “item-by-item” basis.

3. Impact on services

“Qualified production activities” is the threshold definition that must be satisfied for taxpayers to obtain the benefit of a deduction under section 199. The Notice specifies that pure service activities (other than those in connection with “construction” and qualifying architectural and engineering services) are not qualified production activities. Certain safe harbor rules may apply, however, for some types of services.

4. Allocation of gross receipts

If a taxpayer is engaged exclusively in the manufacture of qualifying production property (“QPP”) within the United States and has no other sources of income, qualified production activities income will equal taxable income. However, in other instances, a taxpayer must determine the portion of its gross receipts that are domestic production gross receipts and the portion of its gross receipts that are not domestic production gross receipts. In doing so, the Notice states that a taxpayer must allocate its gross receipts based on a “reasonable method” that is satisfactory to the IRS.

In this regard, the Notice identifies a number of factors to consider in determining whether a method for allocating gross receipts is “reasonable” including whether the taxpayer uses the most accurate information available, the relationship between the gross receipts and the apportionment base chosen, the accuracy of the method chosen as compared with other possible methods, whether the method is used by the taxpayer for internal management or other business purposes, whether the method is used for other federal, state or foreign income tax purposes, and the time and cost of using various methods. Given the variety of factors to consider, what qualifies as a “reasonable method” for allocating gross receipts for purposes of section 199 may be subject to interpretation and dispute between taxpayers and the IRS.

Under a special safe-harbor rule, a taxpayer is not required to allocate its gross receipts between domestic production gross receipts and non-domestic production gross receipts if its gross receipts that are not domestic production gross receipts are less than 5 percent of its total gross receipts. That is, all gross receipts are treated as domestic production gross receipts where less than 5 percent of a taxpayer’s gross receipts are not domestic production gross receipts (after the application of the other de minimis safe harbor rules). This safe-harbor may benefit taxpayers, for example, in the case of embedded services and/or financing transactions (e.g., interest and late fees).

Key issues for industrial manufacturing companies under Section 199

The following discussion addresses the key issues identified above for the industrial manufacturing industry.

1. How is the term “manufacture” defined?

Section 199 defines the term “domestic production gross receipts” to include, among other things, gross receipts “derived from” any lease, rental, license, sale, exchange or other disposition of qualifying production property (“QPP”) which was “manufactured, produced, grown, or extracted” by the taxpayer in whole or in significant part within the United States.

With respect to the phrase “manufactured, produced, grown or extracted,” the Notice states that the term includes activities relating to manufacturing, producing, growing, extracting, installing, developing, improving and creating QPP. The Notice also states that it includes making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining or changing the form of an article, or by combining or assembling two or more articles; cultivating soil, raising livestock, fishing and mining minerals.

The Notice also suggests, and Treasury officials have confirmed, that in determining whether a taxpayer’s activities constitute “manufacturing,” taxpayers should look to the “in significant part” requirement of section 199, which Treasury believes modifies both the “manufacturing” and the “within the United States” requirements of the section.

In this regard, the Notice provides that a taxpayer satisfies the “in significant part” requirement if its manufacturing activities in the United States are “substantial in nature,” based on its facts and circumstances. The Notice makes clear that the “substantial in nature” test is different than the “substantial transformation” test under Treas. Reg. § 1.954-3(a)(4)(ii). In addition, the Notice provides that a taxpayer satisfies the “in significant part” requirement if, under a safe-harbor rule, the taxpayer’s conversion costs (direct labor and related factory burden) for manufacturing activities in the United States are at least 20% of the total cost of the property.

The Notice explains that in determining whether a taxpayer’s manufacturing activities are “substantial in nature,” consideration should be given to a number of factors, including, but not limited to, the relative value added by, and relative cost of, the taxpayer’s manufacturing activity in the United States, the nature of the property, and the nature of the manufacturing activity that the taxpayer performs in the United States.

Some industrial manufacturing companies store, transport and handle other logistics of supplying parts for another manufacturer’s goods. These activities would be eligible for the qualified production activities deduction as manufacturing only if the company changes the form of an article (here, a part), or combines or assembles two or more articles or parts into a new product. Resale and repair activities generally do not qualify for the deduction in the absence of the attribution of MPGE activities.

2. Special industry concerns with the definition of “qualifying production property” in relation to tangible personal property.

An industrial manufacturing company may have products that do not fit perfectly within the definition of tangible personal property. For instance, certain large equipment installations may be deemed real property for purposes of section 199, and thus may be subject to the construction provision rather than the qualifying production property (“QPP”) provision.

