MEMORANDUM

Musings on Selected Provisions of the Final §199 Regulations Applicable to Corporate Manufacturers of Tangible Property

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INTRODUCTION

I. Background

Section 199[1] of the Internal Revenue Code of 1986, as amended (the "Code"), permits taxpayers to claim a deduction equal to a percentage of taxable income attributable to domestic production activities. The deduction, equal to 9% of the *lesser of* a taxpayer's (1) "qualified production activities income" ("QPAI"), or (2) taxable income determined without regard to the deduction itself, 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.[2] The deduction is also limited to 50% of the taxpayer's W-2 wages paid for the calendar year ending during the taxable year, which, for taxable years beginning before May 18, 2006, includes wages paid in connection with non-production activities.[3]

In the Gulf Opportunity Zone Act of 2005 ("GOZA"),[4] Congress made certain technical corrections to §199 (the "Technical Corrections"), with retroactive effect. Section 199 was again amended as part of the 2005 TIPRA,[5] but this time effective only for taxable years beginning after May 17, 2006. In the 2005 TIPRA, Congress provided that only wages attributable to domestic production activities are includible in the computation of the wage limitation.[6] As part of this change, TIPRA repealed the limitation included in the 2004 AJCA on the amount of wages treated as allocated to owners of passthrough entities for purposes of computing the owners' wage limitation on the deduction.[7] Prior to TIPRA, the amount of allocable wages from a passthrough entity that an owner could include in computing its wage limitation was limited to twice the relevant percentage (i.e., 3% for 2005) of QPAI that was allocated to such owner from the passthrough entity for the taxable year.[8]

The purpose underlying §199 is to enhance the ability of domestic businesses, particularly domestic manufacturing firms, to compete in the global marketplace. Congress believed that a reduced tax burden on domestic manufacturing would improve the cash flow of domestic manufacturers, make investments in domestic manufacturing facilities more attractive, and result in the creation and preservation of U.S. manufacturing jobs.[9]

The final regulations under §199 (the "Final Regulations" or Regs. §1.199-1 through -9) were published in the Federal Register on June 1, 2006,[10] effective for taxable years beginning on or after that date.[11] Concurrently with the publication of the Final Regulations, the IRS issued temporary and proposed regulations liberalizing the treatment of online software (the "Temporary Software Regulations"),[12] and Revenue Procedure 2006-22,[13] providing guidance with respect to the determination of a taxpayer's W-2 wage limitation. The Final Regulations finalized a notice of proposed rulemaking that appeared in the Federal Register on November 4, 2005 (the "Proposed Regulations"),[14] and Notice 2005-14 (the "Notice").[15]

With all of that guidance, one might think we had finally reached the end. However, Treasury has indi-

[1] Enacted by the American Jobs Creation Act of 2004 ("AJCA"), P.L. 108-357, §102.

[2] §199(a). Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1986, as amended, and to the regulations promulgated thereunder.

[3] §199(b), as amended by the Tax Increase and Prevention Act of 2005 ("TIPRA"), P.L. 109-222, §514; former §199(b).

[4] P.L. 109-135, §403(a).

[5] P.L. 109-222, §514.

[6] §199(b)(2).

[7] *See* former §199(d)(1)(B), as enacted by the 2004 AJCA, P.L. 108-357, §102.

[8] *Id.*

[9] Joint Committee on Taxation, *General Explanation of Tax Legislation in the 108th Congress*, JCS-5-05, at 170 (2005) (the "Blue Book").

[10] T.D. 9263, 71 Fed. Reg. 31268 (6/1/06).

[11] Regs. §1.199-8(i).

[12] Regs. §§1.199-3T(i)(6)(ii)-(v), -8T(i)(4), T.D. 9262, 71 Fed. Reg. 31074 (6/1/06). These temporary regulations will expire on or before June 22, 2009.

[13] 2006-23 I.R.B. 1033.

[14] Prop. Regs. §§1.199-1 through -8, REG-105847-05, 70 Fed. Reg. 67220 (11/4/05).

[15] 2005-1 C.B. 498. The Notice is obsolete for taxable years beginning on or after June 1, 2006.

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cated[16] that there are seven ongoing projects involving additional guidance under §199: (1) new regulations addressing changes to §199 made by the 2005 TIPRA; (2) a new revenue procedure for calculating W-2 wages under the amendments made by the 2005 TIPRA; (3) a revenue procedure allowing taxpayers to change certain elections under §861;[17] (4) a revenue procedure permitting certain passthrough entities to compute QPAI at the passthrough level, rather than at the partner level; (5) a revenue procedure to deal with the treatment of disallowed losses; (6) guidance on when statistical sampling may be used for purposes of computing QPAI; and (7) finalization of the Temporary Software Regulations.

For taxable years commencing June 1, 2006, and thereafter, taxpayers are required to follow the guidance contained in the Final Regulations. For prior years, taxpayers are given several choices regarding which guidance to apply. It is incumbent on a taxpayer considering the application of §199 to years beginning prior to June 1, 2006, to be familiar with not only the Final Regulations, but also the Proposed Regulations and the Notice, since application of the earlier guidance, or a combination of the earlier guidance, may be advantageous, depending on the taxpayer's circumstances. For taxpayers that do not have the time or patience to make this comparison (or the inclination or resources to hire a professional advisor to do so), the Notice, the Proposed Regulations or the Final Regulations may be applied in their entirety to the earlier years.

II. Placing the §199 Guidance in Context

Section 199 permits taxpayers to claim a deduction in computing their taxable income for federal income tax purposes. Why then is the guidance under §199 so lengthy, complex and seemingly never-ending? The reason, we submit, is that §199, in effect, is a "mini-income tax" regime. In order to determine the deduction, taxpayers must determine whether they engage in domestic production activities and then determine the gross receipts, cost of goods sold (if applicable) and taxable income resulting from those activities. These determinations are a microcosm of the Code, since detailed operating rules are required to address all classes of taxpayers in a multitude of situations. Section 199 is not the only illustration of the enactment of a "mini-Code." Other instances include rules relating to domestic international sales corporations (DISCs), foreign sales corporations (FSCs), extraterritorial income (ETI), and the possession tax credit.

Unfortunately, there is no easy way to devise rules in these situations that are simple or short. Although the drafters of the guidance incorporated some extant rules for purposes of making determinations under §199, other opportunities to incorporate existing guidance were consciously foregone. We understand that §199 guidance had to be crafted to be consistent with the intent of the provision, susceptible of application by taxpayers and administrable by the IRS. However, we think the incorporation of more rules from existing guidance would have been consistent with these goals, as well as with the broader goal of tax simplification.

It is in that context that we highlight a number of the changes that have been made as the guidance has evolved. We make no attempt to be comprehensive; rather, we identify changes that have wide application to the universe of taxpayers seeking to obtain benefits under §199 and raise policy issues which in our view, are interesting or complex and worthy of comment. In particular, we focus on areas in which the Notice and the Proposed and Final Regulations differ, with the aim of helping taxpayers determine what guidance, or, in some cases, what combination of the guidance, to apply for taxable years beginning prior to June 1, 2006. Also, in the interest of simplicity, we limit our comments to issues affecting the implementation of the deduction for corporate taxpayers that manufacture tangible personal property.

We begin our analysis with the effective date provisions and the options that a taxpayer has to select the §199 guidance that it will follow for taxable years commencing prior to June 1, 2006.

DISCUSSION

I. Effective Date Rules

For taxable years beginning on or after June 1, 2006, Regs. §§1.199-1 through -8, as well as the Temporary Software Regulations, are mandatorily applicable. Regs. §1.199-9 (dealing with passthrough entities and the wage limitation), however, may not be applied because it is not effective for taxable years beginning after May 17, 2006.[18]

For taxable years beginning after December 31, 2004, and before June 1, 2006 ("Pre-Effective Date

[16] *See* Tax Analysts, *Highlights and Documents* 2485 (6/27/06).

[17] This revenue procedure is discussed in Part V, below.

[18] The reason for the May 17, 2006, cut-off for applying Regs. §1.199-9 is that the Final Regulations do not address the changes made by TIPRA to the W-2 wage limitation and to the rules for allocating the wages of passthrough entities. To deal with the TIPRA amendments, which were enacted when the regulations were almost complete, the rules for the W-2 wage limitation, as well as all the rules relating specifically to passthroughs, were included in a separate section of the regulations, Regs. §1.199-9, which was made effective only for years beginning before the ef-

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Years"), a taxpayer has certain options regarding which guidance to apply.

For taxable years beginning before May 18, 2006:

- Items arising from a taxable year of a passthrough entity beginning before January 1, 2005, cannot be taken into account for purposes of §199.
- A taxpayer may choose to apply the Temporary Software Regulations, regardless of its choice among the three options presented below.
- In addition, a taxpayer may choose one of the following three options:
  1. A taxpayer may choose to apply the Final Regulations, provided the taxpayer applies Regs. §1.199-1 through -9 in its entirety to the taxable year. Thus, a taxpayer that wishes to rely on a beneficial provision in the Final Regulations generally must take the bad with the good. There is no ability to "cherry pick" between the Final Regulations and prior guidance.
  2. The Final Regulations also extend the option contained in the Proposed Regulations allowing taxpayers to rely on a combination of the Notice and the Proposed Regulations.[19]

     This option includes an expansive "cherry-picking" rule. If the Notice and the Proposed Regulations contain different rules on the same particular issue, a taxpayer may rely on either the rule set forth in the Notice or in the Proposed Regulations.[20] There is no rule of consistency regarding the selection of other rules, subject to the following limitation.

     If the Notice fails to address a particular issue, but the Proposed Regulations contain a specific rule on the issue, taxpayers are not permitted to rely on the absence of a rule in the Notice to apply a rule contrary to the Proposed Regulations.[21] In other words, a taxpayer that chooses to rely on a beneficial provision in the Proposed Regulations generally also must take the bad with the good under the Proposed Regulations, unless the Notice contains a specific rule on the issue that is dealt with unfavorably by the Proposed Regulations.
  3. For taxpayers that choose to forego either of these options, the only mandatory guidance for Pre-Effective Date Years is the Notice.[22] A taxpayer that pursues this option will be foreclosed from relying on any favorable provisions included in the Proposed or Final Regulations that are absent from the Notice.

For taxable years beginning after May 17, 2006, and before June 1, 2006:

- Generally, the same rules apply as for taxable years beginning before May 18, 2006.
- However, under the option to apply the Final Regulations, a taxpayer must apply all the provisions of Regs. §§1.199-1 through -8, but cannot apply Regs. §1.199-9.
- Under the options to apply either (1) a combination of the Notice and the Proposed Regulations, or (2) solely the Notice, a taxpayer may not apply the guidance in a manner that is inconsistent with the TIPRA amendments.

Thus, for Pre-Effective Date Years, taxpayers should consider whether it is more advantageous to apply the Final Regulations, a combination of the Notice and the Proposed Regulations, or the Notice. Under the latter option, taxpayers also must determine which rules from the Notice and the Proposed Regulations to apply. Finally, members of an Expanded Affiliated Group ("EAG")[23] that are not members of a consolidated group each may apply the effective date rules without regard to how other members of the EAG apply the rules.

As a general observation, the express provisions of the Final Regulations are generally at least as favor-

fective date of the TIPRA amendments, i.e., May 18, 2006. Since the Final Regulations are only mandatorily applicable for taxable years beginning on or after June 1, 2006, Regs. §1.199-9 is mandatory only for taxpayers that choose to apply the Final Regulations to a Pre-Effective Date Year (and, even in that case, only for taxable years beginning before May 18, 2006).

[19] Regs. §1.199-8(i)(1).

[20] *Id.*

[21] *Id.*

[22] *Id.* (stating "for a taxable year beginning before June 1, 2006, the guidance under §199 that applies to such taxable year is contained in Notice 2005-14"). To date, this option to forego the benefit of subsequent guidance and instead to rely solely on the Notice has been overlooked by commentators.

