



The 199 Domestic Production Activities Deduction: Opportunities, Pitfall, and Ambiguities for Domestic Manufacturers: Part II

PRACTICE AREAS

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INTRODUCTION This article is Part II of a two-part series that focuses on some of the more significant unresolved issues regarding the implementation of the domestic production activities deduction for corporate taxpayers that manufacture tangible property. Part I of the series n2 focused on two categories of issues under 199. n3 First, we



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considered the proper definition of "item," both for purposes of determining whether a taxpayer produced an item in significant part within the United States and for purposes of applying the exception for de minimis embedded services. Second, we discussed at length the issues involved in applying 199 to contract manufacturing arrangements, including the now mostly academic question of the extent to which ownership of the work-in-process inventory should be a prerequisite to qualification for 199 benefits, as well as the more practical question of how such ownership should be defined.

This Part II continues where Part I left off, by considering additional issues that arise in computing the domestic production activities deduction. The issues are roughly presented chronologically, in the order in which a taxpayer is likely to encounter them in computing the deduction. As for Part I, this Part assumes a basic familiarity with 199 and Notice 2005-14 ("the Notice"). All defined terms are as defined in the Notice.

THE DISTINCTION BETWEEN THE PRODUCTION OF QPP AND THE PROVISION OF SERVICES

The Notice provides that DPGR generally does not include gross receipts from the performance of services. A special rule provides that "de minimis" "embedded" services may be treated as generating DPGR if the price charged for the service is included in the amount charged for the sale of the QPP, and no more than 5% of the total gross receipts are attributable to the embedded services. In addition, another exception provides that gross receipts attributable to a standard warranty are treated as DPGR from the sale of the QPP.

The need to separate revenue from sales of property from revenue from the performance of services raises a number of issues.

Services That Are Integral to the Production and Sale of QPP

The Notice provides little guidance on the distinction between goods and services, where the services performed are an integral part of the production and sale of QPP. Despite confusing language in the Notice, generally, if an integrated taxpayer produces and sells a product, all of the gross receipts derived from the sale of that product should qualify for the deduction under 199. Accordingly, Treasury officials have indicated that a taxpayer will not need to segregate and treat as disqualified gross receipts the revenue from the sale of property that might be attributable to the design or marketing of the product, or to any other activity integral to the production and sale of the property, as long as the taxpayer substantially produced the property. The Notice, however, does not discuss or define the concept of integral services. It remains to be seen whether the forthcoming regulations will provide any guidance regarding when gross receipts that are attributable to activities that would be regarded as services if performed separately, nevertheless should be eligible for treatment as DPGR.



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Example 1. L enters into a contract with a customer to design a new type of equipment for the customer that will satisfy certain performance specifications. For a single lump-sum price, the contract requires L to procure raw materials and purchase component parts produced by other parties for incorporation in the equipment, produce 10 units of the equipment, ship the equipment to the customer, provide operating and maintenance manuals, and provide 100 hours of training to the customer's employees on the use and maintenance of the equipment.

This example raises the issue of how far is the reach of the as-yet unwritten rule that allows gross receipts attributable to services that are integral to the production and sale of QPP to qualify as DPGR. We believe the paramount consideration in determining whether gross receipts attributable to such activities are eligible for treatment as DPGR should be whether the activities at issue are performed incident to and necessary for the production and sale of QPP. This standard should be based on the standard developed in the long-term contract regulations, where in Regs. 1.460-1(d)(1), it is provided that:

[I]f a single long-term contract requires a taxpayer to perform a non-long-term contract activity that is not incident to or necessary for the manufacture, building, installation, or construction of the subject matter of the long-term contract, the gross receipts attributable to that non-long-term contract activity must be separated from the contract and accounted for using a permissible method of accounting other than the long-term contract method.

Regs. 1.460-1(d)(2) goes on to illustrate such non-incidental activities as including the separate provision of design or engineering services unrelated to any manufacture or construction of property.

This rule derives from an earlier rule that was developed under the completed contract method in Regs. 1.451-3 to prevent taxpayers from including unrelated services in a long-term contract in order to qualify the service activity for the completed contract method. In that context, the issue of what types of services should be carved out of a long-term contract was addressed in GCM 39803 (11/27/89). In this GCM, the IRS established the following test:

Therefore, whether a particular activity (and attributable items of income and expense) should be carved out from the rest of a qualifying building, installation, construction, or manufacturing contract depends on whether the activity directly benefits or is undertaken by reason of the obligation to build, install, construct, or manufacture the subject matter of the contract.

In reaching the foregoing conclusion, GCM 39803 distinguished several revenue rulings¹⁰ holding that engineering, construction management, and architectural services performed by a taxpayer who did not also perform fabrication or installation could not be accounted for using a long-term contract method. GCM 39803 concludes that "services



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per-formed with respect to the building, installation, construction, or manufacturing of property by the taxpayer are properly characterized as long-term contract activities, even though, if performed alone, such services may be personal services." We believe that the same standard should apply under 199.

Below, we analyze whether the gross receipts attributable to the various activities in Example 1 should qualify as DPGR.

i. Design Work. Treasury officials have confirmed orally that because the design work performed in connection with the production of the 10 units of equipment is incident to and necessary for the manufacture of QPP, none of the gross receipts from the sale of the QPP that might be viewed as being attributable to the design work should be treated as non-DPGR. Clearly, under the standard for long-term contracts, the design of QPP to be produced by the taxpayer would be a paradigm example of a type of activity that is incident to and necessary for production.

ii. Purchased Parts Incorporated in Original Equipment. Obviously, any portion of the gross receipts from the sale of the QPP that is viewed as being attributable to purchased parts that were incorporated as part of the original equipment produced by L should likewise qualify as DPGR, since L produced the equipment in significant part within the United States.

iii. Shipping Expenses. The gross receipts attributable to the shipping activities should qualify as DPGR when, as in Example 1, the shipping is performed as part of a single agreement to produce and sell QPP and is performed contemporaneous with the sale of QPP. Section 199 explicitly excludes the gross receipts attributable to the distribution of electricity, natural gas, or potable water from DPGR. ⁿ¹¹ No parallel provision requires taxpayers to carve out the gross receipts attributable to the distribution of QPP. Thus, there is a strong argument that by not explicitly excluding gross receipts attributable to the distribution of QPP, Congress intended for such receipts to be eligible for treatment as DPGR.

Soon after the publication of the Notice, Treasury officials indicated that they were considering whether the explicit exclusion of gross receipts attributable to the distribution activities of utilities required the contrary conclusion in the context of QPP -- i.e., that gross receipts attributable to the shipment of QPP should qualify as DPGR. More recently, however, officials have suggested that the gross receipts attributable to the distribution of QPP are includible in DPGR. Thus, we expect the forthcoming regulations to provide that shipping is eligible for treatment as DPGR.

Under the Notice's exception for warranties, taxpayers may include in DPGR the gross receipts attributable to a warranty that is provided in the normal course of business in connection with the sale of QPP and that is not separately offered by the taxpayer or separately negotiated with the customer. ⁿ¹² Shipping activities are no less integral to the sale of QPP



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than a standard product warranty, and Treasury should not treat shipping less favorably. Unlike the exception for standard warranties, however, a taxpayer should be eligible to treat the gross receipts attributable to standard shipping as DPGR even when the shipping appears, as it often does, as a separate charge, priced according to the quantity and weight of the items shipped and the distance required to be traveled. It remains to be seen what effect separate pricing will have on the conclusion that gross receipts attributable to the distribution of QPP are includible in DPGR.

iv. Operating and Maintenance Manuals. It is less clear whether the gross receipts attributable to the operating and maintenance manuals would be treated as DPGR. Treasury officials seem inclined to take an adverse view of any service that is not essential to getting the physical property in the hands of the customer.

The operating and maintenance manuals should be considered an indispensable part of the equipment that is produced and sold by the taxpayer. Most products come with instruction manuals. In most cases, there would be no separate charge for an instruction manual. Moreover, a customer would not know how to operate or maintain the equipment without the benefit of the manual. Such operating and maintenance manuals are particularly important with complex and technologically advanced equipment.

Before issuing the Notice, Treasury representatives often referred to the example of an integrated dress maker that pressed the dresses it produced before offering them for sale to customers. According to the representatives, pressing the dress exemplified the type of service that is integral to the production and sale of QPP, such that the dress maker would not be required to carve out the gross receipts allocable to the pressing activity from the gross receipts allocable to the sale. The operating and maintenance manuals seem like a perfect analogy to pressing the dress, because the provision of operating and maintenance manuals is essential to closing the sale and transferring to its customer equipment that is usable. Accordingly, we hope that the forthcoming regulations will make it clear that any gross receipts from the sale of QPP that is attributable to the preparation of an operating or maintenance manual should be treated as DPGR from the sale of the QPP.

v. Employee Training. Similar arguments as were made for the maintenance and operating manuals might be made for the gross receipts attributable to training the customer's employees. In the case of sophisticated equipment, it would be normal for a producer of the equipment to train the customer's employees on the use and maintenance of the equipment. Accordingly, any gross receipts attributable to introducing the customer's employees to the unique aspects and requirements of the equipment should be treated as DPGR from the sale of the QPP. However, as in the case of the manuals, Treasury may take an adverse view of training activities because such activities are not essential to getting the QPP in the hands of the customer.



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Below, we consider the closely related issue of whether, if, contrary to the position asserted below, Treasury determines that a manufacturer's installation of QPP subsequent to the transfer of its ownership to the customer does not qualify as MPGE by the manufacturer, such installation activities nevertheless should be treated as an integral service, with the result that the gross receipts attributable thereto are treated as "derived from" the sale of the QPP.

What If Integral Services Are Separately Priced?

One unanswered question is whether the conclusion that gross receipts attributable to services that are integral to the production and sale of QPP, however defined, do not have to be carved out of DPGR is altered if the sales agreement contains separate prices for the integral services. This is a highly significant issue for taxpayers with government contracts, where almost every activity under the contract, no matter how small, contains a separate price.

The existence of separate prices for the line items in a sale agreement for QPP should not change the analysis of whether gross receipts attributable to activities that are incident to and necessary for the production and sale of the QPP should qualify as DPGR. There might be various reasons for such a breakdown of the aggregate sales price, such as the desire to provide targets for triggering progress payments under the agreement. In the case of contracts with the U.S. government, such a breakdown might be customary or be required under the applicable government regulations. The mere fact that a contract contains line item prices for activities that clearly form a part of a larger activity of producing and delivering property does not mean that the customer would be satisfied with merely obtaining those separately-priced line items of activity in the contract without also obtaining the QPP being produced by the taxpayer. What good would the manual be without the machine for which it guides operation? Similarly, how would a producer publish a manual for a sophisticated piece of machinery that it never built? For these reasons, it is unlikely the parties would have agreed to the same line item prices set forth in an integrated sales agreement if instead the line items represented independent contracts, apart from the production and sale of the QPP in the sales agreement.

Instead, where the activities represented by the separate line items are not independently offered for sale, separate line item pricing most likely represents an allocation of a single price among the various activities performed pursuant to a single sale, and should not be viewed as signifying that the individual line items constitute separate sales of goods or services that must be separately analyzed under 199. Consistent with this view, the standard under the long-term contract regulations, discussed above, for determining whether the activities at issue are performed incident to and necessary for the production and sale of the property that is the subject of the long-term contract applies regardless of whether the long-term contract contains a separate price for such activities.

Treasury, however, seems inclined to treat separate line item pricing as transforming the line item into a separate transaction that must independently qualify for benefits under 199.