The definition of “tangible personal property” provided in section 4.04(8)(b) of the Notice is derived primarily from, and is generally consistent with, the definition of that term under Treas. Reg. § 1.48-1(c). Section 4.04(8)(b) provides that local law is not controlling for purposes of determining whether property is tangible personal property under section 199(c)(5)(A).

Property may be tangible personal property for purposes of section 199(c)(5)(A) even though under local law the property is considered a fixture and therefore real property. Thus, property such as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs that is contained in or attached to a building constitutes tangible personal property for purposes of section 199(c)(5)(A). Further, property that is in the nature of machinery (other than structural components of a building) is tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, is considered tangible personal property. A structure that is property in the nature of machinery or is essentially an item of machinery or equipment is not an inherently permanent structure and is tangible personal property. In the case, however, of a building or inherently permanent structure that includes property in the nature of machinery as a structural component, the machinery is real property.

As provided in Treas. Reg. § 1.48-1(c), research and storage facilities may under certain circumstances constitute tangible personal property. Land improvements, such as swimming pools, paved parking areas, wharves, docks, bridges, and fences, are deemed real property. Section 3.04(11)(c) of the Notice provides that infrastructure, which is real property, includes roads, power lines, water systems, railroad spurs, communication facilities, sewers, sidewalks, cable, wiring, and inherently permanent oil and gas platforms.

To the extent that an industrial manufacturing company creates machinery as a component part of an inherently permanent structure, its calculations for section 199 may be based upon the construction provision rather than the QPP provision. This would affect the company’s use of subcontractors and other matters.

3. Special industry concerns with the definition of “qualifying production property” in relation to computer software.

Industrial manufacturing companies may be developing software as part of an entirely developed system of hardware and software for a particular machine. Or software may be produced to create additional uses for hardware produced by other companies. For example, software may be produced to allow another company’s equipment to function as a part of a system. In these cases, the income from the software may be eligible for the qualified production activities deduction.

Section 3.04(8)(c)(i) of the Notice provides that the definition of “computer software” is derived from the definition of the term contained in Treas. Reg. § 1.197-2(c)(4)(iv). That regulation specifies that the definition “includes all forms and media in which the software is contained...” Thus, it would appear that software included as part of a machine would qualify. Section 3.04(8)(c)(ii) of the Notice provides that a taxpayer “must allocate its gross receipts between those attributable to the software... and those attributable to” tangible personal property.

In addition to many of the items specifically referenced in Treas. Reg. § 1.48-1(c), section 4.04(8)(b) includes in the term “tangible personal property” videocassettes, computer diskettes, books, and similar items. The guidance refers taxpayers to Treas. Reg. § 1.263A-2(a)(2)(ii) for the inclusion of such intellectual property. (No inference is intended concerning whether these items are tangible or intangible property for purposes of any other section of the Code (for example, section 197).) Treating these items as tangible personal property is consistent with the definitions provided for “computer software,” “sound recordings,” and “qualified films.” These definitions do not include the tangible personal property (if any) in which computer software, a sound recording, or a qualified film is fixed. As a result, “tangible personal property” excludes any property that falls within the definition of computer software, a sound recording, or a qualified film. For example, a sale of a computer game on a CD-ROM has both a tangible personal property element (the disc) and a computer software element (the program fixed on the disc), but a sale of the same program effected instead by an internet download involves computer software only. The term “tangible personal property” does not include the creation of copyrighted material such as a manuscript in a form other than in a tangible medium.

The Notice may be interpreted to mean that software maintained at a Service Center that reads information sent through the internet or through a network from a machine may not qualify. Such software may be deemed to be providing a service to the buyer of the equipment, rather than having been sold to the buyer of the equipment.

The analysis of software embedded in machines will require further inquiry of those familiar with the software provisions of section 199.

4. Special industry concerns with the definition of “derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property.”

Where the industrial manufacturing company is not the owner of the property at determinative stages in the process, this issue may arise. Those familiar with the industry will need to consider this issue when determining eligibility of an activity for the deduction.

Section 4.04(7) of the Notice provides that gross receipts “derived from” QPP are limited to the direct proceeds from the lease, rental, license, sale, exchange, or other disposition of the QPP. Thus, for example, the “derived from the sale of QPP” requirement is met with respect to direct proceeds from the sale of QPP manufactured in whole or in significant part within the United States by a taxpayer for sale (assuming all other requirements of section 199 are met), as well as for direct proceeds from the sale of self-constructed QPP manufactured in whole or in significant part in the United States by a taxpayer and used in the taxpayer’s trade or business (assuming all other requirements of section 199 are met).

