

---

# *IRS releases updated examiner guidance addressing Section 199 'benefits and burden' issues*

November 20, 2013

---

## ***In brief***

The IRS Large Business and International Division (LB&I) recently issued updated Industry Director Directive LB&I-04-1013-008 (the Updated Directive or Directive), which provides guidance to examiners for use in determining whether a taxpayer has the benefits and burdens of ownership under Federal income tax principles (B&B) of qualifying production property, qualified films, or utilities produced under a contract manufacturing arrangement for purposes of Reg. sec. 1.199-3(f)(1).

Like the previous version of the Directive issued in July 2013 (the July 2013 Directive), the Updated Directive permits the parties to a contract manufacturing arrangement to designate which party may claim the Section 199 domestic production activities deduction. The changes made by the Updated Directive should allow more taxpayers to streamline the examination of their Section 199 deductions.

---

## ***In detail***

### ***Background***

Under Section 199(d)(10) and the Section 199 final regulations (the regulations), only one taxpayer may claim the Section 199 deduction with respect to any qualifying activity performed in connection with qualifying property. If a taxpayer performs a qualifying activity pursuant to a contract with another party, then only the taxpayer that has the B&B of the property during the period the qualifying activity occurs is treated as engaging in the qualifying activity. The regulations do not identify specific factors to consider in this analysis and provide that

the B&B determination should be based on all facts and circumstances.

The determination of B&B has been one of the most difficult and controversial areas of Section 199, primarily due to the potential for IRS "whipsaw" in which both parties to a contract manufacturing agreement seek to claim the Section 199 deduction with respect to the same qualifying activity. As noted by the Tax Court in its recent decision in *Advo v. Commissioner*, each party in a contract manufacturing relationship will often have certain aspects of B&B. In this regard, the Tax Court acknowledged in a footnote to

the *Advo* opinion that procedures like those provided by the Updated Directive "can resolve in advance" cases involving the B&B controversy. (for discussion of *Advo*, see WNTS Insight, "[Tax Court addresses Section 199 benefits and burdens test in contract manufacturing context](#)," November 4, 2013.)

### ***Updated Directive***

Consistent with the July 2013 Directive but with certain modifications, the Updated Directive instructs LB&I examiners to request three statements from a taxpayer, described below, for each contract. If a taxpayer provides

all three statements with respect to a contract manufacturing arrangement, examiners are instructed to not challenge that the taxpayer has the B&B for purposes of Section 199.

### *Benefits and burdens statement and certification statements*

Consistent with the July 2013 Directive, the Updated Directive states that an LB&I examiner should request that the taxpayer provide the following three statements to the examiner:

1. Statement that explains the basis for the taxpayer's determination that it had the B&B in the year or years under examination (B&B Statement).

The B&B Statement should explain the basis for the taxpayer's determination that it maintained the B&B for the years under examination.

**Observation:** The Updated Directive does not indicate the level of documentation and B&B evidence required to support the B&B Statement. However, IRS and Treasury officials have indicated that such documentation should demonstrate that the taxpayer possessed some minimum level of B&B evidence to satisfy this portion of the Updated Directive's requirements.

2. Certification Statement signed by the taxpayer (Taxpayer Certification Statement).

The Taxpayer Certification Statement, which must be signed by the taxpayer, requires the taxpayer to make certain assertions such as affirming that it had the B&B over the qualifying activities. Significantly, however, the Updated Directive removes the requirement contained in the July 2013 Directive that the taxpayer certify that it was not required to record a reserve for financial

statement purposes that it had the B&B (financial statement reserve certification).

**Observation:** LB&I became aware that the requirement in the July 2013 Directive regarding the financial statement reserve certification resulted in a significant barrier that prevented many taxpayers from availing themselves of the July 2013 Directive. LB&I should be commended for addressing taxpayers concerns about that requirement, and the removal of the financial statement reserve certification requirement should allow many more taxpayers to attempt to avail themselves of the Updated Directive.

