Section 199 – Qualified Production Activities Deduction

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Section 199: Qualified Production Activities Deduction

- Added by the American Jobs Creation Act of 2004.
  - To stimulate the growth of manufacturing jobs in the U.S.
  - To compensate the loss of extraterritorial income exclusion benefit repealed by the Act
- For taxpayers that have qualified domestic production activities
- The deduction provides a permanent tax benefit

The Amount of the Deduction

- Special deduction for domestic production activities
  - 9%* of lesser of qualified production activities income (QPAI) or taxable income (before the deduction)
  - Not to exceed 50% of W-2 wages
- Effective for tax years beginning after Dec. 31, 2004

* Phase-in of 9% benefits
  - 2005—2006: 3%
  - 2007—2009: 6%
  - 2010—Forward: 9%

General Calculation Steps for Section 199

- The calculation process is complex
  - IRS issued Notice 2005-14 in January, 2005, as interim guidance until regulations are issued.
  - IRS issued proposed regulation in October, 2005.
  - Final regulations are expected to be issued in 2006

1. Allocate gross receipts between Domestic Production Gross Receipts (DPGR) and Non-DPGR (de minimis rules may apply if Non-DPGR are < 5%).
2. Determine the portion of COGS and deductions, expenses, losses directly allocable to DPGR.
3. Determine a ratable portion of other expenses not directly allocable to DPGR.
4. Calculate Qualified Production Activities Income (QPAI): DPGR less allocated expenses from steps 2 and 3.
5. Multiply appropriate percentage (3%, 6% or 9%) to the lesser of QPAI or taxable income.
6. Multiply 50% to total W-2 wage
7. Qualified Domestic Production Activities Deduction is the lesser of steps 5 or 6.

Example

	All Activities	US Production	
Gross Receipts (GR)	15,000,000		
DPGR		10,000,000	
COGS	7,000,000		
Attributable to DPGR		5,200,000	
Gross Margin	8,000,000	4,800,000	
SG&A	4,000,000		
Directly allocable to US proudction		100,000	
Indirectly allocable to US production		2,600,000	
Unadjusted Net Income	4,000,000	2,100,000	
Book to Tax Difference	50,000	40,000	
Taxable Income Before Deduction/QPAI	4,050,000	2,140,000	
Smaller of the two		3%	
Qualified Produciton Deduction Before W-2 Wage Limitation		64,200	A
Total W-2 Wages Per Payroll Tax Returns		2,000,000	
		50%	
W-2 Wage Limitation		1,000,000	B
Qualified Production Deduction (Lesser of A or B)	(64,200)		
Taxable income	3,985,800		
Federal Tax Rate	34%		
Income Tax Due	1,355,172		
Tax saved	21,828		

Domestic Production Gross Receipts (DPGR)

- 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 (MPGE) by the taxpayer *in whole or in significant part within the U.S.*
    - Qualified film produced by taxpayer
    - Electricity, natural gas, or potable water produced by taxpayer in U.S.
  - Construction activities performed in U.S.
  - Engineering or architectural services performed in U.S. for U.S. construction projects
- QPP: tangible personal property, compute software, sound recording

In Whole or Significant Part

- Must be “by the taxpayer in the US” and “substantial in nature”
  - Facts and circumstances test that considers relative value added and costs of MPGE activity in US
  - Packaging, repackaging, labeling, and minor assembly are not substantial
  - Development, creation, or licensing of intangibles are not substantial
    - Exception: Computer software and sound recordings
- Safe harbor
  - 20% or more of COGS is labor and overhead

Statutory DPGR Exceptions

- DPGR *does not* include gross receipts from:
  - Sale of food and beverages prepared by taxpayer at retail establishment
  - Transmission or distribution of electricity, natural gas, or potable water
  - Gross receipts from property leased, licensed, or rented to a related party

Allocation Between DPGR and Non-DPGR

- Allocation of gross receipts between DPGR and Non-DPGR is required
- De minimis exceptions if less than 5% is Non-DPGR
- May need to consult a transfer pricing professional
- Allocation must be by a reasonable method; factors include:
  - Using most accurate available information
  - Relationship of gross receipts and chosen apportionment base
  - Accuracy of chosen method compared with other possible methods
  - Is method used for internal management or other business purposes?
  - Is method used for other tax purposes?
  - Time, burden and cost of various methods
  - Is method used consistently from year to year?

Determining Qualified COGS

- COGS
  - If taxpayer does, or can, without undue burden or expense, specifically identify from its books and records COGS allocable to DPGR is that amount even if the taxpayer uses another method to allocate between DPGR and non-DPGR.
  - If taxpayer cannot, without undue burden or expense, use a specific identification method to determine COGS allocable to DPGR, the taxpayer is not required to use such a method, but may use another reasonable method.
    - Same factors as allocating gross receipts in determining whether a method is "reasonable".
  - Use of a method for allocating COGS between DPGR and non-DPGR that is different from the method for allocating gross receipts between DPGR and non-DPGR is not reasonable unless that method is demonstrably more accurate than the method used to allocate gross receipts.

Determining Other Deductions

- Section 861 method:
  - Applies the principles of determining taxable income within and without the U.S. to other costs attributed to DPGR
    - Step 1: Allocate to class of gross income
    - Step 2: Apportion between statutory grouping (DPGR) and residual grouping
- Gross receipts of $25 million or less
  - Apportion deductions based on relative gross receipts
- Small business simplified overall method
  - Gross receipts of $5 million or less or eligible to use cash method under Rev. Proc. 2002-28
  - Apportion COGS and all deductions based on relative gross receipts

Partnerships, S Corps and Other Pass-through Entities

- Deduction determined at owner level
- Each partner/shareholder must compute its deduction
- For purposes of wage limitation, owner is treated as having W-2 wages equal to the lesser of
  - Allocable share of entity W-2 wages or
  - 18% of allocable share of QPAI

Construction – Industry Issue

- Construction
  - "Construction" is the construction or erection of:
    - Commercial or residential buildings and structural components
    - Inherently permanent structures
    - Land improvements
    - Infrastructure – includes power plants
    - 5% or less may be tangible personal property
  - Under certain circumstances, more than one taxpayer may be regarded as deriving gross receipts from the same activity (e.g., a general contractor and subcontractor).
  - Taxpayer must use construction NAICS code

Construction – Industry Issue

- Construction, cont.
  - Construction includes substantial renovation of real property
  - Construction activity and gross receipts exclusions
    - Tangential services such as hauling trash and debris, delivering materials, even if essential, unless taxpayer is performing construction
    - Improving land (grading and landscaping) and painting unless performed in connection with erection or substantial renovation of real property
    - Leasing real property
    - Sale or other disposition of land

Why Focus Now?

- Estimate of potential 2005 effective rate benefit
- Identify and develop process for capturing data relevant to the calculation
- Development of calculation methodology specific to your facts and circumstances
- Proactive planning to maximize deduction

What's The Next Step?

- Determine whether your activities qualify for the deduction
- Estimate potential tax savings for 2005 and future years
- If estimated tax saving is substantial, consider redesigning accounting system to keep track of DPGR and costs and expenses allocable to DPGR