

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

## **PRACTICE AREAS**

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## **TEXT:**

Major References:

I.R.C. § 199; Notice 2005-14, 2005-7 I.R.B. 498.

This is Part I in a two-part series on the § 199 n1 domestic  
production activities deduction. Part II of this series will  
consider additional issues, to include:

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- The application of § 199 to contracts to rebuild or rehabilitate property that is owned by the customer.
- The qualification of installation activities as manufacturing, where the taxpayer performing the installation activity did not produce the item being installed.
- The qualification of installation activities as manufacturing "by the taxpayer," where the taxpayer produced the item being installed but transferred tax ownership of the item to the customer before installing the item.
- The scope of the requirement that a taxpayer that treats itself as a producer under § 199 also must treat itself as a producer under § 263A, including whether any conformity requirement exists with respect to the treatment of revenue recognized from a sale of qualifying production property.
- The treatment of services integral to the production and sale of QPP.
- The scope of the exception for de minimis embedded services, including application of the exception to non-service activities and to activities that are separately priced.
- The treatment of transactions between related parties.

#### INTRODUCTION

The American Jobs Creation Act of 2004 (2004 AJCA) replaces the extraterritorial income (ETI) exclusion regime with a new deduction equal to 9% of a taxpayer's income from "domestic production activities."<sup>1</sup> The deduction, contained in new § 199, is phased in at 3% for tax years beginning in 2005 and 2006, increases to 6% for years beginning in 2007 through 2009, and reaches 9% for years beginning in 2010 and thereafter. The deduction is limited to the lesser of a taxpayer's taxable income (determined without regard to the deduction itself) and 50% of W-2 wages paid for the year, including wages paid in connection with non-production activities.<sup>2</sup>

To state the obvious, the domestic production activities deduction contained in § 199 is not tax simplification. By creating a new incentive for taxpayers to characterize income as manufacturing and deductions as nonmanufacturing, § 199 raises issues spanning numerous, diverse sections of the Code.<sup>3</sup> Further, although the new section incorporates concepts found in other Code sections, these concepts now must be analyzed by reference to the policy underlying the new deduction.<sup>4</sup>

This memorandum<sup>5</sup> is the first part of a two-part series that focuses on some of the most significant unresolved issues regarding the implementation of the deduction for corporate taxpayers that manufacture tangible personal property.<sup>6</sup> In many cases, we suggest an approach that Treasury should consider in answering a particular interpretive question under § 199, which we believe is

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consistent with the statutory text and the legislative purpose, namely, to foster the creation of domestic manufacturing jobs.

In February, the IRS published Notice 2005-14 n8 (the "Notice"), totaling 102 pages, which provides interim guidance in implementing the new deduction. It is not surprising that, with such a complex topic, and despite the drafters' Herculean effort to answer as many questions as possible, the Notice seems to raise as many questions as it answers. Thus, although the Notice provides that taxpayers may rely on its guidance until final regulations are issued, n9 this assurance is helpful only for issues actually resolved in the Notice.

Section 199 deserves the immediate attention of practitioners and taxpayers, even as we await proposed regulations, expected to be issued this summer, n10 for three principal reasons.

First, § 199 is expected to cost the fisc almost \$ 77 billion over ten years. n11 Because of this projected revenue impact and the current uncertainty regarding how this expenditure will be allocated among different industries, taxpayers that are interested in maximizing benefits under this new provision should take advantage of the opportunity to comment on the application of the provision with respect to open issues affecting their industry or particular situation. n12

Second, the deduction is effective for income recognized for tax purposes in taxable years beginning after January 1, 2005. The Notice imposes several rather formalistic requirements for transactions to qualify for benefits, and taxpayers must structure their transactions accordingly in order to maximize their benefit under § 199. This planning cannot await final or even proposed regulations.

Finally, because § 199 represents a permanent tax benefit rather than merely a timing difference, qualifying transactions will increase a corporation's earnings for financial statement reporting purposes. Thus, CFOs are keenly interested in the efforts of their tax department to maximize § 199 benefits, not only to maximize shareholders' after-tax return, but also to maximize reported earnings n13 and to report accurate quarterly results.

We begin our analysis with a summary of the computation of the deduction.

#### COMPUTATION OF THE § 199 DEDUCTION FOR CORPORATE TAXPAYERS

Section 199 provides that "all members of an expanded affiliated group shall be treated as a single corporation" for purposes of § 199. n14 An expanded affiliated group (EAG) is an affiliated group as defined in § 1504(a), determined by substituting a 50% vote-and-value ownership test n15 for the

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80% vote-and-value test for consolidation and by including insurance companies subject to § 801 and corporations that have elected the possession tax credit under § 936. n16

Although the interim guidance follows the Code by stating that all members of an EAG are treated as a single corporation, the Notice actually provides that an EAG computes its § 199 deduction by first computing each member's separate qualified production activities income (QPAI). n17 Thus, Steps 1 through 3, below, must be completed separately for each EAG member.

STEP 1 -- Identify Qualifying Revenue

The first step in calculating the § 199 deduction is to determine the amount of gross receipts earned from qualifying activities. As relevant here, § 199 defines domestic production gross receipts (DPGR) as the gross receipts that are derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property (QPP) that was manufactured, produced, grown, or extracted (MPGE'd) by the taxpayer in whole or in significant part within the United States. n18 QPP is defined as tangible personal property, any computer software, and certain sound recordings. n19

Under the Notice, the requirement that property was MPGE'd "in significant part" in the United States is met if the taxpayer's manufacturing activity is "substantial in nature," taking into account all of the facts and circumstances, including the relative value added by the taxpayer's activity, the relative cost of the activity, and the nature of the activity (the "facts-and-circumstances test"). n20 In addition, a safe harbor under the Notice provides that if a taxpayer's conversion costs (i.e., direct labor and overhead) are at least 20% of the taxpayer's cost of goods sold for the property, the taxpayer's activities are substantial in nature. n21

Thus, under step one, each member of an EAG must segregate its revenue from the lease, rental, license, sale, exchange, or other disposition of property produced in significant part by a member of the EAG n22 within the United States from all other gross receipts, which would include revenue earned from the mere purchase and resale of property produced by another person, revenue earned from the disposition of goods produced by the taxpayer entirely outside the United States, revenue from the performance of services, and interest and investment income. There is, however, a de minimis rule that permits a taxpayer to treat all of its revenue as gross receipts qualifying for the § 199 deduction if the non-qualifying portion of the taxpayer's total gross receipts is less than 5% of the taxpayer's total gross receipts. n23

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STEP 2 -- Assign Cost of Goods Sold

After subdividing gross receipts between qualifying and non-qualifying sources, each member must assign its cost of goods sold to such revenue sources.

STEP 3 -- Allocate Period Costs and Other Expenses

The last step in determining qualified production activities income (QPAI) for purposes of § 199 is to reduce the taxpayers' qualifying gross income (i.e., revenue minus cost of goods sold) by allocable period costs. For large taxpayers, this allocation must be based on the allocation and apportionment rules of Regs. § 1.861-8. n24

STEP 4 -- Calculation of the EAG's Deduction

Once each member of an EAG has computed its separate QPAI, each member's QPAI, taxable income, and W-2 wages are aggregated in order to apply the taxable income and W-2 wage limitations at the EAG level. To compute the deduction, the EAG multiplies the applicable percentage, 3% for taxable years beginning in 2005, by the lesser of the EAG's aggregate QPAI and aggregate taxable income, determined without regard to the § 199 deduction itself. The Code further limits the amount of the deduction to 50% of the EAG's W-2 wages paid during the calendar year that ends within the taxable year. The EAG's deduction then is allocated among the members in proportion to their relative amounts of QPAI, if any.

We now turn to considering some of the issues taxpayers will encounter when computing their qualified production activities deduction.

THE APPROPRIATE LEVEL OF ANALYSIS FOR DETERMINING QUALIFYING GROSS RECEIPTS

The requirement to segregate revenue from DPGR raises the issue of the level of detail, i.e., the level of the company operations, at which revenue sources must be identified and segregated for purposes of applying the statutory requirements for DPGR. The Notice states that qualified production activities income must be determined on an "item-by-item basis." n25 The Notice does not define the term "item," but only provides that an item is a lower level of detail than a segregation of income by company division, product line, or transaction. n26

Subsequent to the publication of the Notice, Treasury officials publicly have stated that their sole reason for including the item-by-item language was to make it clear that loss transactions must be taken into account to reduce a taxpayer's QPAI under § 199, as distinguished from the foreign sales corporation

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(FSC) and ETI regimes, where a taxpayer could elect to exclude loss transactions from the computation of income eligible for the benefit. Thus, in drafting the item-by-item language, Treasury did not intend to promulgate a rule for the level at which transactions must be tested for qualification under § 199. Nonetheless, Treasury now acknowledges that a definition of item is needed in at least two contexts within § 199. The first is required for purposes of determining whether an "item" of QPP was manufactured by the taxpayer in significant part within the United States. The second is relevant for purposes of applying the transaction-level 5% de minimis rule.

What Is an "Item" for Purposes of the In-Significant-Part Test?

Example 1. Taxpayer B is in the business of selling shirts. B manufactures four shirts in the United States and manufactures a fifth shirt in Mexico. B enters into two sales transactions, selling Customer C two of the shirts for a lump-sum price of \$ 20 and selling Customer D three of the shirts for a lump-sum price of \$ 28.

With respect to the determination of whether QPP was manufactured by the taxpayer in whole or in significant part within the United States, if B can treat the shirts in the aggregate as the item to be tested, all of the proceeds from the sale of the shirts probably would qualify as DPGR; whereas, if B is required to test the shirts individually, only revenue allocable to shirts produced in the United States would qualify as DPGR.

We anticipate that Treasury will define an "item" as each unit of property delivered to the customer; i.e., each individual shirt in Example 1. Although Treasury did not draft the prohibition on calculating QPAI on a division-by-division, product-line-by-product-line, or transaction-by-transaction basis for purposes of defining the appropriate level for application of the test to determine whether QPP was manufactured by the taxpayer in the United States, Treasury officials now seem to take for granted that these rules will apply for this purpose.

Under FSC, the five shirts could constitute a single product line (although FSC benefits also could be determined on a "transaction by transaction" basis), and under ETI, each of the two sales would constitute a single transaction. Thus, any basis for defining the "item" at a higher level than the individual shirt would run afoul of the Notice's instruction that QPAI be determined at a lower level of detail than by division, product line, or transaction.