For purposes of the “derived from the lease, rental, license, sale, exchange, or other disposition of” requirement of section 199(c)(4)(A)(i), existing federal income tax law principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange or other disposition, or whether it is a service. See for example, Rev. Rul 88-65, 1988-2 C.B. 32, cited by the IRS as treating a short-term rental of automobiles and trucks as a service rather than a rental because significant services were performed in connection with the rental.

The proceeds from business interruption insurance and payments not to produce are treated as gross receipts “derived from the lease, rental, license, sale, exchange, or other disposition of QPP” to the extent that they are substitutes for gross receipts that would otherwise qualify as DPGR.

5. When considered separately, the provision of some services, such as extended warranties or transportation, do not qualify under section 199. However, can any portion of the services be included in qualified production activities? When are service costs, such as warranty or transportation costs, integrated into the product?

With certain exceptions, gross receipts derived from the performance of services do not qualify as domestic production gross receipts. Accordingly, in the case of the lease, rental, license, sale, exchange, or other disposition of property that contains a service element (embedded service), the Notice generally requires that the taxpayer allocate the gross receipts between the property and the embedded service. The portion “derived from the lease, rental, license, sale, exchange, or other disposition” of the property may not exceed the selling price of the property without the service element.

There are two exceptions to the allocation requirement. First, a taxpayer may include in domestic production gross receipts the gross receipts from a qualified warranty. A qualified warranty is a warranty that is provided in connection with the sale of QPP if (1) in the normal course of its business, the charge for the warranty is included in the price charged for the lease, rental, license, sale, exchange, or other disposition of the QPP and (2) the warranty is neither separately offered by the taxpayer nor separately bargained for with the customer (that is, the customer cannot purchase the QPP without the warranty).

Second, a de minimis amount of gross receipts from embedded services for each item of property may qualify as domestic production gross receipts. A de minimis amount of gross receipts from embedded services is equal to less than 5 percent of the total gross receipts of the property. If one of these exceptions is met, the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of property and the gross receipts from the embedded services are treated as “derived from the lease, rental, license, sale, exchange, or other disposition” of the property and are treated as domestic production gross receipts (assuming all other requirements of section 199 are met). For purposes of applying this de minimis rule, the gross receipts from a qualified warranty that are included in the price charged for the lease, rental, license, sale, exchange, or other disposition of property are not treated as gross receipts for services.

While the warranty exception provides that embedded warranties qualify, the Notice infers that extended warranties do not qualify. Nevertheless, such gross receipts may fall within the de minimis amounts exception.

6. Are packaging, design, development, minor assembly, and testing activities taken into account in applying the “in significant part” test for tangible personal property?

Packaging, repackaging, labeling, and minor assembly operations are not taken into account for purposes of the “substantial in nature” test or the “in significant part” test according to Section 4.04(5)(b) of the Notice. Thus, a taxpayer cannot qualify for the section 199 deduction if the taxpayer’s only activities in the United States are packaging and labeling property produced outside the United States. Design and development activities also do not constitute manufacturing activities for purposes of the “in significant part” test for tangible personal property because these activities produce an intangible asset (the design) rather than tangible personal property. Finally, it appears that testing activities would not qualify for the deduction.

Packaging

While packaging and package design is often thought of as an extension of marketing, in certain situations it is actually part of the product design. An example would be packaging to maintain sterility of medical supplies. In that type of a situation it would appear to be part of the product. In another setting the packaging to preserve the cleanliness of a part and prevent corrosion could also be a part of the product. In both of these examples the product would have no value in the absence of its packaging.

With respect to the previous Domestic International Sales Corporation (DISC) regime, packaging was not included in manufacturing because of the regulations promulgated as part thereof. *Garnac Grain Co., Inc. v. Comm’r*, 95 T.C. 7 (1990). However, the case distinguished the DISC definition from the Investment Tax Credit regime definition which did not specifically exclude packaging. The case also distinguished state tax definitions of manufacturing that included packaging. In *Cummins Engine Co., Inc v. U.S.*, 17 Cl.Ct. 854 (1989), an excise tax case, the taxpayer did not contend that packaging was included in manufacturing because that would have been harmful to its excise tax position.

If packaging must be split out from the qualifying activities, then it is not clear what happens when the packaging is integral to the product or is produced as part of the product. A case was not found that discussed where manufacturing ends and packaging begins or how the processes are separated.

The portion of the guidance that excludes packaging appears to contradict existing definitions of the terms “manufactured or produced” in the Code and regulations. For example, Treas. Reg. § 1.993-3(c)(2)(iv) provides that “property is manufactured or produced by a person if, with respect to such property conversion costs (direct labor and factory burden *including packaging or assembly*) of such person accounted for 20 percent or more of” the costs of goods sold or inventory value of the property or, for leased property, the adjusted basis of such property. (Emphasis added.) Treas. Reg. § 1.927(a)-1T(c)(2) provides a similar rule.