[23] See Part VI, below, for a discussion of the EAG rules.

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able, if not more favorable, than the rules contained in either the Notice or the Proposed Regulations. There are several exceptions to this generalization, however, many of which are highlighted below. In addition, in a number of areas, the rules in either the Notice or the Proposed Regulations were sufficiently ambiguous that a taxpayer might apply a more favorable interpretation than was subsequently adopted. Thus, the advantages of relying solely on the Notice, with all of its ambiguities, must be weighed against foregoing the benefit of certain taxpayer-favorable rules included only in the Proposed and/or Final Regulations. In addition, the advantages of relying on a combination of the Notice and the Proposed Regulations, including any ambiguities that remain in the Proposed Regulations, must be weighed against foregoing the benefit of taxpayer-favorable rules that are new in the Final Regulations.

We now look to the Final Regulations' more substantive rules.

II. Taxable Income Limitation — New Add-Back of ETI Exclusion

One example of a taxpayer-favorable rule that is new in the Final Regulations is applicable to taxpayers with taxable income that is less than their QPAI. As explained above, the §199 deduction is equal to a percentage of the lesser of a taxpayer's QPAI or taxable income, determined without regard to the deduction itself. Under the new rule, for purposes of computing the taxable income limitation, taxpayers can add back any amount that was excluded from taxable income under the phase-out of the ETI regime (the "ETI add-back").[24]

A §199 deduction generally cannot increase a net operating loss ("NOL") carryback or carryover.[25] Thus, a taxpayer with no taxable income will not benefit from this new rule, even if the ETI add-back would result in positive taxable income. However, most other ETI beneficiaries with taxable income that is less than QPAI[26] will benefit. Since the deduction is equal to only a small percentage of taxable income or QPAI, it would be highly unlikely that, where a taxpayer had positive taxable income before taking into account its §199 deduction, the increased §199 deduction that would result from an ETI add-back would cause the taxpayer to be in an NOL position.

The Final Regulations do not explicitly include this special rule where the alternative minimum taxable income limitation applies instead of regular taxable income.[27] Based on informal discussions with Treasury personnel, this was an oversight and clarification is anticipated.

ETI beneficiaries that have limited taxable income should seriously consider applying the Final Regulations in full to Pre-Effective Date Years in order to take advantage of the new ETI add-back in computing the taxable income limitation.

III. Domestic Production Gross Receipts

In order to compute a §199 deduction, a taxpayer must first determine its QPAI. Since QPAI is a taxable income concept, the determination not surprisingly starts with the segregation of a taxpayer's gross receipts between those that qualify as domestic production gross receipts ("DPGR") and those that do not so qualify ("non-DPGR"). In the case of manufacturers, DPGR is defined as gross receipts derived from the lease, rental, license, sale, exchange or other disposition of qualifying production property ("QPP")[28] that was manufactured, produced, grown, or extracted ("MPGE") by the taxpayer in whole or in significant part within the United States.[29] After the determination of DPGR, it is necessary to (1) allocate costs of good sold ("CGS") between DPGR and non-DPGR and (2) allocate below-the-line deductions between gross income from DPGR and non-DPGR.[30]

The Final Regulations made a number of significant changes to the computation of DPGR that are summarized below.

A. The Definition of an "Item" and its Role under §199

Under all of the guidance, it is clear that, at a minimum, the test for whether property was MPGE in whole or in significant part by the taxpayer within the United States, and therefore is eligible to generate DPGR, must be applied at the individual "item"

[24] Regs. §1.199-1(b).

[25] §172(d)(7), as amended by the 2005 GOZA, P.L. 109-135, §403(a)(17) (the Technical Corrections); Regs. §1.199-1(b). The only exception to this rule applies in the context of an EAG where (1) the EAG, in the aggregate, has positive QPAI and positive taxable income, so that a §199 deduction is allowed, and (2) a portion of the deduction is allocated to a member of the EAG that had positive QPAI but an NOL for the year. In this limited situation, the §199 deduction allocated to the loss member would increase the loss member's NOL. Regs. §1.199-7(c)(2).

[26] Taxable income might be less than QPAI, for example, because a taxpayer must include any deductions for NOL carryovers or carrybacks in computing the taxable income limitation, but NOL deductions are excluded from the computation of QPAI. Regs. §1.199-4(c)(2).

[27] *See* Regs. §1.199-8(d).

[28] QPP refers to tangible personal property, any computer software and sound recordings. §199(c)(5).

[29] §199(c)(4).

[30] §199(c)(1)(B).

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level. In fact, the Notice and the Proposed Regulations directed taxpayers to compute QPAI "on an item-by-item basis (and not, for example, on a division-by-division, product line-by-product line, or transaction-by-transaction basis)."[31] The Final Regulations provide instead that only DPGR must be computed on an item-by-item basis.[32]

We turn first to the evolution of the definition of an "item" and then to the role of an item in computing QPAI.

1. *The Definition of "Item," Including the Shrink-Back Rule*

a. The Notice

The Notice did not define "item." Thus, although it was clear from the above-quoted statement in the Notice that an item was defined at a level lower than a division, product line or transaction, it was not clear whether an item was the property offered for sale to customers or a component thereof.[33] In light of this uncertainty, taxpayers relying solely on the Notice for Pre-Effective Date Years should be able to take any reasonable approach to the definition of "item," including that set forth in the Proposed or Final Regulations.[34]

b. The Proposed Regulations

The Proposed Regulations clarified this uncertainty by adopting what has come to be known as the "shrink-back rule" for defining the "item."

Under the Proposed Regulations, an item generally is the property that is offered for sale to customers, provided that the gross receipts from the disposition of such property qualify as DPGR.[35] However, under the Proposed Regulations, it was not actually sufficient for two separate properties (such as two toy cars) to be offered for sale together (such as in a two-for-the-price-of-one sale) in order for the two properties to be treated as a single item; rather, the two properties had to be packaged and sold together.[36]

If the property offered for sale does not qualify under §199, the Proposed Regulations require a taxpayer to treat as a single item *any portion* of the property offered for sale that would qualify to generate DPGR.[37] Thus, under the Proposed Regulations, the portion of the property offered for sale that was treated as the item could not exclude any other portion of the property that met the requirements to generate DPGR.[38] In effect, a taxpayer was required to "shrink back" the item offered for sale to those components that, in the aggregate, satisfied the DPGR requirement. For example, assume a taxpayer MPGE shoe soles and the grommets for the shoe laces, and assembled the shoe by attaching the soles and grommets to imported "uppers." Under the shrink-back rule in the Proposed Regulations, if the taxpayer could

[31] Notice 2005-14, §4.03(1); former Prop. Regs. §1.199-1(c)(1).

[32] Regs. §1.199-3(d)(1).

[33] Immediately following its directive that QPAI be computed on an item-by-item basis, the Notice includes the following example, intended to demonstrate that QPAI from an item may be positive or negative:

> [I]f a taxpayer manufactures a shirt and a hat in the United States, and the QPAI derived from the manufacture of the shirt is $3 and the QPAI derived from the manufacture of the hat is ($1), the taxpayer's QPAI is $2.

Notice 2005-14, §4.03(i). The remainder of the examples in the Notice speak in terms of whether "property" or "QPP" qualifies for the deduction, rather than in terms of an "item." For example, the Notice uses the following example to demonstrate the application of the substantial in nature standard:

> [I]f property is MPGE by the taxpayer outside the United States . . . and the property is used as a component part of the QPP produced by the taxpayer within the United States, the QPP (including the component part) will be treated as MPGE in significant part by the taxpayer within the United States if the production of the QPP performed by the taxpayer within the United States is substantial in nature.

Id. at §4.04(5)(b). For an extensive discussion of the uncertainty under the Notice regarding the definition of an item, see Granwell & Rolfes, "The Domestic Production Activities Deduction: Opportunities, Pitfalls & Ambiguities for Domestic Manufacturers: Part I," *Tax Mgmt. Memo.* 288 (7/11/05). Query whether the shirt and hat example establishes a reasonable basis for the position that, for taxpayers relying solely on the Notice, an item is limited to the property offered for sale to customers and that subcomponents thereof can never qualify as an item. This interpretation would be preferred by any taxpayer generating losses from the production of subcomponents, where the property offered for sale to customers into which the subcomponents are incorporated would not qualify as having been MPGE in significant part by the taxpayer.

[34] The Preamble to the Proposed Regulations cites footnote 27 to the Conference Report for the AJCA (also known as, "the coffee footnote") as indicating that a component may be treated as qualifying property in the context of food and beverages. *See* H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. 259 (2004). The Preamble further cites the Blue Book as indicating Congressional intent that this treatment is not limited to food and beverages, but rather applies to §199 in general. Thus, taxpayers relying solely upon the Notice should be able to interpret "item" to include a subcomponent of the property offered for sale to customers.

[35] Prop. Regs. §1.199-1(c)(2)(i).

[36] Prop. Regs. §1.199-1(c)(2)(ii) *Exs. 3, 4.* This rule was relaxed in the Final Regulations which provide that an item can consist of two or more properties offered for disposition in the normal course of business as a single item regardless of how the properties are packaged. Regs. §1.199-3(d)(2)(i).

[37] Prop. Regs. §1.199-1(c)(2)(i).

[38] *Id.*

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not qualify the entire shoe under §199, the soles together with the grommets would be treated as a single item.

c. The Final Regulations

The Final Regulations generally retain the definition of item, including the shrink-back rule, from the Proposed Regulations, subject to one important modification to the shrink-back rule.[39]

Under the Final Regulations, if the gross receipts derived from the property offered for sale would not qualify as DPGR, a taxpayer must "shrink back" and treat as the item any "component" of the property offered for sale, provided that the gross receipts allocable to the disposition of that component qualify as DPGR.[40] Under this rule, each qualifying component must be treated as a separate item; a qualifying component may not be combined with any other nonqualifying component.[41] This represents a narrowing of the rule in the Proposed Regulations. The Preamble states that allowing more than one component to be treated as a single item effectively would permit taxpayers to define an item as any combination of components that, in the aggregate, met the §199 requirements, a result that the IRS and Treasury believe could lead to significant distortions.

This rule raises a policy issue and interpretational ambiguities. As a policy matter, it is unclear why the IRS and Treasury believed that an aggregation rule could lead to significant distortions, when 20 years earlier the IRS and Treasury allowed taxpayers to aggregate or disaggregate on an annual basis for purposes of defining the term "product," which was a key term used to determine the credit under the now-repealed possession tax credit under §936. We would submit that the policy directive for the possession tax credit was similar to that of the domestic activities production deduction — encouragement of manufacturing in the possessions or the United States, as the case may be. (We note in passing that the §199 deduction does not apply to manufacturing activities in Puerto Rico or the other possessions eligible for the possession tax credit.) We further query why the IRS and Treasury did not adopt in a more wholesale fashion the §936 approach to the required computations, since similar to §199, §936 in effect was a mini-Code.[42]

In terms of interpretational ambiguities, we raise three illustrations:

First, probably the most interesting unanswered question in this area is "what is a component?" Can a subassembly be a component if it contains purchased and produced parts? Treasury has indicated that an automobile engine could be viewed as a component, even though it is made up of purchased and produced parts. Perhaps the key is that the individual parts must be MPGE together, as would be the case with an engine.

Second, the new definition of an item raises uncertainties for taxpayers that are engaged in the business of repairing or rebuilding customer-owned equipment. It had been thought that, where such taxpayers first MPGE purchased and/or produced parts into subassemblies that constitute QPP, a taxpayer would be able to qualify the sale and installation of such subassemblies into customer-owned equipment as DPGR. While we still think this result was intended by the Final Regulations, the language of the Final Regulations leaves some room for doubt on this point.