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The rules in the Notice provide some relief from the need to specifically track the individual shirts to each invoice in Example 1, by allowing taxpayers to use "a reasonable method" to allocate gross receipts between qualifying and non-qualifying dispositions of QPP. n27

Although the definition of item is relatively clear under Example 1, there is considerable uncertainty regarding the application of the definition where significant "sub-items" are involved.

Example 2. Taxpayer R manufactures razors in the United States and manufactures razor blades abroad. R packages the razor and five replacement blades together and sells the packaged unit to customers for a single price. Query, are the items the razor and razor blades or is the item the packaged unit offered for sale?

R's cost structure will determine which rule is more favorable in this example. If, on the one hand, the conversion costs of manufacturing the razor are greater than 20% of the cost of goods sold for the packaged unit, R will prefer to treat the packaged unit as the item, since doing so would allow the entire sales price to qualify as DPGR under the safe harbor test for whether QPP was manufactured in significant part within the United States. On the other hand, if R's conversion costs for the razor are less than 20% of R's cost of goods sold for the packaged unit and R's MPGE activities are not substantial in nature with respect to the packaged unit under the facts-and-circumstances test, R will prefer to treat the razor and blades separately, as individual items, so that the gross receipts attributable to the razor would qualify as DPGR.

Treasury officials publicly have acknowledged that the next round of guidance must resolve the issue posed by Example 2. It will be difficult for Treasury to craft a one-size-fits-all definition of item where substantial sub-items are involved.

Example 3. Taxpayer D enters into an agreement with a customer to deliver five pieces of sophisticated machinery and various quantities of 20 different types of replacement components for the machinery. D produces five of the 20 different types of replacement components in the United States and purchases the remaining 15 types of replacement components. The finished machinery contains both types of components, as well as substantial subassemblies that D purchases from third parties. Although D integrates the subassemblies and components into finished machines in the United States, D's MPGE activities are insignificant with respect to the integrated machines. What is the item or items in this example?

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If, as expected, Treasury defines "item" as each unit of property delivered to the customer, the five machines will be treated as five items, notwithstanding that the integrated machines contain both purchased and produced parts. Because D's assembly activities and the components produced by D in the United States and incorporated into the five machines are insignificant in relation to the integrated machines, the example assumes that D will not be treated as having MPGE'd the machines in significant part within the United States under either the safe harbor conversion-cost test or the facts-and-circumstances test. As a result, none of the gross receipts allocable to the five machines will qualify as DPGR. In the case of the individual components that are sold in that form to the customer, however, each unit of each type of component will be treated as a separate item. Thus, the gross receipts from the sale of components produced by D in Michigan will qualify as DPGR, whereas gross receipts from the sale of components purchased by D will not so qualify.

To a lesser extent, the integrated machines in Example 3 pose the same dilemma as the packaged razor and razor blades in Example 2. In Example 3, D earned DPGR for the replacement components D produced in the United States and sold to customers in that form. However, D did not earn any DPGR when D incorporated those same components into the integrated machines, because D's MPGE activities with respect to the integrated machines were not significant enough to cause the machines to be treated as MPGE'd by D in significant part. n28 If, instead, D could determine DPGR at the lowest level, i.e., the components, D could earn DPGR for the gross receipts from the sale of the machinery that are allocable to the components D produced in the United States. Although the issue posed by the integrated machinery in Example 3 is similar to that posed by the packaged razor and blades in Example 2, Treasury consistently has indicated that the integrated machine in Example 3 will be treated as a single item and never has suggested that taxpayers might earn DPGR for components produced in the United States and incorporated by the taxpayer into an integrated machine that was not produced by the taxpayer in significant part within the United States.

Instead of trying to craft a one-size-fits-all definition of item for dealing with the dilemma posed by Examples 2 and 3, we suggest that Treasury allow taxpayers to elect whether to treat the item as the individual components or the assembled unit offered for sale to customers. In a highly analogous context, the regulations under § 936 n29 allow taxpayers to elect, on an annual basis, the level at which to apply the test for whether a product was manufactured in a U.S. possession. Specifically, taxpayers that produce both component parts and integrated products may choose to treat the component, the integrated product, or the end-product form as the item to be tested for a significant

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business presence. n30

This test would apply in Example 2 to allow the taxpayer to elect whether to treat the packaged unit or just the razor as the item. Similarly, the § 936 regulations would allow the taxpayer in Example 3 to elect to test either the integrated machine or the individual component parts as the item. Under this approach, taxpayers that could not meet the requisite § 199 test for the entire machine at least could obtain QPAI for the return on the components; whereas § 199 would produce greater benefits if the test could be met for the entire machine, including components that were not produced by the taxpayer within the United States. Allowing this type of election under § 199 would benefit all taxpayers that sell items that are built from both purchased and produced "sub-items" or components. As for all taxpayer elections, the benefit would be at the expense of the fisc.

Treasury officials publicly have stated that it is not the Treasury's aim in drafting regulations to develop new concepts exclusively for purposes of § 199 in any case where there are existing concepts in the tax law that can be either directly applied or readily applied for purposes of § 199. The drafters of the § 936 regulations dealt with an issue virtually identical to that which Treasury now faces regarding the definition of item. Treasury should adopt their comprehensive and flexible approach for purposes of § 199.

The second context in which the definition of item is relevant under the Notice is for purposes of applying the 5% de minimis rule for embedded services. Below, we suggest that this de minimis exception should instead be applied at the level of the transaction, in order to avoid creating onerous administrative burdens for taxpayers.

The Test for Whether Embedded Services Are De Minimis in Amount Should Apply at the Transaction-Level

Under § 199, gross receipts from the provision of services generally do not qualify as DPGR. The Notice provides an exception to this general rule, providing that "a de minimis amount of gross receipts from embedded services for each item of property may qualify as DPGR." n31 A de minimis amount is less than 5% of the gross receipts derived from sale or other disposition of the property. In the forthcoming regulations, Treasury should provide that this 5% test is measured at the transaction-level instead of at the item-level.

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Example 4. Same facts as in Example 3, except that D also agrees in the sales contract with the customer to provide three years of routine maintenance of the machinery, which could include replacing worn out parts with the spare parts provided to the customer. This obligation to provide routine maintenance is included in the lump-sum price in the agreement. For purposes of applying the 5% test, are the gross receipts attributable to the routine maintenance compared to the gross receipts attributable to the five machines and the replacement parts in the aggregate, or must such receipts be allocated among the various "items" of QPP that were identified in Example 3?

The gross receipts attributable to the routine maintenance services will not be DPGR unless they qualify under a de minimis exception. Attempting to compare the gross receipts from the embedded services with the gross receipts from particular units of QPP in these circumstances would be arbitrary and impractical and would add transfer-pricing complexities.

Under an item-level test, D would have to allocate the embedded maintenance services among the various items to which such services factually relate. Arguably, the maintenance services are more closely connected to the sale of the individual parts and components, which will be installed as part of the maintenance services, than to the sale of the integrated machines; although D also could argue that the maintenance services would not have been sold absent the sale of the integrated machines. Such fact intensive inquiries into the details of a single transaction substantially reduce the simplifying benefit of the 5% de minimis rule.

It is understandable that Treasury would define item narrowly as each unit delivered to the customer for purposes of applying the test for whether QPP was MPGE'd in significant part within the United States. In contrast, for purposes of applying the 5% de minimis test, aggregation of the DPGR attributable to all items of QPP transferred in a single transaction or sales agreement should be permitted. If the regulations adopt a transaction-level test, D would apply the 5% de minimis test by comparing the gross receipts attributable to the maintenance services with the total gross receipts from the transaction that qualify as DPGR; D would not have to allocate the embedded maintenance services among the individual items making up the transaction.

The potential for abuse under our suggested approach is self-limiting because of the 5% limitation on de minimis embedded services. Thus, significant revenue attributable to nonqualifying services would not qualify for the deduction as a result applying the de minimis test for embedded services at the transaction-level instead of at the item-level.

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ISSUES RELATED TO CONTRACT MANUFACTURING

Introduction

The determination of which party to a contract manufacturing arrangement -- the principal, the contractor, or both -- should qualify for § 199 benefits for their respective efforts to produce QPP has generated substantial controversy under § 199.

In a typical contract manufacturing relationship, the principal provides the contract manufacturer with the product specifications, rights to use intangibles to manufacture the product, and, in some instances, the tools and dies, while the contractor owns the plant, property, and equipment used to manufacture the product, uses its own employees to perform the actual manufacturing activities, and, in some instances, uses its own intangibles in the manufacturing process. The principal may exercise varying degrees of control over the manufacturing activities, such as timing, quantity, and quality of production. Either the principal or the contractor may have title to the raw materials, components, work in process, and finished products.

Contract manufacturing arrangements can be subdivided into two categories based on which party has legal title to the work product. In a "consignment" or "tolling" arrangement, the principal acquires the raw materials and components and consigns them to the contract manufacturer, who performs the manufacturing service. In this type of arrangement, the principal has title to the property while it is undergoing manufacturing and thereafter. In contrast, in a "buy-sell" arrangement, the contractor holds title to the raw materials, components, and work in process and, upon completion of the manufacturing process, transfers title to the finished product to the principal. Thus, under a buy-sell arrangement, the contractor typically has the risk of loss while the property is undergoing the manufacturing process prior to sale to the principal.

In both types of arrangements, the principal has the entrepreneurial risk of selling the finished product to customers, and the contractor has the risk of manufacturing the goods to the satisfaction of the principal. Other benefits and burdens of ownership of the property being produced, apart from legal title to the property, may be allocated under both types of arrangements between the principal and the contractor based on myriad variations in the contractual terms. Therefore, this nomenclature, without more, generally sheds little light on which party has the majority of the benefits and burdens of ownership of the property and therefore would be treated as the owner of the property for federal tax purposes. However, we use the term "traditional consignment manufacturing arrangement" to refer to a

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contract manufacturing arrangement under which the principal not only has title to the work-in-process inventory, but also has the majority of the benefits and burdens of ownership of the property while it is being produced. We use the term "traditional buy-sell arrangement" to refer to an arrangement under which the contractor has title and the majority of the benefits and burdens of ownership of the property during the production process.