Design and development

Design and development activities do not constitute manufacturing activities for purposes of the “in significant part” test for tangible personal property because these activities produce an intangible asset (the design) rather than tangible personal property. Nevertheless, Section 4.04(5)(b) of the Notice provides an exception for computer software and sound recordings.

Minor assembly

The minor assembly exception does appear consistent with existing definitions of the term “manufacture”, though assembly that is not minor does appear to qualify as “substantial in nature” for purposes of the “in significant part” test. Treas. Reg. § 48.0-2(a)(4)(i) defines the term “manufacturer” to include “any person who produces a taxable article from scrap, salvage, or junk material, or from new or raw material, by processing, manipulating, or changing the form of an article, or by combining or assembling two or more articles [into a new article].” This definition is substantially similar to the definition of “manufactured” contained in Section 4.04(3)(a) of the Notice. In *Ruan Financial Corp v. U.S.*, 976 F.2d 452 (8th Cir. 1992), the court quotes Treas. Reg. § 48.0-2(a)(4)(i) and notes that court decisions and IRS rulings have found “manufacture” in a number of situations, including when the combining or assembling of parts is so extensive that one brings about the production of a new or different article. For a discussion of these authorities, please review *Ruan Financial Corp. v. United States*, 765 F. Supp. 985, 987-88 (S.D. Iowa 1990).

Testing

The Notice does not specify whether testing activities qualify for the “in significant part” test. It would appear that testing would not be included in the “in significant part” test inasmuch as testing does not change the form of the manufactured article.

7. For purposes of determining qualification for the deduction, how should “taxpayer” be defined? More specifically, how should contract manufacturing arrangements be treated?

Obviously, this is an important issue in many industries. One example of where the issue is prevalent in the industrial manufacturing industry involves an equipment producer which only conducts research, development, and design in the United States, with all manufacturing contracted out to another entity. The contract manufacturer then resells the product to the producer who resells the equipment to a dealer network. In this scenario, if the equipment producer is not considered to be engaged in manufacturing, the issue becomes whether the difference between the price paid to the contract manufacturer and the price paid by the dealer is considered qualified production activities income. It could be considered something else such as marketing or sales income, which probably would not qualify as qualified production activities income.

The Notice provides significant guidance with regard to this issue. According to the Notice, only one taxpayer – either the producer or the subcontractor – may claim the section 199 deduction with respect to a particular manufacturing activity. Further, the Notice provides that only the entity with the “benefits and burdens of ownership” of the property at issue during the manufacturing process is considered the manufacturer. Factors to consider include the right to possession, title, and responsibility of loss, to name a few. Direct supervision and control is not determinative. If a contractor does not have the benefits and burdens of ownership during the manufacturing activity, the contractor is a mere service provider. Thus, for example, if A enters into an agreement with an unrelated customer B to manufacture 100 widgets for B, either A or B is treated as having manufactured the widgets for purposes of section 199. If A does not have the benefits and burdens of ownership during the manufacturing process, it is a mere service provider and B would be considered the manufacturer for purposes of section 199.

Accordingly, in the case described above (i.e., an equipment producer that only conducts research, development, and design in the United States), the producer’s ability to obtain a section 199 deduction will depend on whether it retains the benefits and burdens of owning the manufactured property during the manufacturing process. If the producer, and not the contractor, has the benefits and burdens of owning the manufactured property, then the activities of the contractor will be attributed to the producer so that the producer is treated as the manufacturer for purposes of section 199 and will be entitled to a section 199 deduction (assuming all other requirements are met). If, on the other hand, the producer does not have the benefits and burdens of ownership, then it will not qualify for the section 199 deduction regardless of the value of the research, development, and design activities conducted by it.

Under the Notice, such design and development activities are disregarded for purposes of determining whether manufactured property meets the test of being manufactured “in whole or in significant part by the taxpayer within the United States.”

Although the Notice provides that research and design activities are disregarded for purposes of meeting the “substantial in nature” test (discussed *supra*), the Notice does not necessarily require that gross receipts attributable to these activities be excluded from qualified production activities income. In a vertically integrated manufacturing operation, for example, gross receipts attributable to such activities would appear to be included as part of qualified production activities income eligible for the section 199 deduction. In this regard, the definition of an “expanded affiliated group” (“EAG”) may benefit some equipment producers that manufacture through a loosely affiliated group of entities. Section 199 and the Notice make clear that all members of an EAG are treated as a single corporation for purposes of section 199.