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INSTALLATION ACTIVITIES

Installation of Items Not Produced by the Taxpayer

Treasury has defined MPGE very broadly to include, among others, "activities relating to manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP." n13 Treasury representatives have stated that they generally did not intend for the definition of MPGE to perform much work in terms of limiting the availability of the deduction. Instead, this gate-keeping function is primarily performed by the requirement that the tax-payer must have MPGE'd the QPP "in whole or in significant part" within the United States. n14

Since issuing the Notice, however, Treasury officials have stated that the proposed regulations will narrow the definition of MPGE contained in the Notice to exclude the installation of an item that the taxpayer did not itself produce. Instead of excluding the installation of items that the taxpayer did not itself produce from the definition of MPGE, Treasury should remain true to its general approach under 199 of interpreting the term MPGE broadly and relying instead on the requirement that the taxpayer MPGE'd the property in significant part in order to prevent routine installation from inappropriately converting purchased items into items that generate DPGR. n15

Obviously, mere routine installation of a purchased item should not transform the item into QPP that was MPGE'd by the taxpayer in significant part. Under the tests for whether taxpayer MPGE'd QPP "in significant part," however, installation activities could only convert the sale of a purchased item into a qualifying transaction if the installation activities were so significant that they substantially transformed the item being installed, such that the installation itself should qualify as a manufacturing activity. That is, under the facts-and-circumstances test, the taxpayer's installation activities would have to be "substantial in nature," and, under the safe harbor test, the labor and overhead costs associated with the installation activities would have to equal at least 20% of the taxpayer's cost of goods sold for the item in order for the QPP to be treated as MPGE'd by the taxpayer in significant part. Under either test, the installation of purchased items would only convert the purchased items into items treated as having been produced substantially by the taxpayer in extreme cases where the installation itself ought to qualify as a manufacturing activity.

It remains to be seen whether Treasury will change its current position that the installation of purchased items does not qualify as MPGE. Based on the adamancy with which Treasury officials have addressed the subject at conferences and in speeches, however, it seems unlikely that Treasury will be convinced to change the position.



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Notice 2005-14 provides that taxpayers may rely upon the rules described therein until regulations are issued.¹⁶ The Notice unequivocally includes all "installing" activities in the definition of MPGE. Thus, until proposed regulations are issued restricting the inclusion of installation activities to the installation of QPP produced by the taxpayer, taxpayers should be entitled to treat the installation of purchased parts as MPGE, at least for purposes of computing required estimated tax payments.

In view of Treasury's narrow interpretation of "installation" activities, perhaps it is more appropriate to characterize any such activities that would be substantial enough to meet the facts-and-circumstances test or the 20% safe harbor as the "complex assembly" of the purchased parts with the customer's preexisting property. Query, however, whether characterization of an activity as complex assembly requires that the taxpayer own all of the components being assembled, whereas the incorporation of new parts into a customer's preexisting equipment or machinery is more appropriately termed "installation."

Qualification of Installation Following the Transfer of Ownership as MPGE

As discussed at length in Part I of this series, the Notice provides that only the taxpayer that has the benefits and burdens of ownership of property during the period a qualifying activity occurs is treated as engaging in the qualifying activity for purposes of determining eligibility for the 199 deduction.¹⁷ Absent a special exception to this rule, installation will not qualify as MPGE with respect to any taxpayer in cases where the manufacturer had the benefits and burdens of ownership of QPP during the time the property was originally produced, but transferred ownership to the customer before performing the installation activities.

Example 2. Taxpayer D enters into an agreement with a customer to produce, deliver, and install a turbine for a lump sum price. The contract provides that the benefits and burdens of ownership of the turbine pass to the customer when the turbine arrives at the customer's location, even though D is required to install the turbine at the customer's location.

Absent a special rule, in Example 2, the installation activities will not be treated as MPGE by D, because D did not have tax ownership of the turbine while D installed the turbine. Further, the customer, although the owner of the QPP during the installation, could not be treated as performing an MPGE activity because the customer did not produce the QPP being installed and, under Treasury's position, installation qualifies as MPGE only with respect to the producer of the QPP being installed.



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Various substantial business reasons, having nothing to do with federal income tax considerations, might cause a manufacturer to transfer the benefits and burdens of ownership of QPP to a customer before installing the QPP. For example, a manufacturer may wish to reduce its exposure to liability for events occurring at the customer's location or to recognize the income from the sale for financial accounting purposes. Additionally, state or local tax considerations might prompt the decision as to when to transfer ownership of the QPP from the manufacturer to the customer. None of these reasons provide a basis for disqualifying the manufacturer from being treated as the taxpayer that performed the installation activities.

Importantly, this issue affects both contract manufacturers and manufacturers who sell property out of their inventory, because in both cases the manufacturer might transfer the benefits and burdens of ownership to the customer prior to installing the property at the customer's location. This issue would not arise, however, in traditional consignment manufacturing arrangements, where the customer owned the work-in-process inventory from the inception of production. Where the customer owned the property while it was being produced, the customer would always continue its ownership of the property during installation and thus the installation activities would always constitute MPGE performed by the customer.

We understand that Treasury is considering whether to allow installation activities to qualify as MPGE by the manufacturer in situations such as that in Example 2, where the manufacturer performs the installation after transferring ownership of the QPP to the customer.¹⁸ If a manufacturer such as D has the benefits and burdens of ownership of property while it is produced, the transfer of ownership to the customer before the manufacturer installs the property should not bar qualification of the installation activities as MPGE by the manufacturer, where the installation is directly related to the sale of the property. Treasury interprets 199 to provide that only one taxpayer may claim the deduction with respect to any particular MPGE activity.¹⁹ Treasury further provides that the determination as to which of the possible taxpayers is allowed the deduction is based on which taxpayer owned the property while the activity was performed.²⁰ If the premise that only one taxpayer should qualify for the deduction for each activity is accepted, Treasury's ownership test for determining which taxpayer qualifies makes sense, because only a taxpayer that has had ownership of the QPP can earn qualifying gross receipts from the lease, rental, license, sale, exchange, or other disposition of the QPP.

The policy that only one taxpayer should get a 199 benefit for a particular qualifying activity is not implicated, however, when a manufacturer has the benefits and burdens of ownership of QPP while it is produced, but transfers those benefits and burdens to the customer before installing the QPP. In such a case, regardless of which taxpayer owns the property during the installation, the installation activities could never constitute MPGE with respect to the customer



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because the customer did not produce the property being installed, and Treasury has indicated that installation of QPP can qualify as MPGE only where the taxpayer performing the installation also produced the QPP being installed. Thus, the ownership test's only purpose -- to determine which taxpayer is attributed qualifying activities in factual situations where two taxpayers might otherwise claim the deduction -- is not at issue for installation activities.

Where the ownership test does not serve its usual tie-breaking function, Treasury should not impose the ownership test to deny treatment of activities actually performed by the taxpayer as MPGE by that taxpayer. Thus, an exception should be made to the Notice's requirement that QPP be owned by the taxpayer claiming the 199 deduction at the time the activity is performed in the case of installation activities performed by a manufacturer that occur shortly after the manufacturer transfers ownership of the goods it produced.

In Example 2, the installation of the turbine should be treated as MPGE performed by D. As a preliminary matter, because D had the benefits and burdens of ownership of the turbine while D manufactured the turbine, D is treated as the producer of the turbine and is therefore eligible to treat the installation of the turbine as an MPGE activity. Although D transferred the benefits and burdens of ownership of the turbine to the customer shortly before installing the turbine, the installation activities should nonetheless qualify as MPGE by D because the installation is a production activity that is directly related to the sale of the turbine by D, and the installation cannot qualify as MPGE with respect to D's customer.

Furthermore, as explained below, a manufacturer's gross receipts attributable to installation activities that occur following the transfer of ownership should be treated as gross receipts derived from the sale of QPP regardless of whether Treasury agrees that such installation activities qualify as MPGE.

Qualification of Installation Following the Transfer of Ownership as an Integral Service

Above, we dealt generally with the application of the Notice's distinction between goods and services, where the services performed are integral to the production and sale of QPP. Here, we consider in particular the qualification as DPGR of gross receipts attributable to installation activities, when the installation is performed by the original manufacturer and occurs after the manufacturer transfers ownership of the QPP to the customer.

If the Treasury does not agree with our assertion above, that such installation should qualify as MPGE by the manufacturer, we are faced with the question of whether, if the QPP being installed nevertheless qualifies as having been MPGE'd by the manufacturer in significant part, the manufacturer's gross receipts attributable to the installation activities should be treated as derived from the sale of the QPP. This question should be answered in the affirmative where the installation occurs shortly after the transfer of ownership and is directly related to the sale. In such cases, the installation is not an ancillary "embedded service," but rather is performed as an integral part of the production and sale of the QPP.



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Many of the observations made above regarding services that are integral to the production and sale of QPP, are equally applicable to installation activities that follow the transfer of ownership. In addition, however, 3.04(4) of the Notice provides that a contractor that does not satisfy the requirement that the property be owned by the taxpayer at the time of the activity is considered to be deriving gross receipts from the provision of services and the receipts are not considered to be "derived from any lease, rental, license, sale, exchange, or other disposition of" the property. This rule might be applied to installation activities performed by the manufacturer after title to the QPP has passed to the customer.

It is doubtful that Congress intended for the mere fact that an activity integral to the production and sale of QPP occurred after the transfer of ownership of the QPP to preclude gross receipts attributable to that activity from being treated as derived from the sale of the QPP. Installation clearly is an activity that is integral to the production and sale of QPP. At least when installation precedes the transfer of ownership, installation is treated as MPGE for purposes of determining whether the manufacturer substantially produced the item. Even if the manufacturer does not treat installation that occurs after the manufacturer transfers ownership as MPGE, the timing of title passage should not convert such an integral activity from being viewed as part of the production of the QPP itself into an ancillary service that must be carved out from the sale of the QPP.

Especially with complex and technologically advanced equipment, the manufacturer is often the only person qualified to integrate the equipment into the customer's preexisting operations. As in the case of the manuals and training discussed above, the assistance of the manufacturer in the installation of sophisticated equipment is indispensable to the transfer of beneficial enjoyment of operable equipment to the customer. Further, as discussed above, the decision of when to pass title is based on entirely independent considerations and, thus, does not change the nature of the gross receipts attributable to the installation activities as integrally related to the sale of the QPP.

Finally, the Code only requires that gross receipts be "derived from" a sale of the QPP. Thus, even if installation activities occurring after title passage are not themselves considered MPGE or are not considered direct sales proceeds, the gross receipts attributable thereto are certainly derived from the sale of the QPP when the installation is incident to the sale of the QPP. Although the Notice indicates that Treasury will interpret "derived from" narrowly to include only the direct proceeds from the lease, rental, license, sale, exchange, or other disposition of the qualifying production property, Treasury has provided exceptions for business interruption insurance, payments not to produce, advertising income, and oil and gas partnerships.ⁿ²¹ The case for qualification of installation activities following title passage is at least as sympathetic as the case for these exceptions.

Accordingly, any gross receipts attributable to the installation of the equipment should be treated as gross receipts derived from the sale of the equipment, even if Treasury does not agree that installation by a manufacturer following the



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transfer of ownership should qualify as MPGE by a manufacturer that had the benefits and burdens of ownership during production.

CONTRACTS TO REPAIR OR REBUILD CUSTOMERS' PROPERTY n22

The Notice's rule providing that only the tax owner of property is treated as engaging in a qualifying activity n23 that is performed with respect to that property results in an inappropriate cutback in 199 benefits when applied to contracts to substantially rebuild customer-owned property. In such contracts, ownership of the property being produced is divided between the customer and the contractor, with the customer owning the preexisting property that is the subject of the rebuild contract and the contractor owning all of the new parts and components that will be incorporated into the rebuilt item. If the ownership of the new material and the preexisting property resided in one taxpayer during the rebuild process, the rebuilt property (i.e., an integrated piece of equipment) clearly would be treated as a single "item" to be tested for qualification under 199. n24 Under the Notice, however, the split ownership precludes viewing the re-built property, as a whole, as the "item." Instead, the Notice requires a taxpayer performing a rebuild contract to treat each individual part or component as a separate item that must qualify independently for 199 benefits. Individual testing of each part or component takes on added significance in view of Treasury's position, discussed above, that only the installation of parts that were produced by the taxpayer qualifies as MPGE.

Repair Contracts

Although we generally disagree with the Notice's ownership test for the attribution of MPGE activities n25 and with the Treasury's position that the installation of purchased parts does not qualify as MPGE, n26 we do not disagree with the particular application of these rules to ordinary repair contracts.

Example 3. For a lump-sum price, Taxpayer G performs a 45-day "heavy maintenance visit" on a customer's air-frame, such as that described in Situation 1 of Rev. Rul. 2001-4 (holding that an airframe's owner could deduct the cost of a 45-day heavy maintenance visit). None of the work performed by G results in a material upgrade or addition to the airframe or involves the replacement of any major component or substantial structural part of the airframe.