Third, and perhaps the most interesting question for transfer pricing specialists under §199, is "how does a taxpayer attribute intangible property return to an item that is a component of the property sold to a customer?" Assume that a taxpayer manufactures shoe soles in the United States and imports the shoe uppers. The taxpayer manufactures shoes for sale by sewing or otherwise attaching the soles to the imported uppers. If the gross receipts derived from the sale of the shoes do not qualify as DPGR, the taxpayer must treat the sole as the item if the gross receipts derived from the sole would qualify as DPGR. Further assume much of the retail value of the shoe is attributable to the brand name. How does one attribute that return to the item in this case? Should it make a difference if the taxpayer also sewed a trademarked symbol onto the shoe uppers, such as the Nike swoosh symbol? It is clear that under §199 an integrated manufacturer and seller of QPP is entitled to the entire return for (1) the actual manufacturing process related to the product, (2) distribution activities related to the sale of the product, and (3) the return attributable to manufacturing and marketing intangibles related to the qualifying property. This example raises difficult valuation and transfer pricing issues. Again,

[39] Regs. §1.199-3(d)(1). The Final Regulations made two additional minor changes. First, they clarify that an item is defined with reference to the property offered by the taxpayer for lease, rental, license, sale, exchange or other disposition to the taxpayer's customers in the normal course of the taxpayer's business, whether the taxpayer is a wholesaler or a retailer. Regs. §1.199-3(d)(1)(i). Under the Proposed Regulations, it appeared that "customers" referred only to retail customers and not to the customers of a wholesaler. *See* Prop. Regs. §1.199-1(d)(ii) *Ex.* 2. Second, the Final Regulations provide that an item can consist of two or more properties that are offered for disposition in the normal course of the taxpayer's business as a single item, regardless of how the properties are packaged. Regs. §1.199-3(d)(2)(i).

[40] Regs. §1.199-3(d)(1)(ii).

[41] *Id.*

[42] See the discussion in Part IV.

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we would suggest that guidance in an analogous area can be found in the §936 regulations.[43]

2. The "Second Sale" Rule

Although the Notice did not address the issue, the Proposed and Final Regulations provide an example to illustrate that gross receipts from a second disposition of an item by the taxpayer that originally MPGE the item can qualify as DPGR.[44] Thus, a taxpayer that originally MPGE property within the United States, sold the property, and then reacquired the property would earn DPGR upon the subsequent sale or lease of the property.

This rule, in combination with the shrink-back rule, imposed an administrative hardship on some taxpayers. The Final Regulations provide an exception to the application of the shrinkback rule in this situation by permitting the gross receipts from the second disposition of property that contains or may contain qualifying QPP to be treated entirely as non-DPGR where it would be administratively burdensome to calculate the fraction of the property that was previously MPGE by the taxpayer.[45]

3. The Role of an "Item" in the Computation of QPAI

None of the guidance mandates a particular method of determining DPGR and non-DPGR, because the IRS and Treasury recognize that no single method would be appropriate for all taxpayers.[46] Instead, the guidance provides merely that taxpayers must use a reasonable method to identify DPGR and non-DPGR, based on all the facts and circumstances.[47] Of course, if a taxpayer has the information readily available and can, without undue burden or expense, use a specific identification method for determining DPGR, then such method may be the only method considered reasonable.[48]

Regardless of whether an allocation method or a specific identification method is used to determine the gross receipts attributable to DPGR, the Notice and the Proposed Regulations required this calculation, as well as the allocation of CGS and below-the-line expenses, to be performed on an item-by-item basis and not, for example, on a division-by division, product line-by-product line, or transaction-by-transaction basis.[49] Although an item-by-item determination might be reasonable for computing DPGR, the requirement to compute QPAI at the item level was burdensome and inconsistent with the cost allocation methods used to determine QPAI. The Final Regulations modified the rule in the prior guidance to provide that only DPGR must be computed on an item-by-item basis.[50] Once DPGR has been determined, all other allocations can be made by reference to two categories — DPGR and non-DPGR. Thus, CGS generally is attributed to DPGR and non-DPGR based on a method that is reasonable under all of the facts and circumstances or on the small business simplified overall method.[51] Below-the-line deductions are similarly attributed to DPGR and non-DPGR based on three possible allocation methods, depending on the size of the business.[52]

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[43] *See* Regs. §1.936-6(b)(1) *Q&A 12*, T.D. 8669, 61 Fed. Reg. 21366 (5/10/96); Regs §1.936-6(b)(1) *Q&A 12*, T.D. 8090 (6/9/86); *Coca-Cola Co. v. Comr.*, 106 T.C. 1 (1996) (approving taxpayer's use of the production cost ratio); FSA 200035024. *See also* Regs. §1.936-6(a)(2) *Q&A 10-14*.

[44] Prop. Regs. §1.199-3(h)(2) *Ex. 1*; Regs. §1.199-3(i)(2) *Ex. 2*. Query whether taxpayers relying solely on the Notice could take a position that the second sale or lease did not qualify as generating DPGR. This may be advantageous where the second transaction generates a loss, as frequently is the case in the leasing industry due to the effect of accelerated depreciation on the reacquired property.

[45] Regs. §1.199-3(d)(3).

[46] Notice 2005-14, §3.04(1).

[47] Notice 2005-14, §4.03(2); Prop. Regs. §1.199-1(d)(1); Regs. §1.199-1(d)(2). Although the language in the Notice and the Proposed and Final Regulations providing this standard is somewhat different, we do not believe that any substantive difference was intended among the three pieces of guidance in this respect. Some commentators have suggested that language in the explanation portion of the Notice would mandate that a specific identification method be used to determine DPGR whenever such a method was used for any other purpose. *See* Notice 2005-14, §3.04(1) ("For example, a taxpayer that uses a specific identification method (that is, a method that specifically identifies where the item was MPGE) for any other purpose is required to use that method to determine DPGR."). Similarly, the Proposed Regulations provide that "if a taxpayer can, without undue burden or expense, specifically identify where an item was manufactured, or if the taxpayer uses a specific identification method for other purposes, then the taxpayer must use that specific identification method to determine DPGR." We do not believe that this was the intended result under the Notice or the Proposed Regulations in cases where a specific identification method would be administratively burdensome because, although the information might exist within the taxpayer's information systems (for example, for purposes of administering a warranty program or for complying with FDA requirements), accessing such information for purposes of computing DPGR would be overly burdensome. Thus, we believe that the provision in the Final Regulations providing that a taxpayer must use a specific identification method only if such information is "readily available . . . without undue burden or expense" is merely a clarification of the prior guidance. Accordingly, taxpayers relying on the earlier guidance should not be required to incur unreasonable expenditures to extract specific identification information from their information systems where such information is not readily available.

[48] Regs. §1.199-1(d)(2).

[49] Notice 2005-14, §4.03(1) (requiring QPAI to be determined on an item-by-item basis); Prop. Regs. §1.199-1(c)(1) (same).

[50] Regs. §1.199-3(d)(1).

[51] Regs. §1.199-4(b), (f).

[52] Regs. §1.199-4(c)(1), (d), (f). These allocation methodologies are discussed in Part V, below.

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As a practical matter, the result should be the same regardless of whether costs are allocated based on a two-bucket (DPGR and non-DPGR) approach or on an item-by-item basis. In either case, the costs generally will be attributed to the object based on allocations and not based on specific identification. Thus, the only practical effect of a requirement to allocate costs on an item-by-item basis would be bigger spreadsheets, that is, if the requirement were actually enforced, which is doubtfully the case in practice. Thus, in choosing which guidance to apply for Pre-Effective Date Years, taxpayers should give little weight, if any, to this change.

B. New Exception for De Minimis DPGR

Section 199 is not elective. Prior to the promulgation of the Final Regulations, taxpayers complained that neither the Notice nor the Proposed Regulations contained a de minimis exception for DPGR. Thus, irrespective of how small a taxpayer's DPGR, the taxpayer was compelled to expend resources to identify its QPAI and to ascertain its §199 deduction. This effort was thought to be particularly burdensome in the case of small partnerships.

In response, the Final Regulations established two new 5% de minimis exceptions for DPGR, one that applies at the item-level and another that applies at the entity level. Under the item-level exception, all of a taxpayer's gross receipts from a qualifying disposition of QPP may be treated as non-DPGR if less than 5% of the gross receipts from that item are DPGR.[53] After application of this item-level de minimis rule, the entity-level rule is applied. Under this rule, if less than 5% of the taxpayer's total gross receipts are DPGR, all of a taxpayer's receipts may be treated as non-DPGR.[54]

The entity-level de minimis exception for DPGR applies as follows:

- for members of an EAG that are not members of a consolidated group, at the separate entity level rather than at the EAG level;
- for consolidated groups, at the consolidated group level rather than at the entity level; and
- for partnerships, the exception applies at both the partnership and the partner level.

C. The De Minimis Exceptions for Non-DPGR

Conversely, there are item- and entity-level exceptions that permit certain non-DPGR to be treated as DPGR. Under the Final Regulations, there are six such item-level exceptions[55] and one entity-level de minimis exception.[56]

Under the item-level exceptions in the Final Regulations, if certain requirements are met,[57] gross receipts from the following services or nonqualifying property may be treated as DPGR:

- qualified warranties,
- qualified delivery,
- qualified operating manuals,
- qualified installation,
- services performed pursuant to a computer software maintenance agreement, and
- de minimis embedded services and nonqualifying property, where the gross receipts attributable to such nonqualifying services and property is less than 5% of the total gross receipts derived from the qualifying disposition.

Of these six exceptions, only the first and the last were included in the Notice, and, in the case of the last exception, the Notice's version included only de minimis embedded services and not embedded property (such as the provision of purchased spare parts in connection with a qualifying disposition).[58] The exceptions for qualified delivery, qualified operating manuals, and qualified installation were added in the Proposed Regulations.[59] Finally, the exception for services performed pursuant to a computer software maintenance agreement is new in the Final Regulations.[60] Since these exceptions are provided as a matter of administrative grace, a taxpayer will only be entitled to apply a particular exception for Pre-Effective Date Years if the taxpayer chooses to apply a version of the guidance that includes that exception.

[53] To reflect the adage that "nothing is simple," even in the case of this exception a rule had to be added to address situations in which gross receipts are received over a period of time, such as in a multi-year lease or installment sale. In this case, eligibility for the de minimis exception is determined by taking into account the total gross receipts expected to be derived from the transaction. If a taxpayer chooses to treat gross receipts from a multi-year transaction as non-DPGR under this rule, the taxpayer must consistently treat the gross receipts recognized in each subsequent taxable year as non-DPGR. Regs. §1.199-3(i)(4)(ii).

[54] Regs. §1.199-1(d)(3)(ii).

[55] Regs. §1.199-3(h)(4)(i)(B).

[56] Regs. §1.199-1(d)(3)(i) (allowing taxpayers to treat all of its gross receipts as DPGR if less than 5% of its gross receipts are non-DPGR).

[57] In general, to qualify for these exceptions a price cannot be separately stated for the service or nonqualifying property (that is, the price must be embedded in the price for the qualifying QPP) and the service or nonqualifying property cannot be separately bargained for or offered for sale.

[58] Notice 2005-14, §4.04(7)(b).

[59] Prop. Regs. §1.199-3(h)(4)(ii)(A)–(E).

[60] Regs. §1.199-3(i)(4)(B)(5).

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The entity-level de minimis rule for non-DPGR results in treating all gross receipts as DPGR if less than 5% of the taxpayer's gross receipts are non-DPGR.[61] This rule was included in all versions of the guidance. With respect to EAGs, consolidated groups, and partnerships, this rule applies at the same level as the entity-level exception allowing de minimis DPGR to be treated as non-DPGR, discussed above.[62] With respect to consolidated groups, this is a significant change from the Proposed Regulations, discussed below.

