

IRC Section 199 Manufacturing Deduction

This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding U.S. federal, state or local tax penalties.

The American Jobs Creation Act of 2004 (P.L. 108-357) enacted Section 199 of the Internal Revenue Code to provide taxpayers with a deduction attributable to domestic production activities. The Section 199 manufacturing deduction was enacted as a replacement for the Extraterritorial Income Exclusion provision, which was repealed in response to WTO findings. The WTO found that the purpose of ETI was to give an export subsidy to enhance competitiveness of U.S. businesses in global markets and to enhance US exports. The new manufacturing deduction is available to entities with domestic production activities (corporations, partnerships, sole proprietors, estates, and trusts), but it is not available to taxpayers who are solely distributors or wholesalers who do not perform manufacturing activities. Section 199 is effective for tax years beginning after December 31, 2004. This article is based on Notice 2005-14 issued by the Internal Revenue Service in January 2005 and the Proposed Treasury Regulations (Section 1.199) which were issued in October 2005.

1. Outline

Section 199 permits a phase-in deduction over a 6 year period for taxpayers. The deduction is calculated as 3% - 9% of the Qualified Production Activities Income (QPAI), discussed later, for the taxable year.

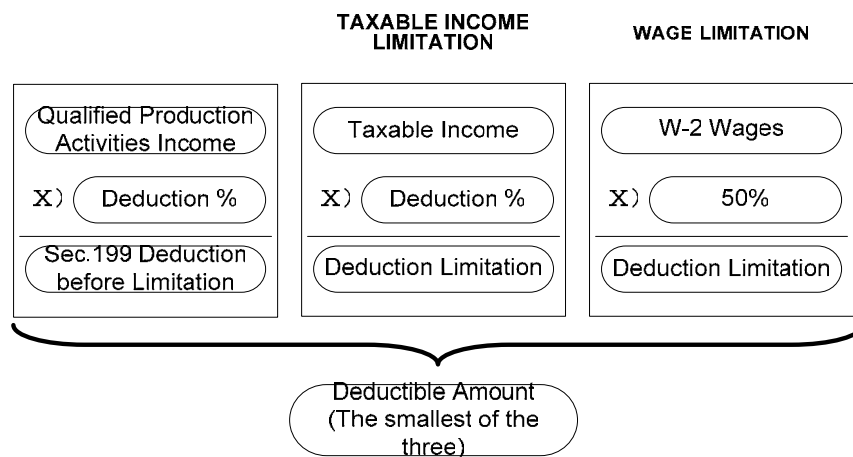
Each taxable year beginning after 2004 and before 2010, the transition percentages are applied as follows:

For Taxable Years Beginning In:	The Deduction Percentage
2005 or 2006	3%
2007, 2008, or 2009	6%
2010 and after	9%

The Section 199 manufacturing deduction for a taxable year is the smallest of:

- QPAI multiplied by the deduction percentage the year
- 50% of the W-2 wages paid by the taxpayer during the calendar year that ends in such taxable year, and
- Taxable income before the Section 199 manufacturing deduction for the taxable year multiplied by the deduction percentage of the year.

Section 199 does not allow the deduction creating or increasing net operating loss (NOL) carryforwards and/or carrybacks. The Section 199 manufacturing deduction is allowed for purposes of calculating AMT.



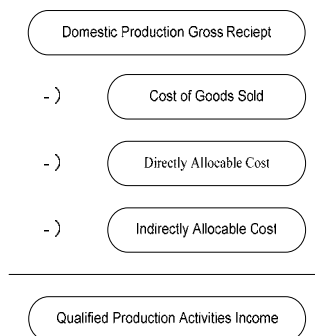
Example 1. X, a United States corporation, engages in production activities that generate QPAI and taxable income (before Section 199 manufacturing deduction) of \$600 in 2010. During 2010, X incurs W-2 wages of \$300. X has an NOL carryover to 2010 of \$500. X's deduction under Section 199 for 2010 is \$9 (9% x the lesser of QPAI of \$600 or taxable income of \$100) with W-2 wage limitation of \$150 (50% x \$300).

Example 2. X, a United States corporation, engages in production activities that generate QPAI and taxable income (before Section 199 manufacturing deduction and NOL deduction) of \$100 in 2010. X has W-2 wages of \$300 and an NOL carryover to 2010 of \$500. X's Section 199 manufacturing deduction for 2010 is \$0 (9% x the lesser of QPAI of \$100 or taxable income of \$0). The NOL to be carriedforward to 2011 is \$400 (NOL carryforward to 2010 of \$500 less NOL used in 2010 of \$100).