In the case of ordinary repair contracts such as in Example 3, the contractor must test each sale that is embedded in the repair contract in order to determine if the sale qualifies for 199 benefits. Thus, G should be entitled to treat as DPGR the portion of its gross receipts from the repair that is attributable to the value of the parts produced by G in significant part within the United States, as well as to the value of the labor to remove the old part and the labor to install the replacement part. In contrast, G will not earn DPGR for any gross receipts attributable to the sale or installation of parts



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and components that G purchased, regardless of how substantial the installation activities are with respect to the parts. In addition, G also will not earn DPGR for any work that G performs exclusively on the customer's equipment, such as work performed to refurbish preexisting parts.

Rebuild Contracts

We believe that a distinction should be drawn between ordinary repair contracts and rebuild contracts. In the case of rebuild contracts, the contractor should be eligible to test all of its gross receipts from the rebuild transaction in the aggregate for qualification as DPGR. In such cases, it should not be necessary to separate the work as a whole into each individual task. Instead, the taxpayer performing the work should be treated as having produced and sold a single item of property, namely, the improvement of the relevant property.

Example 4. Taxpayer F enters into an agreement with a customer to rebuild one of the customer's railcars. See, e.g., Rev. Rul. 88-57 (describing the capital rehabilitation of railcars). The rebuild takes place entirely within the United States and includes a complete disassembly, inspection, and reconditioning or replacement of the various components of the car. In addition, modifications are made to the car in order to upgrade various components to the latest engineering standards. The value of the rebuild work is substantial in relation to the value of the customer's property immediately before the rebuild. In addition, a majority of the value of the rebuild work is attributable to the fair market value of new parts and components that were produced by F. During the rebuild process, F has the benefits and burdens of ownership for all of the supplies and new parts and components that are incorporated into the rebuilt rail car, whereas the customer retains the benefits and burdens of ownership of its preexisting rail car.

In the foregoing example, F's activities clearly constitute manufacturing, in light of the substantial value of the work performed relative to the value of the rail car immediately before the rebuild, as well as the substantial level of use of materials that were produced by F, the taxpayer performing the work. However, if F were required to treat the rebuild transaction in the same manner as an ordinary repair transaction under Notice 2005-14, the rebuild transaction would be disaggregated into the installation of the individual parts and components. As a result, only the gross receipts allocable to the sale and installation of parts and components produced by F would generate DPGR. Further, a question exists as to whether any of the gross receipts allocable to F's substantial effort to tear down and reassemble the railcar would be treated as allocable to the installation of particular parts or components that were produced by F.

The only obstacle to F treating all of the new parts and components installed in the customer's property as a single item of property for purposes of testing under 199 is that, during the rebuild, ownership of the ultimate property being produced -- i.e., the rebuilt rail car -- is divided between F and F's customer.²⁷ This fact prevents the separate parts



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from being aggregated into a single item of QPP, despite the fact that the separate parts are incorporated into a single item of property.

We recommend that Treasury resolve the issue raised by this division of ownership by providing that, in a rebuild contract, the contractor should be allowed to treat all of the separate purchased and produced parts and components in-stalled in the rebuilding of a single piece of equipment as a single "item" of property. As a result, where the purchased and produced parts and components qualify in the aggregate as having been produced by the taxpayer within the United States, all of the contractor's gross receipts allocable to the parts and components, as well as the gross receipts attributable to the disassembly and reassembly of the customer's property, would qualify as DPGR. Furthermore, because most of the costs or value in such a rebuild contract are incurred in the acquisition, development, and installation of new parts and components, it is entirely consistent with the Code for the Treasury to treat the gross receipts earned from a qualifying rebuild contract as gross receipts derived from the sale of QPP.

Definition of a "Qualifying Rebuild Contract"

Obviously, if the gross receipts from a rebuild contract were to be treated differently from an ordinary repair transaction, it would be necessary to distinguish between these two types of transactions for purposes of 199. We would recommend that Treasury adopt an objective test to distinguish rebuild contracts that warrant the special treatment ("qualifying rebuild contracts") from repair and rebuild contracts that should not so qualify.

Recommended Definition of a Rebuild Contract

Generally, where the contractor performs work on property owned by the customer that is so substantial that the work is properly viewed as a rebuild of the customer's property instead of as a repair, the customer would be required to capitalize the cost of the work. n28 However, since the approach we recommend would apply to the contractor, the availability of the approach should not be tied directly to the treatment by the customer in terms of either whether the customer actually capitalized or deducted the cost of the rebuild or whether the customer should have capitalized the cost of the rebuild under existing federal tax law. In many cases, the contractor will not have access to the facts and circumstances relevant to either determination and, even if the contractor had this information, considerable uncertainty has developed regarding when heavy maintenance and overhaul contracts are required to be capitalized under existing law. n29

Therefore, to ease the administrative burden of requiring the contractor to determine whether the customer either did capitalize or should have capitalized the rebuild, we recommend that "rebuild contract" be defined as any contract where the value of the rebuild work performed exceeds some percentage of the value of the preexisting property immediately



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before the rebuild. An appropriate percentage might be 25%.

Recommended Definition of a "Qualifying Rebuild Contract"

In light of the fact that the treatment we recommend focuses on the ownership of the new parts and components and disregards the ownership of the preexisting property, a prerequisite for this treatment should be that the new material is substantial in relation to the entire rebuild project. Furthermore, in light of the Treasury's current position that only the installation of parts produced by the taxpayer qualifies as MPGE, Treasury could further limit our proposed treatment to rebuild contracts where either (1) the majority of the taxpayer's cost of performing the rebuild work is attributable to the cost of parts and components produced by the taxpayer, or (2) the majority of the value of the rebuild work is attributable to the fair market value of parts or components produced by the taxpayer. Taxpayers should be allowed to elect to determine the percentage of the rebuild work that is attributable to new parts and components based on either cost or fair market value data, because taxpayers' access to such data varies and one of the two ratios may be easier to compute.

Under this test, since eligibility for special treatment would depend on such a high level of produced parts, when that cost is taken together with the cost of installing such parts, the predominant nature of the transaction is that of a sale of produced parts and not a simple repair.

Why Should Rebuild Contracts Be Treated Differently than Repair Contracts?

Performance under a rebuild contract requires delivery of a rebuilt piece of equipment or machinery and not the delivery of individual parts. It is clear that, in Example 4, if one taxpayer owned both the preexisting rail car and the new parts and components during the rebuild process, the rail car would be the item tested for whether it was MPGE'd in whole or in significant part within the United States. A rebuild contract requires integration of the new parts and components into a single end product, which includes the customer's preexisting property, to the same degree as where the manufacturer owns both the preexisting property and the new parts and components during production. The taxpayer performing the rebuild work is in effect producing and selling a single item of property, namely, the substantial improvement of the preexisting property. Thus, in cases where the majority of a contractor's activities under a rebuild contract, whether measured based on costs or fair market value, are attributable to the production of new parts and components, the contractor should be able to treat all of the new parts and components that it incorporates into the customer's single item of preexisting property in the rebuild transaction as a single item for purposes of 199.

Application of the Ownership Test to Rebuild Contracts



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For qualifying rebuild contracts, Treasury should apply the ownership test for determining which taxpayer is attributed the MPGE activities by looking only to the taxpayer that owns the new parts and components used in the rebuild. This variation of the ownership test would accomplish Treasury's purpose for imposing the test, by ensuring that only one taxpayer is eligible for the 199 deduction based on the rebuilding activity.

The rule in the Notice that eligibility for the 199 deduction is determined by reference to the party that has ownership of the property being processed does not contemplate the type of split ownership that is present in a rebuild contract. In such a situation, the fact that the taxpayer that is actually performing the work is also the owner of all of the new material that is being added to the preexisting property should be sufficient to offset the single fact that this taxpayer is not the owner of the original property that is being rebuilt. Because the purpose of the ownership test is to determine which taxpayer should be treated as performing the production activities, it makes sense for the test to turn on the ownership of the new parts and components instead of the ownership of the preexisting property, particularly where the material produced by the taxpayer accounts for the majority of either the cost or the fair market value of the rebuild.

Definition of the "Item" in a Qualifying Rebuild Contract

If the definition of "item" is not varied for rebuild contracts, manufacturing performed pursuant to rebuild contracts will be treated substantially worse for purposes of 199, as compared to other arrangements for performing the exact same work. Three fact patterns demonstrate the disparate treatment under the current rules. First, in Example 4, if F's customer had simply performed the rebuild activity itself, the rebuilt rail car would be treated as the item to be tested under 199 because F's customer would have had the benefits and burdens of ownership of the preexisting rail car and the new parts and components during the rebuild process, in which these items would be incorporated into a single integrated piece of equipment. As a result, the customer would be treated as having MPGE'd the rail car. Second, F could have purchased the rail car before performing the rebuild, and, similarly, F would have been treated as having MPGE'd the rail car. However, when the rules set forth in the Notice are applied to the facts of Example 4, neither F nor F's customer would be treated as having MPGE'd the rail car, because during the rebuild process neither had the benefits and burdens of ownership of both the preexisting rail car and the new parts and components. Instead, under the facts of Example 4, F separately must test each part and component that is incorporated into the rebuilt rail car for qualification under 199.

In all three fact patterns, the manufacturing activity performed is exactly the same. Consequently, the potential for 199 benefits should also be the same. Neither the statutory term "by the taxpayer" nor the definition of "item" requires a different result.



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Thus, Treasury should resolve the split ownership in qualifying rebuild contracts by allowing all of the parts and components that are installed in the customer's preexisting property to be treated as a single item for purposes of 199. In such a rebuild contract, most of the disassembly and reassembly costs are attributable to the installation of the new parts and components produced by the taxpayer. By treating all of the work performed as a single item, the approach we recommend would eliminate the need for onerous allocations of installation activities among the various purchased and produced parts that are installed as part of the rebuild transaction.

Gross Receipts from a Rebuild Contract are Gross Receipts Derived from Sales

It is consistent with the Code to treat the gross receipts earned from a qualifying rebuild contract as gross receipts derived from the sale of QPP. A rebuild contract is not similar to a consignment manufacturing arrangement, under which the contractor does not own the property being worked on and is therefore considered to provide a service. Further, under the proposed definition for qualifying rebuild contracts, special treatment would be reserved for contracts in which the contractor transfers to the customer a substantial amount of new parts and components that are incorporated into the customer's property. Moreover, these contracts do not represent the mere resale of purchased property because of the substantial level of activity performed by the contractor in incorporating these parts and components into the property being rebuilt.

Thus, applying the treatment we propose to Example 4, since the rebuild substantially increases the value of the preexisting rail car and the fair market value of the new materials produced by the taxpayer and used in the rebuild is more than 50% of the fair market value of the rebuild work, F should be eligible to treat the new parts and components as a single item for purposes of 199, because they are being integrated into the customer's single item of preexisting property. As a result, F would be treated as earning gross receipts from the sale of the parts and components in the aggregate, and such gross receipts would qualify as DPGR provided that the parts and components, as a unit, qualify as having been produced by F in significant part within the United States.

TAX ACCOUNTING CONFORMITY REQUIREMENTS UNDER 199

Conformity with 263A

Because of the similarity between the definition of MPGE for 199 purposes and the definition of production for 263A purposes, the Notice imposes a conformity requirement between eligibility for 199 and treatment of the activity as production for purposes of 263A. n30 Specifically, any activity treated as MPGE for purposes of 199 must be treated as production for purposes of 263A. n31 If a taxpayer presently is not treating an activity as production under 263A for



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which it would like to claim 199 benefits, a method change request will need to be filed to change the taxpayer's treatment for regular tax purposes.

The conformity requirement with 263A is a one-way street. Taxpayers treated as producers of property under 263A do not necessarily qualify as having MPGE'd the property for purposes of 199. There are several reasons for the limited scope of the conformity requirement.

First, 263A, in addition to applying to taxpayers that own the property being produced, applies to taxpayers that contract with other parties to produce property for the taxpayer.ⁿ³² These so-called "payment producers" would not qualify for 199 benefits because they do not own the work-in-process inventory.

Second, the test for tax ownership under Regs. 1.263A-2(a)(1)(ii)(A) is potentially different from the test for tax ownership under 199 with respect to both the scope of the inquiry and the number of taxpayers that may be treated as a tax owner at a single point in time.