D. Contract Manufacturing: Tax Policy Issues and Uncertainties

The use of contract manufacturing has become an increasingly common business practice, both domestically and internationally. In the international area, the use of contract manufacturing has been controversial, particularly in the area of subpart F of the Code. In the domestic context, prior to the enactment of §199, the rules were well settled. However, with the enactment of §199, the determination of which party to a contract manufacturing arrangement — the principal or the contractor — should qualify for the deduction for its respective efforts to produce QPP has generated substantial controversy.

1. The Technical Requirements for Contract Manufacturing

As set forth above, a disposition of QPP generates DPGR if the property was (1) MPGE, (2) by the taxpayer, (3) in whole or in significant part, and (4) within the United States.[63] How the foregoing requirements are applied in the area of contract manufacturing has been controversial since the enactment of §199. The controversial issue relates to the "by the taxpayer" element and which party to a contract manufacturing arrangement should be treated as performing the MPGE activities.

The Final Regulations, consistent with the prior guidance, provide that only one taxpayer may claim the §199 deduction with respect to an MPGE activity.[64] The regulations go on to provide that if one taxpayer performs a qualifying activity within the United States pursuant to a contract with another party, then only the taxpayer that has the benefits and burdens of ownership of the QPP during the period in which the MPGE occurs is considered the manufacturer and therefore entitled to the §199 deduction.[65]

Thus, if a principal enters into a contract with an unrelated contract manufacturer for the contractor to MPGE QPP for the principal, and the principal has the benefits and burdens of ownership of the QPP under applicable federal income tax principles (i.e., the principal is the "tax owner") during the period the MPGE activity occurs, the principal is considered to MPGE the QPP. In this case, the principal will only qualify for the deduction if the principal can demonstrate that the MPGE activities performed by the contractor on behalf of the principal were performed in whole or in significant part within the United States. In this respect, the attribution of the contractor's activities applies for both the "substantial-in-nature" test and the safe harbor (discussed below) for meeting the "in whole or in significant part" requirement.[66] In contrast, if the contract manufacturer has the benefits and burdens of ownership of the property during the production process, the contract manufacturer will be treated as performing the MPGE activities. All of these rules were also included in the Notice and Proposed Regulations.[67]

In a previous article, we asserted that the Notice was wrong as a matter of policy to limit the attribution of MPGE activities to one taxpayer in the context of a contract manufacturing arrangement.[68] Section 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 CGS to the principal if the principal subsequently were to resell the QPP (a prerequisite for the principal to earn gross receipts eligible for treatment as DGPR).

In fact, instead of avoiding a duplication of benefits, limiting the deduction to only one party to a contract manufacturing arrangement actually results in a significant cutback of §199 benefits, as compared with the benefit available to an integrated producer, because §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

[61] Regs. §1.199-1(d)(3)(i).

[62] *Id.*

[63] §199(c)(4); Regs. §1.199-3(a)(1)(i).

[64] Regs. §1.199-3(f)(1).

[65] *Id.*

[66] In this case, in applying the substantial-in-nature test or the safe harbor, the principal's MPGE activities or direct labor and overhead to MPGE the QPP within the United States include both the principal's U.S. MPGE activities or direct labor and overhead, as well as the U.S. MPGE activities or direct labor and overhead of the contractor. Regs. §1.199-3(g)(4).

[67] Notice 2005-14, §§3.04(4), 4.04(4) and 4.04(5); Prop. Regs. §1.199-3(e), (f)(3).

[68] *See* Granwell & Rolfes, "The Domestic Production Activities Deduction: Opportunities, Pitfalls & Ambiguities for Domestic Manufacturers: Part I," *Tax Mgmt. Memo.* 288 (7/11/05).

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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 the rules in the guidance for 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 they are conducted by an integrated manufacturer or pursuant to a contract manufacturing arrangement, no policy reason justifies this disparate treatment.[69]

Nonetheless, Congress settled this debate, at least for purposes of §199, in the Technical Corrections, by providing explicitly:

> The Secretary shall prescribe such regulations as are necessary to carry out the purposes of this section, including regulations which prevent more than 1 taxpayer from being allowed a deduction under this section with respect to any activity described in subsection (c)(4)(A)(i).[70]

In light of this statutory mandate, it is difficult (or at least pointless) to quarrel with Treasury's approach to its implementation. Accordingly, taxpayers must determine which party to a contract manufacturing arrangement is the tax owner of the work-in-process inventory to determine which taxpayer will be eligible for §199 benefits. This approach could lead to planning opportunities or traps for the unwary, as discussed below.

2. The Benefits and Burdens Standard

Since contract manufacturing arrangements usually can be structured so that either the contractor or the principal will be treated as the tax owner during the production process, taxpayers need to consider whether their arrangements maximize benefits under §199.

Background: The Structure of Contract Manufacturing Arrangements

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, necessary tools or 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 controlling the quantity, quality and timing of production. Either the principal or the contractor may have title to the raw materials, 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 being manufactured 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 incurs the risk of loss while the property is being manufactured.

In both buy-sell and consignment 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, the traditional labels of "buy-sell" and "consignment," without more, generally shed little light on which party to the arrangement 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.

Guidance under §199 Regarding the Benefits and Burdens Standard

In the Preamble to the Final Regulations, Treasury indicated that it rejected suggestions to allow unre-

[69] 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 to most efficiently organize their operations, including the decision whether to be an integrated manufacturer or to outsource some activities to third-party contractors. Thus, 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.

[70] §199(d)(4)(8), as amended by §403(a)(13) of the Technical Corrections (2005 GOZA).

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lated parties to designate who has the "benefits and burdens" for purposes of §199 on the basis that the benefits and burdens must be determined based on all of the facts and circumstances and stated that a designation of benefits and burdens would not be appropriate. The Final Regulations do not, however, specify particular factors to consider in determining which party has the benefits and burdens.

Thus, we are left with the question of how one applies the benefits and burdens standard to a contract manufacturing arrangement. Initially, the Notice provided that, for purposes of §199, the benefits and burdens of ownership standard is "based on the principles under section 936 and section 263A."[71] Nonetheless, in addressing the meaning of that statement, Treasury have informally indicated that ownership under §199 is to be determined in light of the purposes of §199.[72]

The Preamble to the Proposed Regulations is not instructive as to Treasury's reasoning with respect to why the benefits and burdens is not based on either §263A or §936, stating simply: "While sections 199, 263A, and 936 all have benefits and burdens standards, the standard under section 199 is not the same as those under sections 263A and 936."[73] Unfortunately, no reasons were supplied as to why the standards of the sections are not the same (or at least similar). We thus have no choice but to turn to the case law regarding the application of the benefits and burdens standard. In addition, the Final Regulations do contain two examples that illustrate the application of the standard, which we turn to after reviewing the case law.

The Traditional Benefits and Burdens Standard

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,[74] determining whether a taxpayer is subject to the inventory rules of §§471 and 263A,[75] and distinguishing a sale from a secured financing.[76] The courts and the IRS have formulated various lists of factors to be taken into account in deciding the issue.[77] 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 nature of the property involved.

The most-often cited benefits and burdens of ownership are the location of formal legal title to the property, the right to possession of the property, exposure to risk of loss upon physical destruction of the property,[78] control over the management of the property,[79] opportunity for economic gain or exposure to economic loss with respect to the sale of the property, and control over the disposition of the property, which in-

[71] Notice 2005-14, §3.04(4).

[72] *See, e.g.,* Joyce, "Domestic Production Deduction Requires Attention to Statute's Intent, Officials Say," *Daily Tax Report* G-6 (3/29/05) (quoting a Treasury official, "[j]ust 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 Section 199").

[73] Preamble to the Proposed Regulations. The Preamble rejected the broad standard of Regs. §1.263A-2(a)(1)(ii)(A), which provides that 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 of whether a taxpayer is considered an owner is based on "all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxpayer." *Id.* The Preamble further states that "[b]ecause the standard under the section 263A regulations is broad, it has been interpreted to allow two or more taxpayers to be considered the producer of the same property. Compare, for example *Suzy's Zoo v. Comm'r.,* 114 T.C. 1, *aff'd* 273 F.3d 875 (9th Cir. 2001) and *Golden Gate Litho v. Comr.,* T.C. Memo 1998-184."

[74] *See, e.g., Grodt & McKay Realty Inc. v. Comr.,* 77 T.C. 1221 (1981) (finding 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); *Robert Bosch Corp. v. Comr.,* T.C. Memo 1989-655 (same).

[75] *See Suzy's Zoo v. Comr.,* 273 F.3d 875 (9th Cir. 2001), *aff'g* 114 T.C. 1 (2000).

[76] *See, e.g., Country Food Co. v. Comr.,* 51 T.C. 1049 (1969); *Frank Lyon Co. v. U.S.,* 435 U.S. 561 (1978).

[77] *See Suzy's Zoo v. Comr.,* 273 F.3d 875; *Paccar, Inc. v. Comr.,* 85 T.C. 754; *Robert Bosch Corp. v. Comr.,* T.C. Memo 1989-655; Rev. Rul. 83-59, 1983-1 C.B. 103; PLR 200328002.

[78] 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.

[79] 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 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 over the manufacturing process, this factor should weigh in favor of treating the contractor as the producer of the property. Perhaps this conclusion is reinforced by the Notice's reference to the principles under §936, which, as discussed above, would attribute contract manufacturing activity to a principal in cases where the principal directly supervises the contract manufacturer.

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cludes the right to intellectual property incorporated into the property.[80]

Although no single one of these factors is determinative as to which party is the owner of property, the most important factors in the court cases relate to the nature of the economic outcome that the parties will experience with respect to the subject property.[81] In assessing the potential for profit or loss outside of the contract manufacturing context, the authorities 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. Thus, although often stated as a separate factor, the right to control the disposition of the property — i.e., whether one party has the right to compel another to purchase the property and, conversely, whether a party can require another person to transfer the property to it — is really subsumed under the factor of opportunity for economic gain or loss.

We next consider the application of the traditional indicia of benefits and burdens of ownership to contract manufacturing arrangements.

Applying the Benefits and Burdens Standard to Contract Manufacturing

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 generally 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 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 cases, whether the contractor is legally compelled to sell particular items of custom manufactured property to the customer or could instead fulfill the contract by manufacturing replacement items is moot, because the property will be valuable only to the customer and will have only scrap value to the contractor.[82] Furthermore, the customer often retains ownership of intangibles, such as patents, copyrights, and trademarks, which are incorporated into the finished product.[83] 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 standard 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. Thus, for purposes of determining which taxpayer is the owner of property produced pursuant to a contract manufacturing arrangement, all of the benefits and burdens of ownership must be 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

[80] *Suzy's Zoo v. Comr.*, 114 T.C. 1 (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, 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).

[81] *See, e.g., 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, based on such factors as title, possession, and the right to receive excess proceeds from any actual sale of the debt); *Illinois Power Co. v. Comr.*, 87 T.C. 1417 (1986) (holding that the potential for profit or loss is a significant factor in analyzing a sale-leaseback transaction). *Compare American National 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 National 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 National Bank of Memphis v. U.S.*, 426 F.2d 115 (6th Cir. 1970); *Paccar, Inc. v. Comr.*, 85 T.C. 754; *Robert Bosch Corp. v. Comr.*, T.C. Memo 1989-655.

[82] *See Frank G. Wikstrom & Sons, Inc.*, 20 T.C. 359 (1953) (reasoning 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 contractor and therefore subject to the cost capitalization rules); *The Fame Tool & Manufacturing 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).

[83] *Suzy's Zoo v. Comr.*, 114 T.C. 1 (2000), *aff'd*, 273 F.3d 875 (9th Cir. 2001).