Only one taxpayer may claim the Section 199 manufacturing deduction with respect to the same function for the same property. For example, if A enters into a manufacturing contract with an unrelated party B, and B produces widgets for A, only one of the taxpayers is treated as having manufactured, produced, grown, or extracted (MPGE) the widgets under Section 199. If A owns widgets and B conducts manufacturing activities while widgets are owned by A, only A is treated as engaging in the qualifying manufacturing activity for Section 199. For the purpose of Section 199, B is viewed as providing a service to A and is not qualified for the Section 199 manufacturing deduction. On the other hand, if B owns the widgets while B performs manufacturing activities and B sells finished goods to A, B is qualified to take the Section 199 manufacturing deduction for its portion of QPAI based on its MPGE activity while B owns widgets.

2. Qualified Production Activities Income (QPAI)

QPAI for a taxable year is an amount equal to the excess domestic production gross receipts (DPGR) over the sum of the cost of goods sold (COGS), other deductions, expenses, or losses directly or indirectly allocable to DPGR. QPAI 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. QPAI is the sum of the QPAI derived by the taxpayer from each item. QPAI from each item may be positive or negative. For example, if a taxpayer has \$3 of QPAI from the sale of a shirt and derives negative \$1 of QPAI from the sale of a hat, the taxpayer's QPAI is \$2. For construction, engineering, and architectural services, a taxpayer may use a reasonable method to determine QPAI for items based on all of the facts and circumstances.



3. Domestic Production Gross Receipts (DPGR)

Domestic Production Gross Receipts (DPGR) are the gross receipts derived from the following activities:

- Any lease, rental, license, sale, exchange, or other disposition of qualifying production property (QPP) that is manufactured, produced, grown, or extracted (MPGE) by the taxpayer in whole or in significant part within the United States;
- Construction performed in the United States;
- Engineering or architectural services performed in the United States for construction projects in the United States;
- Any lease, rental, license, sale, exchange, or other disposition of any qualified film produced by the taxpayer in the United States; or
- Any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States.

On the other hand, DPGR does not include gross receipts derived from the following activities:

- Sale of food or beverages prepared by the taxpayer at a retail establishment;
- Transmission of electricity from the generating facility to a point of local distribution, and gross receipts attributable to the distribution of electricity to final customers;
- Transmission of pipeline quality gas from a natural gas field to a local distribution company's city gate (or to another customer);
- Storage of potable water after completion of treatment of the potable water, as well as the transmission and distribution of potable water; and
- Gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person.

If a taxpayer purchases unfinished goods and transforms it to finished goods, the taxpayer's sales will be treated as DPGR if MPGE activity by the taxpayer within the United States is substantial in nature. Whether a taxpayer's MPGE activity is "substantial in nature" for purposes of Section 199 depends on the facts and circumstances. A taxpayer will be treated as having MPGE QPP in whole or in significant part within the United States, if, in connection with the QPP, conversion costs (direct labor and related factory burden) of the taxpayer related to MPGE of QPP within the United States account for 20% or more of the taxpayer's COGS of the QPP. All of a taxpayer's gross receipts may be treated as DPGR if less than 5% of the taxpayer's total gross receipts are non-DPGR (with some exceptions).

4. Costs Allocable To Domestic Production Gross Receipts

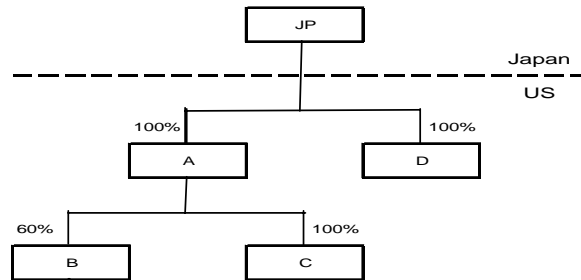
Cost of Goods Sold (COGS) is equal to beginning inventory, plus purchases and production costs incurred during the taxable year, less ending inventory. COGS is determined under the methods of accounting used by a taxpayer to compute taxable income rather than the COGS determined for financial reporting purposes. If a taxpayer has both DPGR and non-DPGR, the taxpayer must use a reasonable method to allocate COGS between DPGR and non-DPGR. A qualifying small taxpayer (defined as a taxpayer that has both average annual gross receipts of \$5,000,000 or less for the 3 taxable years preceding the current taxable year and total costs for the current taxable year of \$5,000,000 or less) may use the small business simplified overall method which apportions the taxpayer's total costs for the current taxable year between DPGR and other receipts based on relative gross receipts.