Generally, the Notice interprets § 199 broadly in order to implement Congress's intent to lower the tax burden on income attributable to domestic manufacturing activities. n32 With respect to manufacturing that occurs pursuant to a contract manufacturing arrangement, however, the Notice applies § 199 quite narrowly, providing for a significant cutback in the total § 199 deduction available to the principal and the contractor, as compared with the deduction that would be allowed if the exact same manufacturing activity had been conducted by an integrated producer. No policy reason justifies this disparate treatment. Although § 199 is intended to influence taxpayers' choices regarding where, in a geographical sense, to locate their manufacturing activities, there is no indication that Congress intended to influence taxpayers' decisions regarding how most efficiently to organize their operations, including the decision whether to be an integrated manufacturer or to outsource some activities to third-party contract manufacturers. Treasury should eliminate the disparate treatment of contract manufacturing arrangements under § 199 to the extent it can consistent with the statutory text.

Admittedly, the statutory requirement that gross receipts be "derived from the lease, rental, license, sale, exchange, or other disposition" of QPP requires a taxpayer to have had an ownership interest in the QPP in order to earn DPGR. Thus, a contract manufacturer that never had an ownership interest in its work product -- i.e., a traditional consignment manufacturer -- cannot qualify for § 199 benefits regardless of whether it were treated as a manufacturer of the property, because the contractor would not earn gross receipts from the sale or other disposition of the property. As a result, the total § 199 benefit available to the principal and contractor under a traditional consignment manufacturing arrangement necessarily will be less than those available to an integrated producer that conducts equivalent manufacturing activities. Regrettably, the Code itself mandates this disparate treatment.

The Notice's discriminatory treatment of contract manufacturing arrangements goes much further than is required under the Code, however. The Notice's unfavorable treatment of contract manufacturing arrangements is primarily the result of Treasury's interpretation of the statutory requirement that, to qualify for benefits, QPP must have been MPGE'd "by the taxpayer." Specifically, the Notice requires that,

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in order for the taxpayer to be treated as having engaged in an MPGE activity, the taxpayer must have had the benefits and burdens of ownership of the property when the qualifying MPGE activity occurred with respect to the property. n33 This rule, in conjunction with Treasury's view that there is only one tax owner at any point in time, n34 means that either the principal or the contractor, but not both, will be treated as having manufactured the QPP and as earning DPGR from its subsequent disposition.

We recommend that Treasury limit the disparate treatment of contract manufacturing arrangements to that which is mandated by the Code by changing two aspects of the Notice's interpretation of § 199 in the forthcoming regulations.

First, below, we conclude that, when property is produced pursuant to a contract that obligates the principal to purchase the contractor's finished product that conforms to the contract requirements, both the principal and the contractor should be treated as having MPGE'd the finished product. This interpretation is consistent with the statutory text, would not provide for any inappropriate duplication of § 199 benefits, and would equalize the § 199 consequences of manufacturing that is performed under a traditional buy-sell arrangement with manufacturing that is performed by an integrated producer. Under a traditional buy-sell arrangement, both the contractor and the principal earn gross receipts from sales, because both taxpayers own the QPP at different points in time and transfer that ownership interest in exchange for gross receipts. (This, of course, assumes that the principal ultimately sells the QPP to customers and does not retain it for use in the principal's business.) However, even if the regulations were to eliminate the ownership test for the attribution of MPGE activities and were to treat both the principal and the contractor as producers of QPP, a traditional consignment manufacturer would not qualify for § 199 benefits because the traditional consignment manufacturer would not earn gross receipts from the sale or other disposition of the property -- i.e., the contractor cannot transfer an ownership interest it never had.

Second, below, we conclude that the test for determining whether a taxpayer is considered to own QPP under § 199 should be the same as the test under Regs. § 1.263A-2(a)(1)(ii)(A) for determining whether a taxpayer owns its work product and therefore is treated as a producer subject to the uniform capitalization rules of § 263A. If, on the one hand, the regulations follow our recommendation and do not require ownership as a prerequisite for treating a taxpayer as having manufactured property, this ownership test would apply solely for purposes of determining whether a taxpayer earns gross receipts from the sale or other disposition of QPP. On the other hand, if the regulations retain the Notice's rule

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requiring tax ownership as a prerequisite for attributing manufacturing activities to the taxpayer, the test under Regs. § 1.263A-2(a)(1)(ii)(A) should also apply for this purpose.

The various cases and rulings dealing with the question of which taxpayer has the benefits and burdens of ownership emphasize different factors depending on the context in which the tax ownership issue arises. The authorities under Regs. § 1.263A-2(a)(1)(ii)(A) have developed the factors most relevant for determining which party is the tax owner in the context of goods being produced pursuant to a contract manufacturing arrangement. Because no policy reason suggests that the definition of tax owner should be different under § 263A and 199, the regulations should remove the uncertainty and cross reference Regs. § 1.263A-2(a)(1)(ii)(A) and the authorities thereunder for the determination of which taxpayer has the benefits and burdens of ownership.

We recognize that in the limited cases where both the contractor and the principal have significant indicia of ownership, the test under Regs. § 1.263A-2(a)(1)(ii)(A) may result in treating both taxpayers as tax owners of the same property at the same time. If this interpretation is appropriate under § 263A, it also should be appropriate under § 199 because no policy justifies imposing different standards for the two sections. Furthermore, any ownership requirement imposed under § 199 -- which we would limit to the statutory requirement that gross receipts be derived from a sale or other disposition of QPP -- should be interpreted narrowly in order to minimize the disparate treatment of manufacturing conducted by an integrated producer and manufacturing conducted pursuant to a contract manufacturing arrangement.

Finally, this memorandum briefly considers the current state of the law regarding the determination of which taxpayer has the benefits and burdens of ownership under § 263A.

We now turn to a detailed discussion of these points.

#### Tax Ownership Should Only Be Required to the Extent Mandated by the Code

Unless specifically intended, the tax system should not distort taxpayers' decisions regarding how to conduct their business. Congress enacted § 199 with the hope that lowering the tax burden on manufacturing activities that occur within the United States would cause more taxpayers to choose to conduct manufacturing activities here. Apart from Congress's intent to affect taxpayers' decisions regarding where to locate their manufacturing activities, Congress did not intend to affect taxpayers' decisions regarding how to structure their manufacturing operations. In the absence of a clear purpose to affect how taxpayers conduct their business, Treasury should implement § 199 by providing for equal

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treatment of the various arrangements taxpayers use for manufacturing products within the United States, to the extent possible consistent with the statutory language. Notice 2005-14 falls far short of this goal of tax neutrality by treating manufacturing conducted pursuant to a contract manufacturing arrangement significantly less favorably than when the identical activities are performed by an integrated manufacturer.

To a limited extent, this disparate treatment is mandated by the statutory requirement that DPGR must be derived from the lease, rental, license, sale, exchange, or other disposition of QPP. Contract manufacturers cannot satisfy this requirement in cases where they never acquire an ownership interest in their work product. Thus, in this limited situation, the Code requires that contract manufacturing arrangements be treated less favorably than integrated producers.

Instead of narrowly interpreting this statutory rule, Notice 2005-14 goes much further, by imposing a second, much broader ownership test for determining whether QPP was MPGE'd "by the taxpayer." The regulations should eliminate this second ownership requirement so that both parties to a contract manufacturing arrangement are treated as having manufactured the QPP. We believe that Treasury has the authority to equalize the treatment for contract manufacturing that is structured as a traditional buy-sell arrangement -- i.e., the contractor has the benefits and burdens of ownership its work product during the production process -- , in a manner that would go a long way to providing for equal treatment be consistent with the statutory language.

#### The First Ownership Test

The first ownership requirement follows straightforwardly from the statutory text: DPGR must be "derived from the lease, rental, license, sale, exchange, or other disposition of QPP." In other words, DPGR must be derived from the transfer of a property interest in the QPP; a taxpayer cannot transfer an interest it never had.

There is a plain difference in this statutory text requiring DPGR from QPP to be derived from the "lease, rental, license, sale, exchange, or other disposition of qualifying production property" and the parallel provisions providing the deduction for "construction performed in the United States" and "engineering or architectural services performed in the United States for construction projects in the United States." n35 As a result, the Notice does not require taxpayers performing construction, architectural, or engineering services to have had an ownership interest in the construction project to which the services relate.

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Some taxpayers have argued that, regardless of the words Congress chose, Congress could not possibly have intended for a deduction titled "Income Attributable to Domestic Production Activities" to be available for architectural and engineering services and not for manufacturing services. It is argued, therefore, that Treasury should exercise its broad grant of regulatory authority under § 199 to accomplish the statutory purpose of providing the deduction to those enterprises that create domestic production jobs, regardless of whether their gross receipts are from sales or other dispositions of the QPP. n36

A Treasury representative who was present at legislative drafting conferences for § 199, however, publicly has stated that the drafters understood the significance of the different statutory language used to describe gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP and gross receipts from construction projects or architectural and engineering services. In this case, it would be inappropriate for Treasury to override the plain meaning of the statutory text. Taxpayers must accept that the Code mandates this first ownership test.

The Second Ownership Test

The derivation of the second ownership requirement is much less straightforward. Treasury interprets the statutory requirement that property was MPGE'd "by the taxpayer" as implying that only one taxpayer may qualify for the § 199 deduction with respect to a particular production activity. n37 Treasury implements this conclusion by providing that, where one taxpayer performs a qualifying activity pursuant to a contract with another party, only the taxpayer with the benefits and burdens of ownership of property when a qualifying activity is performed with respect to the property is treated as engaging in the qualifying activity. n38 The Notice's explanation of this provision further provides, "If a contractor does not have the benefits and burdens of owning the property under federal income tax principles during the period the qualifying activity occurs, the contractor is more appropriately viewed as performing a service for the customer." n39 Thus, under a traditional buy-sell arrangement, where the contract processor is considered to own its work-in-process, only the contract processor will be entitled to the § 199 deduction. If, instead, the principal is considered the tax owner of the work product, which it merely consigns to the contract processor, only the principal will be entitled to the § 199 deduction, and then only if the principal earns gross receipts by subsequently transferring a property interest in the QPP to a third party. If retained in the forthcoming regulations, this approach could lead to planning opportunities or traps for the unwary.

