IRS seeks to reduce uncertainty in meeting Section 199 'benefits and burdens' test

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In brief

The IRS Large Business and International Division (LB&I) recently issued Industry Director Directive LB&I-04-0713-006 to examiners for use in determining whether a taxpayer has the benefits and burdens of ownership (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).

The Directive, which supersedes a previous Section 199 industry director directive, is intended to further simplify and streamline what has been one of the most difficult and controversial issues under Section 199 for taxpayers and the IRS. The Directive is effective for all Section 199 open tax years. Deadlines for submitting required statements are discussed below.

Under the Directive, an examiner should not challenge a taxpayer that meets the requirements of the Directive. Taxpayers that do not, or cannot, meet those requirements are subject to regular audit procedures.

In detail

Background

Subject to a W-2 wage limitation, the Section 199 deduction is computed as a percentage (generally nine percent for 2010 and thereafter) of the lesser of a taxpayer's qualified production activities income (QPAI) or taxable income.

In general, a taxpayer's QPAI equals the excess of its domestic production gross receipts (DPGR) over the sum of the cost of goods sold allocable to such receipts and other expenses, losses, or deductions that are properly allocable to such receipts. DPGR includes gross receipts of the taxpayer derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property, qualified films, and utilities (hereinafter referred to collectively as qualifying property) that was manufactured, produced, grown, or extracted (MPGE or qualifying activity) by the taxpayer in whole or in significant part within the United States.

Taxpayers frequently enter into contractual agreements with unrelated parties to perform some or all of the activities to MPGE qualifying property (contract manufacturing). In general, only one taxpayer may claim the Section 199 deduction with respect to any qualifying activity performed in connection with qualifying property.

Reg. sec. 1.199-3(f)(1) provides that 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 qualifying activity. The Section 199 regulations state that the analysis is to be based on all the facts and circumstances and provide examples illustrating certain factors that are relevant in determining which party has the B&B.

The primary concern of the IRS with respect to any B&B issue is whether both parties to a contract manufacturing agreement are seeking to claim the Section 199 deduction with respect to the same qualifying activity. For example, if one taxpayer engages another taxpayer to perform any or all manufacturing activities associated with the manufacture of product A, Section 199 permits only one of the two parties to claim the Section 199 deduction with respect to that activity (assuming neither party engages in any additional manufacturing activities with respect to product A).

Accordingly, the IRS continually has sought to find ways to avoid this dynamic – commonly referred to as a "whipsaw" – and ensure that only one of the parties to the contract can claim the Section 199 deduction with respect to the qualifying activity.

Previous guidance

A prior Industry Director Directive (LB&I-04-0112-001) (the prior directive), released in February 2012, set forth a three-step process that an LB&I examiner could use in determining whether a taxpayer that was a party to a contract manufacturing agreement had the B&B associated with the qualifying activity. The three steps related to (1) contract terms, (2) production activities, and (3) economic risks. Each step required the examiner to analyze and answer three questions. The prior directive provided that if the answer was "yes" to at least two of the questions, the step was completed. If any two of the three steps were completed, the taxpayer had the B&B.

If at least two of the three steps were not completed, then the examiner was instructed to determine whether the taxpayer had the B&B based on all facts and circumstances as in any examination risk assessment. The prior directive explicitly instructed the examiner, when performing an all-facts-and-circumstances determination, to consider all relevant factors rather than relying solely on the nine questions in the three-step process of the prior directive.

Observation: The Section 199 regulations are clear that the taxpayer must have the B&B of qualifying property "under Federal income tax principles" during the period the MPGE activity occurs. Despite the numerous factors that have arisen under the Code, regulations, and case law, the prior directive focused solely on nine factors, some of which typically had not been considered in a B&B determination for other areas of tax law. More importantly, the prior directive failed to define many of the terms used in the nine factors, which resulted in disagreements between the IRS and taxpayers.

New Directive

The Directive supersedes the prior directive and provides guidance to examiners in determining whether a taxpayer has the B&B under a contract manufacturing arrangement for purposes of Reg. sec. 1.199-3(f)(1). It is effective for all Section 199 open years.

The Directive instructs LB&I examiners to request three statements from a taxpayer, described below, for each contract. The Directive states that if a taxpayer provides all three statements, then the examiner should not challenge the taxpayer's claim that it has the B&B for purposes of Section 199 with respect to each qualifying property on which a qualifying activity is performed under the contract manufacturing arrangement.