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contractor has been held to be the owner of the property being produced.[84]

For example, 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 has other indicia of ownership, such as risk of loss, ownership of intangibles used in the manufacturing process, and discretion to decide how to produce the property, and the contractor is subject to a wide range of possible economic outcomes from its production activity. Regarding this last factor, although a contractor that is compelled to sell its output to the principal may not have the benefits and burdens of fluctuations in the value of the property, the contractor nonetheless may be subject to a wide range of economic outcomes from its manufacturing activities, such as, for example, where a contractor is paid on a per piece basis and the manufacturing process is complex and variable. Similarly, for purposes of §199, contractual terms that establish a relatively wide range of possible financial outcomes for the contractor should militate in favor of treating the contractor as the owner.

The examples in the regulations confirm the foregoing conclusions.[85] In the first example, the principal hires a contract manufacturer to produce a machine for which the principal owns the design. The contract provides that the contract manufacturer may only use the design in the production process and has no right to exploit the intellectual property — i.e., the contractor cannot sell the produced property to anyone other than the principal. Nonetheless, because the contractor (1) controls the manufacturing process, (2) has legal title and the risk of loss during the manufacturing process, and (3) is paid a fixed price, with the result that the contractor is subject to economic gain or loss upon the sale of the machine, the example concludes that the contractor is the tax owner and therefore is treated as the manufacturer of the machine for purposes of §199.

The second example is less illuminating. It provides that a principal hires a contractor to produce a machine for which it owns the design. We are told that the contract is a cost-reimbursable contract and that the principal has the benefits and burdens of ownership of the machine while it is being produced, although the contractor has legal title. The example concludes that the principal is treated as the manufacturer of the machine. The example is, of course, not particularly illuminating because it states as an assumption that the principal has the benefits and burdens of ownership. However, the example does demonstrate that a principal can be the tax owner of goods produced for it under contract, even when the principal lacks legal title to the work-in-process.

3. Opportunities and Traps for Cross-Border Contract Manufacturing and the TIPRA Wage Limitation

Where both the principal and the contractor are domestic corporations, the §199 benefit usually will be maximized if the transaction is structured so that the principal is treated as the tax owner of the work-in-process inventory, since the principal's return on its intangibles and distribution activities is likely to be higher than the contractor's return on its manufacturing activities. However, this would not be the case if, for example, the principal planned to retain the QPP for use in its business (i.e., would not earn gross receipts from a sale or other disposition of the QPP) or if the principal expected to report a taxable loss for the year, since the §199 deduction is limited by taxable income.

The considerations differ, however, if the principal is a foreign corporation. If a foreign corporation enters into a consignment manufacturing arrangement with a domestic corporation in which the foreign corporation has the benefits and burdens of the work-in-process inventory, the foreign corporation would be treated as the manufacturer of the product for §199 purposes. The foreign corporation, however, may not be able to utilize the deduction because of its U.S. tax position. In this situation, it may be desirable for the parties to restructure the arrangement as a traditional

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[84] *See, e.g.*, PLR 200328002. The Tax Court's holding in *Suzy's Zoo v. Comr.*, 114 T.C. 1, however, has created some uncertainty regarding whether a contract manufacturer that is compelled to sell its output to a customer can ever be the tax owner for purposes of the uniform capitalization rules under §263A. This conclusion reads too much into the Tax Court opinion. For a lengthy discussion of *Suzy's Zoo*, see Granwell & Rolfes, "The Domestic Production Activities Deduction: Opportunities, Pitfalls & Ambiguities for Domestic Manufacturers: Part I," *Tax Mgmt. Memo.* 288 (7/11/05). More 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. The reasoning in PLR 200328002, however, was based in part on the additional facts and circumstances that are relevant under §263A, such as the complexity of and value added by the contractor's manufacturing process, which appear not to be relevant under the traditional benefits and burdens standard. See the discussion above regarding Treasury's rejection of the applicability of these "additional facts and circumstances" for purposes of the benefits and burdens standard under §199.

[85] Regs. §1.199-3(f)(4) *Exs. 1, 2*. The regulations also contain a third example dealing with the treatment of contractors and subcontractors that produce property for the federal government pursuant to the Federal Acquisition Regulations (Title 48, Code of Federal Regulations). This example illustrates the application of special rules in the regulations providing that government contractors generally are treated as the tax owner of property produced under such contracts, despite the fact that title to the property passes to the federal government prior to the completion of the manufacturing process. *See* Regs. §1.199-3(f)(2), (3).

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buy-sell contract manufacturing arrangement in order to obtain a §199 benefit for the contractor. The principal may then be able to negotiate to share in the value of the deduction through a reduced price for the manufactured goods. In seeking to maximize benefits under §199, care should be taken by the foreign corporation that it does not unknowingly risk additional exposure to U.S. taxation.[86]

Planning opportunities for contract manufacturing may have a limited shelf life because of the 2005 TIPRA amendment relating to wages. For taxable years, beginning after May 17, 2006, only wages allocable to DPGR may be taken into account for purposes of the rule that limits the total amount of the §199 deduction to 50% of the taxpayer's W-2 wages reported during the year. Thus, depending on the circumstances of the taxpayer, the wage limitation may prevent a principal in a contract manufacturing arrangement from claiming a §199 deduction because it has no employees that are engaged in production activities.

Apart from contract manufacturing, this limitation will have a significant impact on many taxpayers, including taxpayers operating primarily through partnerships, where another partner provides all of the employees used in the partnership's production activities. Also, for those taxpayers that utilize independent contractors or leased employees, the 2005 TIPRA amendment will not be a beneficial change.

Finally, we note that in a colloquy between Senators Charles Grassley (R-Iowa) and Max Baucus (D-Mont), chairman and ranking member, respectively, of the Senate Finance Committee, both members pledged to reconsider the 2005 TIPRA change if it had the unintended effect of depriving taxpayers of the benefit of §199.[87]

IV. The "In Whole or In Significant Part" Requirement

QPP must be MPGE in whole or in significant part by the taxpayer within the United States to qualify as DPGR.[88] QPP will be treated as MPGE in significant part by the taxpayer within the United States if the MPGE of the QPP by the taxpayer within the United States is "substantial in nature," taking into account all of the facts and circumstances.[89] Factors that reflect substantiality include (1) the nature of the property; (2) the relative value added by the taxpayer's MPGE activity within the United States; (3) the relative cost of the taxpayer's MPGE activity within the United States; and (4) the nature of the taxpayer's MPGE activity within the United States.[90] The MPGE of a key component of QPP of itself does not satisfy the substantial in nature requirement of the Final Regulations.[91] Thus, for example, if a taxpayer manufactures computer chips within the United States, installs the computer chips in the purchased computers and sells the finished computers to customers, the manufacture of the computer chip of itself is not substantial in nature, even though the computer chips are key components of the computers and the computers will not operate without them.[92]

The Preamble to the Final Regulations notes that although the language in the §199 substantial-in-nature requirement bears similarities to language in the definition of manufacturing under the subpart F regulations, the "two standards are different both in purpose and substance." The Preamble goes on to provide that:

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[86] If either a domestic or a foreign corporation enters into a contract manufacturing arrangement of any type in the United States, it should not overlook the rule contained in Regs. §1.863-3, dealing with the 50/50 source-of-income rule for income from the manufacture and sale of inventory that is produced in one country and sold in another. That rule precludes a principal from claiming that it manufactured property produced by a contractor for purposes of §863. Thus, even though a principal may be treated as the manufacturer for §199 purposes, it will not be treated as the manufacturer for applying the §863 source-of-income rule, with the result that, if title to the QPP passes outside of the United States, all of the income from the sale of the QPP may be treated as foreign source income. Regs. §1.863-3(c)(1)(i)(A). The preamble to the regulations sets forth the reasoning of the IRS with respect to this provision as follows:

> [P]roduction assets are limited to those owned directly by the taxpayer that are directly used by the taxpayer to produce the relevant inventory. These rules are intended, to insure that taxpayers do not attribute the assets or activities of related or unrelated parties manufacturing under contract with the taxpayer .... Treasury and the IRS, however, believe it is appropriate to limit production assets in the apportionment formula to assets owned by the taxpayer and used by the taxpayer to produce the inventory .... Further, it would be very difficult to draw a clear line between contract manufacturers and other suppliers. Thus, Treasury and the IRS do not believe the source of a taxpayer's income should take into account activities of others or assets owned by others with whom the taxpayer has manufacturing arrangements. The final regulations clarify, however, that this rule does not override the single entity rules set forth under §1.1502-13 (dealing with members of an affiliated group filing on a consolidated basis), or the rules under §1.863-3(g) dealing with partnerships.

T.D. 8687, 61 Fed. Reg. 60540 (11/29/96).

[87] 152 Cong. Rec. S4441-S4442 (daily ed. May 11, 2006).

[88] §199(c)(4); Regs. §1.199-3(g)(1).

[89] Regs. §1.199-3(g)(2).

[90] *Id.*

[91] *Id.*

[92] Regs. §1.199-3(g)(5) *Ex. 10.*

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Whether operations are substantial in nature is relevant under §954 in determining whether manufacturing has occurred. By contrast, the substantial-in-nature requirement is relevant in determining whether the MPGE activity, already determined to have occurred . . . was performed in whole or in significant part by the taxpayer within the United States. Accordingly, as stated in the preamble to Notice 2005-14, case law and other precedent under section 954 are not relevant for purposes of the substantial-in-nature requirement under section 199. Nor are they relevant for purposes of determining whether an activity is an MPGE activity under section 199. Similarly, the regulations under section 199 are not relevant for purposes of section 954."[93]

This explanation appears to be disingenuous. The incorporation of the subpart F manufacturing standards could have effectuated the purposes of §199. Under the §936 regulations, there is a regulation dealing with "whether a product is manufactured or produced by a possession corporation in a possession," which incorporates the rules for manufacturing under §954.[94] But we do not mean to fight battles that have been lost.

In addition to the substantial-in-nature test, the Notice and the Proposed Regulations provided a safe harbor under which the "in whole or in significant part" requirement would be satisfied if the taxpayer's conversion costs, defined as direct labor and related factory burden, to MPGE the property incurred within the United States accounted for 20% or more of the total CGS of the property.[95] This safe harbor is identical to the safe harbor contained in Regs. §1.954-3(a)(4)(iii) for purposes of determining whether a controlled foreign corporation should be treated as having manufactured a product when purchased components constitute part of the property sold. The Final Regulations also incorporate this safe harbor, with two modifications.[96]

Under the Final Regulations, the "in whole or in significant part" requirement is satisfied if the taxpayer's direct labor *and overhead* to MPGE the QPP within the United States account for 20% or more of the taxpayer's CGS, or, in a transaction without cost of goods sold (such as a lease, rental or license),[97] account for 20% of the taxpayer's unadjusted depreciable basis of the QPP. The Final Regulations substituted "overhead"[98] for the term "factory burden," which was the term imported from the analogous subpart F regulations, because commentators were unsure about the meaning of related factory burden. The Preamble provides that "[n]o inference is intended regarding any similar safe harbor under the Code, including the safe harbor in [Regs.] §1.954-3(a)(4)(iii)."[99]

The regulatory clarification is to be commended, but now we have one standard for §199 and another for subpart F, when the §199 safe harbor was derived from subpart F. Oh what a tangled web we weave!

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[93] Preamble, T.D. 9263.