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The Second Ownership Test Is Broader than the First

Treasury officials often defend the imposition of the second ownership test by resorting to the statutory mandate for the first ownership test. The second ownership test, however, is actually much more restrictive than the first ownership test because, in situations where the contractor owned the QPP while it was manufactured and subsequently sold the QPP to the principal, which, in turn, sold the QPP to consumers, both the contractor and the principal would earn gross receipts from the sale of the QPP. Under the second ownership test, however, only the contractor would be treated as having MPGE'd the QPP, and thus only the contractor would be eligible for § 199 benefits.

Treasury has drawn sharp criticism from the tax community for requiring ownership of QPP as a prerequisite for § 199 benefits. Representatives of contract manufacturers argue that it is absurd that taxpayers are not treated as having MPGE'd property that was manufactured in their factories, regardless of which person owned the property while the MPGE activities occurred. n40 These taxpayers argue that the Code clearly would support an alternative interpretation of "by the taxpayer" that attributes MPGE activities to the taxpayer whose employees physically performed the MPGE activities.

Alternatively, representatives of principals in contract manufacturing arrangements argue that the statutory text "by the taxpayer" is sufficiently broad to attribute the manufacturing activities to the taxpayer that is responsible for purchasing the output of a contract manufacturer and bears the ultimate benefits and burdens of the decision to manufacture in the United States, regardless of whether the principal has the benefits and burdens of ownership during the manufacturing process. n41 Both groups make good points.

Although neither ownership test can be justified in terms of the policy underlying § 199 -- i.e., the creation of domestic manufacturing jobs -- the first ownership test follows plainly from the statutory text, whereas the second ownership test does not. The statutory requirement that QPP was "MPGE'd by the taxpayer" would support treating both the contractor and the principal as the producers of property where both taxpayers had responsibility for its production. This is the case whenever a principal hires a contractor to produce property for the principal according to the principal's custom specifications. In such a case, it is reasonable to treat the principal as having produced the property because the principal, as the entrepreneur, bears the ultimate economic benefits and burdens of the decision to produce the property. It is also reasonable to treat the contractor whose employees physically performed the manufacturing activities as having produced the property.

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The Notice states that the purpose of the second ownership test is to assure that only one taxpayer is able to claim the § 199 deduction with respect to any particular production activity. However, § 199 benefits would not be duplicated if both parties to a contract manufacturing arrangement qualified for benefits based on the same activity, because the contractor's gross receipts would represent cost of goods sold to the principal if the principal subsequently were to resell the QPP. In fact, instead of avoiding a duplication of benefits, Treasury's rule actually results in a significant cutback of § 199 benefits for contract manufacturing arrangements, as compared with the benefit available to an integrated producer, because under Treasury's rule § 199 benefits are only available for the profit margin of either the contractor or the principal, but not both.

An integrated manufacturer generally may treat the retail sales price of QPP as DPGR. As a result, the integrated manufacturer earns QPAI for all four components of its profit from the sale of QPP, which include: (1) the return on intellectual property, including proprietary product features and manufacturing processes, incorporated into or used to produce the QPP; (2) the return on marketing intangibles that enable the manufacturer to charge a premium; (3) the return on the actual manufacturing processes; and (4) the return on distribution activities.

The application of Treasury's second ownership test to contract manufacturing arrangements means that, depending on which taxpayer has the benefits and burdens of ownership while the QPP is manufactured, either (1) the principal will earn QPAI for the return on its intellectual property, marketing intangibles, and distribution activities, or (2) the contract manufacturer will earn QPAI for the return on manufacturing activities (and any intellectual property that it owns and employs to manufacture the QPP). Since the U.S. manufacturing activities are the same, regardless of whether conducted by an integrated manufacturer or pursuant to a contract manufacturing arrangement, we see no policy justification for the Notice's disfavored treatment of contract manufacturing arrangements. Further, contrary to the Notice's assertion, the Code does not require that manufacturing conducted pursuant to a traditional buy-sell arrangement -- whereby both parties are the tax owner of the QPP at different times and thus can earn gross receipts from sales -- be treated less favorably than manufacturing conducted by an integrated producer. The regulations therefore should limit the disfavored treatment to that mandated by the Code.

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In order to minimize the disparate treatment of contract manufacturing under § 199, the regulations should attribute to a contract manufacturer any manufacturing activities actually performed by the employees of the contractor. These same activities also should be attributed to the principal if the principal contracted for the production of the property. n42

Although our suggested rule would attribute manufacturing activities to a contractor regardless of whether the contractor had an ownership interest in its work product, the contractor would have to have had an ownership interest in the property in order to earn gross receipts from a sale or other disposition of that property.

Our suggested approach is similar, although not identical, to that contained in the uniform capitalization (UNICAP) rules under § 263A. Under Regs. § 1.263A-2(a)(1)(ii)(A), the tax owner of work-in-process inventory is treated as a producer and is required to maintain inventories according to the UNICAP rules. In addition, § 263A provides that a so-called "payment producer" is treated as producing any property produced for it by another party under a contract, even though the taxpayer is not the tax owner of the work-in-process. n43 Payment producers are required to capitalize to the cost basis or ending inventory of the property produced payments or other costs incurred by the payment producer with respect to the property, of which the payment producer almost always will acquire ownership upon completion. Thus, under § 263A, both parties to a contract manufacturing arrangement can be treated as producers of the property that is the subject of the contract. The contract manufacturer, however, will only be treated as a producer if the contractor is the tax owner of the property while it is being produced.

Thus, the difference between the rule under § 263A and the rule we propose for purposes of § 199 is that we would attribute to the contractor all activities actually performed by the contractor, regardless of whether the contractor owned its work product while the activities occurred. Because a taxpayer treated as a producer under § 263A must capitalize its costs to the basis (or inventory) of the property produced, it is appropriate to limit treatment as a producer under that § to taxpayers that either own the work product or that subsequently will acquire an interest in the property. Under § 199, in contrast, there is no similar policy reason for requiring a taxpayer to have ownership in order to be treated as having MPGE'd the QPP. Although the first ownership test will require the contractor to have had an ownership interest in the QPP as a prerequisite to earning qualifying gross receipts from the transfer of a property interest, that requirement should be interpreted narrowly and should not be used to justify the imposition of a second ownership test where neither the statutory language nor any policy requires it.

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n44

The attribution of contract manufacturing activities has been controversial in other contexts, such as in subpart F. n45 The policies under subpart F, however, are distinct from those under § 199. n46 To effectuate the purposes of subpart F, attribution can be permitted only under circumstances that prevent a CFC from being used to separate sales activities from the manufacturing activities of a related corporation to obtain a lower rate of tax for the sales income. n47

Under § 199, however, so long as the manufacturing activities take place in significant part within the United States, the amount of § 199 benefits should not depend on whether a single, integrated taxpayer performs all of the functions to develop, produce, and sell the QPP, or whether multiple taxpayers participate in this effort. Furthermore, § 199 is not concerned with the location of the non-manufacturing activities required to develop, produce, and sell QPP. If an integrated producer manufactured QPP in significant part within the United States, the integrated producer would earn DPGR for its retail sales price, even if other support services were conducted outside the United States.

In summary, where both the contractor and the principal are able to satisfy the first ownership test, because at different points in time the contractor and the principal each had an ownership interest in the QPP that it sold, both should be treated as having MPGE'd the QPP, with the result that both parties to the arrangements should be eligible for § 199 benefits on their respective profits from the production and sale of the QPP.

Unfortunately, Treasury representatives have shown no indication that they are reconsidering the Notice's imposition of the second ownership test. n48 In any event, even if Treasury were to eliminate the second ownership test and therefore allow more than one taxpayer to qualify for § 199 benefits with respect to a single manufacturing activity, there still would be the issue of when a contract manufacturer is treated as the owner of its work product, since a contractor must own the property before it can derive qualifying gross receipts from a disposition of the property. The determination of whether a taxpayer is considered to own QPP so that (1) its gross receipts can be said to be derived from a disposition of the QPP, and (2) if Treasury retains the second ownership test, the taxpayer is attributed the MPGE activities that occur with respect to the QPP should be consistent with the ownership test under § 263A, for the reasons set forth immediately below.

Section 199 Should Use the Same Standard as § 263A for Determining the Tax Owner

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Notice 2005-14 provides that which taxpayer has the benefits and burdens of ownership for purposes of § 199 is to be determined "by reference to" the principles under § 936 and 263A. Nonetheless, Treasury representatives have stated on several occasions that ownership under § 199 is to be determined in light of the purposes of § 199, and, therefore, the Notice does not directly import the rules developed for determining which taxpayer has the benefits and burdens of ownership under § 936 and 263A for purposes of making the determination under § 199. We conclude below, however, that Treasury should adopt the test under § 263A for determining when a taxpayer has the benefits and burdens of ownership.

Based on the purposes of § 263A, the principles developed under that section for determining tax ownership should be entirely consistent with the purposes of § 199. Although these principles are not entirely clear and have produced confusion and conflicting results for taxpayers, Treasury should not establish inconsistent standards under the two provisions but rather should take this opportunity to clarify the standard under § 263A for purposes of both provisions.

The Inquiry Under § 263A Is Not Broader Than That Required by the Notice

Some commentators have suggested that the standard articulated under § 263A for determining tax ownership takes into account additional factors that are not taken into account under the standard articulated in Notice 2005-14. The UNICAP regulations specifically state:

[A] taxpayer is not considered to be producing property unless the taxpayer is considered the owner of the property produced under federal income tax principles. The determination as to 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. A taxpayer may be considered the owner of property produced, even though the taxpayer does not have legal title to the property.

In contrast, Notice 2005-14 states, "only the taxpayer that has the benefits and burdens of ownership of the property under federal income tax principles during the period the qualifying activity occurs is treated as engaging in the qualifying activity." Thus, while both provisions treat the owner of property for federal tax purposes as the producer of the property, § 263A explicitly provides for an inquiry into all of the facts and circumstances, whereas Notice 2005-14 does not.

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However, the determination of which party is treated as the owner under general federal tax principles is always based on all the facts and circumstances. The articulation of the test for tax ownership in Regs. § 1.263A-2(a)(1)(ii)(A) is consistent with that set forth by countless courts in various contexts. n55 Thus, because Notice 2005-14 incorporates general federal tax principles and specifically references the principles developed under § 263A for purposes of determining which party is treated as the tax owner, we do not believe that the Notice requires a narrower inquiry than that provided for under § 263A. For the removal of doubt, the regulations should clarify that this is the case.