8. How is “in whole or in significant part within the United States” defined?

According to Section 4.04(5) of the Notice, property will be treated as manufactured by the taxpayer “in significant part within the United States” either if, (i) the taxpayer’s MPGE activities performed in the United States are “substantial in nature,” based on its facts and circumstances, or (ii) the taxpayer’s direct labor and related factory burden costs incurred in the United States in performing MPGE are at least 20 percent of the taxpayer’s total cost for the property.

The Notice explains that, in determining whether a taxpayer’s manufacturing activities are “substantial in nature,” consideration should be given to a number of factors, including, but not limited to, the relative value added by, and the relative cost of, the taxpayer’s manufacturing activity in the United States, the nature of the property, and the nature of the manufacturing activity that the taxpayer performs in the United States. In this regard, the Notice provides that development activities and the creation or licensing of intangibles do not qualify as substantial in nature for any qualifying production property other than computer software and sound recordings.

Whether a taxpayer’s manufacturing activity is “substantial in nature” for purposes of section 199 generally depends upon all of the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer’s manufacturing activity in the United States, the nature of the property, and the nature of the manufacturing activity that the taxpayer performs in the United States. Although this “substantial in nature” requirement applies on a facts and circumstances basis like the “substantial in nature” requirement in Treas. Reg. § 1.954-3(a)(4)(iii), this “substantial in nature” requirement is not the same as the requirements underlying the “not the property which it purchased” standard in Treas. Reg. § 1.954-3(a)(4). In particular, the substantial transformation test of Treas. Reg. § 1.954-3(a)(4)(ii) is not relevant. The Service and Treasury Department concluded that such a general rule would not be suitable in all circumstances.

Section 3.04(6) of the Notice provides that the definition of “United States” for purposes of section 199 is the definition contained in section 7701(a)(9). That section provides that the term “United States” when used in a geographical sense includes only the 50 states and the District of Columbia. It also includes the territorial waters of the United States and the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. However, because neither section 199 nor the legislative history explicitly include possessions and territories of the United States or the airspace over the United States and these areas within the definition of United States, the term “United States” does not include possessions and territories of the United States or the airspace over the United States and these areas for purposes of section 199.

Safe harbor

The value added by the taxpayer's U.S. manufacturing, however, may not be substantial when compared to the value of the final product because of the relatively high value of the purchased materials. Similarly, the cost of the taxpayer's U.S. manufacturing may not be substantial when compared to the total cost of the product. However, the nature of the product, and the nature of the taxpayer's U.S. manufacturing activity, may be such that the U.S. manufacturing activity is "substantial in nature."

The Notice provides a safe harbor under which a taxpayer will be treated as manufacturing property in whole or in significant part within the United States if, in connection with the property, conversion costs (direct labor and related factory burden) to manufacture the property are incurred by the taxpayer within the United States, and those costs account for 20 percent or more of the property's total costs of good sold. This rule would operate similarly to the safe harbor provided under Treas. Reg. § 1.954-3(a)(4)(iii) for determining whether, for purposes of computing foreign base company sales income, the sale of property is treated as the sale of a manufactured product rather than the sale of a component part, when purchased components constitute part of the property.

Questions remain regarding the interpretation of the safe harbor. First, it is unclear how the determination might be done at the "property" level rather than at the "item" level for purposes of the safe harbor. Further, the Notice does not define the term "related factory burden."

Many taxpayers, due to the nature of their manufacturing processes, will not satisfy the 20 percent safe harbor despite the fact that their activities are commonly considered manufacturing activities. Such taxpayers likely will not be comfortable relying on a facts and circumstances test, thereby raising the issue why a broader safe harbor was not promulgated.

9. What methodology should be used for the allocation of expenses?

The Notice recognizes that the legislative history to section 199 states that the rules for allocating costs of goods sold and other deductions to domestic production gross receipts should, when appropriate, be similar to, and consistent with, the relevant cost allocation rules provided by sections 263A and 861.

In this regard, the Notice provides in general that cost of goods sold must be specifically identified with, or directly traced to, domestic production gross receipts in accordance with the taxpayer's books and records. If a taxpayer's books and records do not allow the taxpayer to identify the cost of goods sold directly allocable to domestic production gross receipts, then the taxpayer may use a "reasonable method" to allocate the cost of goods sold between domestic production gross receipts and other gross receipts. If the taxpayer uses a method to allocate gross receipts between domestic production and non-domestic production, then the taxpayer may not use a different method to allocate the cost of goods sold. For purposes of section 199, the cost of goods sold includes the cost of inventory sold during the year, as well as the adjusted basis of non-inventory sold or exchanged during the year.