[94] Regs. §1.936-5(b)(6) *Q&A-1*:

> Question 1: What is the test for determining, within the meaning of §954(d)(1)(A), whether a product is manufactured or produced by a possessions corporation in a possession?
>
> Answer 1: A product is considered to have been manufactured or produced by a possessions corporation in a possession within the meaning of §954(d)(1)(A) and §1.954-3(a)(4) if —
>
> (i) The property has been substantially transformed by the possessions corporation in the possession;
>
> (ii) The operations conducted by the possessions corporation in the possession in connection with the property are substantial in nature and are generally considered to constitute the manufacture or production of property; or
>
> (iii) The conversion costs sustained by the possessions corporation in the possession, including direct labor, factory burden, testing of components before incorporation into an end product and testing of the manufactured product before sales account for 20 percent or more of the total cost of goods sold of the possessions corporation.
>
> In no event, however, will packaging, repackaging, labeling, or minor assembly operations constitute manufacture or production of property. See particularly examples (2) and (3) of §1.954-3(a)(4)(iii).

[95] Notice 2005-14, §4.04(5)(c); Prop. Regs. §1.199-3(f)(3). The explanation portion of the Notice states that this rule "would operate similarly to the safe harbor provided under §1.954-3(a)(4)(iii) for determining whether . . . the sale of property is treated as the sale of a manufactured product rather than the sale of a component part, when purchased components constitute part of the property." Notice 2005-14, §3.04(5)(c).

[96] Regs. §1.199-3(g)(3)(i).

[97] This provision was added in response to comments that not all transactions yielding DPGR involve CGS. Preamble, T.D. 9263.

[98] For taxpayers subject to §263A, the Final Regulations define overhead as all costs required to be capitalized under §263A except direct materials and direct labor. For taxpayers not subject to §263A, overhead may be computed using any reasonable method that is satisfactory to Treasury based on all of the facts and circumstances, but may not include any cost that would not be required to be capitalized under §263A if the taxpayer were subject to §263A. For producers of tangible personal property, §174 research and experimental ("R&E") costs and the cost of creating intangible assets should not be treated as direct labor or overhead, and taxpayers should exclude such costs from their CGS (or unadjusted depreciable basis) for purposes of determining whether the taxpayer meets the safe harbor. Regs. §1.199-3(g)(3)(i).

[99] Preamble, T.D. 9263.

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Finally, as under prior guidance, for purposes of the "in whole or in significant part" test and the safe harbor, (1) packaging, repackaging, labeling, and minor assembly operations are disregarded and (2) §174 R&E activities are disregarded.[100]

V. Allocation of Below-the-Line Deductions

The Final Regulations continue to provide three methods for allocating and apportioning below-the-line deductions, consistent with the Notice and the Proposed Regulations: the §861 method, the simplified deduction method, and the small business simplified overall method.[101] If a taxpayer does not qualify for one of the simplified methods, the taxpayer must apply the §861 method.

The most important change made by the Final Regulations was to increase the limit for application of the simplified deduction method to include taxpayers who have either average gross receipts (over the three prior years) of $100 million or less or, alternatively, total assets at the end of the taxable year of $10 million or less.[102] Previously, the gross receipts prong of this test required a taxpayer to have gross receipts of $25 million or less.[103] Under this method, a taxpayer allocates deductions other than CGS based on the ratio of DPGR to total gross receipts.

The other development relates to taxpayers applying the §861 method. The IRS has announced that it will issue a revenue procedure granting taxpayers automatic consent to change certain elections relating to the apportionment of interest expense and research and experimental expenditures under §861.[104] Automatic consent is appropriate, because the application of the §861 regulations for purposes of §199 may lead taxpayers to reconsider previous elections.

Specifically, with respect to interest, the revenue procedure will provide taxpayers with guidance for obtaining automatic consent to make changes under Regs. §1.861-8T(c)(2) (change from FMV to tax book value method) and Regs. §1.861-9(i)(2) (change from FMV to alternative book value method). With respect to the apportionment of R&E, taxpayers will be granted automatic consent under Regs. §1.861-17(e) to change to either the sales or gross income method, which, absent consent, normally is binding for five years.

The automatic consent will be effective for a taxpayer's first taxable year beginning after December 31, 2004 (the taxpayer's 2005 year). In addition, Treasury intends to extend the automatic consent to a taxpayer's taxable year immediately following the taxpayer's 2005 taxable year, except with respect to changes in elections that first took effect in the taxpayer's 2005 taxable year.[105] This window ensures that taxpayers will be able to consider the implications of their §861 methods, taking into account not only foreign tax credit planning but also §199.

VI. EAGs and Consolidated Groups

With respect to EAGs and consolidated groups, the Final Regulations generally retain most of the substantive provisions of the Proposed Regulations, but add more specificity and several new examples. The Final Regulations made one significant change for consolidated groups, discussed below, by requiring that the overall 5% de minimis test be applied at the level of the consolidated group, rather than at the individual entity level, as under the prior guidance. In addition, the Final Regulations made several smaller changes that could have a significant impact on particular taxpayers in certain circumstances.

A. EAGs

Section 199 provides that "all members of an expanded affiliated group shall be treated as a single corporation for purposes of this section."[106] An EAG is an affiliated group as defined in §1504(a), determined by substituting a "more than 50%" vote-and-value ownership test for the "at least 80%" vote-and-value ownership test for consolidation, and by including certain insurance companies and §936 corporations.[107] The statute does not elaborate on what is meant by the requirement to treat all members of an EAG as a single corporation. A literal interpretation of this language would mean that transactions between members of an EAG are disregarded for purposes of computing a §199 deduction. All of the guidance,

[100] Regs. §1.199-3(g)(2). For taxpayers that elect to capitalize §174 costs to QPP under §263A, a rule of administrative grace permits taxpayers to exclude such costs as CGS or unadjusted basis for purposes of the safe harbor. Regs. §1.199-3(g)(3)(i).

[101] Regs. §1.199-4(a). Under the small business simplified overall method, all deductions, including CGS, are allocated based on relative gross receipts. Regs. §1.199-4(f)(1). This method, however, is only available to taxpayers with average annual gross receipts of $5 million or less and to certain taxpayers eligible to use the cash method of accounting. Regs. §1.199-4(f)(2).

[102] Regs. §1.199-4(e)(2). In the case of an EAG, this test is applied at the EAG level. Regs. §1.199-4(3)(3)(ii).

[103] *See* former Regs. §1.199-4(e)(2).

[104] Preamble, T.D. 9263.

[105] *Id.*

[106] §199(d)(4)(A).

[107] §199(d)(4)(B), as amended by §403(a)(10) of the Technical Corrections (2005 GOZA).

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however, has given short shrift to the requirement to treat the members of an EAG as one corporation.[108]

1. Recognition of Intra-EAG Transactions

Instead of providing that all members of an EAG are treated as a single corporation, as directed by the statute, all of the guidance actually provides that an EAG computes its §199 deduction by aggregating each member's *separately computed* QPAI, taxable income and W-2 wages.[109] Under the Proposed and Final Regulations, it is clear that transactions between members of an EAG are taken into account in computing each member's separate QPAI and, consequently, the EAG's total §199 deduction.[110]

Although the Notice is not entirely clear on this point, a careful reading of the anti-abuse rule included in the section dealing with EAGs reveals the drafters' intent that intra-EAG transactions generally would affect the amount of an EAG's §199 deduction:

> If a transaction between members of an EAG is engaged in or structured with a principle [sic] purpose of qualifying for, or modifying the amount of, the §199 deduction for one or more members of the EAG, adjustments must be made to eliminate the effect of the transaction on the computation of the §199 deduction.[111]

Since the anti-abuse rule is framed only in terms of transactions between members of an EAG, it is implicit that under the Notice such transactions generally are capable of increasing or decreasing a §199 deduction, provided they are not structured for that purpose. The Proposed and Final Regulations retain this anti-abuse rule in substantially similar form.[112]

Thus, it seems that taxpayers relying solely on the Notice would be taking a position contrary to the Notice if they disregarded intra-EAG transactions or redetermined their attributes in order to create the effect of treating the EAG members as one corporation for purposes of §199. However, given the statutory directive to treat an EAG as one corporation, query whether a reasonable basis might nonetheless exist for taking such a position under the Notice.

2. Attribution of Activities

As partial homage to the statutory directive that all members of an EAG should be treated as one corporation, all of the guidance generally provides that each member of an EAG is attributed the MPGE activities performed by the other members of the EAG.[113] This is important since, if an integrated taxpayer produces and sells QPP, all of the gross receipts derived from the sale of QPP qualify as DPGR, including gross receipts attributable to services such as marketing and distribution activities that are integral to the production and sale of the QPP.[114] Thus, if one member of an EAG produces a product and sells the product to another member, which acts as a distributor, all of the gross receipts earned by the second member on a subsequent resale of the product are eligible for treatment as DPGR, because the second member is attributed the MPGE activities of the first member.

The Proposed Regulations narrowed the attribution of MPGE activities relative to the Notice, and the Final Regulations restrict activity attribution even further. The Notice provided simply that, "[e]ach member of an EAG is treated as conducting the activities conducted by each other member of the EAG."[115] The Proposed Regulations restricted the attribution of activities for purposes of the application of both the "substantial in nature" test and the safe harbor to include only the "*previous* activities" (and not the subsequent activities) conducted by other members of the EAG.[116]

The Final Regulations retain this restriction.[117] Thus, an EAG member that acts as a buy-sell distributor of finished product that is produced by another member of the EAG within the United States will get the benefit of §199. In contrast, under the Proposed and Final Regulations, an EAG that consolidates the purchase of raw materials in one entity, which sells the purchased materials to other members of the EAG for their use in U.S. production activities, will not get the benefit of §199 on the profit earned by the entity engaged in the consolidated purchasing activities.

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[108] Treasury officials have informally indicated that they believe Congress's sole purpose for the rule providing that all members of an EAG are treated as a single corporation was to prevent taxpayers from segregating loss activities from activities that generate QPAI.

[109] Regs. §1.199-7(b); Prop. Regs. §1.199-7(b); Notice 2005-14, §4.09(2)(a). Once each member of an EAG has computed its separate QPAI, each member's separate 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. The EAG's deduction is then allocated among the members in proportion to their relative amounts of QPAI, if any. Regs. §1.199-7(b), (c). *See also* Regs. §1.199-7(e) *Ex. 9*.

[110] In terms of the Proposed Regulations, see Prop. Regs. §1.199-7(a), (e) *Ex. 1*. In terms of the Final Regulations, see Regs. §1.199-7(a), (e) *Exs, 1, 3, 5*.

[111] Notice 2005-14, §4.09(2)(c).

[112] Regs. §1.199-7(a)(5); Prop. Regs. §1.199-7(a)(5).

[113] Regs. §1.199-7(a)(3); Prop. Regs. §1.199-7(a)(3); Notice 2005-14, §4.09(2)(b).

[114] See the discussion of contract manufacturing, above.

[115] Notice 2005-14, §4.09(2)(b).

[116] Prop. Regs. §1.199-3(f)(2), (3) (dealing with the substantial in nature test and the safe harbor test).

[117] Regs. §1.199-7(a)(3).

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Similarly, if (1) one member of an EAG purchases raw materials and performs MPGE activities thereon that are insufficient in themselves to satisfy either the safe harbor or the substantial in nature test, and (2) that member sells the work-in-process to a second EAG member that performs further processing to complete the finished product, under the Proposed and Final Regulations, the second member would be able to take into account the previous MPGE activities of the first member in determining whether its gross receipts from selling the finished product are DPGR, whereas the first member would not be able to take into account the future activities of the second member in determining whether its gross receipts from the sale of the work-in-process qualify as DPGR. This restriction seems unjustified in light of the statutory mandate to treat all members of an EAG as one corporation for purposes of §199.

The Final Regulations further restrict the attribution of activities between members of an EAG, by requiring that, in order for a member earning gross receipts from a disposition of QPP to be attributed the previous MPGE activities of another member, the disposing member must be a member of the same EAG as the member whose activities are being attributed *at the time that the disposing member disposes of the QPP*.[118] Neither the Notice nor the Proposed Regulations contained this restriction.[119]

As set forth in the following discussion of consolidated groups, the Final Regulations contain an example that we believe incorrectly applies this restriction in the context of a departing member of a consolidated group.