In Part I of this series, we asserted that, although Regs. 1.263A-2(a)(1)(ii)(A) provides that "whether a taxpayer is an owner is based on all the facts and circumstances, including the various benefits and burdens of ownership vested with the taxpayer," while Notice 2005-14 refers only to the benefits and burdens of ownership, the scope of the inquiry under both tests nevertheless should be the same, because courts applying a benefits and burdens test always consider all the facts and circumstances. However, in response to questioning by one of the authors, a Treasury representative recently stated that, in her view, the inquiry into ownership under 199 is limited to the traditional indicia of benefits and burdens and would not include such additional factors as the complexity of the manufacturing process or the extent to which the contractor enhances the merchantability of the end product, which have been considered relevant under 263A.ⁿ³³ Thus, it is possible that, in a case where these "additional factors" tip the scale under Regs.

1.263A-2(a)(1)(ii)(A) and cause a taxpayer to be treated as an owner and therefore as a producer subject to 263A, the taxpayer nonetheless would not be treated as an owner eligible for 199 benefits.

In addition, as discussed in Part I of this series, Regs. 1.263A-2(a)(1)(ii)(A) may result in two taxpayers being treated as tax owners of the same property at the same time, with the result that both taxpayers are treated as producers of the property under 263A.ⁿ³⁴ For 199 purposes, the Notice is clear that, at any single point in time, only one taxpayer will be treated as the tax owner of property and therefore as eligible for attribution of the MPGE activities that occur with respect to the property.



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Finally, taxpayers may be treated as a producer subject to 263A, yet not be eligible for 199 benefits, because the threshold of activity that would subject a taxpayer to the uniform capitalization rules, which generally employ a 10% test, n35 is lower than that which is required under 199's 20% conversion cost safe harbor.

Do Other Conformity Requirements Exist?

The Notice does not impose a conformity rule requiring taxpayers to treat DPGR as gross receipts from the lease, rental, license, sale, exchange, or other disposition of QPP for other tax accounting purposes. Thus, in appropriate circumstances, taxpayers may continue to account for gross receipts from transactions generating DPGR as revenue from services, and may continue to treat the materials generating the DPGR as supplies used in the provision of services, in-stead of as inventory.

Example 5. Taxpayer J is engaged in the business of providing routine maintenance of customers' equipment. J is paid a fixed fee for providing the maintenance service for a one-year period. The maintenance mainly consists of lubricating the various parts of the customer's equipment, as well as periodically replacing certain filters and other minor parts. J purchases the filters and other minor parts. In contrast, the lubricants used by J represent a unique blend of components that are produced by J.

For regular federal income tax purposes, a taxpayer may account for a particular transaction according to the predominant nature of the transaction. Thus, a taxpayer may accrue revenue from a service transaction under the three-part test set forth in Rev. Rul. 74-607, n36 even though the transaction includes an embedded sale of goods. Accordingly, in Example 5, because J's business is characterized as a service business for regular tax purposes, J would account for the transaction as the performance of services using materials and supplies within the meaning of Regs. 1.162-3. It is unlikely that the lubricants would be regarded as inventory under 471, despite the fact that a portion of the lubricants are physically transferred to a customer each time that maintenance is performed, because the lubricants are not driving the income recognition transaction and the lubricants are not a material income producing factor. As a result, revenue would be recognized under the three-part test in Rev. Rul. 74-607 and expenses deducted as incurred, with the cost of the parts, filters, and lubricants deducted as consumed, pursuant to Regs. 1.162-3.

For 199 purposes, however, Treasury has determined not to look only to the predominant nature of a transaction as would be required, for example, under subpart F. Instead, when transactions include a mix of goods and services, Treasury requires taxpayers to allocate the gross receipts from the transaction among the transaction's components. Thus, it is possible that a transaction from which revenue is properly accounted for under Rev. Rul. 74-607 will generate DPGR. Further, 199 does not appear to be limited to a sale of QPP that is inventory in the hands of the taxpayer. Thus,



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in Example 5, since J produces the lubricants and transfers ownership of the lubricants to the customer when J lubricates the customer's equipment, the portion of the gross receipts from the maintenance transaction that is allocable to the lubricants should qualify as DPGR for purposes of 199.

A Treasury representative has orally confirmed that the sole impact of the conformity rule in Example 5 is that J must apply 263A to determine the cost of the lubricants. To qualify for 199 benefits, J should not be required to treat the lubricants as inventory rather than as supplies. Further, J should not be required to change its method of accounting for the income from the maintenance transaction from treating the transaction as a service to a method that treats the transaction as partly the performance of a service and partly the sale of goods. Hopefully, the forthcoming regulations, or at least the preamble thereto, will state explicitly that the notion that 199 fragments a transaction that is part sale and part service into these two components does not override long-standing principles in 446 and 471 as to whether a particular transaction is characterized as a sale of goods or the performance of services based on the overall character of the transaction.

Of course, taxpayers should not be allowed to take inconsistent factual positions, such as by characterizing a single transaction as the provision of a service for regular tax purposes and as a sale of goods for 199 purposes. Taxpayers that need to change the classification of a transaction for regular tax purposes in order to characterize the transaction as a sale of goods for 199 purposes may need to file a request to change their accounting method.

THE EXCEPTION FOR DE MINIMIS EMBEDDED SERVICES

Generally, as discussed above, the Notice provides that DPGR does not include gross receipts from the performance of services. The Notice recognizes that services that are not integral to the production and sale of QPP may be provided as part of a single transaction or contract for the sale of QPP. An example of a non-integral service might be an agreement to provide routine maintenance on equipment after the sale. The Notice contains a special de minimis rule that may apply when the price for a nonqualifying services is "embedded" in the sales price of QPP. If the revenue attributable to the "embedded" services is less than 5% of the total revenue from the item, n37 all of the revenue will qualify for the 199 deduction. As discussed above, the Notice provides sparse guidance on the distinction between embedded services and service-type activities that are integral to the production and sale of QPP.

What If the Services Are Separately Priced?



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One issue is whether services that have separate prices in the contract or sales agreement should be eligible for treatment as embedded services for purposes of the de minimis rule. The Notice defines embedded services as non-qualifying services, the price for which is included in the sales price of the QPP.ⁿ³⁸ This narrow definition of an embedded service would virtually nullify the effect of the exception for taxpayers that perform government contracts, because such contracts typically contain a separate price for every identifiable activity to be performed under the contract. Such a result is unjustified and should be reversed.

Taxpayers frequently account for regular tax and financial reporting purposes for all of the revenue and costs from a transaction where there is a de minimis amount of non-qualifying services in accordance with the predominant nature of the activities in the transaction, regardless of whether there is a separate price in the sales agreement for the services. In our experience, it would be rare to encounter a taxpayer that is performing a production contract in which the costs of production comprise 98% of the total costs in the contract, but the taxpayer accounts for only 98% of the revenue and costs from the transaction as a sale of inventoriable goods and the remaining 2% is accounted for as a service transaction. Moreover, the rules on advance payments both in Regs. 1.451-5 and Rev. Proc. 2004-34ⁿ³⁹ are designed to allow a single treatment of the progress payments based on the predominant nature of the transaction, regardless of whether line items are separately priced. As a result, the separate pricing information, although contained within the four corners of the contract, is likely not to be available in the taxpayers' accounting system, and extracting such information from the contracts will impose a significant hardship. It seems unduly harsh to require such taxpayers to separately account for the revenues and costs of the qualifying and non-qualifying activities in circumstances where the amount of non-qualifying services at issue is not large.

Activities should be eligible for the de minimis exception notwithstanding the existence of separate pricing in the sales contract. From a policy point of view, the potential for abuse under this approach is self-limiting because de minimis embedded services are limited to 5%.

Qualification of Non-Service Activities

Although the safe harbor allowing a taxpayer with less than 5% of total gross receipts from items other than DPGR to treat all gross receipts as DPGR does not depend on the nature of the non-qualifying gross receipts,ⁿ⁴⁰ the transaction-specific de minimis exception is limited to embedded services. Treasury should expand this exception to reach embedded transfers of QPP that do not separately qualify for 199 benefits, such as the spare parts in Example 6.

Example 6. Taxpayer E enters into a contract with a customer to design and produce 10 units of a sophisticated piece of machinery and to provide the customer with certain spare parts, some of which E purchased. The contract contains a



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single lump-sum price. If E produces the machinery in significant part within the United States, can the gross receipts allocable to the purchased spare parts qualify as DPGR?

Treasury's purpose in providing the de minimis exception is to minimize the administrative burden on taxpayers. It is equally burdensome for taxpayers to isolate non-qualifying activities that are de minimis in amount regardless of whether the activities represent the provision of goods or the performance of services. No potential for abuse should exist if Treasury expanded the de minimis exception for embedded services to include any type of non-qualifying activity, because non-qualifying goods would have to be embedded in the transaction and the gross receipts allocable to such activities could not exceed 5% of the total gross receipts from the transaction.

Expanding the de minimis exception for embedded services to also include transfers of property would ease the burden imposed by the Notice's rule requiring taxpayers to bifurcate the sale of any software, sound recording, or qualified film into the property's tangible and intangible components, n41 and to test each component separately for qualification under 199. Unless the exception for de minimis embedded services is expanded to also cover embedded non-qualifying transfers of tangible and intangible property, taxpayers will be required to identify and treat as non-DPGR the gross receipts attributable to any software embedded in qualifying QPP that the taxpayer did not self-develop, and software developers similarly will have to treat as non-DPGR the gross receipts attributable to the diskettes on which software is transferred to a customer. The absurdity of requiring such allocations in every case demonstrates the need for a broader de minimis rule.

It remains to be seen whether Treasury will expand the exception for de minimis embedded services to also cover non-qualifying transfers of property.

THE ALLOCATION OF GROSS RECEIPTS

Once a taxpayer has determined that a particular item of QPP satisfies the requirements of 199, the potentially difficult task of identifying or allocating the gross receipts attributable to that item remains.

Generally

The Notice provides that if a taxpayer currently separately tracks qualified and non-qualified gross receipts or has the information readily available to specifically identify qualified and non-qualified gross receipts, the taxpayer must use a specific identification methodology to determine the qualified and non-qualified gross receipts for 199 purposes.



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If the information to make this determination on a specific identification basis is not readily available, the Notice provides that any "reasonable method" may be used to allocate gross receipts between DPGR and non-DPGR. n42 Among the factors to be considered in determining whether a method is reasonable is whether the taxpayer is using the most accurate information available; the relationship between the gross receipts and the base chosen; whether the method is used by the taxpayer for internal management, other business purposes, or for federal, state, or foreign in-come tax purposes; the time, burden, and cost of using various methods; and whether the taxpayer applies the method consistently from year to year. n43

The flexibility provided in the Notice to use any reasonable allocation method comes as welcome relief. Before the Notice was issued, practitioners were warning taxpayers that they might have to implement system changes in order to specifically identify transactions that qualify for the deduction.

However, while one can imagine a taxpayer having sufficient information to develop a reasonable allocation method to distinguish revenue derived from produced property from revenue derived from purchased property and to distinguish revenue derived from property produced in the United States from revenue derived from property produced outside the United States, it is difficult to envision how any approach other than specific identification would be feasible to differentiate between revenue derived from sales of property and revenue derived from the performance of services.

Identification of DPGR from Long-Term Contracts

For taxpayers that recognize revenue before the completion of the sale of property, such as in a long-term contract accounted for under the percentage-of-completion method, the requirement to segregate DPGR from non-DPGR poses the additional issue of how to subdivide the revenue that is recognized between qualifying and non-qualifying activities.

The Notice provides guidance on how to determine the qualifying portion of "advance payments" when such payments are received by the taxpayer and included in gross income prior to the time the taxpayer provides the QPP to the customer or performs services for the customer. n44 In general, the Notice provides that a reasonable method must be used to allocate advance payments between DPGR and non-DPGR. The Notice cross-references the provision discussed above, generally permitting the use of a reasonable method to allocate gross receipts between DPGR and non-DPGR, for the factors to be considered in determining what constitutes a reasonable method of allocation.

The Notice fails to address the similar but separate issue of how contractors reporting their income from a long-term contract under the percentage-of-completion method under 460 should determine the portion of the percentage-of-completion revenue reported for each taxable year that is allocable to DPGR and non-DPGR.