In determining its QPAI, a taxpayer must subtract its COGS, deductions directly allocable, and deductions indirectly allocable to DPGR. A taxpayer generally must allocate and apportion these subtractions (other than COGS) using the rules of IRC Section 861. Section 861 identifies and allocates deductions attributable to relevant classes of gross income and apportions the remaining deductions under a reasonable method. For a qualified small taxpayer and a taxpayer with average annual gross receipts of \$25,000,000 or less, or total assets at the end of the taxable year of \$10,000,000 or less, the simplified deduction method which apportions deductions between DPGR and non-DPGR is available. Under the simplified deduction method, deductions are ratably apportioned between DPGR and non-DPGR based on relative gross receipts.

5. Treatment for Expanded Affiliated Groups (EAG)

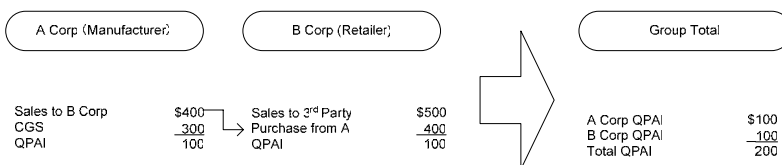
All members of an expanded affiliated group (EAG) are treated as a single corporation to compute the Section 199 manufacturing deduction. An EAG is defined as a parent-subsidiary group with a chain of stock ownership of more than 50% of the total voting power and more than 50% of the total stock value. Brother-sister corporations with foreign corporate parents are not included in the same EAG. A consolidated group is treated as one member of the EAG.

For example, in the following chart, Corporation A, B, and C belong to the same EAG, whereas D does not.



In order to calculate the Section 199 manufacturing deduction for an EAG, each member's taxable income or loss, QPAI, and W-2 wages are combined. In determining the taxable income of an EAG, if a member of an EAG has a net operating loss (NOL) carryback or carryover to the taxable year, the usage of the NOL is limited to the taxable income of that member.

In general, if a member of an EAG (a disposing member) has MPGE activity in the United States, another member or members of the same EAG may be treated as conducting the MPGE activity which was actually conducted by the disposing member. For example, Corporations A and B above are members of the same EAG. A is engaged in manufacturing QPP in the United States and B purchases the QPP of A for resale, then B's gross receipts attributable to its sale of the QPP are treated as DPGR because B is a member of the EAG that includes A and B. QPAI of the whole group is computed by subtracting COGS and other expenses from B's DPGR.



An EAG's Section 199 manufacturing deduction is allocated among the members of the EAG in proportion to each member's QPAI. If a member has negative QPAI, the QPAI of the member is treated as zero. The allocation of the Section 199 manufacturing deduction is not affected by each EAG member's taxable income or loss, or each EAG member's W-2 wages. If a member of an EAG has an allocated Section 199 manufacturing deduction which exceeds the member's taxable income, the excess amount will create an NOL for the member to be carried back or carried forward.

X Corp		Y Corp		Group Total	
QPAI	\$400	QPAI	\$200	QPAI	\$600
Other Income or Loss	<u>200</u>	Other Income or Loss	<u>(400)</u>	Other Income or Loss	<u>(200)</u>
Taxable Income	600	Taxable Income	(200)	Taxable Income	400
W-2 Wages	1,000	W-2 Wages	100	W-2 Wages	1,100
Sec.199 Deduction (\$12 x 400 / (400 + 200))	\$8	Sec.199 Deduction (\$12 x 400 / (400 + 200))	\$4	QPAI x Sec.199 Percentage 3%	\$18
Taxable Income after Sec.199 Deduction	592	Taxable Income after Sec.199 Deduction	(204)	Limitation Based on Taxable Income	12
				Limitation Based on Wage	550
				Sec.199 Deduction	12

If members of an EAG have different taxable years, a member who computes his Section 199 manufacturing deduction (computing member) should take into account the taxable income or loss, QPAI, and W-2 wages of each group member that are both:

- Attributable to the period that the other members of the EAG and the computing member are both members of the EAG; and
- Taken into account in a taxable year that begins after the effective date of Section 199 and ends with or within the taxable year of the computing member with respect to which the Section 199 manufacturing deduction is computed.

The following example illustrates the rules above.

Corporations X, Y, and Z are members of the same EAG. Neither X, Y, nor Z is a member of a consolidated group. X and Y are calendar year taxpayers and Z is a June 30 fiscal year taxpayer. Each corporation has taxable income that exceeds its QPAI and has sufficient W-2 wages to avoid the limitation under Section 199. For its taxable year ending June 30, 2005, Z's QPAI is \$4,000. For the taxable year ending December 31, 2005, X's QPAI is \$8,000 and Y's QPAI is (\$6,000). For its taxable year ending June 30, 2006, Z's QPAI is \$2,000.

- Because Z's taxable year ending June 30, 2005, began on July 1, 2004, prior to the effective date of Section 199, Z is not allowed a Section 199 manufacturing deduction for its taxable year ending June 30, 2005.

