WNTS Insight

A Washington National Tax Services (WNTS) Publication

February 6, 2012

IRS guidance addresses section 199 "benefits and burdens" issues

The IRS Large Business and International Division (LB&I) has issued an Industry Director Directive (the Directive) to LB&I examiners for use in determining whether a taxpayer has the benefits and burdens of ownership (B&B) under a contract manufacturing arrangement for purposes of Reg. sec. 1.199-3(f)(1). The Directive is intended to simplify and streamline what has been one of the most difficult and controversial section 199 determinations for taxpayers and the IRS.

The Directive sets forth a three-step process that focuses solely on nine factors for making the B&B determination. However, it appears likely that at least some of the nine factors will generate disagreement and issues of interpretation. As a result, many situations will continue to require an analysis of the regulations' "all the facts and circumstances" test.

Background

Subject to a W-2 wage limitation, the section 199 deduction is computed as a percentage (generally 9 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) by the taxpayer in whole or in significant part within the United States.

In general, only one taxpayer may claim the section 199 deduction with respect to any qualifying activity performed in connection with qualifying property. The final

section 199 regulations require a taxpayer to maintain the B&B, as determined under Federal income tax principles, of the qualifying property during the period the qualifying activity takes place in order for gross receipts derived from the MPGE activity to be eligible to qualify as DPGR. If one taxpayer performs a qualifying activity pursuant to a contract with another party, then only the taxpayer that has the B&B during the period in which the qualifying activity occurs is treated as engaging in qualifying activity. The regulations state that the analysis is to be based on all the facts and circumstances and provide examples illustrating certain factors that are relevant to the determination of who has the B&B.

Section 199 Task Force

Because the B&B issues under section 199 have been troublesome for taxpayers, practitioners, and the IRS, a section 199 working group -- composed of individuals from each of these three groups -- was formed by LB&I to focus on possible guidance that could be issued on the B&B determination. At an October 2010 meeting, participants collectively agreed that it would be helpful to identify a list of the most significant and relevant factors that should be used in performing a B&B analysis under section 199. LB&I developed an initial list of factors that was presented to the working group for comments. A number of the factors initially proposed by LB&I have been included in the nine factors on which the Directive focuses.

The Directive's Three-Step Process

The Directive provides a three-step process that an LB&I examiner should use in determining whether a taxpayer has the B&B. The three steps relate to (1) contract terms, (2) production activities, and (3) economic risks. Each step requires the examiner to answer three questions. If the answer is "yes" to at least two of the questions, then the step is completed. If any two of the three steps are completed, then the taxpayer has the B&B.

If at least two of the three steps are not completed, then the examiner should determine whether the taxpayer has the B&B based on all facts and circumstances as in any examination risk assessment. The Directive explicitly instructs the examiner, when performing an all facts and circumstances determination, to consider all relevant factors, rather than relying solely on the nine questions listed in the three-step process. Finally, the Directive only applies to persons that are not treated as related persons under Section 199(c)(7).

Observations

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. The Code, regulations, and case law, which collectively articulate such principles, also make clear that the determination of which party to a transaction has ownership of property is based on all the facts and circumstances.

These authorities articulate many more than nine relevant factors. However, the Directive focuses solely on nine factors, some of which have not been articulated in the body of law through which Federal income tax principles of ownership have evolved. More importantly, the Directive fails to define many of the terms used in the nine factors set forth in the Directive, which, without further guidance on how each of the factors should be interpreted, likely will lead to continued disagreements between the IRS and taxpayers.

The Nine Factors

Step One: contract terms

In Step One, the examiner is to answer three questions related to the terms of the contract:

(1) Did the taxpayer have title to the work in process (WIP)?

(2) Did the taxpayer have risk of loss over the WIP?

(3) Was the taxpayer primarily responsible for insuring the WIP?

Observations

The answer to the first question often will be unclear. It is not uncommon in contract manufacturing arrangements for the principal to supply and own throughout the MPGE process some or all of the raw materials necessary for the contract manufacturer to perform its manufacturing activities. In these arrangements, title and risk of loss to such raw materials supplied by the principal generally are not transferred from the principal to the contract manufacturer. However, these same contractual arrangements also may include a provision stating that title and risk of loss to the finished goods are transferred to the principal or the principal's customer at the F.O.B. or other point. Thus, an examiner's answer to this question may be subject to disagreement.