B. Consolidated Groups

As a consequence of Treasury's decision generally to give effect to transactions among members of an EAG for purposes of §199, consolidated groups must take the consolidated return rules into account in calculating QPAI for a given taxable year. Although the Notice did not address the application of the consolidated return rules, the Proposed and Final Regulations acknowledge that the rules under Regs. §1.1502-13 for intercompany transactions apply for purposes of determining the effect of an intercompany transaction under §199.[120] Because the Proposed and Final regulations do not contain new substantive rules regarding the application of Regs. §1.1502-13 to determine QPAI, but merely contain examples demonstrating how these rules apply in the context of §199, the consolidated return rules will apply regardless of which guidance a taxpayer applies for Pre-Effective Date Years.

1. Application of the Intercompany Rules under §199[121]

a. The Intercompany Rules, Generally

An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction.[122] As under Regs. §1.1502-13, we refer to a member transferring property or providing services to another member as S, and B is the member receiving the property or services.

In general, S's income, gain, deduction, and loss from an intercompany transaction are its "intercompany items."[123] For example, S's gain from the sale of property to B is intercompany gain. An item is an intercompany item whether it is directly or indirectly from an intercompany transaction.[124] In addition, S's related costs incurred to generate intercompany items are also intercompany items.[125] Thus, S's costs of producing the property sold to B are also intercompany items that may be deferred and/or recharacterized under the consolidated return rules.

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[118] Regs. §1.199-7(a)(3). There is a taxpayer-favorable side to this rule. So long as the disposing member and the MPGE member are members of the same EAG at the time of the disposition, the disposing member is attributed the MPGE activities of the MPGE member even if the disposing member and the MPGE member were unrelated at the time the MPGE activities occurred. Regs. §1.199-7(a)(4) *Ex. 5.*

[119] *See* Prop. Regs. §1.199-7(a)(3) (providing only that "... the disposing member is treated as conducting the activities conducted by each other member of the EAG"); Prop. Regs. §1.199-7(a)(2)(ii) ("If a corporation becomes or ceases to be a member of an EAG, the corporation is treated as becoming or ceasing to be a member of the EAG at the end of the day on which its status as a member changes."); Notice 2005-14, §4.09(2)(b).

[120] Regarding the Proposed Regulations, see Preamble, REG-105847-05, 70 Fed. Reg. 67220 (11/4/05), and Prop. Regs. §1.199-7(d), (e) *Exs. 2, 4.* Regarding the Final Regulations, see Regs. §1.199-7(d) (providing that Regs. §1.1502-13 applies to determine the timing for recognizing DPGR from an intercompany transaction), Regs. §1.199-7(e) *Exs. 2, 4, 6, 7, 8.*

Importantly, the Preamble to the Final Regulations actually overstates the effect of the consolidated return rules under §199, stating "[a]s specifically noted in the preamble to the proposed regulations, the regulations under §1.1502-13(c) already ensure that the section 199 deduction cannot be reduced on account of an intercompany transaction." Preamble, T.D. 9263. This is an overstatement, because, as discussed below, the acceleration rule under Regs. §1.1502-13(d) should be able to affect the amount of a §199 deduction. See the discussion of Regs. §1.199-7(e) *Ex. 10,* below.

[121] The authors would like to thank Andy Dubroff, John Broadbent, and George White for their thoughtful comments on an earlier draft of this section.

[122] Regs. §1.1502-13(b)(1)(i).

[123] Regs. §1.1502-13(b)(2)(i).

[124] *Id.*

[125] *See* Regs. §1.1502-13(b)(2)(ii). This is important under §199 because S's income and related CGS are both subject to attribute redetermination.

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B's income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction, are its corresponding items.[126] For example, if B pays rent to S, B's deduction for the rent is a corresponding deduction. If B buys property from S and sells it to a nonmember, B's gain or loss from the sale to the nonmember is a corresponding gain or loss; alternatively, if B recovers the cost of the property through depreciation, B's depreciation deductions are corresponding deductions. An item is a corresponding item whether it is directly or indirectly from an intercompany transaction (or from property acquired in an intercompany transaction).[127]

Under the single-entity concept, Regs. §1.1502-13(c) (the "matching rule") generally redetermines the timing, character, and other attributes of intercompany items and corresponding items as if the members participating in the transaction were divisions of a single corporation.[128] The consolidated return rules do not, however, change the location or amount of items of income or expense.[129] That is, the consolidated return rules generally do not redetermine which entity recognizes an item of income or expense.

The term "attributes" is defined in an open-ended fashion as all of the intercompany or corresponding item's characteristics (except amount, location, and timing) necessary to determine the item's effect on taxable income and tax liability.[130] Whether an item is included in the computation of QPAI, either as DPGR or as a cost allocable against DPGR, obviously affects the computation of consolidated taxable income.[131]

Thus, although the guidance does not generally give effect to the statutory directive to treat an EAG as one corporation for purposes of §199, the consolidated return rules generally do accomplish this result in the context of a consolidated group, by recharacterizing the attributes of, and the timing for recognizing, intercompany transactions in order to create the result as if the two members were divisions of a single corporation.

b. Application to §199

Regs. §1.199-7(e) contains several examples demonstrating the application of the consolidated return rules in the context of §199. The aspects of the examples dealing with attribute redetermination are summarized below. In our view, the final example included below, Example 10, misapplies the consolidated return rules.

The regulations counterpose several of the examples involving intercompany transactions against examples involving similar transactions between non-consolidated members of an EAG, demonstrating that single-entity treatment generally does not apply for purposes of §199 in the EAG setting. It is interesting to note that Regs. §1.199-7(d)(5) requires a consolidated group's §199 deduction to be allocated to the group's individual members in proportion to each member's QPAI, computed *without regard* to any redetermination under Regs. §1.1502-13(c) of a member's receipts, CGS, or other deductions from an intercompany transaction. Accordingly, the rules for determining an EAG's QPAI on a separate entity basis are more relevant to consolidated groups than might at first appear.

Example 2 under Regs. §1.199-7(e) deals with an intercompany rental of a machine from S to B (X and Y in the example, respectively), where B uses the machine to produce qualifying QPP. The example concludes that S's rental income should be redetermined as DPGR and S's depreciation expense on the machine should be allocated against DPGR. Since B's rental payments increase, dollar-for-dollar, B's cost of goods sold that is allocable to B's DPGR, redetermining S's intercompany income as DPGR results in the consolidated group having the same QPAI as it would have had if S and B were divisions of the same company.

As discussed above, Regs. §1.1502-13(c)(1) requires the separate entity attributes of S's intercompany items and B's corresponding items to be redetermined "to the extent necessary" to produce the same effect on consolidated taxable income as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions. Presumably, Example 2 correctly recharacterizes S's intercompany items as related to DPGR, since B's corresponding deductions offset B's own DPGR. That is, Regs. §1.1502-13(c) must recharacterize something to prevent the group's QPAI from being artificially reduced by B's corresponding deductions, and recharacterizing S's items as related to DPGR accomplishes this result.

It should be noted, however, that the group's total QPAI also would be unaffected by the intercompany transaction if, instead of recharacterizing S's rental receipts and depreciation expense as related to DPGR, B's deductions for the rental payments were recharacterized as being allocable to non-DPGR. The regulations provide a tiebreaker, however, for this situation,

[126] Regs. §1.1502-13(b)(3)(i).

[127] *Id.*

[128] Regs. §1.1502-13(a)(2).

[129] *Id.*

[130] Regs. §1.1502-13(b)(6).

[131] *Cf.* PLRs 200048034, 199936045 (applying this reasoning in the FSC context to redetermine intercompany royalties as foreign trading gross receipts for purposes of computing deductible commissions to a FSC).

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where redetermining either S's or B's items could achieve the effect of treating S and B as divisions. In this situation, Regs. §1.1502-13(c)(4)(i)(A) provides that the attributes of S's intercompany items should be redetermined to conform to the attributes of B's corresponding deductions.[132] This rule would seem to govern in Example 2, since redetermining S's intercompany items as related to DPGR is sufficient for the group's total QPAI to equal that which it would have been if S and B were divisions.[133]

In contrast to Example 2, Example 1 under Regs. §1.199-7(e), dealing with the same facts in the context of a non-consolidated EAG, concludes that S's (X's in the example) gross receipts do not qualify as DPGR because, although S MPGE the machine in the United States, the related party rents do not qualify as DPGR under §199(c)(7).[134] Thus, in a non-consolidated setting, the intra-EAG rental creates leakage of QPAI to the extent of S's net income from the rental.

Example 4 under Regs. §1.199-7(e) deals with an intercompany license from S to B (P and S in the example resepctively), where B uses the licensed intangible to produce qualifying QPP. The example concludes that S's royalty income should be redetermined as DPGR and, because S anticipated during the development of the intangible that the intangible would be used in the production of QPP, S's cost of developing the intangible should be allocated against DPGR. Example 4 presents the same type of consolidated return issues as Example 2.

Example 4 is counterposed against Example 3 under Regs. §1.199-7(e), dealing with the same facts but in a non-consolidated EAG setting. Example 3 concludes that, due to the application of §199(c)(7), as well as the fact that the intangible is not QPP, S's royalty income is not DPGR. This fact pattern is not uncommon. A common state tax-minimization strategy (that has been vigorously challenged by various states) is to locate intangibles in a Delaware subsidiary that is paid royalties by manufacturing members. Absent the application of the attribute redetermination rules under Regs. §1.1502-13(c)(1), the producing member would have to reduce its QPAI by the applicable royalty expense, whereas the Delaware subsidiary, though treated as a manufacturer under the EAG activity attribution rule, would not have gross receipts derived from sales. Thus, in the non-consolidated EAG context, the intra-EAG royalty creates leakage of QPAI to the extent of S's net royalty income.

Example 6 under Regs. §1.199-7(e) deals with a situation where, in Year 1, S ("A" in the example) produces QPP that it sells to B, which, in Year 2, sells the QPP to unrelated persons. The example also provides that the consolidated group uses the simplified deduction method of allocating below-the-line deductions. The example concludes that: (1) S's revenue from the intercompany sale is deferred until Year 2, when B sells the QPP to unrelated persons; (2) S's revenue is redetermined to be non-DPGR and as not being gross receipts for purposes of allocating costs between DPGR and non-DPGR; and (3) notwithstanding that S's gross receipts are redetermined to be non-DPGR, S's CGS is allocated against DPGR, since it is allocable to the group's DPGR; and (4) B's CGS is redetermined to be allocable to non-DPGR.

In Example 6, attribute redetermination applies to a greater extent than in Examples 2 and 4. Here, the attributes of certain of S's intercompany items (i.e., S's revenue from the intercompany sale) as well as certain of B's corresponding items (i.e., B's CGS from B's sale to a third party) are redetermined. In the earlier examples, only S's items were redetermined, with the result that, even after the application of the attribute redetermination rules, the group's total DPGR and total expenses allocable thereto were higher, by offsetting amounts, than what they would have been if S and B were merely divisions. Nonetheless, in the earlier examples, the redetermination of S's receipts as DPGR and of its related expenses as allocable thereto was sufficient to ensure that the group's QPAI, and therefore its consolidated taxable income, were equal to what it would have been had S and B been divisions of the same company.[135]

This would not be the case in Example 6, where we are told to assume that the consolidated group allocates its below-the-line expenses under the simplified deduction method. Under that method, below-the-line expenses are allocated between DPGR and non-DPGR based on the group's ratio of DPGR to non-DPGR. Accordingly, attribute redetermination must apply to a greater extent, in order to ensure that the group's ratio of DPGR to non-DPGR is equal to what it would have been if S and B were merely divisions.

