

Manufacturing and Production Receipts Deduction: Section 199

Enacted as part of the 2004 American Jobs Creation Act, IRC Section 199 allows companies to deduct a percentage of certain US manufacturing and production related income (3% for 2005 and 06; 6% for 2007, 2008 and 2009; 9% for 2010 and thereafter). The deduction is generally limited to 50% of the US payroll of the taxpayer during the calendar year.

The US initially issued a Notice (Notice 2005-14) providing taxpayer guidance. On October 21, 2005 the US issued additional guidance in the form of extensive proposed Treasury Regulations ("Prop. Regs."). The Prop. Regs. provide clarification of certain issues that were unresolved under the Notice and reflect certain changes made in response to taxpayer comments. Until final regulations are published, taxpayers may generally rely on the Prop. Regs. or Notice 2005-14.

The rules provide that the base upon which deductions are determined (qualified production activities income, or "QPAI") is generally equal to the excess of: A) US manufacturing and production receipts (the domestic production gross receipts, or "DPGR"); over B) the sum of: the cost of goods sold, deductions directly allocable to the DPGR, and a ratable portion of deductions not directly allocable to the DPGR. Design and R&D related costs are subject to special rules.

October 30, 2005

DPGR generally includes receipts derived from the lease/rental/license/sale of tangible personal property/computer software that is manufactured in whole or in significant part within the US. Also included in DPGR are receipts for film production, construction, engineering or architectural services performed in the US.

Anticipated planning points include:

- Group Application: greater than 50% company ownership
- Identifying a Product: generally apply on component basis rather than an integrated product basis
- Identifying US Manufactured Products: safe harbor if direct costs in the US account for 20% or more of an item's total costs of goods sold
- Expenses for Services, e.g., installation, distribution, warranty: depends on benefits and burdens of ownership, whether services are embedded v. separately offered/charged for, and normal business practice
- Related Party Transactions: special limitations apply to gross receipts received from related parties

Taxpayers and their advisers should become familiar with the opportunities afforded by section 199. Taxpayers and their advisers will be required to develop and implement processes to accurately classify receipts and deductions, taking into account the various complexities set forth in section 199 and the administrative guidance provided.

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