Similarly, the question "was the taxpayer primarily responsible for insuring the WIP" may not have a clear answer. For example, if the principal insists on a contract provision obligating the contract manufacturer to insure the WIP and to name the principal as an additional insured, and the insurance costs are included in the contract pricing provisions, it will be unclear which party is "primarily responsible" for insuring the WIP. If each party is a named insured (because generally each party has an insurable interest in the property being manufactured) and the insurance costs are borne through the contract pricing provisions by the principal, then the examining agent reasonably could conclude that the principal is "primarily responsible" for insuring the WIP. On the other hand, the contract manufacturer reasonably could be found to be primarily responsible because the contract terms obligate the contract manufacturer to maintain a given level of insurance. Finally, when the principal supplies and owns the key, or all, raw materials throughout the manufacturing process, both the principal and contractor likely will have an insurable interest in the WIP over their respective raw materials, leaving unclear which party is primarily responsible for insuring the WIP.

Step Two: production activities

In Step Two, the examiner is to answer three questions related to the production activities:

(1) Did the taxpayer develop the qualifying activity process (determined without regard to who designed the property, provided the specifications for the property, or holds intellectual rights to the property)?

(2) Did the taxpayer exercise oversight and direction over the employees engaged in the qualifying activity (determined without regard to who designed the property, provided the specifications for the property, or holds intellectual rights to the property)?

(3) Did the taxpayer conduct more than 50 percent of the quality control tests over the WIP while the qualifying activity was occurring?

If the examiner is able to answer "yes" to at least two questions in both Step One and Step Two, then the taxpayer has the B&B and no further analysis of the B&B issue is necessary. If the examiner answers "no" to at least two questions in both Step One and Step Two, then the examiner must determine whether the taxpayer has the B&B on all the facts and circumstances. If the examiner answers "yes" to at least two questions in either Step One or Step Two, then the examiner must continue to Step Three in the Directive.

Observation

Neither the term "develop" nor the term "qualifying activity process" is defined in the Directive. Thus, whether the principal or the contract manufacturer developed that process may not be clear. For example, if the principal insists that a particular type of equipment must be used to accommodate the particular design specifications for its product, and the contract manufacturer purchases such equipment and installs it in its production facility, it is unclear which party would be deemed to develop the qualifying activity process.

Step Three: economic risks

In Step Three, the examiner is to answer three questions related to economic risks:

(1) Was the taxpayer primarily liable under the "make-good" provisions of the contract?

(2) Did the taxpayer provide more than 50 percent, based on cost, of the raw materials and components used to produce the property?

(3) Did the taxpayer have the greater opportunity for profit increase or decrease from production efficiencies and fluctuations in the cost of labor and factory overhead?

If the examiner answers "yes" to two of the three questions in Step Three, then the taxpayer has the B&B and the issue is resolved. If the examiner answers "no" to at least two questions in Step Three, then it must determine whether the taxpayer has the B&B based on all the facts and circumstances.

Observation

In many cases, the principal and a contract manufacturer share the economic risks related to goods that are manufactured under a contract. Accordingly, these questions often may not result in a clear yes or no answer. As a result, contract manufacturing arrangements that spread the economic risks between the two parties will be subject a traditional B&B analysis.

Final Observations

As indicated above, the Directive provides guidance to IRS examining agents. Presumably, in the course of their examinations, taxpayers will seek to provide their interpretation of the various questions that the examiners will be attempting to answer. In the event that the examiner ultimately answers the questions in a manner that denies the taxpayer the B&B, the matter may go to Appeals. In preparation for Appeals, both the examiner's team and the taxpayer will present arguments not only that certain of the nine factors should be resolved in favor of their respective

positions, but also that all the facts and circumstances support their respective positions as well.

Given the subjective nature of many of the factors, it is unclear whether the Directive will significantly resolve the difficulties the IRS and taxpayers have had in agreeing which party in a contract manufacturing arrangement has the B&B.

For more information, please contact:

George Manousos	*(202) 414-4317*	george.manousos@us.pwc.com
Wayne Robinson	*(646) 471-1010*	wayne.robinson@us.pwc.com
Diana Steele	*(646)471-6141*	diana.steele@us.pwc.com
Ed Geils	*(202) 414-1326*	edwin.p.geils@us.pwc.com
Colleen Green	*(202) 414-1382*	*colleen.m.green@us.pwc.com*

Link to WNTS Insight archive: http://www.pwc.com/us/en/washington-national-tax/newsletters/washington-national-tax-services-insight-archives.jhtml