3. Certification Statement signed by the counterparty (Counterparty Certification Statement).

The Counterparty Certification Statement, which must be signed by the counterparty, requires the counterparty to assert that it did not claim, and will not claim, the Section 199 deduction for any tax year covered by the contract. In addition to the counterparty's name, the counterparty also must provide the counterparty's EIN, contract starting and ending dates, and other identifying information about the contract.

**Observation:** The Updated Directive does not reflect a request made by practitioners and taxpayers that would have explicitly allowed a counterparty that had claimed the Section 199 deduction in prior years to amend its prior-year returns to "give back" its Section 199 deductions, thereby permitting the counterparty to sign the Counterparty Certification Statement for the taxpayer. LB&I had concerns with this request regarding a situation in which any of the counterparty's tax years at issue were closed under the statute of limitations, making the counterparty unable to

amend its returns for those closed years and therefore unable to give back all its prior-year Section 199 deductions. However, if all the counterparty's tax years at issue could be amended then it would appear the policy intent behind the Updated Directive would be met if the counterparty amended all such tax years.

**Observation:** Taxpayers preparing to enter into or revise contract manufacturing arrangements with unrelated third parties should consider incorporating the respective Taxpayer and Counterparty Certification Statements into their contract negotiations. Memorializing these certifications as part of the legal contract will help a taxpayer or counterparty, as applicable, document its B&B position and entitlement to the Section 199 deduction.

The B&B positions asserted in the Taxpayer and Counterparty Certification Statements are in effect for the duration of the contract term. If there is a change regarding which party has the B&B during the term of the contract, the Directive no longer applies and examiners are instructed to apply regular audit procedures for the year of change or any subsequent years to which that contract applies.

### *Deadlines for submitting statements*

The B&B Statement, along with the Taxpayer and Counterparty Certification Statements, should be provided to the examiner within 30 days after an information document request is issued to the taxpayer with respect to the Section 199 deduction. The Updated Directive states that if the B&B determination was under examination as of the release date of the Directive (July 24, 2013), the B&B Statement and the Taxpayer and Counterparty Certification Statements should have been provided to the

examiner within 60 days of the date of the Directive. However, another important change incorporated into the Updated Directive allows a taxpayer to request an extension of time beyond the 60-day period; the extension must be approved by the Territory Manager.

**Observation:** The Updated Directive does not indicate the amount of additional time that can be granted. However, this change should allow more taxpayers to collect the necessary information to meet the requirements of the Updated Directive for tax years under examination.

### ***The takeaway***

Practitioners and taxpayers should credit LB&I for making the Updated Directive more user-friendly relative to the July 2013 Directive. The modifications implemented by the Updated Directive should allow more taxpayers to provide the requisite B&B Statement and Taxpayer and Counterparty Certification Statements that otherwise could not have been provided under July 2013 Directive.

The Updated Directive represents the IRS's continuing efforts to help resolve the numerous Section 199

examinations involving B&B. By allowing the parties to a contract manufacturing arrangement to designate which party is eligible for the Section 199 deduction, the Directive will help reduce the uncertainty underlying a Section 199 deduction involving contract manufacturing arrangements and simplify the B&B analysis required to support a Section 199 claim. However, it remains to be seen whether, and how many, taxpayers can obtain the requisite certifications to avail themselves of the Updated Directive.

### ***Let's talk***

For a deeper discussion of how this might affect your business, please contact:

#### ***Tax Policy Services***

Brian Meighan  
(202) 414-1790  
[brian.meighan@us.pwc.com](mailto:brian.meighan@us.pwc.com)

#### ***Federal Tax Services***

George Manousos  
(202) 414-4317  
[george.manousos@us.pwc.com](mailto:george.manousos@us.pwc.com)

Colleen Green  
(202) 414-1382  
[colleen.m.green@us.pwc.com](mailto:colleen.m.green@us.pwc.com)

Kala Walton  
(202) 312-7934  
[kala.s.walton@us.pwc.com](mailto:kala.s.walton@us.pwc.com)