In Section 4.05, Notice 2005-14 provides three alternative methods for the allocation and apportionment of other directly and indirectly allocable deductions. Under the first method (the section 861 method), which is available to all taxpayers, a taxpayer determines the deductions allocated and apportioned to domestic production gross receipts by applying the allocation and apportionment rules provided by §§ 1.861-8 through 1.861-17 and §§ 1.861-8T through 1.861-14T (the section 861 regulations) subject to the provisions of the Notice. The Notice provides special rules for apportioning certain charitable deductions and research and experimentation deductions. The Service and Treasury Department recognize that these allocation and apportionment rules may be burdensome to certain taxpayers that otherwise would not be required to use these rules, particularly for taxpayers that are not currently using the section 861 cost allocation regime. Accordingly, the Notice provides two alternative apportionment methods for certain taxpayers, with a goal of minimizing the need for smaller taxpayers to devote additional resources to compliance. Any taxpayer with average annual gross receipts of \$25,000,000 or less may use the simplified deduction method. Under the simplified deduction method, a taxpayer's deductions generally are ratably apportioned between domestic production gross receipts and other receipts based on relative gross receipts. Alternatively, a qualifying small taxpayer may use the small business simplified overall method to allocate costs of goods sold and deductions to domestic production gross receipts. A qualifying small taxpayer is a taxpayer that has average annual gross receipts of \$5,000,000 or less or a taxpayer that is eligible to use the cash method as provided in Rev. Proc. 2002-28, 2002-1 C.B. 815.

The Notice clarifies that certain deductions do not reduce domestic production gross receipts or gross income attributable to domestic production gross receipts under any of the three methods. A loss generated by the sale of property reduces domestic production gross receipts or gross income attributable to domestic products gross receipts only if the proceeds from the sale of the property are, or would have been, included in domestic production gross receipts. A deduction allowed under section 172 for a net operating loss is not allocated or apportioned to domestic production gross receipts or gross income attributable to domestic products gross receipts. Under section 199(d)(5), deductions not attributable to the actual conduct of a trade or business are not taken into account under section 199 and, therefore, are not allocated or apportioned to domestic production gross receipts or gross income attributable to domestic products gross receipts.

The cost allocation rules are not entirely satisfactory without significant modifications. One significant departure from the uniform capitalization rules will result from the conference report's specific reference to "selling and marketing" expenses as direct costs allocable to the domestic production activities and to general and administrative costs allocable to selling and marketing activities as indirect production costs. This treatment of selling costs is contrary to the current uniform capitalization rules, which specifically exclude such costs from their scope. The legislative history of section 199, however, raises the specter of producers potentially having to offset against domestic production gross receipts (and thereby reduce the amount of the deduction ultimately allowed) the costs of advertising; all or some portion of the compensation paid to internal or external sales personnel; rent, depreciation, and other overhead paid on retail outlets, showrooms, and other sales facilities; costs associated with on-line marketing and sales efforts; and a potentially wide range of other selling expenses. Because the tax benefit of the new deduction is inversely proportional to the breadth of expenses that must be offset against domestic production gross receipts, considerable controversy over the scope of "sales and marketing" costs (as well as other potentially allocable expenses) is inevitable.

Section 199 also provides a special rule to be used in calculating cost of goods sold where the manufactured item includes imported components purchased at other than an arms-length price. In such circumstances, the imported component is treated as having been purchased for a price of not less than its customs value at the time of importation. A similar adjustment is required where an item is exported for further manufacture abroad, with the increase in cost or adjusted basis not exceeding the difference in value of the property when exported and its value when re-imported by the taxpayer.

It should be noted that, if the taxpayer's entire domestic production gross receipts qualify because less than 5 percent of the taxpayer's gross receipts otherwise do not qualify (i.e., the less-than-5-percent safe harbor of section 4.03(2) applies), then the taxpayer will not be required to allocate costs for purposes of section 199. That is, all costs would be allocated to DPGR.

10. What methodology should be adopted for determining qualified production activities income (*i.e.*, at which level should testing be done)? More specifically, how should testing be done on an item-by-item basis? How does this testing differ from testing on a transaction-by-transaction basis or product-line-by-product-line basis?

The Notice provides that qualified production activity income is determined on an item-by-item basis (and not for example, on a division-by-division, a product line-by-product line, or a transaction-by-transaction basis) and is the sum of the qualified production activity income derived by the taxpayer from each item. This Notice also points out that qualified production activity income from each item may be positive or negative.