The Same Ownership Test Should Serve the Policies of Both Sections

Not only is the scope of the inquiry into tax ownership the same under § § 199 and 263A, the context is also the same -- i.e., the determination of which party to a contract manufacturing arrangement has tax ownership of work-in-process inventory. Furthermore, no policy reason justifies the imposition of different standards of tax ownership for purposes of § § 263A and 199.

The tax ownership test in § 263A is applied to determine whether a taxpayer should be required to defer the direct and indirect costs of producing property until the year in which the property is sold to a customer. If, on the one hand, a taxpayer owns its work-in-process and finished goods inventory, the taxpayer's income would be distorted if the taxpayer were to deduct currently the costs of producing the inventory, rather than deferring the costs until the inventory is sold and the related revenue included in income. On the other hand, if a taxpayer does not own the goods it produces and thus is merely performing a service, the taxpayer is not required to match the timing of the costs with the related revenue recognition because the costs do not create an asset for federal tax purposes. n56

There is no reason that the test for determining whether a taxpayer owns inventory, and thus required to defer the costs of producing the inventory until a sale or other disposition occurs, should be different from the test imposed under § 199 for determining whether a taxpayer earns gross receipts from transferring a property interest in goods the taxpayer MPGE'd.

In recognition of this similarity, the Notice imposes a conformity requirement, providing that if a taxpayer is treated as MPGE'g property for purposes of § 199, the taxpayer also must treat itself as a producer of that property under § 263A. n57 This conformity requirement 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 two primary reasons for this limitation on the scope of the conformity requirement.

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First, as explained above, § 263A, in addition to applying to taxpayers that own the property being produced, applies to a limited extent to taxpayers that have property produced for them under a contract with another party. n58 As a result, when a contract manufacturer is treated as the owner of property it produces pursuant to a contract, both the contractor and the principal are treated as producers of the property and both are therefore subject to § 263A with respect to the property. Thus, § 263A by design applies more broadly than § 199 as interpreted by the Treasury, because under the Notice only one taxpayer may qualify for § 199 benefits with respect to a particular activity. If, as we recommend in our discussion above, the regulations were to replace the tax ownership test for the attribution of MPGE activities with a test that attributed MPGE activities to both the principal and the contractor, this inconsistency largely n59 would be eliminated.

Second, in rare cases, the test under 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. The regulation 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. 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. n60 However, as explained above, we believe the statutory requirement that gross receipts be derived from a sale or other disposition of property should be interpreted narrowly, in order to limit the distortion caused by taxing integrated producers and contract manufacturing arrangements differently. Thus, to the extent ownership under § 263A is interpreted broadly to allow two taxpayers to be treated as co-owners when the benefits and burdens of ownership are divided between the taxpayers, § 199 should do the same.

A common complaint from taxpayers regarding the ownership tests imposed under the Notice is that any test that turns on the benefits and burdens of ownership is inherently uncertain. Treasury should avoid exacerbating this uncertainty by promulgating a new standard or by referring to principles developed under multiple Code sections with competing purposes. The standard developed under § 263A is tailored for purposes of applying the general federal principles for determining tax ownership to the unique context of contract manufacturing arrangements. Therefore, Treasury should provide that the standard for determining the tax owner under § 199 is the same as that under § 263A.

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The next section briefly describes the current state of the law regarding tax ownership under § 263A.

Application of the Test for Tax Ownership to Property Manufactured Pursuant to a Contract Manufacturing Arrangement

The benefits and burdens of ownership test has been applied to determine which taxpayer is the owner of property for federal income tax purposes in a variety of factual circumstances, such as determining whether a sale ever occurred, n61 distinguishing a sale from a lease, n62 and distinguishing a sale from a secured financing. n63 The courts and the IRS have formulated various lists of factors to be taken into account in deciding the issue. n64 The specific factors listed and the relative weight given to each factor have varied depending on the context, since the analysis is usually tailored to fit the particular circumstances in which the issue arises and the specific nature of the property involved.

The most-often cited benefits and burdens of ownership are the location of formal legal title to the property, n65 the right to possession of the property, exposure to risk of loss upon physical destruction of the property, n66 control over the management of the property, n67 opportunity for economic gain or exposure to economic loss upon the sale of the property, and control over the disposition of the property, which includes the rights to intellectual property rights to the property. n68

Although no single one of these factors is determinative in deciding which party is the owner of property, the most important factors in the court cases and IRS documents relate to the nature of the economic outcome that the parties will experience with respect to the property at issue. n69 In assessing the potential for profit or loss, the authorities outside of the contract manufacturing context naturally focus on which taxpayer would have the benefit or burden of a change in the value of the property during the period for which ownership is at issue. For example, which taxpayer would benefit if it were discovered that the property cures cancer? Thus, although often stated as a separate factor, the factor of control over the disposition of the property -- i.e., whether the contractor has the right to compel the customer to purchase the produced property and, conversely, whether the customer can require the contractor to sell it the property -- is really subsumed under the factor of opportunity for economic gain or loss.

These cases are less useful when the tax ownership of property that is the subject of a contract manufacturing arrangement is at issue. In the contract manufacturing context, there is usually no question that, when the contract is completed, the customer will be the owner of the property; the only question is the determination of the precise point in time when the customer becomes the owner of the

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property.

When goods are custom manufactured to the customer's specifications, the customer will almost always be obligated to purchase the produced property. In many such cases, whether the contractor is legally compelled to sell particular items of custom manufactured property to the customer or, instead, could fulfill the contract by manufacturing replacement items will be moot, because the property will only be valuable to the customer and will have only scrap value to the contractor.<sup>n70</sup> Furthermore, the customer often retains ownership of intangibles, such as patents, copyrights, and trademarks that are utilized by the contract manufacturer to produce the finished product.<sup>n71</sup> Under these circumstances, the contract manufacturer cannot legally sell its finished product to anyone other than the customer that owns the intangibles. When a contract manufacturer is obligated to sell all of its work-in-process to the customer at a predetermined price, the contractor lacks the benefits and burdens of fluctuations in the value of its work product.

It simply cannot be that the customer rather than the contractor is treated as the tax owner of a contractor's work-in-process inventory whenever circumstances, whether legal or practical, compel the contractor to sell the finished product to the customer. Thus, cases applying the benefits and burdens test outside of the contract manufacturing context have limited application to contract manufacturing arrangements, since these cases tend to elevate the right to benefit from fluctuations in the value of property and to control the disposition of the property above the other factors. If the weight given to the various factors in these cases applied in the contract manufacturing context, a contractor would rarely be treated as the owner for tax purposes of the property it produces and therefore would not be subject to § 263A or eligible for § 199 benefits. Although a contractor should not be treated as the owner in every case, the determination should not be made exclusively on the factor of whether the contractor stands to benefit from fluctuations in the value of the QPP, the hallmark of a strict application of the benefits and burdens standard in other contexts.

Thus, for purposes of determining which taxpayer is the owner of property produced pursuant to a contract manufacturing arrangement, all of the facts and circumstances of the case are considered, with the result that, even in cases where the contractor is legally compelled to sell the finished product to the customer at a pre-determined price upon the completion of the production process, the contractor has been held to be the owner of the property being produced.

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The Tax Court's holding in *Suzy's Zoo v. Comr.*<sup>n72</sup> created some uncertainty regarding whether a contract manufacturer that is compelled to sell its output to a customer can ever be the tax owner under § 263A. We think that this conclusion represents an over reading of the Tax Court opinion. Most recently, in PLR 200328002, the IRS rejected the notion that control over the disposition of property, and the consequent ability to benefit from fluctuations in the value of the property, is the sine qua non of ownership for purposes of § 263A. For the removal of doubt, the Treasury should remove the uncertainty caused by *Suzy's Zoo* by embodying in generally applicable guidance, applicable for purposes of §§ 263A and 199, the factors articulated in PLR 200328002 for determining whether a contractor that lacks the unfettered ability to sell its output nonetheless is considered the tax owner.

*Suzy's Zoo v. Comr.*

In *Suzy's Zoo v. Comr.*, the Tax Court considered whether the taxpayer, a greeting card company, should be considered the tax owner of the greeting cards being produced by various contract manufacturers, which would have the effect of subjecting the taxpayer to the full scope of the UNICAP provisions in valuing its inventories of unsold greeting cards. The taxpayer created cartoon characters and sold greeting cards and other paper products imprinted with the copyrighted cartoon characters. The taxpayer hired unrelated printing companies to produce greeting cards depicting its designs. The printers owned the paper and ink used to make the cards and bore the risk of loss for the cards until the cards were shipped.

The Tax Court held that *Suzy's Zoo* had tax ownership of the greeting cards and therefore was not merely a payment producer under § 263A(g)(2).<sup>n73</sup> There were two themes to the Tax Court's reasoning.

First, the Tax Court focused on the relative utility added by *Suzy's Zoo* and the contractors. *Suzy's Zoo's* ownership in the greeting cards attached at what the Tax Court termed "the first stage of their production" -- when the cartoon characters were developed and drawn. It was this step that was critical and indispensable to the production of the cards and which required "the most skill, expertise and creativity of any step in the production process." The printers' reproduction of the cartoons "in a specified manner onto standard sheets of plain paper," on the other hand, was merely "one small step" in *Suzy's Zoo's* exploitation of its characters. The reproduction process was "mechanical in nature in that it involv[ed] little independence on the printers' part and [was] subject to petitioner's control, close scrutiny, and approval."<sup>n74</sup> In sum, the contractors were fungible, *Suzy's Zoo* was not.

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Second, the Tax Court focused on the "added fact" that the printer did not acquire a propriety interest in the cartoon characters and thus had no right to sell the finished greeting cards to anyone other than Suzy's Zoo. n75 It is this second aspect of the holding that has attracted substantial attention from the tax community.

On appeal, the Ninth Circuit affirmed, n76 emphasizing that Suzy's Zoo exercised a great deal of control over the printers, which were interchangeable and whose processes were mechanical, pointing out that Suzy's Zoo frequently used more than one contractor for each portion of the manufacturing process. n77 The Ninth Circuit deemphasized the contractors' lack of unfettered disposition, concluding:

Suzy's Zoo is the creator and sole owner of the cartoon images printed on its products. Although the printers use their own supply of paper in producing the greeting cards and bear the risk of loss until shipment, Suzy's Zoo is the owner of the cards from the beginning stage of production due to the degree of control it exercises over the manufacturing process. Therefore, Suzy's Zoo is a "producer" under § 263A. n78

The Ninth Circuit's holding only referred to the inability of the printers to sell the finished cards to anyone other than Suzy's Zoo in the statement of facts. Furthermore, the Tax Court opinion suggests that its holding would have been different if the printers were not fungible but instead exercised substantial discretion in a complex manufacturing process that added substantial value to the property produced. Neither the Tax Court nor the Ninth Circuit in Suzy's Zoo held that the unfettered right to dispose of property is the sine qua non of tax ownership.