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Example 7. Taxpayer S enters into a long-term contract to design and produce 20 units of a new type of jet aircraft. After design and production is completed, the aircraft are to be delivered at a rate of one aircraft per month over a 20-month period. In addition, S is obligated under the terms of the contract to provide 100 different types of replacement parts to the customer, with some of the parts being purchased from third parties and some of the parts being produced by S. S generally purchases the replacement parts at the same time that it purchases comparable parts for use in the production process. Also included in the contract is an agreement to perform three years of routine maintenance on the jet aircraft after they are delivered to the customer.

In the example, some of the activities for which non-DPGR is generated are performed during the earlier stages of the contract and other activities for which non-DPGR is generated are performed toward the end of the contract. Tax-payers should be allowed to use the same type of facts-and-circumstances analysis to allocate revenue recognized under the percentage-of-completion method between DPGR and non-DPGR during the term of a long-term contract, as can be used by a taxpayer that includes advance payments in gross income prior to the sale of property or the performance of services. The problems posed by these two situations are similar and they should be resolved using the same approach.

However, for many taxpayers, it would be extremely difficult to obtain from their accounting systems such fact-based information during the course of performing a contract. In those circumstances, a default allocation method should be provided that is based on the simple assumption that the ratio of DPGR to non-DPGR in the final contract price determines the allocation between DPGR and non-DPGR throughout the term of the contract. Thus, the default allocation method would presume that the allocation of the contract price between DPGR and non-DPGR would be based on the same ratio during each taxable year throughout the term of the contract.

Treasury officials have provided few hints as to whether or how they will deal with long-term contracts in the forthcoming regulations.

THE ASSIGNMENT OF COST OF GOODS SOLD

Qualifying gross receipts must be reduced by the allocable portion of both components of a taxpayer's cost of goods sold: (1) the 471 book cost of goods sold and (2) the additional 263A costs. With respect to the additional 263A costs, since most taxpayers allocate 263A costs between current sales and ending inventory only at year-end in order to value the ending inventory for tax purposes, a method will need to be devised to allocate 263A costs to product sales throughout the year.



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The Notice indicates that if a taxpayer uses a particular method to allocate gross receipts between DPGR and non-DPGR, the taxpayer must use the same method to allocate cost of goods sold between DPGR and non-DPGR. n45 It is not clear whether this provision was intended to apply in circumstances where the taxpayer is able to specifically identify the portion of gross receipts that is DPGR and non-DPGR. If the specific identification of gross receipts is considered to be an "allocation" method under the Notice, a taxpayer that has specific identification information available for gross receipts would be required to use the specific identification method to determine the cost of goods sold for items generating DPGR and non-DPGR, respectively.

Example 8. Taxpayer R purchases from unrelated third parties all of its crude oil supply needs for use in the refining of gasoline and other refined products. While the overwhelming majority of its crude oil is acquired for use in its refining operations, R will occasionally sell crude oil that it purchased because of a temporary imbalance between its supply and storage capacity. When R sells purchased crude oil to a third party, R is able to specifically identify the gross receipts attributable to such sales, which sales would generate non-DPGR.

However, for costing purposes, R uses a standard cost system, with all crude oil purchases valued at their standard cost, adjusted for variances as an additional 263A costs under R's UNICAP allocation method. In addition, R values its inventories on the dollar-value LIFO method and includes all of its crude oil and basic refined products in a single natural business unit pool.

In the example, R would be permitted under the UNICAP regulations to determine the cost of its crude oil purchases using a standard cost method. n46 Moreover, since the crude oil was purchased by R for use in its refining business, the Service has ruled that such crude oil may be included in the same natural business unit pool with crude actually used in the refining process, as well as the refined products produced by the taxpayer, despite the fact that there may be occasional sales of the purchased crude oil. n47

In view of the foregoing, it would be impossible for R to isolate by physical identification the actual cost of the crude oil that was sold in the transaction that generated non-DPGR. There is no policy reason why R should not use its normal UNICAP cost accounting method and its dollar-value LIFO method to determine the allocated cost of the crude oil that was sold. The proposed regulations should clarify that the use of a specific identification method to determine the portion of gross receipts that is DPGR and non-DPGR does not mean that a specific identification approach also is required to determine the cost of goods sold associated with DPGR and non-DPGR.

THE ALLOCATION OF PERIOD COSTS AND OTHER EXPENSES



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The last step in determining QPAI for purposes of 199 is to reduce the taxpayers' qualifying gross income (i.e., DPGR minus cost of goods sold) by allocable period costs. For large taxpayers, the Notice provides that this allocation must be based on Regs. 1.861-8. Taxpayers should not overlook in their computation the fact that, after they determine the portion of an overhead cost (either a 471 book-overhead cost or a 263A tax-only overhead cost), such as depreciation or a mixed service cost, that is allocable either to cost of goods sold or ending inventory, taxpayers need to treat the remainder of such overhead cost as a period cost that must be allocated between DPGR and non-DPGR based on the regulations under 861.

Unfortunately, Regs. 1.861-8 provides little guidance as to the allocation of most period costs, particularly where it is necessary to allocate costs between revenue from product sales and revenue from the performance of services. However, we would suggest that the regulatory emphasis on factual allocations should be adequate, as it generally is in the foreign area. The regulations do contain specific allocation rules for 174 R&E, interest expense, and state and local income taxes, among others.

All costs must be allocated between DPGR and non-DPGR, with the result that the QPAI of a taxpayer that earns all of its gross receipts from the sale of QPP substantially manufactured by the taxpayer in the United States should equal the taxpayer's taxable income. There are two important exceptions to this rule for corporations:

-- Taxpayers are not required to reduce DPGR by a 165 loss relating to property, which, if sold, would not generate DPGR. Thus, if a taxpayer recognizes a taxable loss on the sale of a factory that was not constructed by the taxpayer, the taxable loss would not be allocated to DPGR, even though the taxpayer had used the factory to produce QPP that generated DPGR.

-- Taxpayers do not have to allocate a net operating loss deduction under 172(a) to DPGR, regardless of whether the NOL was generated by manufacturing activities. Note, however, that, as discussed immediately below, NOLs are includible in the computation of the taxable income limitation.

When drafting Notice 2005-14, Treasury officials were under the impression that most companies with income in excess of \$ 25 million were familiar with the cost allocation rules under 861. n48 Since that time, the Treasury has received comments, especially from the construction industry, calling that belief into question. n49 In response, the Treasury is considering proposals that would allow larger taxpayers to use the simplified method available under the Notice to companies with income of \$ 25 million and under, possibly under the condition that large taxpayers would be locked into using the same allocation method for a period of years. In addition, the Treasury is considering the possibility of allowing other cost allocation methods.



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EFFECT OF NOL DEDUCTIONS ON THE TAXABLE INCOME LIMITATION

The 199 deduction is limited to the applicable percentage (9%, when fully phased-in) of a taxpayer's taxable income, determined without regard to 199, for the taxable year.ⁿ⁵⁰ For years in which the taxable income limitation applies, the Code does not provide for the carry forward of any unused QPAI to subsequent years.

The Notice provides that the definition of taxable income under 63 applies for purposes of the taxable income limitation.ⁿ⁵¹ Section 63(a) defines taxable income as "gross income minus the deductions allowed by this chapter." Since "this chapter" includes 172, which permits the deduction for net operating loss (NOL) carrybacks and carry-overs, it is clear that NOL carrybacks and carryovers must be included in computing the taxable income limitation for any particular year. However, it appears that a 199 deduction that is disallowed by the taxable income limitation as the result of an NOL deduction may nonetheless increase the amount of the NOL, if any, that is carried to a subsequent taxable year.

Example 9. Taxpayer T has QPAI in 2005 of \$ 100,000 and has taxable income, before giving effect to sections 199 or 172, of \$ 100,000. In 2004, T had a net operating loss of \$ 200,000, for which T elected to waive the carryback period under 172(b)(3).

As a result of the NOL carryforward, T has no taxable income in 2005 and therefore is not allowed any 199 deduction.

In computing T's NOL carryforward to 2006, however, 172(b)(2) provides that the portion of the unabsorbed loss that is carried to subsequent years is equal to "the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried." For this purpose, 172(b)(2)(B) provides that "the taxable income for any such prior taxable year shall be computed ... by determining the amount of the net operating loss deduction without regard to the net operating loss for the loss year or for any taxable year thereafter ..." (emphasis added).

Thus, the amount of T's 2004 NOL that is carried to 2006 is equal to the amount of the NOL, or \$ 200,000, less T's taxable income "without regard to the net operating loss" for each pre-2006 taxable year to which the 2004 loss may be carried. At first blush, the amount of T's taxable income "without regard to the net operating loss" for 2005 would seem to be \$ 100,000. However, to give full effect to subsection 172(b)(2)(B), quoted above, T also must redetermine its 199 deduction without giving effect to the 2004 loss. Absent the 2004 NOL, T would have been entitled to a 199 deduction of \$ 3,000 (\$ 100,000 QPAI x 3%). Thus, T's taxable income in 2005, without giving effect to the NOL carry-forward, is \$ 97,000. The amount of T's 2004 loss that is carried forward to 2006, then, is equal to \$ 103,000 (\$ 200,000, less \$ 97,000). Under the plain meaning of 172(b)(2), the 199 deduction, although disallowed in 2005, increases T's NOL carryforward.



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The same principles apply in computing the amount of an NOL carryback.

Example 10. Taxpayer R has QPAI in 2005 of \$ 100,000 and has taxable income, before giving effect to sections 199 or 172 of \$ 100,000. R has no NOL carryforward to 2005. Therefore, R is allowed a 199 deduction of \$ 3,000 and reports taxable income of \$ 97,000 for 2005.

In 2006, R again has QPAI of \$ 100,000 and taxable income, before giving effect to sections 199 or 172 of \$ 100,000. Therefore, R is allowed a 199 deduction of \$ 3,000 and reports taxable income of \$ 97,000 for 2006.

In 2007, however, R reports an NOL of \$ 200,000. R does not waive the NOL carryback period.

R first carries the 2007 NOL back to 2005, which eliminates R's taxable income, and therefore any 199 deduction, for that year. The amount of the 2007 loss that can be carried to 2006 is equal to the excess of the 2007 loss over R's 2005 taxable income, computed without regard to the deduction for the NOL for 2007 or any year thereafter. Since, without regard to the 2007 loss, R had taxable income of \$ 97,000 in 2005, R can carry \$ 103,000 of the loss forward to 2006. As a result, R has no taxable income in 2006 and, therefore, no 199 deduction is allowed in 2006. The NOL carryforward to 2008, however, is equal to \$ 6,000, which is equal to the 199 deductions that were foreclosed in 2005 and 2006 due to the taxable income limitation under 199. Thus, R will enjoy the benefit of these 199 deductions as soon as R has taxable income in an equal amount.

The fact that the value of the 199 deduction is preserved only by means of the calculation of an NOL carryover or carryback produces anomalous results. That is, when an NOL carryover or carryback operates to reduce, but not to eliminate, taxable income, the amount by which a 199 deduction consequently is reduced is not preserved, because no portion of the NOL is carried forward to a subsequent year.

Example 11. The facts are the same as in Example 10. In 2007, however, R's NOL is only \$ 50,000. R carries the NOL back to 2005 and, as a result, R's taxable income is reduced to \$ 50,000 for 2005, before giving effect to 199. R's 199 deduction therefore is reduced to \$ 1,500.

In computing the amount of the 2007 loss that can be carried to 2006, if any, R must subtract from the amount of the loss R's 2005 taxable income, computed without regard to the NOL for 2007 or any year thereafter. Since, without regard to the 2007 NOL carryback, R had taxable income of \$ 97,000 in 2005, R cannot carry any portion of the 2007 loss to 2006. As a result, the \$ 1,500 of 199 deduction that was eliminated in 2005 due to the carryback of the 2007 NOL is not preserved in the computation of the amount of the NOL that may be carried to a subsequent year.

In addition, in Example 11, if R had positive QPAI in 2007 R would never receive any 199 benefits with respect to that QPAI, since the Code does not provide for the carryforward of unused QPAI. Furthermore, R would not benefit from the preservation of the 199 deduction by means of the calculation of the portion of an NOL deduction that is carried forward



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to a subsequent year, because R did not have positive taxable income in 2007 without regard to 172.