Observation: The Directive is a safe harbor that, if met, means that a taxpayer's B&B claim will not be challenged by the IRS. At the same time, the Directive states that if a taxpayer does not want to, or cannot, avail itself of the Directive -- e.g., because the counterparty will not provide the necessary certification to the taxpayer) -- it should not be presumed that the taxpayer does not have the B&B. Rather, in that case the examiner is instructed to apply regular audit procedures to determine which entity (the taxpayer or the counterparty) has the B&B.

Benefits and burdens statement and certification statements

Under the Directive, an LB&I examiner should request the taxpayer to provide the following three statements:

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

Observation: The Directive does not indicate the level of documentation that would be deemed needed to support the B&B statement. Taxpayers should be prepared to substantiate their B&B claims by documenting the facts of their contact manufacturing agreement and the application and analysis of B&B indicia.

2. Certification statement signed by the taxpayer.

This first certification statement, which must be signed by the taxpayer under penalty of perjury, requires the taxpayer to provide (upon request of the IRS) all relevant data and records

required under Code Section 6001 to establish to the satisfaction of the IRS that all the following statements are true, correct, and complete:

- The taxpayer has determined that it had B&B over the qualifying property when the qualifying activities were performed and filed its federal income tax return(s) consistent with this determination.
- The taxpayer was not required to record a reserve for financial statement purposes under its accounting standard for its determination that it had B&B over the qualifying property.
- The contract to which the first certification statement applies was not governed by the rules applicable to expanded affiliated groups (EAGs) under Reg. sec. 1.199-7; qualifying in-kind partnerships under Reg. secs. 1.199-3(i)(7) and 1.199-9(i); EAG partnerships under Reg. secs. 1.199-3(i)(7) and 1.199-9(j); and government contracts under Reg. sec. 1.199-(3)(f)(2); and
- The qualifying activities occurred in whole or in significant part within the United States.

Observation: It is unclear whether a taxpayer that had a reserve in prior years but releases it in a future year -- e.g., after fulfilling all aspects of the Directive -- is within the scope of the Directive, given that the taxpayer once had a reserve established for financial statement purposes.

3. Certification statement signed by the counterparty.

The second certification statement, which must be signed by the counterparty under penalty of perjury, 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 providing the counterparty's name, the taxpayer also must provide the counterparty's EIN, contract starting and ending dates, and other identifying information about the contract.

Observation: A taxpayer preparing to enter or revise contract manufacturing arrangements with unrelated third parties should consider incorporating the certification statements into its contract negotiations. Memorializing these certifications as part of the legal contract with the counterparty should help the taxpayer document that it possesses the B&B over the qualifying activity.

Observation: The Directive does not state whether a counterparty that claimed a Section 199 deduction on prior returns is permitted to certify for the other party and file amended returns without Section 199 deductions. Although a literal reading of the Directive seems to imply that such a counterparty could not certify for the other party if it had claimed the Section 199 deduction for any tax year covered by the contract, the goals of the Directive would not appear to be frustrated by allowing such counterparty to amend prior-year returns and not claim any Section 199 deductions related to contract manufacturing agreements with the other party.

The B&B positions asserted in the certification statements are in effect for the duration of the contract term. In addition, if there is a change to which party has the B&B during the term of the contract, then the Directive no longer applies and examiners should apply regular audit procedures for the year of change or any subsequent year(s) to which that contract applies.

Deadlines for submitting statements

The B&B statement, along with the two 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. If the B&B determination is under examination as of the release date of the Directive (July 14, 2013), then the B&B statement and the two certification statements should be provided to the examiner **within 60 days of the date of the Directive.**

Observation: Taxpayers that have B&B determinations currently under exam have a very short time frame within which to comply with the Directive for the tax years under exam. Obtaining the requisite certification of the counterparty likely will be a particularly challenging task for affected taxpayers that have several, if not dozens, of contact manufacturing agreements.

The takeaway

The Directive represents another attempt by the IRS to help resolve the numerous Section 199 examinations involving B&B. By allowing the parties to a contract manufacturing agreement to designate which party is eligible for the Section 199 deduction, the Directive reduces the uncertainty underlying a Section 199 deduction involving contract manufacturing arrangements and simplifies the B&B analysis required to support a Section 199 claim. At the same time, it remains to be seen whether, and how many, taxpayers can obtain the requisite certifications to avail themselves of the Directive.

Let's talk

For a deeper discussion, please contact:

Federal Tax Services

George Manousos
(202) 414-4317
george.manousos@us.pwc.com

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

Christine Kowal
(202) 414-1389
christine.a.kowal@us.pwc.com

Joe Maselli
(646) 471-5156
joseph.f.maselli@us.pwc.com