PLR 200328002

In PLR 200328002, the IRS ruled that a contract manufacturer's inability to sell its finished product to anyone other than the particular customer that ordered the product does not prevent the contractor from having tax ownership of its work product, at least where the taxpayer's activities add substantial value to the final product. The taxpayers in the ruling developed and produced "delivery systems" -- i.e., gelscaps, capsules, and inhalers -- as well as packaging, such as blister packaging and child-resistant packaging, for customers in the pharmaceutical industry. The taxpayers incorporated their customers' proprietary ingredients into the finished pharmaceutical products. The taxpayers contended that they were not tax owners of their work product because their customers' contract rights and intellectual property rights in the goods produced, as well as regulatory laws, prevented the taxpayers from having legal title to and

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selling the finished product to anyone other than the particular customer that ordered the product. Accordingly, the taxpayers argued that they should not be required to use an inventory accounting method for their manufacturing activities.

In reaching the conclusion that the taxpayers were the tax owners of the pharmaceutical products being produced, regardless of their limited rights to sell the products, the IRS emphasized that, although the taxpayers manufactured the product according to specifications from customers, the taxpayers also used their own intellectual property and substantial expertise to design and produce the delivery systems. Unlike the mechanical process engaged in by the printers in *Suzy's Zoo*, the taxpayers in the ruling provided early guidance to their customers on the compatibility of various pharmaceutical and non-pharmaceutical ingredients and sometimes conducted clinical trials, analytical studies, and stability studies. In addition, the packaging produced by the taxpayers was produced using the subsidiaries own proprietary packaging processes and technologies. In sum, the taxpayers' efforts contributed substantially to the merchantability of their customers' products.

The IRS's reasoning is worth quoting at length:

The determination of whether a taxpayer is an owner of property it produces is based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxpayer. See § 1.263A-2(a)(1)(ii)(A). A taxpayer may be considered an owner of property produced even though it does not have legal title to the property. Some of the benefits and burdens of ownership are economic risk, degree of control exercised by the parties, right to dispose of the property, and rights and compulsion to repurchase the property. See *Paccar, Inc. v. Commissioner*, 85 T.C. 754 (1985), aff'd 849 F.2d. 393 (9th Cir. 1988) and Rev. Rul. 83-59, 1983-1 C.B. 103.

While the various benefits and burdens of ownership are important in analyzing tax ownership, they are not the exclusive tax ownership factors. Indeed, § 1.263A-2(a)(1)(ii)(A) specifies that the determination should be based on all the facts and circumstances. Other facts and circumstances relevant to the determination of whether a taxpayer is an owner of property it produces include the degree of utility or value added by the taxpayer, the separability of the products, the extent to which a taxpayer's production activities transform or convert the materials into a different product, and whether the taxpayer's efforts are necessary for a merchantable product. (emphasis added).

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Thus, although the right to dispose of property and therefore to benefit from fluctuations in the property's value might be the hallmark of ownership in many contexts, the inquiry is broader when the question is whether the taxpayer is the tax owner of property being produced pursuant to a contract with a customer. In that case, a contractor may be considered the tax owner of property produced, despite the contractor's legal obligation to sell all of its output to the customer, if the contractor's manufacturing processes are highly involved, add substantial value, and the contractor uses its own intellectual property to complete the finished product.

Although PLR 200328002 did not address Suzy's Zoo, the holdings are easily reconciled. In Suzy's Zoo, the third party contract manufacturers did not enhance the competitive advantage that Suzy's Zoo's greeting cards had in the marketplace -- the contractors were fungible. In contrast, the contractors in PLR 200328002 incorporated their own preexisting intellectual property to manufacture delivery systems for its customers that it helped to customize to the particular pharmaceutical. Thus, unlike the interchangeable printers in Suzy's Zoo, the taxpayers in the ruling were not readily replaceable.

The Treasury should issue generally applicable guidance for determining tax ownership under § § 263A and 199 for property that is being produced under a contract. This guidance should provide that factors relevant to the determination of which party is a tax owner of the work-in-process include:

- Whether the contractor's manufacturing activities add substantially to the merchantability of the finished product in the principal's hands. This factor should take into account the complexity of the manufacturing process and whether the contractor uses its own manufacturing intangibles and expertise to produce the product.
- Which party has discretion to decide how to produce the property and to determine the details of the production process, such as what type of quality control program to implement. Under this factor, it is also relevant whether the contractor is entitled to establish any of the specifications of the property to be produced.
- The range of economic outcomes that the contractor might experience from its manufacturing activities. For example, under § 936, a principal was attributed the manufacturing activities of its contractor when the contractor did not undertake a significant risk in manufacturing the product, for example, because it was paid by the hour.<sup>n79</sup> Similarly, for purposes of § § 199 and 263A, contractual terms that establish a relatively narrow range of possible financial outcomes for the contractor should militate against treating the contractor as the owner.

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The guidance should provide that when the above-listed factors are present, the contract manufacturer's inability to sell the finished product to a person other than the customer who ordered the product -- whether by virtue of contract rights, regulatory laws, or the principal's ownership of intangibles that are incorporated into the finished product -- will not affect whether the contractor is treated as the owner for purposes of § 199 and 263A.

Part II of this series will discuss additional issues, as set forth above, that must be resolved under § 199.

FOOTNOTES:

n1 Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

n2 P.L. 108-357.

n3 In Notice 2005-14, 2005-7 I.R.B. 498, Treasury set forth a detailed definition of W-2 wages for this purpose, which is beyond the scope of this memorandum. Because W-2 wages include all wages paid by an expanded affiliated group regardless of whether the employees perform activities that generate domestic production gross receipts, the W-2 wage limitation should not be an issue for most large corporate taxpayers. The only possible exception is that of technology companies that manage to generate significant taxable income from a relatively small payroll.

n4 To its credit, the Treasury opposed taxing income from manufacturing activities differently from income from other activities and instead favored an across-the-board cut in the corporate tax rate. See Kenney, "ETI Repeal Bills Could Result In Tax 'Sea Change,'" Jenner Says, 103 Tax Notes 1443 (6/21/05) (quoting the then acting assistant Treasury secretary for tax policy as stating that a requirement to differentiate between different types of income "would cause a sea change in the way that we tax business income, and it's a change that I don't think is for the better").

n5 See, e.g., Joyce, "Domestic Production Deduction Requires Attention to Statute's Intent, Officials Say," 59 Daily Tax Rep. G-6 (3/29/05) (quoting a Treasury official: "Just because you see the same words in another part of the code, or a similar concept in another part of the code, does not mean you can just apply those interpretations the same way in [§ 199]").

n6 This memorandum assumes familiarity with the general workings of the new section and Notice 2005-14 and is not intended to be a comprehensive summary of the new provision or the issues raised thereunder. For two excellent summaries of the new provision, Notice 2005-14, and the issues presented thereunder, see Conjura, Zuber, & Breaks, "The Domestic Manufacturing Deduction: Treasury and IRS Fill

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in Some Gaps," 102 J. Tax'n 198 (Apr. 2005) and Hecimovich, Danilack, Mahoney, Skelton, & Garay, "Producing Results: An Analysis of the New Production Activities Deduction," 2005 Tax Notes Today 35-35 (2/21/05).

n7 Aside from producers of tangible property, other potential beneficiaries of § 199 include software developers, film production companies, utilities that produce electricity, natural gas, or potable water, farms and other processors of agricultural products, construction companies, and engineering and architectural firms that work on construction projects in the United States. These taxpayers also are faced with other issues that they must resolve to benefit from the § 199 deduction. A discussion of these issues is beyond the scope of this memorandum.

n8 2005-7 I.R.B. 498.

n9 Notice 2005-14, § 1.

n10 Treasury plans to issue proposed regulations by "mid-Summer" and final regulations by Apr. 21, 2006, 18 months after the 2004 AJCA was signed into law.

n11 Estimated Budget Effects of the Conference Agreement for H.R. 4520, The "American Jobs Creation Act of 2004," JCX-69-04 (Oct. 7, 2004).

n12 Although the time for formally submitting comments on the Notice has passed, there undoubtedly will be a second opportunity under the proposed regulations. Treasury repeatedly has encouraged taxpayers to submit comments about their particular situations and their reasons for believing they are entitled to benefits under the Code. That Treasury is receptive to comments is evidenced, for example, by the Notice's inclusion in the definition of domestic production gross receipts of advertising revenue earned from magazine and newspaper publishers. Absent a special rule, such revenue would be viewed as income from services and not from the sale of tangible personal property. An example of effective lobbying that produced results at the expense of other taxpayers is the rule providing that, for software, sound recordings, and films, gross receipts attributable to the tangible media used to deliver the intangible property must be carved out and separately tested for qualification under § 199. The rule was included in the Notice at the behest of manufacturers of such tangible media, that were concerned that without such a rule their gross receipts would not qualify for the deduction. The special rule, however, reduces the benefit available to software developers and producers of sound recordings or films that do not produce the tangible media on which their intangible property is delivered.

n13 Although, ideally, financial statements only report the economic impact of transactions and do not influence them, this is not always the case. Accordingly, some companies are willing to relinquish more valuable tax deferral benefits in exchange for a larger § 199 deduction. Such a dilemma could exist where a taxpayer has a choice between structuring or characterizing a transaction as the provision of

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services instead of as the sale of goods. If a transaction is treated as the provision of services, the taxpayer can defer revenue recognition until performance is completed, payment is due, or payment is made, whichever occurs first, while currently deducting costs as they are incurred. See Rev. Rul. 74-607, 1974-2 C.B. 149. See also Regs. § 1.446-1(c)(1)(ii). Although only sale treatment would render the transaction eligible for § 199 benefits, such treatment may come at the expense of deferring costs under the inventory rules of § 471 and the uniform capitalization rules of § 263A until the revenue is recognized, or, worse, accounting for the transaction under the percentage-of-completion method under § 460. See, however, the discussion in Part II of this series regarding the narrow scope of the conformity requirement with § 263A, which is the only explicit requirement to conform the tax accounting treatment of items under the Notice.