Congress probably intended for the taxable income limitation under 199 to foreclose the possibility that a 199 deduction would directly increase the amount of an NOL. However, in informal discussions, Treasury officials have indicated that they believe the plain meaning of 199 and 172 mandates the results demonstrated by the foregoing examples. Although there has been some talk of the possibility of a technical correction to eliminate the preservation of 199 deductions in NOL carryovers, the Bluebook, which generally goes out of its way to identify each aspect of 199 that might require a technical correction, does not mention the need for such a correction, n52 and Treasury officials do not appear to be advocating for such a correction. Thus, although far from certain, we expect the forthcoming regulations to be consistent with the results reached in the foregoing examples.

TRANSACTIONS BETWEEN RELATED PARTIES

The Code provides that gross receipts from a related-party lease, rental, or license do not generate DPGR. n53 No such rule precludes related-party sales from constituting DPGR. Perhaps the statutory rule providing that an EAG shall be treated as a single corporation and the Notice's rule providing that a consolidated group shall be treated as a single member of the EAG could be read to exclude from the calculation of a 199 deduction related party sales between members of an EAG or consolidated group. Treasury officials, however, have stated that they believe the omission of sales from the Code's rule excluding other related party transactions evidences Congress's intent that, as a general matter, sales between related parties, including members of the same consolidated group, can generate DPGR.

This interpretation is potentially good news for all taxpayers who produce property within the United States but do not sell the property to third parties in a qualifying transaction.

Treatment of an EAG as a Single Corporation

The Code provides that "all members of an expanded affiliated group shall be treated as a single corporation" for purposes of 199. n54 This rule would seem to give the Treasury a statutory basis for disregarding all transactions between members of the same EAG in the computation of the deduction.

Furthermore, a rule that treated the EAG as one corporation by disregarding sales between members would not render meaningless the distinction drawn in the related-party rule between lease, license, and rental transactions on the one hand and all other dispositions on the other hand. A "related party" under 199 is defined more broadly than an EAG. For example, non-corporate and foreign entities can constitute related parties, but not members of an EAG. n55 Thus, even



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if an EAG were treated as one corporation, with the result that all intra-EAG transactions were disregarded, there still would be related parties that could generate DPGR by structuring a transaction between themselves as a sale, instead of as a lease, license, or rental. Nonetheless, Treasury representatives have stated that they doubt whether Treasury has the authority to disregard sale transactions among members of an EAG for purposes of 199. n56 Instead, Treasury officials have said that they believe Congress's sole purpose for providing that an EAG is treated as a single corporation was to prevent taxpayers from segregating loss activities from activities that generate QPAI. Therefore, although the interim guidance parrots the Code by stating that all members of an EAG are treated as a single corporation, the Notice goes on to provide that an EAG computes its 199 deduction by aggregating each member's separately computed QPAI. n57 Subject to the intercompany rules under Regs. 1.1502-13, n58 an EAG member's separately computed QPAI will include income earned from sales to other members. Thus, Treasury's aggregation approach to computing an EAG's QPAI does not result in actually treating an EAG as a single corporation. The "explanation" portion of the Notice confirms this result, stating, "[a]lthough transactions between members of an EAG are disregarded in computing the EAG's 199 deduction only to the extent provided in 199(c)(7)...." n59 Section 199(c)(7) contains the rule that precludes the lease, license, or rental of QPP to a related party from generating DPGR.

Treatment of a Consolidated Group as a Single Member

The Notice itself provides that, in applying the aggregate approach to computing an EAG's 199 deduction, a consolidated group is treated as single member of the EAG. n60 If applied literally, this rule could mean that sales between affiliates are disregarded in the computation of the deduction, even if sales between non-affiliated members of an EAG are included.

The Notice is clear, however, that this rule does not go so far. Instead, treating a consolidated group as a single member affects only the application of the taxable income limitation. Specifically, if an EAG includes a consolidated group, the consolidated taxable income of the consolidated group, rather than the separate taxable income of each member of the consolidated group, is taken into account when computing the taxable income limitation for the EAG as a whole. Intercompany sales are included in the computation of consolidated taxable income, subject, of course, to the timing rules under Regs. 1.1502-13. Thus, treatment of a consolidated group as a single member of an EAG does not preclude the use of intercompany sales to generate DPGR.

Application of the Anti-Abuse Rule

The Notice contains an anti-abuse rule, which provides:



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If a transaction between members of an EAG is engaged in or structured with a principle purpose of qualifying for, or modifying the amount of, the 199 deduction for one or more members of the EAG, adjustments must be made to eliminate the effect of the transaction on the computation of the 199 deduction. n61

There is a lot of confusion about how this anti-abuse rule will operate.

Some commentators have suggested that the anti-abuse rule might preclude the recognition of related party sales that are not incidental to a qualifying transaction with a third party. Under this interpretation, the anti-abuse rule would apply in any case where the purchasing party intends to use the property internally, such as in the provision of services to customers. The Conference Report draws such a distinction for related party lease, rental, and license transactions, by providing that the exclusion of such transactions under the related party rule does not apply where, for example, property is leased to a related person and held for sublease, or is subleased, by the related person to an unrelated person for the ultimate use of such unrelated person. n62 Similarly, the license of computer software to a related person for reproduction and sale, exchange, lease, rental or sublicense to an unrelated person for the ultimate use of such unrelated person is not treated as excluded property by reason of the license to the related person. n63

The anti-abuse rule generally should not apply to preclude related party sale transactions from generating DPGR just because the purchasing party does not hold the property for eventual sale to, or use by, a third party. Treasury's reasoning for allowing related party sales to generate DPGR in the first place is that the Code mandates treating related party sales differently from related party lease, rental, and license transactions. Thus, the anti-abuse rule should not be interpreted to effectively draw the same distinction for related party sales as is drawn for related party lease, rental, or license transactions.

A Treasury representative has generally confirmed this view. The representative stated that software developers that are denied 199 benefits because of the Notice's position that making software available to customers for online use does not involve a qualifying transfer of software have a "self-help" option. Specifically, according to the representative, such taxpayers could earn DPGR for the fair market value of the self-developed software by developing the software in one affiliate and then selling the software to a second affiliate, which would use the software to provide the online services. The representative further stated that the intercompany rules would determine when the DPGR from the related party sale was recognized for tax purposes.

Taxpayers might have worried that this self-help solution for online software providers would violate the anti-abuse rule, which applies even if qualifying for 199 benefits was only a principal purpose for structuring the intercompany transaction. Under this type of anti-abuse rule, even transactions motivated by a business purpose could be disqualified



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from generating 199 benefits if it were found that another purpose for the transaction was increasing the taxpayer's 199 benefit. Nonetheless, the Treasury official was of the opinion that the anti-abuse rule would not apply to the soft-ware self-help solution.

If the Treasury official was correct that online software providers can, as a general matter, structure intercompany transactions in order to convert the fair market value of the software into DPGR, it is unclear in what circumstances the anti-abuse rule might apply. It remains to be seen whether the Treasury will clarify the application of the anti-abuse rule in the forthcoming regulations.

Application of the Consolidated Return Intercompany Rules

Intercompany Sales

A consequence of Treasury's decision to take related party sales into account for purposes of 199 is that, for consolidated groups, the consolidated return rules must be considered in calculating QPAI for a given taxable year.

Under the single-entity concept, the consolidated return rules generally redetermine the timing, character, and other attributes of intercompany transactions as if the selling member and the buying member were divisions of a single corporation.⁶⁴ Thus, if the selling member sells QPP to a buying member, and the QPP is inventory in the hands of the buying member, the selling member would recognize its income from the sale, and concomitantly its DPGR, in the taxable year in which the buying member sells the QPP to a nonmember.⁶⁵

Alternatively, if as in the case of the self-help solution for online software providers, the buying member will use the QPP in its business, such as in the provision of services, the selling member will recognize income from the sale, and concomitantly its DPGR, as the buying member recovers the cost of the asset through depreciation or amortization deductions.⁶⁶ Acquired software is amortizable ratably over 36 months.⁶⁷ Thus, the selling affiliate would recognize the DPGR from the sale ratably over three years.

Regardless of whether the purchasing affiliate will resell the QPP or use the QPP in its business, pursuant to the single-entity concept, the consolidated group's total taxable income would not be affected from the intercompany sale, apart from the 199 benefit.

Intercompany Royalties



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The intercompany payment of royalties for the use of intangibles in the production or sale of QPP presents a slightly more difficult consolidated return question. In order to neutralize the effect of such intercompany royalties under 199, whether an item affects the computation of QPAI must be treated as an "attribute" that is subject to redetermination. We expect that the forthcoming regulations will clarify that this is the case.

For example, a common state tax-minimization strategy is to locate intangibles in a Delaware subsidiary that is paid royalties by manufacturing members. Absent the application of the attribute redetermination rules under Regs. 1.1502-13(c)(1), the producing member would have to reduce its QPAI by the allocable royalty expense, whereas the Delaware subsidiary, though treated as a manufacturer under the EAG attribution rule, would not have "gross receipts derived from sales."

Under the single-entity concept, the consolidated return rules generally redetermine the character and other attributes of intercompany and corresponding items as if the seller and buyer were divisions of a single corporation.ⁿ⁶⁸ The term "attributes" is defined in an open-ended fashion as all of the intercompany or corresponding item's characteristics, except amount, location, and timing, necessary to determine the item's effect on taxable income and tax liability.ⁿ⁶⁹ Whether an item is included in the computation of QPAI clearly affects the computation of consolidated taxable income. Thus, the treatment of the royalty expense as reducing DPGR without treating the royalty as DPGR results in an attribute mismatch that must be redetermined under Regs. 1.1502-13(c)(4) to the extent necessary to produce the same effect on consolidated taxable income as if the payor and payee were merely divisions of the same company.

PLRs 200048034 and 199936045 applied this reasoning in the foreign sales corporation (FSC) context to redetermine intercompany royalties as foreign trading gross receipts for purposes of computing deductible commissions to a foreign sales corporation. Both rulings arose in the context of a commission FSC. The common parent of a consolidated group formed an intangible holding company. The intangible holding company held intangibles that parent, in exchange for royalty payments, used in the U.S. in connection with manufacturing and selling certain products, including products subject to the FSC commission. Thus, a portion of the parent's royalty payment to the intangible holding company had to be allocated and apportioned to the foreign trading gross receipts of the FSC, without a corresponding requirement to allocate and apportion a portion of the intangible holding company's royalty income for purposes of computing the taxable income of the FSC and its related supplier under 925. The rulings properly held that a portion of the intangible holding company's royalty income should be redetermined as foreign trading gross receipts.

These PLRs would seem to be directly applicable to the problem presented by intercompany royalties under 199. Treasury officials have indicated that they will address this issue in the forthcoming regulations, and we expect that the regulations will adopt the reasoning set forth in the rulings.



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ATTRIBUTION OF MPGE ACTIVITIES BETWEEN PARTNERS AND PARTNERSHIPS

Section 199 benefits are available for activities conducted through partnerships. Partnerships, however, cannot be members of an EAG, even if the EAG owns all of the interests in the partnership.ⁿ⁷⁰ This exclusion, in conjunction with the Notice's "entity" approach to partnerships, produces a loss of 199 benefits whenever the production of QPP and activities that are integral to the production and sale of QPP, such as distribution activities, are fragmented between a partner and a partnership.

In the case of corporations, the Notice provides that each member of an EAG is attributed the MPGE activities performed by the other members of the EAG.ⁿ⁷¹ As discussed above, if an integrated taxpayer produces and sells a product, all of the gross receipts derived from the sale of that product, including those attributable to services that are integral to the production and sale of the QPP, such as marketing and distribution activities, should qualify for the 199 deduction.

Thus, if one member of an EAG produces QPP and sells the QPP to another member, any gross receipts earned by the second member on a subsequent resale of the QPP are eligible for treatment as DPGR, because the second member is treated as having produced the QPP and is therefore eligible to earn DPGR for its distribution activities. For this purpose, the EAG attribution rule in effect treats multiple corporations as a single integrated producer if the corporations are connected through a common parent and share at least 50% common ownership.