With that said, it is not entirely clear from the Notice what constitutes an "item-by-item" basis. Elsewhere in the Notice, the term "property" is used in instances where the term "item" would appear more appropriate based on the requirements in the Notice. Based on recent comments made by Treasury officials, it is anticipated that Treasury and the IRS will provide more detailed guidance in the future with regard to computing qualified production activity income on an "item-by-item" basis. Treasury officials have stated informally in public, non-binding comments that the "item-by-item" language was included merely to emphasize that the item-by-item rule is not intended to require calculating QPAI on an item-by-item basis. They stated that the intent was to indicate that QPAI is determined based on the sum of all of a taxpayer's qualifying activities, whether they produce a profit or a loss.

Two examples best illustrate the issue.

First, an industrial manufacturer produces a particular product line of equipment (tracked dozers). With respect to the tracked dozers, 20-percent of the units are produced wholly in Canada and 80-percent of the units are produced wholly in the United States. The questions then become in determining the taxpayer's qualified production activities, whether the determination is made at the individual unit level or at the entire product line level (i.e., the tracked dozer), and whether the unit or model is made "in significant part" in the United States. If, in the example above, the determination is made at the individual unit level, those units wholly made in Canada clearly would not qualify for the section 199 deduction (at least with regard to the assembly process). If, on the other hand, the determination is

made at the product line level, the entire tracked dozer product line would be considered produced in the United States even though some of the models are wholly made in Canada.

Second, an industrial manufacturer manufactures engines and transmissions in the United States, which it then ships to Canada for installation in a particular model of equipment that is otherwise produced wholly in Canada. The question then becomes whether the engines and transmissions can be treated as separate QPP even though the equipment units are not. If so, are the allocable portions of gross receipts attributable to the engines and transmissions deemed qualifying gross receipts for purposes of section 199? It would appear that the engines and transmissions would qualify as the calculation is done on an item-by-item basis.

11. How does the availability of the ETI deduction impact the availability and use of the section 199 deduction?

The section 199 deduction is a mandatory, not elective, deduction. Generally, ETI is worth more to most multi-national manufacturers than the section 199 deduction, especially during the early transition years. Thus, a strategy for timing of expense and income recognition to maximize the benefits of both should be considered. Additionally, with respect to the ETI deduction, although not specifically within the scope of this memorandum, it is important to note that, for binding contracts in force, the ETI may be available for more than two years. With respect to output and requirements contracts which are essentially open-ended as to some of their terms, the determination of what constitutes a binding contract will be dependent upon state law. Often, industrial industry supply contracts, like automotive industry supply contracts, may not contain a price. Thus, the availability of the ETI may be subject to state law. As a result, it is in the best interest of taxpayers to perform “with and without” computations to determine the best strategy to follow with respect to the ETI and QPA deductions.

12. What is the proper application of the deduction where equipment is sold to a dealer, and then the dealer enters into a lease of the equipment with the customer? Essentially this results in a sale back to the manufacturer followed by a lease arrangement by the leasing entity of the manufacturer.

This issue centers on the determination of gross receipts derived from tangible property manufactured by the taxpayer. Clearly, the gross receipts from the initial sale to the dealer are qualifying gross receipts (assuming all the requirements of section 199 are satisfied). It is not clear, however, whether the subsequent lease stream is qualifying gross receipts. More specifically, the issue is whether the taxpayer satisfies the “by the taxpayer” requirement when it initially sells the equipment outside its expanded affiliated group to an unrelated dealer, and then reacquires the equipment through an affiliated leasing company that is treated as a single taxpayer with the taxpayer for purposes of section 199. Arguably, the subsequent lease transaction involves property manufactured by the taxpayer due to the single taxpayer rule. On the other hand, the leasing company arguably is simply engaged in the resale (re-lease) of equipment acquired

from an unrelated party and incurs selling/leasing costs unrelated to manufacturing activities.

The Notice does not specifically address this issue. However, informal non-binding comments made by Treasury officials suggest that the gross receipts from the subsequent leasing transaction may be qualifying gross receipts.

In this context, it might make administrative sense for Treasury to let the manufacturer decide how to treat such transactions. For example, the manufacturer could decide to treat the lease situation as one integrated transaction to be followed consistently.

13. What is the proper treatment of the deduction where there is a net operating loss carryover?

Currently, some companies in the industrial manufacturing industry are carrying net operating loss (NOL) carryovers. Obviously, the presence of net operating losses diminishes the benefit of the section 199 deduction. This follows because the section 199 deduction cannot exceed taxable income and taxable income is defined in the Notice to have the same meaning as that in section 63 (i.e., Line 30 of the corporate tax return, after net operating loss carryovers). As a result, in a year in which the NOL carryover exceeds the Line 28 taxable income amount, a taxpayer will not be entitled to a section 199 deduction. However, under the ordering rules of section 172, the disallowed section 199 deduction may be added to an NOL carryforward to future years. In essence, the disallowed section 199 deduction may be refreshed for future years as part of an NOL carryforward.