n14 § 199(d)(4)(A).

n15 A technical amendment to § 199 may replace this test with a greater-than-50% control test.

n16 § 199(d)(4)(B).

n17 Notice 2005-14, § 4.09(2)(a).

n18 § 199(c)(4)(A)(i)(I).

n19 § 199(c)(5).

n20 Notice 2005-14, § 4.04(5)(b).

n21 Notice 2005-14, § 4.04(5)(c). Importantly, under these rules, more than one taxpayer can qualify as manufacturing the same end product "in significant part," where one taxpayer's finished product becomes another taxpayer's raw material, and each taxpayer's activities with respect to the property are substantial in nature.

n22 Under the Notice, each member of an EAG is treated as conducting the activities conducted by each other member of the EAG. Notice 2005-14, § 4.09(2)(b).

n23 Notice 2005-14, § 4.03(2).

n24 Id. at § 4.05(3)(c).

n25 Id. at § 4.03(1).

n26 Id.

n27 Id. at § 4.03(2). The explanation section of the Notice provides, however, that a taxpayer that has the information readily available to specifically identify DPGR generally must use the specific identification method, even if the taxpayer does not use that method for any other accounting purpose, and the taxpayer's use of any other method generally is not considered reasonable.

n28 A self-help solution may be available for taxpayers in this situation. Although § 199 contains a provision excluding from the definition of DPGR revenue derived from property that is leased, licensed,

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or rented for use by a related person, the exclusion does not extend to sales of property between related persons. § 199(c)(7). Thus, D could earn DPGR for the components it manufactures and incorporates into the finished machines if D structured a two-party transaction through the use of an affiliate, whereby Entity A manufactured the components and sold them to Entity B, which then incorporated the components into the integrated machines. For an in depth discussion of the issues presented by this type of transaction, see the discussion of related party transactions in Part II of this series.

n29 Section 936 allows a tax credit for certain income derived from the active conduct of a trade or business within a U.S. possession for the purpose of encouraging job creation and investment in the U.S. possessions. See S. Rep. No. 938, 94th Cong., 2d Sess. 277-278 (1976); H. Rep. No. 658, 94th Cong., 2d Sess. 254-255 (1975). See also *Medchem v. Comr.*, 116 T.C. 308, 336-37 (discussing the legislative purposes for § 936); note 50, *supra*.

n30 See Regs. § 1.936-5(a), especially Q&A-2. Under the § 936 regulations, the term "product" means an item of property that is the result of a production process (emphasis supplied). The term "product" includes component products, integrated products, and end-product forms. A component product is a product that is subject to further processing before sale to an unrelated party. Further, a component product may be produced from other items of property, and if it is so produced, may be treated as including or not including (at the choice of the possessions corporation) one or more of such other items of property. An integrated product is a product that is not subject to any further processing before sale to an unrelated party and includes all component products from which it is produced. An end-product form is a product that is: (a) not subject to any further processing before sale to an unrelated party, (b) is produced from a component product or products, and (c) is treated as not including certain components.

n31 Notice 2005-14, § 4.04(7)(b) (emphasis added). For issues relating to the distinction between property and services under § 199, including issues relating to the exception for de minimis embedded services, see the discussion in Part II of this series.

n32 For example, the Notice provides that the term MPGE must be construed broadly, "in light of the specific policies underlying § 199." Notice 2005-14, § 3.04(3)(a).

n33 Notice 2005-14, § 4.04(4).

n34 *Id.* at § 3.04(4) ("Under this rule, either A or B may qualify for the deduction, but both cannot obtain the benefit of the deduction for the same activity.").

n35 § 199(c)(4)(A) (emphasis added).

n36 Mechanically, to eliminate any ownership requirement under § 199, Treasury would have to promulgate a rule providing that, for purposes of § 199, gross receipts derived from the lease, rental,

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license, sale, exchange, or other disposition of QPP include gross receipts derived from the performance of manufacturing services. To avoid reading the statutory description of qualifying gross receipts out of the law entirely, Treasury could limit the special rule to situations where the principal ultimately will earn gross receipts from transferring an interest in the property to a third party, so that the contract manufacturer's income from performing manufacturing services could be said to be derived from the ultimate sale or other disposition of the property by the principal. Such a requirement, however, would cause contractors' tax results to depend on what principals ultimately did with the QPP, so that contractors that produce property for use in the principals' business would still have to own their work product during the production process in order to qualify for § 199 benefits. In this latter case, however, the contractor's return is the only return that would be eligible for the § 199 deduction under any rule, because the principal will not earn qualifying gross receipts from a transfer of the property. Although Treasury does have a broad grant of regulatory authority under § 199 and no taxpayer would have cause to complain, either approach would be a fairly far-reaching statutory interpretation.

n37 Notice 2005-14, § 3.04(4).

n38 *Id.* at § 4.04(4).

n39 *Id.* at § 3.04(4).

n40 See, e.g., Comment Letter from Robert T. Marlow on behalf of the Aerospace Inds. Assoc. (3/7/05), 2005 Tax Notes Today 49-33 (3/15/05). See also Seago, "Who Is Worthy of the Producers' Deduction for Production under Contract?," 107 Tax Notes 721 (5/9/05) (asserting that the producer classification for purposes of § 199 should be based on who performed the physical production).

n41 See Comment Letter from the Grocery Manufactures of America to the IRS (3/29/05), 2005 Tax Notes Today 67-12 (3/29/05).

n42 The term "contract" should be defined for this purpose as under Regs. § 1.263A-2(a)(1)(ii)(B)(2), which generally includes contracts entered into for the production of property before the production of the property is completed. Importantly, under the "routine purchase order exception," this definition excludes purchase orders for fungible property -- i.e., property requiring only de minimis modifications to accommodate the customer -- unless the customer has reason to know that the contractor cannot satisfy the contract within 30 days out of existing stocks and normal production of finished goods. Regs. § 1.263A-2(a)(1)(ii)(B)(2)(ii). MPGE activities should be attributed only to principals that bear entrepreneurial risk with respect to the decision to manufacture the property. Under the exception for routine purchase orders, simple distributors should not be able to cast themselves as principals in contract manufacturing arrangements simply by preordering goods from the manufacturer.

n43 § 263A(g)(2); Regs. § 1.263A-2(a)(1)(ii)(B).

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n44 Because a contractor must have had tax ownership of its work product at some point in time in order to satisfy the first ownership test, the results should be the same in most cases regardless of whether the regulations (1) adopt the test under Regs. § 1.263A-2(a), which would impose the additional requirement that the contractor must have had ownership of the work product in order to be treated as having MPGE'd the QPP, or (2) adopt the test we propose, which would not require a contractor that actually performs the MPGE activities to have ownership in order to be treated as having MPGE'd the QPP. Since the contractor must transfer ownership of the QPP in order to satisfy the first ownership test -- i.e., in order to earn gross receipts from a disposition of the QPP -- it would make little difference if the contractor also were required to own its work product in order to be treated as having MPGE'd the property. Nonetheless, we do not think that ownership should be relevant to the determination of whether the contractor is treated as having MPGE'd the property. There are cases where, although a taxpayer does not own the QPP while an MPGE activity occurs, the gross receipts attributable to the activities nonetheless could be considered to be "derived from" the sale or other disposition of the QPP. This is the case, for example, when a manufacturer transfers the benefits and burdens of ownership over QPP to the taxpayer before installing the QPP at the taxpayer's location. Where the installation activities are incidental to the sale of the QPP, we think the gross receipts attributable thereto should be treated as derived from the sale of the QPP, although this conclusion is not free from doubt. In such a case, the fact that ownership of the QPP passed to the customer prior to the installation or assembly activities should not preclude such activities from being treated as MPGE by the contractor. For a detailed discussion of the issues regarding the qualification of revenue attributable to installation activities as DPGR, see Part II of this series.

n45 See Rev. Rul. 97-48, 1997-2 C.B. 89 (revoking Rev. Rul. 75-7, 1975-1 C.B. 244 and announcing that the activities of a contract manufacturer will not be attributed to a CFC for purposes of the foreign base company sales rules under § 954(d)(1) or § 954(d)(2)).

n46 In other contexts, Treasury has recognized that it has broad authority to interpret the terms used in § 199 in order to accomplish the statutory purposes of the section, without regard to how those terms are interpreted under other sections. For example, after providing that the definition of manufacturing is interpreted broadly for purposes of § 199, the Notice provides that this definition is provided "solely for purposes of § 199 based on the authority provided to the Secretary under § 199(d)(7) and does not affect the construction of these terms in other parts of the Code (for example § 954(a)(1)(A))."

n47 See, e.g., FSA 200220005 (articulating the policies behind subpart F and considering, in light of those policies, when attribution of a contract manufacturer's activities to the principal is appropriate).

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n48 See, e.g., Bennett, "Proposed Rules on Manufacturing Tax Break Expected by Summer; Multiple Issues Studied," 64 Daily Tax Rep. G-13 (4/4/05) (reporting that a Treasury official had indicated that, although Treasury is considering some safe harbors under the proposed rules, it is doubtful the government will change the test for ownership of property in a contract manufacturing situation).

n49 The applicability of principles developed under § 936 to the determination of which taxpayer has the benefits and burdens of ownership is opaque, because § 936 does not deal specifically with that issue. Section 936(a) provides that a domestic corporation that elects the application of that section and meets certain requirements is entitled to a possessions tax credit with respect to, inter alia, taxable income from the active conduct of a trade or business within a possession. Section 936(h) deals with the tax treatment of income from intangible property and encompasses active income from the manufacture and sale of property produced in whole or in part in a possession and from the provision of services within a possession. Thus, with respect to income derived from the manufacture and sale of property, the Code is crafted on the basis that the possessions corporation has the benefits and burdens with respect to that property. The regulations, however, provide certain rules with respect to contract manufacturing. As used in § 936, the term "contracting manufacturing" includes any arrangement between a possessions corporation (or another member of the affiliated group) and an unrelated person if the unrelated person (i) performs work on inventory owned by a member of the affiliated group for a fee without the passage of title (i.e., consignment manufacturing), (ii) performs production activities under the direct supervision and control of a member of the affiliated group, or (iii) does not undertake a significant risk in manufacturing the product (i.e., it is paid by the hour). Regs. § 1.936-5(c), Q&A-1. Further, an arrangement between a member of the affiliated group and an unrelated party constitutes contract manufacturing if the unrelated party uses intangible property owned or licensed by a member of the affiliated group in producing the product which becomes part of the possessions product of the possessions corporation. These contract manufacturing rules were designed to assist the possessions corporation in meeting various aspects of the eligibility tests under § 936(a) and (h) for a possessions corporation to use either the cost sharing or profit split methods for purposes of computing intangible property income under § 936. See generally Regs. § 1.936-5(c), Q&A-1-5. The courts have considered the concept of contract manufacturing in the context of § 936 in *Medchem (P.R.), Inc. v. Comr.*, 295 F.3d 118 (1st Cir. 2002), *aff'g* 116 T.C. 308 (2001), and *Electronic Arts, Inc. v. Comr.*, 118 T.C. 226 (2002). These cases broadly held that for purposes of § 936, a contract manufacturer's activities may be attributed to the taxpayer, provided that the taxpayer is sufficiently involved in the manufacturing process.

n50 See note 5, *supra*.