In contrast, when qualified activities and integral services are conducted through separate entities that are not members of the same EAG, such as by a partner and a partnership, the Notice does not provide for the attribution of activities among the entities. Furthermore, although the Code provides that 199 is to be applied at the partner level, the Notice seems to provide that only the computational aspects of 199 are performed at the partner level. Although the Notice is far from clear on this point, Treasury officials have indicated that it was their intent in drafting the Notice that the character of gross receipts earned by a partnership as DPGR or non-DPGR would be determined at the level of the partnership based solely on the activities of the partnership, and only the taxable income and W-2 wage limitations would be applied at the partner level.ⁿ⁷²

Due to the statement in 199 that "this section is to be applied at the ... partner level" and the Notice's ambiguity on this point, Treasury's interpretation of the application of 199 to partnerships has caught many taxpayers by surprise.

In-Kind Distributions of QPP



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Absent a special rule, no DPGR would be earned under the Notice for the manufacturing activities of a partnership that distributes the property produced in-kind to its partners under 731. This is because the partnership would not have any gross receipts from sales and the partner would not be treated as having MPGE'd the QPP, since the activities of the partnership would not be attributed to the partner. While taxpayers might have argued for a carryover of attributes from the partnership to the partner by reason of the tax-free nature of the 731 distribution, the Notice may be interpreted as rejecting this approach because it denies the carryover of attributes from a partner to a partnership under 721. n73

To avoid this inequity, the Notice contains a special exception for partnerships that are engaged solely in the extraction, refining, or processing of oil or gas and that distribute the oil or gas products to the partners. Under this rule, for purposes of 199, the gross receipts derived by the partners from the sale of the oil or gas products are treated as gross receipts derived by the partnership from the MPGE of QPP. n74 Thus, in this limited case, all of the partner's profits from selling the QPP that was produced by the partnership are eligible for treatment as DPGR.

According to Treasury officials, the exception was limited to the oil and gas industry because only that industry had demonstrated to the Treasury a longstanding and prevalent practice of producing property in partnerships that make in-kind distributions of the property to the partners. The Treasury has stated that it is willing to expand this special rule to additional industries on a case-by-case basis, but would require as a prerequisite that the industry submit a comment letter demonstrating the historical use of this business model.

At a minimum, this special rule for oil and gas should be expanded to include all in-kind distributions of QPP from partnerships. No policy reason exists for limiting this rule to certain industries or to businesses that traditionally have used the business model of operating through partnerships that make in-kind distributions. The same inequity results -- whereby no DPGR is realized for QPP that was MPGE'd in the United States and ultimately sold to third parties -- in any case in which QPP is manufactured by a partnership and distributed in-kind to a partner.

Other Situations

A similar, though less egregious, cutback in 199 benefits results under the Notice whenever production activities and activities that are integral to the production and sale of QPP are fragmented between a partner and a partnership. n75

For example, such a mismatch would occur if a partner produces QPP and sells the QPP to its distribution partnership, which sells the QPP to the third parties. The partner's share of the partnership's distribution income would not constitute QPAI under the Notice, because the Notice would determine the character of the partnership's gross receipts as DPGR or non-DPGR at the level of the partnership and would not attribute the partner's MPGE activities to the partnership for this purpose. Similarly, if a partnership manufactures QPP and sells it to a partner, who sells the QPP to



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third parties, the Notice would limit the partner's QPAI to its allocable share of the partnership's manufacturing income. The partner's profit on its distribution activities would not constitute QPAI, since the partner would not be attributed the MPGE activities of the partnership. n76

The Code would seem to mandate a contrary result. Section 199 states, "this section shall be applied at the ... partner level." n77 As set forth in detail in the comment letter submitted by McKee Nelson LLP, asserting that the Treasury should apply an aggregate approach to partnerships, this is the same type of language that Congress previously has used to provide that the character of income should be determined at the partner level. n78 At a minimum, this language would seem to provide the Treasury with regulatory authority to apply an aggregate approach to partnerships for purposes of 199.

Under an aggregate approach to 199, the partnership's activities and items of income and expense would be allocated to the partner. The character as DPGR or non-DPGR of gross receipts earned directly by both the partner and the partnership would be determined at the partner level, based on the activities of both the partner and the partnership. For example, if a partner manufactured goods in the United States and sold the goods to its partnership, which, in turn, earned gross receipts from the sale of the goods to third parties, the partner's allocable share of the partnership's gross receipts from the distribution activities would constitute DPGR, because the character of the receipts would be determined at the partner level and the partner MPGE'd the goods in the United States. The same result should follow if the example were reversed, with the partnership performing the manufacturing activities and the partner engaging in the buy-sell distribution activities. Under a purely aggregate approach, the partner would be attributed the partnership's manufacturing activities, with the result that the partner's gross receipts from the distribution activities would constitute DPGR. n79

However, the Notice does not give full effect to the statutory requirement that 199 be applied "at the partner level." Although the language in the Notice is ambiguous on this point, n80 the special exception for oil and gas partnerships would not be necessary if Treasury intended to apply an aggregate approach to partnerships for purposes of 199. Furthermore, Treasury officials have stated on numerous occasions that the Notice would apply only the computational aspects of 199 at the partner level. n81 In addition, the recently released Bluebook could be read to reinforce the view that partnerships are treated as separate entities for purposes of determining the character of income as DPGR:

With respect to the domestic production activities of a partnership ... , the deduction under the Act is determined at the partner ... level. In performing the calculation, each partner ... generally will take into account such person's allocable share of the components of the calculation (including domestic production gross receipts; the cost of goods sold allocable to such receipts; and other expenses, losses, or deductions allocable to such receipts) from the partnership ...



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as well as any items relating to the partner[s] ... own qualified production activities, if any. n82

Treasury representatives have suggested that the italicized language reinforces its view that the character of gross receipts as DPGR is determined separately at the partner and partnership levels.

Under Treasury's present approach, organizational structures that separate MPGE activities and other activities that are integral to the production and sale of QPP, such as distribution activities, between a partnership and its corporate partners result in a loss of 199 benefits. This situation can be compared with the economically equivalent case where both the manufacturer and the distributor are members of the same EAG. In the latter case the EAG is effectively treated as an integrated producer, with the result that the distribution profits qualify for 199 benefits. There is no policy reason for treating these economically equivalent structures differently.

Treasury officials' preliminary reaction to suggestions that an aggregate approach be applied to attribute to a partnership the MPGE activities of a partner and vice versa is far from reassuring. Treasury officials seem to have adopted the view that the Code does not generally allow distribution profits to qualify for the deduction, and the ability of integrated producers to earn DPGR for distribution activities is merely an exception to this general rule developed for administrative convenience. n83 From this perspective, the case for developing a special exception for in-kind distributions from partnerships is far more compelling, since, absent a special rule, even the gross receipts attributable to the manufacturing activities would not constitute DPGR.

Nonetheless, the Treasury has stated that it is considering whether it has the authority to attribute MPGE activities between partnerships and partners and whether Congress intended such attribution. n84 In doing so, we hope that the Treasury will take seriously the statutory directive that 199 is to be applied at the partner level and will not continue to limit this general rule to the computational aspects of 199.

CONCLUSION

As this article goes to press, the proposed regulations are expected to be issued any day. Given the complexity of the issues under 199, it is inevitable that the proposed regulations will raise many additional issues.

FOOTNOTES:

n1 The authors would like to thank our Ivins, Phillips & Barker colleagues Leslie J. Schneider and Patrick Smith for their thoughtful comments and insights in drafting this memorandum.

n2 See Vol. 45, No. 14 Tax Mgmt. Memo. 288 (7/11/05).



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n3 Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

n4 We describe this issue as academic because Treasury officials have made it clear that the forthcoming regulations generally will retain the requirement in the Notice that, to qualify for 199 benefits, the taxpayer must have had the benefits and burdens of ownership of QPP while it was being produced.

n5 Our discussion of several of the issues in this Part II is based on comments submitted by our firm under 199. See Comment Letter from Schneider, Smith & Rolfes on 199, 2005 Tax Notes Today 77-30 (4/22/05); Comment Letter from Schneider, Smith & Rolfes on the Treatment of Rebuild Contracts Under 199, 2005 Tax Notes Today 102-15 (5/27/05).
n6 2005-7 I.R.B. 498.

n7 Notice 2005-14, 4.04(7)(b). This is true except with respect to construction, engineering, or architectural services. 199(c)(4)(A)(ii), (iii).

n8 Notice 2005-14, 4.04(7)(b). See Part I of this series for a discussion of whether this 5% de minimis test should be applied at the item level, as seems to be indicated in the Notice, or, alternatively, at the level of the contract or transaction.

n9 Notice 2005-14, 4.04(7)(b).

n10 Rev. Rul. 82-134, 1982-2 C.B. 129; Rev. Rul. 80-18, 1980-1 C.B. 103; Rev. Rul. 70-67, 1970-1 C.B. 117.

n11 199(c)(4)(B).

n12 Notice 2005-14, 4.04(7)(b).

n13 *Id.* at 4.04(3)(a) (emphasis added).

n14 Thus, Treasury representatives have stated that they did not adopt the substantial transformation test imposed in the regulations under 954 because that test is imposed as a limitation on the definition of manufacturing, whereas Treasury intended for manufacturing to be broadly defined and for any limits to be imposed by the requirement that the taxpayer MPGE'd the QPP in whole or in significant part. Although not stated in terms of the definition of MPGE, the Notice does provide that minor activities such as packaging, repackaging, labeling, and minor assembly operations, as well as design and development activities, are not "substantial in nature." Notice 2005-14, 4.04(5)(b). In the case of the safe harbor test for determining whether the taxpayer's MPGE activities were substantial in nature, such costs are excluded from consideration as conversion costs. *Id.* at 4.04(5)(c). Thus, in the case of the safe harbor, this rule would seem to have the same effect as simply excluding these activities from the definition of MPGE. For purposes of the facts and circumstances test, however, although such activities cannot qualify as substantial in nature in and of themselves, such activities should not be excluded from the consideration of whether, in conjunction with other MPGE activities, the taxpayer's activities were substantial in nature.

n15 This requirement would be consistent with the IRS's approach to the definition of production under the uniform capitalization rules. See Notice 88-86, 1988-2 C.B. 401 (indicating that installation of purchased items might be treated



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as production under 263A, but concluding that, where such activities are de minimis in relation to the tax-payer's resale business, the taxpayer would not be precluded from using the simplified resale method).

n16 Notice 2005-14, 1.

n17 Id. at 4.04(4). Part I of the series refers to this requirement as the "second ownership test."

n18 Even if Treasury does not provide an exception to the ownership test for attribution of MPGE activities for manufacturers that install property after transferring tax ownership of the property to the customer, where the QPP being installed nonetheless qualifies as having been MPGE'd by the manufacturer in significant part, the manufacturer's gross receipts attributable to the installation activities should in any event be treated as being derived from the sale, based on the fact that the installation "service" is integral to the sale of the QPP. This conclusion is far from certain, however. See below, for a discussion of this issue.

n19 See Notice 2005-14, 3.04(3).

n20 Id.

n21 Id. at 4.04(7).

n22 This discussion is based largely on comments submitted to the Treasury by our firm. See Comment Letter from Schneider, Smith & Rolfes on the Treatment of Rebuild Contracts under 199, 2005 Tax Notes Today 102-15 (5/27/05).

n23 Notice 2005-14, 4.04(4). See Part I of this series for an in depth discussion of the ownership requirement.

n24 See Part I of this series for an in depth discussion of the meaning of "item" for purposes of determining whether the requirements under 199 have been met with respect to a particular transaction.

n25 See Part I of this series.

n26 See the discussion, above.

n27 If, instead, the customer had the benefits and burdens of ownership of the new parts and components during the rebuild, there would be no split ownership and the rebuilt railcar would be treated as the "item" to be tested under the general rule in the Notice.

n28 See, e.g., Rev. Rul. 88-57, 1988-2 C.B. 36 (describing the rehabilitation of railcars and requiring capitalization by the owner) and Rev. Rul. 2001-4, 2001-3 I.R.B. 295, Situation 3 (describing the upgrade of an airframe and requiring capitalization by the owner).

n29 See, e.g., *Fedex Corp v. U.S.*, 291 F.Supp. 2d 699 (W.D. Tenn. 2003), *aff'd*, 95 AFTR2d 2005-1105 (2d Cir. 2005) (dealing with the deductibility of aircraft engine maintenance costs).