Nevertheless, PricewaterhouseCoopers, in various informal discussions, now understands that it is almost certain that a technical correction will be made to preclude taxpayers that are profitable in the current year, but whose taxable income is completely offset by NOL carryforwards, from receiving a benefit under section 199 either as a deduction or as an increase in the taxpayer's NOL carryforward under the rules of section 172. Although nothing is final until passed into law, it is apparent that key Congressional tax writing committees have concluded that permitting such taxpayers to benefit through the interaction of section 199 and section 172 was not intended by the legislation. As such, a technical corrections bill will amend section 199 or section 172 to preclude this interaction. Technical corrections, by their nature, are retroactive to the date of enactment of the underlying provision (i.e., October 22, 2004). Accordingly, industrial manufacturing companies should carefully consider NOL planning in the affected section 199 year, as well as in future years.

14. To what extent can industrial manufacturing companies benefit from section 199 with respect to the construction of their own stores or franchisee outlets?

Section 199 provides that DPGR includes gross receipts derived from (i) construction performed in the United States, and (ii) engineering or architectural services performed in the United States for construction projects in the United States.

The Notice provides that the term “construction” includes activities of a taxpayer that is in a trade or business that is considered construction for purposes of the North American Industry Classification System (“NAICS Codes”). Most industrial manufacturing companies likely would not meet this requirement in the absence of having an affiliated member in its EAG that is engaged in the construction business.

Some industrial manufacturing companies have franchised dealers for their products. The dealers are required to have specified facilities in order to maintain the franchise dealerships. If the construction affiliate of the industrial manufacturing company reimburses the dealer’s costs for the erection of these facilities, and maintains oversight and direct management of such construction, or retains subcontractors to perform such construction, it is possible that the company may be eligible for the portion of the deduction related to construction performed in the United States as a result of the erection of the facilities.

To the extent that an industrial manufacturing company has gross receipts derived from engineering or architectural services with respect to construction, such receipts may qualify as DPGR.

15. How should joint ventures or other activities undertaken by the industry be treated under section 199, including those that are meant to establish standards or establish means of meeting standards? Will such joint ventures contribute gross receipts or expenses that will be included in the calculation of the deduction? Will manufactured items that are sold by an affiliate of a partner in the manufacturing partnership have the activity attributed to the selling affiliate?

Joint ventures occur to carry out functions and activities of industrial manufacturing. This may include the development of standards for products such as software, activities to meet safety standards, activities to meet emissions standards, or other business purposes. These joint ventures may be contractual in nature such that they are not partnerships for local law or tax purposes (e.g., they elect out of subchapter K). In other circumstances, the joint ventures will be deemed partnerships for federal income tax purposes and for purposes of the section 199 calculations. The section 199 rules are clear that the activities of “pass-thru” entities are eligible for the section 199 deduction, providing rules for allocating revenues, wages, etc. An issue arises, therefore, as to whether a joint venture is a pass-thru entity for purposes of section 199.

The Notice does not provide that the character of items of income, gain, loss, and deduction is passed through to the partner together with the item itself. While Section 4.09(2)(b) of the Notice provides that the qualified production activities of the members of an EAG are attributed to the other members of an EAG, the Notice does not provide that the qualified production activities of a partnership are attributed to its partners, except in the case of an oil or gas partnership as provided in section 4.04(7)(e) of the Notice. Thus, if a partnership manufactures qualifying property and sells or distributes the property to a partner for sale of the property by the partner to third parties, it is not clear that the qualified production activity of the partnership would be attributed to the partner.

16. Are there special industry concerns with the definition and qualification of “qualified films” and sound recordings?

Industrial manufacturing companies frequently produce films to introduce clients to their products, train people to install or use the product and train people to maintain and repair the product. For some industrial manufacturing companies, these training films may extend beyond application to their specific products and may be generic so as to become a separate product line. Accordingly issues may arise concerning films and sound recordings.

Need to participate in guidance process

The industrial manufacturing industry will need to consider marshalling its forces, starting now, to argue for appropriate definitions, as the IRS and Treasury undertake to develop regulations and other guidance defining the types of activities and transactions that will reap the benefits of section 199.

PricewaterhouseCoopers initiative

PwC has been analyzing the impact of the new legislation on industrial manufacturing industry companies. We are in consultation with a number of companies and are in the process of analyzing their operations and contracts and formulating strategies. We are starting to advise and assist companies in formulating their case for presentation to the relevant Treasury and IRS officials.

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