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n51 See, e.g., Comment Letter from McCurdy on behalf of the Electronic Inds. Alliance (3/25/05), 2005 Tax Notes Today 62-25 (4/1/05); Comment Letter from Robert T. Marlow on behalf of the Aerospace Inds. Assoc. (3/7/05), 2005 Tax Notes Today 49-33 (3/15/05).

n52 Regs. § 1.263A-2(a)(1)(ii)(A) (emphasis added).

n53 Notice 2005-14, § 4.04(4).

n54 See PLR 200323002 (interpreting this language and explaining that the various benefits and burdens of ownership are not the exclusive factors for determining tax ownership).

n55 See, e.g., Baird v. Comr., 68 T.C. 115 (1977) ("The question of when a sale is complete for tax purposes is essentially one of fact which must be resolved by an examination of all of the facts and circumstances, no single one of which is controlling."); Deyoe v. Comr., 66 T.C. 904, 910 (1977) ("The test to be applied is a practical test, taking into account all the facts and circumstances and viewing the transaction in its entirety... Among the factors to be considered in determining whether a sale is complete are the transfer and legal title and the shift of the economic benefits and burdens of ownership of the property.") (emphasis added).

n56 If the taxpayer does not own the goods it produces, the taxpayer cannot be said to have a tangible asset. Further, production expenses incurred to generate future service income do not create an intangible asset. Regs. § 1.263(a)-4(b)(3)(iii) (providing that amounts paid in performing services under an agreement do not have to be capitalized as an intangible asset, regardless of whether the amounts result in the creation of an income stream under the agreement).

n57 See Notice 2005-14, § 4.04(3)(b).

n58 § 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).

n59 If the regulations followed the approach we recommend above, an inconsistency would remain in cases where the contract manufacturer is not the tax owner of the goods being produced. Under our approach, the contractor would nonetheless be treated as having MPGE'd the goods, even though the contractor would not qualify for § 199 benefits unless at some point in time the contractor had an ownership interest in the property that it transferred in exchange for gross receipts. Such a contractor would not be treated as a producer under § 263A. If, in the interest of consistency and simplicity, the regulations under § 199 modified our approach by requiring tax ownership as a prerequisite to attribution to the contractor, but not for purposes of attribution to the principal, this inconsistency would be eliminated. Furthermore, as explained in note 44, supra, requiring tax ownership as a prerequisite to attribution of MPGE activities to a contractor would make little difference, since to qualify for § 199

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benefits the contractor must earn gross receipts from transferring a property interest in the QPP.

n60 See Hecimovich, Danilack, Mahoney, Skelton, and Garay, note 7, *supra*. 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). Treasury representatives publicly have stated in discussions regarding § 199 that they believe that under Regs. § 1.263A-2(a)(1)(ii)(A) only one taxpayer should be treated as the owner of property.

n61 See, e.g., *Grodt & McKay Realty Inc. v. Comr.*, 77 T.C. 1221 (1981) (holding that a sale of cattle had no economic substance; the benefits and burdens of ownership never passed to the purported purchaser); *Paccar, Inc. v. Comr.*, 85 T.C. 754 (1985), *acq.* 1987-2 C.B. 1, *aff'd* 849 F.2d 393 (9th Cir. 1988) (holding that transfers of surplus and obsolete inventory to an unrelated warehouse did not constitute a sale because the taxpayer retained dominion and control over the transferred inventory) See also *Robert Bosch Corp. v. Comr.*, T.C. Memo. 1989-655 (same).

n62 See, e.g., *Frank Lyon Co. v. U.S.*, 435 U.S. 561 (1978).

n63 See, e.g., *Country Food Co. v. Comr.*, 51 T.C. 1049 (1969).

n64 See *Suzy's Zoo v. Comr.*, 273 F.3d 875 (9th Cir. 2001); *Paccar, Inc. v. Comr.*, 85 T.C. 754 (1985), *acq.* 1987-2 C.B. 1, *aff'd*, 849 F.2d 393, (9th Cir. 1988); *Robert Bosch Corp. v. Comr.*, T.C. Memo 1989-655; Rev. Rul. 83-59, 1983-1 C.B. 103; PLR 200328002.

n65 The regulations under § 263A provide that the taxpayer may be determined to be the owner of property notwithstanding that the taxpayer does not have legal title to the property. Regs. § 1.263A-2(a)(1)(ii)(A).

n66 In the context of contract manufacturing, the factor of liability for damage to work-in-process inventory in the possession of the contractor is often not helpful, because, even when the contractor does not own the property, the contractor typically has risk of loss under the bailment rules that apply when the property of one person is in the custody of another.

n67 In the context of contract manufacturing, this factor looks to which taxpayers controls the details of the manufacturing process while the property is being produced. Under § 263A, control by the principal of the contractor is a factor militating against treating the contractor as a tax owner. This factor, however, may not be as important under § 199. Following the Notice's description of the tax ownership

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rule, the Notice states, "[t]his rule applies even if the customer exercises direct supervision and control over the activities of the contractor..." Notice 2005-14, § 3.04(4). Nonetheless, if a contractor exercises substantial control and discretion regarding the manufacturing process, this factor should weigh in favor of treating the contractor as the producer of the property. This conclusion is reinforced by the Notice's reference to the principles under § 936, which, as discussed in note 49, *supra*, would attribute contract manufacturing activity to a principal in cases where the principal directly supervises the contract manufacturer.

n68 See *Suzy's Zoo v. Comr.*, 273 F.3d 875 (9th Cir. 2001).

n69 See, e.g., *Illinois Power Co. v. Comr.*, 87 T.C. 1417 (1986) (holding that the potential for profit or loss is a significant factor in analyzing sale-leaseback transaction); *Town & Country Food Co. v. Comr.*, 51 T.C. 1049 (1969) (holding that a transaction involving third-party debt was a secured loan rather than a sale, relying on factors including title, possession, and the right to receive excess proceeds from any actual sale of the debt). Compare *American Nat'l Bank of Austin v. U.S.*, 421 F.2d 442 (5th Cir. 1970) (finding that the purported seller's right to control the subsequent disposition of bonds that were supposedly sold to a bank meant that the purported seller had retained the benefits and burdens of ownership of the bonds) with *American Nat'l Bank of Austin v. U.S.*, 573 F.2d 1201 (1978) (holding, for the same type of transaction but for different years, that the bank was the tax owner because, when the crunch finally came and the matter was put to the test (i.e., interest rates rose substantially), it was proven that the bank actually bore the risk of loss on a decrease in the value of the bonds below the option price); *United Planters Nat'l Bank of Memphis v. U.S.*, 426 F.2d 115 (6th Cir. 1970); *Paccar, Inc. v. Comr.*, 85 T.C. 754 (1985), acq. 1987-2 C.B. 1, *aff'd*, 849 F.2d 393 (9th Cir. 1988); *Robert Bosch Corp. v. Comr.*, T.C. Memo 1989-655.

n70 See *Frank G. Wikstrom & Sons, Inc. v. Comr.*, 20 T.C. 359 (1953) (holding that the fact that the property was custom-ordered and therefore would be difficult to sell to anyone but the specific customer that ordered the property did not prevent the property from being considered the inventory of the customer and therefore subject to the cost capitalization rules); *Fame Tool & Mfg. Co., Inc. v. Comr.*, 334 F.Supp. 23 (S.D. Ohio 1971) (rejecting the taxpayer's contention that, because of the custom-order nature of the property it produced, the taxpayer was engaged in the business of performing services and accordingly should not be subject to the inventory rules requiring deferral of costs pending the reporting of the associated revenue).

n71 *Suzy's Zoo v. Comr.* 114 T.C. 1 (2000), *aff'd*, 273 F.3d 875 (9th Cir. 2001) (holding that a greeting card company was the tax owner of greeting cards produced by a contract manufacturer, even though the contract manufacturer purchased all the raw materials for making the cards and held legal title,

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because the greeting card company retained all copyrights to the cartoons depicted on the cards, which denied the contract manufacturer the unfettered ability to dispose of the cards produced).

n72 114 T.C. 1 (2000), aff'd, 273 F.3d 875 (9th Cir. 2001).

n73 114 T.C. 1, 9 (2000). Had Suzy's Zoo been treated as a payment producer, the scope of costs subject to capitalization under § 263A would have been narrower, § 263A(g)(2), and, more importantly, Suzy's Zoo would have been eligible for the exception under Regs. § 1.263A-3(a)(3) for small resellers with property produced under contract. 114 T.C. 1, 10 (2000).

n74 114 T.C. 1, 8 (2000).

n75 In reaching its conclusion, the Tax Court cited the similar case of *Charles Peckat Mfg. Co. v. Jarecki*, 196 F.2d 849 (7th Cir. 1952). There, the taxpayer owned a patent on a bracket for sun visors and contracted with an independent machine shop to fabricate the bracket. The machine shop's entire output had to be sold to the taxpayer at a per-piece price. The Seventh Circuit held that the taxpayer manufactured the bracket for purposes of the federal excise tax, focusing on the control maintained by the taxpayer over the manufacturing process and observed that the machine shop never had a proprietary interest in the bracket because the bracket was subject to the patent that the taxpayer controlled. *Id.* at 852.

n76 273 F.3d 875 (9th Cir. 2001).

n77 *Id.* at 883.

n78 *Id.* at 880.

n79 See note 49, *supra*, for a discussion of the principles under § 936.