n30 Notice 2005-14, 4.04(3)(b).

n31 The mere fact that an activity is treated as production under 263A does not mean that the taxpayer will be subject to 263A. Section 263A only applies to real or tangible personal property produced or acquired for resale by the taxpayer. 263A(b). Generally, software is considered intangible property unless it is embodied on tangible media intended to be mass distributed. See, e.g., *Applied Commc'ns, Inc. v. Comr.*, T.C. Memo 1989-469 (holding that



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off-the-shelf software programs developed for sale to customers constitute inventory for purposes of the accrual method requirement in 446). Thus, although the development of software is an MPGE activity and therefore is treated as production under 263A, 263A nonetheless will not apply if the resulting software is not intended to be mass distributed and therefore is treated as intangible property. Note that, even when software is treated as tangible property, the preamble to the UNICAP regulations provides that the cost of developing the software itself (i.e., writing the actual program) is not subject to capitalization under 263A. See Preamble to the regulations, T.D. 8482, 58 Fed. Reg. 42198, 42202 (8/9/93).

n32 263A(g)(2); Regs. 1.263A-2(a)(1)(ii)(B). These so-called "payment producers" are treated as having produced property to the extent the taxpayer makes payments or otherwise incurs costs relating to the property. 263A(g)(2); Regs. 1.263A-2(a)(1)(ii)(B).

n33 Stratton, "Government Officials Pressed for Details on Production Deduction," 107 Tax Notes 1364, (6/13/05) (quoting then-Tax Legislative Counsel Helen Hubbard). Regarding the other "facts and circumstances" that might be relevant under 263A, see PLR 199928002. Part I of this series contains a detailed discussion of this PLR and of why we think the standard for determining tax ownership under 199 ought to be identical to the standard under 263A.

n34 This argument is based on the language in Regs. 1.263A-2(a)(1)(ii)(A), which provides that whether a taxpayer is considered to be producing property depends on whether the taxpayer is considered "an owner" of the property being produced under federal income tax principles. However, we note that the preamble to the regulation refers to "the owner," rather than "an owner," suggesting that the reference to "an owner" in the regulation may not represent a deliberate choice of words by the drafters. Preamble to the regulations, T.D. 8482, 58 Fed. Reg. 42198, 42201 (8/9/93). Although we have not identified any authorities actually holding that the regulation's reference to "an owner" instead of "the owner" means that two tax owners can coexist with respect to the same property for purposes of 263A, we understand that the National Office and the Examination Division on occasion have interpreted the regulation to treat two taxpayers as tax owners of the same property. See Hecimovich, Danilack, Mahoney, Skelton, & Garay, "Producing Results: An Analysis of the New Production Activities Deduction," 106 Tax Notes 961 (2/21/05). The Tax Court has reached the result that two taxpayers were treated as owners of the same inventory. Compare *Suzy's Zoo v. Comr.*, 114 T.C. 1 (2000), *aff'd*, 273 F.3d 875 (9th Cir. 2001) (holding, without acknowledging the Tax Court's prior decision in *Golden Gate Litho*, that a greeting card company was the tax owner under Regs. 1.263A-2(a)(1)(ii)(A) of its contract manufacturer's work-in-process inventory) with *Golden Gate Litho v. Comr.*, T.C. Memo 1998-184 (dealing with the contract manufacturer at issue in *Suzy's Zoo* and holding that the contract manufacturer owned its inventory under 471 and therefore was required to use the accrual method of accounting). In concluding that the scope of the inquiry into tax ownership under 199 is narrower than that under 263A, see note 33, *supra*, and text accompanying note 33, a Treasury representative pointed to these two cases and suggested that their *de facto* treatment of more than one taxpayer as an owner might be the result of 263A's broader inquiry into facts and circumstances in addition to the



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traditional benefits and burdens factors.

n35 In order to be eligible for the small reseller exception and the simplified resale method, the taxpayer's production activities must be de minimis. Regs. 1.263A-3(a)(2) (small reseller exception); Regs. 1.263A-3(a)(4) (simplified resale method). For these purposes, production activities are presumed de minimis if (1) gross receipts from sales of property produced by the taxpayer are less than 10% of all the gross receipts of the trade or business, and (2) less than 10% of the labor costs of the trade or business are allocable to production activities.

n36 1974-2 C.B. 149.

n37 Although the Notice provides that this 5% test is applied at the "item" level, we asserted in Part I of this series that the de minimis test instead should be applied at the transaction level. We are concerned that a requirement to allocate a single embedded service among several items of QPP that are sold in one transaction will lead to difficult factual issues regarding whether the service should be treated as relating more to one item of QPP than to another. Such allocation issues would erode the simplification achieved by the de minimis rule, which, in any event, could never convert more than 5% of otherwise nonqualifying revenue from a transaction into DPGR.

n38 Notice 2005-14, 4.04(7)(b).

n39 2004-22 I.R.B. 991.

n40 Id. at 4.03(2).

n41 See id. at 4.04(8)(b) (providing that the tangible medium on which software, sound recordings, or films are fixed is considered tangible personal property); 4.04(8)(c) (requiring bifurcation between the tangible and intangible property in the case of software); 4.04(8)(d) (same for sound recordings); 4.04(9)(c) (same for qualified films). For general federal tax purposes, on the other hand, the tangible medium on which software is contained is treated as part of the software itself. See Rev. Rul. 2000-50, 2000-2 C.B. 601.

n42 Notice 2005-14, 4.03(2).

n43 Id.

n44 Id. at 4.03(3).

n45 Id. at 4.05(2)(b).

n46 Regs. 1.263A-1(f)(3)(ii)(A).

n47 See PLRs 8842061, 8807036.

n48 Bennett, "Treasury, IRS Considering Host of Changes to Guidance on New Manufacturing Break," 124 Daily Tax Rept. at G-10 (6/29/05).

n49 Id.

n50 199(a)(1)(B). The amount of the deduction is also limited to 50% of the W-2 wages paid by a taxpayer for the taxable year. 199(b)(1).

n51 Notice 2005-14, 4.01.



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n52 See Joint Comm. on Tax'n, General Explanation of Tax Legislation Enacted in the 108th Congress (JCS-5-05) (May 2005), at 170.

n53 199(c)(7).

n54 199(d)(4)(A).

n55 199(c)(7)(B).

n56 See, e.g., Bennett, "Proposed Rules on Manufacturing Tax Break Expected by Summer; Multiple Issues Stud-ied," 64 Daily Tax Rept. at G-13 (4/5/05).

n57 Notice 2005-14, 4.09(2)(a).

n58 For a discussion of the effect of the intercompany rules, see below.

n59 Notice 2005-14, 3.08(2)(c) (emphasis added).

n60 Id. at 4.09(4).

n61 Id. at 4.09(2)(c).

n62 H.R. Rep. No. 755, 108th Cong., 2d Sess. 260, n.29 (2004). The Conference Report further provides that principles similar to those under the extraterritorial income regime apply for this purpose. See Regs. 1.927(a)-1T(f)(2)(i). These statements are repeated in the Bluebook. Joint Comm. on Tax'n, General Explanation of Tax Legisla-tion Enacted in the 108th Congress (JCS-5-05) (May 2005) at 172, n.293. Though not included in the Notice, Treasury officials have indicated that the final regulations will incorporate these rules.

n63 H.R. Rep. No. 755, 108th Cong., 2d Sess. 260, n.29 (2004).

n64 Regs. 1.1502-13(a)(2).

n65 Regs. 1.1502-13(b)(3)(i).

n66 Id.

n67 167(f)(1); Rev. Proc. 2000-50, 2000-52 I.R.B. 601.

n68 Regs. 1.1502-13(c)(1)(i).

n69 Regs. 1.1502-13(b)(6).

n70 An EAG is an affiliated group as defined in 1504(a), determined by substituting a 50% vote-and-value ownership test for the 80% vote-and-value test for consolidation and by including certain insurance companies 936 corporations. 199(d)(4)(B). Significantly, under 1504, only corporations are eligible for inclusion in an affiliated group. 1504(b).

n71 Notice 2005-14, 4.09(2)(b).

n72 See Stratton, "Government Officials Pressed for Details on Production Deduction," 107 Tax Notes 1364 (6/13/05).

n73 Notice 2005-14, 4.12(1).

n74 Notice 2005-14, 4.04(7)(e).

n75 For a detailed description of this problem, see Comment Letter from McKee Nelson LLP Requesting an Ag-gregate Approach to Partnerships under 199, 2005 Tax Notes Today 121-31 (6/24/05).



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n76 Note that a cutback in benefits also would result if the partnership either performed services integral to the production and sale of the QPP, such as acting as a distribution agent for the partner, or owned intangibles used by the partner in its qualifying production activities. In such cases, the distribution commission or the royalty charged by the partnership would constitute an expense allocable to the DPGR earned by the partner. Where the partnership never owns the QPP, however, there are two reasons that the partnership's income would not constitute DPGR. First, as discussed in the text, the partnership would not be treated as having produced the QPP. In addition, the partnership's royalties or commissions would not constitute gross receipts from the sale or other disposition of QPP, since the partnership could not sell what it never owned. In the consolidated return context, this mismatch is dealt with through the attribute redetermination rules discussed in the immediately preceding section. Outside of the consolidated return context, however, there is no mechanism for eliminating such a mismatch, whereby the expense reduces DPGR but the income does not constitute a qualifying category of gross receipt. Thus, this type of arrangement is problematic not only for partnerships, but also for members of an EAG that are not also members of the same consolidated group. Perhaps a taxpayer facing this problem could argue that the commissions or royalties are "derived from" the sales of the related party. The Notice, however, interprets the statutory term "derived from" very narrowly. See Notice 2005-14, 4.04(7)(a).
n77 199(d)(1)(A)(i).

n78 See Comment Letter submitted by McKee Nelson, *supra* note 75 (explaining that the language in 865(i)(5), providing that "this section shall be applied at the partner level," has been interpreted to require that, for purposes of determining whether a sale of personal property by a partnership is attributable to a fixed place of business, the partner is treated as if it had made the sale and, if the partnership has a fixed place of business, such office is treated as an office of the partner for this purpose). This comment letter also contains a detailed discussion of the legislative history beyond the "partner level" language in 199.

n79 If a manufacturing partnership is not wholly owned, a question arises as to whether, under an aggregate approach, the partner should be treated as having manufactured 100% of the QPP produced by the partnership, or instead should be treated as having MPGE'd only the proportion of the goods that corresponds to the partner's interest in the partnership. The comment letter submitted by McKee Nelson, *supra* note 75, advocates for the pro rata approach.

n80 The Notice provides: The 199 deduction is determined at the partner level. As a result, each partner must compute its deduction separately. Each partner is allocated, in accordance with 702 and 704, its share of items (including items of income, gain, loss, deduction, cost of goods sold allocated to such items of income, and gross receipts that are included in such items of income) allocated or attributable to the partnership's activities described in 199(c)(4) (qualified production activities), along with any other items of income, gain, loss, deduction or credit of the partnership. To determine its 199 deduction for the taxable year, a partner aggregates its share of the items allocated or attributable to the partnership's qualified production activities, any expenses incurred by the partner directly that are allocated to the partnership's qualified production activities, and those items of the partner that are allocated or attributable to qualified



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production activities from sources other than the partnership. Notice 2005-14, 4.06(1). The last sentence quoted above could be read to suggest an entity approach to the determination of the character of gross receipts, since the partner explicitly is directed to take into account expenses incurred directly by the partner and attributable to the partnership's qualified production activities without an analogous provision for income earned by the partner that is attributable to the partnership's qualified production activities. Furthermore, under an aggregate approach, it would not be necessary to distinguish between the items "attributable to the partnership's qualified production activities" and the partner's items "that are allocated or attributable to qualified production activities from sources other than the partnership."

n81 See, e.g., Stratton, Government Officials Pressed for Details on Production Deduction, 107 Tax Notes 1364, 2005 TNT 109-3 (June 13, 2005).

n82 Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (JCS-5-05), May 2005, p. 175.

n83 Stratton, "Production Deduction Reg Project on Track for Summer Release," 2005 Tax Notes Today 124-3 (6/29/05).

n84 Id.