- In computing X and Y's respective Section 199 manufacturing deduction for taxable years ending December 31, 2005, Z's items from its taxable year ending June 30, 2005, are not taken into account because Z's taxable year began before the effective date of Section 199. The EAG's QPAI for this purpose is \$2,000 and the EAG's Section 199 manufacturing deduction is \$60 ($\$2,000 \times 3\%$). The \$60 deduction is allocated to X.
- In computing Z's Section 199 manufacturing deduction for its taxable year ending June 30, 2006, X's and Y's items from their respective taxable years ending December 31, 2005, are taken into account. The EAG's QPAI is \$4,000 (X's QPAI of \$8,000 + Y's QPAI of (\$6,000) + Z's QPAI of \$2,000). Accordingly, the EAG's Section 199 manufacturing deduction is \$120 ($\$4,000 \times 3\%$). The \$120 deduction is allocated to Z in proportion to QPAI based on the percentages of Z's QPAI that was taken into account in computing the EAG's Section 199 manufacturing deduction. Z's Section 199 manufacturing deduction for its taxable year ending June 30, 2006, is \$24 ($\$120 \times \$2,000 / (\$8,000 + \$0 + \$2,000)$).

6. Application of Section 199 for Pass-Through Entities

For partnerships and S corporations, the Section 199 manufacturing deduction is determined at the partner and the shareholder level. This article focuses the application of Section 199 to partnerships since the application of Section 199 to S corporations is similar to the partnership computations.

Each partner is allocated its share of partnership income, deduction, gain, or loss. Each partner is also allocated its share of DPGR, related COGS and other deductions. In case the partner's distributive share of deductions from partnerships are not allowed by provisions of the IRC, such as limitations due to a partner's adjusted basis, the partner is unable to take into account the deductions in computing the Section 199 manufacturing deduction. If such disallowed deductions are allowed in a subsequent taxable year, the partner takes into account those deductions for computing its QPAI for that taxable year.

To compute the Section 199 manufacturing deduction limitation, a partner aggregates its distributive share of W-2 wages with other W-2 wages outside the partnership. A partner's share of W-2 wages from a partnership used to compute the partner's Section 199 limitation is the lesser of:

- The partner's allocable share of W-2 wages; or

- 2 x 9% (3% for taxable years beginning in 2005 or 2006, and 6% for taxable years beginning in 2007, 2008, or 2009) of the QPAI computed by taking into account only the partnership items allocated to the partner for the taxable year of the partnership.

7. State Treatment of the Federal Domestic Production Activities Deduction

The state treatment of the Section 199 manufacturing deduction depends on each state's conformity to the IRC. For example, absent a provision that requires taxpayers to add back the Section 199 manufacturing deduction amount, states that conform to the IRC, automatically incorporate Section 199. Similarly, absent a provision that requires taxpayers to add back the Section 199 manufacturing deduction amount, states which conform to the IRC as of a certain date, conform to Section 199 if the date of conformity is after October 22, 2004. If a state adopts only select provisions of the IRC, such state will conform to Section 199 only if Section 199 is among the federal provisions adopted into the state tax codes.

As of October 16, 2005, the following states adopt Section 199 in computing state taxable income: Alabama, Alaska, Arizona, Colorado, Connecticut, Delaware, District of Columbia, Florida, Idaho, Illinois, Iowa, Kansas, Kentucky, Louisiana, Missouri, Nebraska, New Mexico, New York, Ohio, Oklahoma, Pennsylvania, Rhode Island, Utah, Virginia, and Wisconsin. In addition, as of October 16, 2005, the following states do not adopt Section 199 in computing state taxable income: Arkansas, California, Georgia, Hawaii, Indiana, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Montana, New Hampshire, North Carolina, North Dakota, Oregon, South Carolina, South Dakota, Tennessee, Texas, Vermont, and West Virginia. As of October 16, 2005, pending Michigan legislation would require taxpayers to add back any Section 199 manufacturing deduction claimed in computing federal taxable income. Enacted New Jersey legislation prohibits any Section 199 manufacturing deduction derived from the lease, rental, license, sale, exchange, or other disposition of QPP. Accordingly, New Jersey limits the Section 199 manufacturing deduction to more traditional types of manufacturing activities (for example, automobile manufacturing). Nevada, Washington, and Wyoming do not impose an income-based tax on corporations.

The majority of states begin the computation of state taxable income with federal taxable income. Accordingly, taxpayers that file returns in states that do not conform to Section 199 must add back any Section 199 manufacturing deduction claimed in computing federal taxable income.

© 2006 PricewaterhouseCoopers. All rights reserved. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

For further information, please contact Yasuko Takahashi or Mayumi Nakamura at:

E-mail: pwcjapan.taxpr@jp.pwc.com Tel:03-5251-2400