In the previous examples, below-the-line expenses were allocated under the §861 method, which gener-

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[132] Regs. §1.1502-13(c)(4)(i)(B) provides that B's attributes should instead be redetermined where this result would be more consistent with treating S and B as divisions of the same company. This situation is demonstrated in Example 6, discussed below.

[133] The result in Example 2 also is consistent with PLRs 200048034 and 199936045, where, in the FSC context, the IRS similarly opted to recharacterize S's income as foreign trading gross receipts for purposes of computing deductible commissions to a FSC rather than to recharacterize B's corresponding deduction as not being allocable thereto.

[134] Under §199(c)(7), DPGR does not include any gross receipts derived from property leased, licensed, or rented by the taxpayer for use by a related person.

[135] *See* Regs. §1.1502-13(c)(1)(i) (providing for the redetermination of attributes to the extent necessary to produce the same effect on consolidated taxable income as if S and B were divisions of a single company).

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ally emphasizes factual relationships between expenses and the classes of gross income to which they relate. However, when an expense is found to relate to a class of gross income that is broader than the relevant "statutory grouping" (i.e., DPGR), apportionment factors are used to allocate the expenses between the statutory grouping and the "residual grouping" (i.e., non-DPGR).[136] Based on the reasoning of Example 6, it would seem that in any case where an apportionment factor based on gross receipts is used under the §861 method to allocate expenses between DPGR and non-DPGR, taxpayers will have to apply attribute redetermination "to the extent necessary" in order to arrive at a total DPGR and non-DPGR that is equal to that which would have been achieved if the consolidated group were a single corporation.

It is interesting to note that, although Example 6 takes a radically different approach to attribute redetermination than that taken in Examples 2 and 4, the particular approach taken to attribute redetermination — that is, whether it is S's or B's items, or both, that are redetermined — should not have any effect on the final determination of S's and B's separate taxable income. This is because Regs. §1.199-7(d)(5) provides that a consolidated group's total §199 deduction is allocated among the member's based on each member's QPAI, *computed without regard to the Regs. §1.1502-13(c) process*. Thus, although in Examples 2 and 4, S's income is redetermined to be DPGR, S will not be allocated any of the group's §199 deduction, since, under §199(c)(7) (which prohibits related party leases or licenses from generating DPGR), S would not have earned any QPAI but for the application of the attribute redetermination rules. In Example 6, if S and B did not join in filing a consolidated return, S and B would have each earned QPAI for their respective sales, since §199(c)(7) does not apply to sales. Thus, although in Example 6 S's gross receipts from the intercompany sale are redetermined to be non-DPGR, and B's cost of goods sold is redetermined to be related to non-DPGR, both S and B will be allocated the portion of the §199 deduction generated by the intercompany transaction and the subsequent third party transaction that corresponds to S's and B's relative net income from the two transactions.

Examples 7 and 8 under Regs. §1.199-7(e) both deal with a situation where S ("A" in Example 8) manufactures property and sells the property to B for use in B's business. In both examples, if S and B were members of a non-consolidated EAG, S's gross receipts would be DPGR, since §199(c)(7) does not apply to related party sales. Under the consolidated return rules, however, both examples conclude that S's gross receipts (when recognized pursuant to the timing rules) are redetermined to be non-DPGR and S's costs are redetermined to be allocable to non-DPGR.

Example 7 states explicitly that B does not generate DPGR in its business. Presumably the same assumption applies in Example 8, since if the property S sold to B were used by B to produce DPGR, attribute redetermination would be necessary to the extent greater costs were allocable to B's DPGR as a result of the intercompany transaction.

Example 10 under Regs. §1.199-7(e) deals with essentially the same facts as Example 6, except that the common parent of B and S (S and T in the example, respectively) sells 60% of the stock of B in Year 2, before B sells the QPP to unrelated persons. The results under Example 10 remain the same as under Example 6 in Year 1 because there is no sale to an unrelated person in Year 1. In Year 2, B is deconsolidated. Under Regs. §1.1502-13(d), S takes the intercompany transaction into account immediately before B becomes a non-member of the consolidated group. The example concludes summarily, "[i]n order to produce the same effect as if [S] and [B] were divisions of a single corporation, [S]'s gross receipts from the sale of the QPP to [B] are redetermined under Regs. §1.1502-13(c)(1)(i) as non-DPGR. Further, because [S] and [B] are not members of the same EAG when [B] sells the QPP to the unrelated person, and because [S]'s transfer of the QPP to [B] did not take place in a transaction to which §381(a) applies, [B] is not treated as conducting the activities conducted by [S] in determining if [B]'s receipts are DPGR, notwithstanding that [S] and [B] were members of the same EAG when [S] MPGE'd the QPP and when [S] sold the QPP to [B]. Accordingly, neither [S]'s consolidated group nor [B] will have DPGR with respect to the QPP.[137]

Not only does this *seem* like a ridiculous result, but the example appears to misapply the rules under Regs. §1.1502-13 in two respects: (1) the consolidated return rules would treat S's income from the accelerated intercompany item as DPGR, and (2) the consolidated return rules would continue to attribute S's pre-deconsolidation MPGE activities to B following the deconsolidation. The rules under Regs. §1.1502-13 are quite clear and specific on these points.

The treatment of an intercompany transaction that is triggered by the deconsolidation of a member is de-

[136] For a detailed discussion regarding the application of the §861 method for purposes of computing QPAI, see Granwell & Rolfes, "The Domestic Production Activities Deduction: Demystifying the International Aspects," *Tax Mgmt. Int'l J.* 411 (8/12/05).

[137] *Compare* Regs. §1.199-7(a)(4) *Ex. 4* (dealing with a similar fact pattern in the context of a non-consolidated EAG and reaching the same result).

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termined under Regs. §1.1502-13(d) (the "acceleration rule"). Under Regs. §1.1502-13(d)(1)(ii)(A)(1), when the item triggered by the deconsolidation is from an intercompany sale, its attributes are determined under the principles of the matching rule as if B sold the property to an unrelated person[138] immediately before B becomes a non-member, for a cash payment equal to B's adjusted basis in the property (i.e., at no net gain or loss). Had B sold the QPP to a nonmember at no gain or loss prior to becoming a nonmember, S's intercompany gain would have been triggered and S's gross receipts would have qualified as DPGR under the matching rule.

Furthermore, under Regs. §1.1502-13(d)(2), the attributes of B's corresponding items continue to be redetermined under the principles of the matching rule; however, the attributes of B's corresponding items are determined as if the S division (but not the B division) was transferred by the single corporation to an unrelated person. Thus, the regulation provides "S's activities (and any applicable holding period) before the intercompany transaction continue to affect the attributes of the corresponding items (and any applicable holding period)."[139] Therefore, the consolidated return rules contain their own activity attribution rule for pre-deconsolidation activities. This makes sense, since, under the single-entity approach, these activities took place when S and B were divisions of the same company and, therefore, attribution continues to be appropriate following the deconsolidation. Thus, in the example, after the deconsolidation B would continue to be attributed S's MPGE activities that occurred prior to the deconsolidation, with the result that B's subsequent sale of the QPP would generate DPGR to B.[140]

The Government's Interpretation of Example 10

Based on informal conversations with IRS personnel, the government currently stands by the result in Example 10, but acknowledges that the reasoning behind the result may need to be clarified. Under the government's view, the result in Example 10 is consistent with the result that would follow if S and B were merely divisions of the same company, and the company sold the B division in a taxable transaction.

In that case, the government would argue, S's intercompany item would not generate DPGR because, if S and B were in fact divisions of a single company, the intercompany transaction would not exist, and, therefore, by definition, S's intercompany item would not generate DPGR. With respect to B's corresponding item, the government believes that, where, as in Example 10, it is B rather than S that is sold, single-entity treatment requires that B's subsequent sale of the QPP would generate non-DPGR. If, on the other hand, S is sold, B's subsequent sale of the QPP would generate DPGR.

The reason the government believes that single-entity treatment requires the result for S's intercompany item and B's corresponding item to turn on which entity leaves the group is best demonstrated through an example involving the application of §199 to a stand-alone corporation that sells a division.

> *Example.* Corporation C has two divisions: Division S, which produces toy cars, and Division B, which consists of stores that sell the toy cars produced by Division S. At the end of Year 1, Division B has 10 toy cars in its inventory that were produced by Division S during the year. In Year 2, before Division B sells any of the 10 toy cars to customers, Corporation C sells Division B to Corporation F, an unrelated person, in a transaction to which §381(a) does not apply.

In the government's view, no DPGR is generated from the transactions illustrated in the example. Where S and B are truly divisions of a single company, S's intercompany transaction does not exist. Furthermore, under §199, when Division B (now Corporation F) subsequently sells the 10 toy cars, Corporation F will not earn DPGR from the sale. Corporation F did not manufacture the cars. There is no attribution of MPGE activities between Corporation C and Corporation F, since they are not members of the same EAG. In fact, the Final Regulations go so far as to provide that, contrary to the situation for a §381(a) transaction,[141] even when a business is transferred by a taxpayer to a transferee-entity in a §351 or §721 transaction, the determination of whether gross receipts subsequently derived by the transferee are DPGR is based solely on the activities performed by the transferee, without any attribution of the activities performed by the transferor prior to the contribution

[138] If, however, B continued to be related to S following the deconsolidation, B would be treated in the hypothetical sale as selling the property to a related person. Regs. §1.1502-13(d)(1)(ii)(A)(1).

[139] Regs. §1.1502-13(d)(2)(i)(B).

[140] *See also* Regs. §1.1502-13(d)(3) *Ex. 2*.

[141] If a corporation acquires the assets of another corporation in a transaction to which §381(a) applies, then the acquiring corporation is treated as having performed the activities of the target corporation with respect to the acquired assets of the target corporation. Therefore, to the extent that the acquired assets of the target corporation would have given rise to DPGR in the hands of the target corporation, such assets will give rise to DPGR if leased, rented, licensed, sold, exchanged, or otherwise disposed of by the acquiring corporation. Regs. §1.199-8(e)(3).

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of the property.[142] Although the policy behind this rule is questionable,[143] it leaves no room for doubt that Corporation F would not be treated as the manufacturer of the 10 toy cars as a result of acquiring a former division of Corporation C in a taxable acquisition. Thus, the government asserts that, in this example, no DPGR would accrue to Corporation C or Corporation F from the manufacture of the 10 toy cars.

This example can be contrasted with a second example where, instead of selling Division B, Corporation C sells Division S. In this case, the 10 toy cars would remain in Corporation C, with a cost basis equal to S's cost of producing the cars, and Corporation C, as the manufacturer of the cars, would earn DPGR when it subsequently sold the toy cars.

Accordingly, it seems to be the government's view that, if in Example 10 the stock of S had been sold instead of the stock of B, both S's intercompany item and B's corresponding item would generate DPGR, since that result would best replicate single entity treatment. At a minimum, the IRS should clarify its reasoning and put taxpayers on notice that a different result would follow if S were deconsolidated rather than B.

IRS personnel have informally acknowledged that the acceleration rule might technically apply as set forth above in our analysis of Example 10, with the result that both S and B would earn DPGR from the transactions. Nonetheless, the government believes that such a literal application would reach the wrong result on the facts of Example 10, since if S and B in fact were divisions of a single corporation, no DPGR would result from the transactions. Accordingly, even if the acceleration rule technically applied as set forth in our analysis above, the government's current view is that some overarching attribute redetermination should apply to override the technical application of the acceleration rule in order to ensure that no DPGR results from the transaction described in Example 10.

Our Response to the Government's View of Example 10

First, we as the authors do not agree that the results in Example 10 are consistent with that which would apply if a single entity sold Division B in a taxable transaction. Of course, if S and B were actually divisions of a single corporation, Division S would not generate DPGR (or taxable income for that matter) from a mere transfer of QPP to Division B. However, if the corporation subsequently sold the assets of Division B to an unrelated person, the QPP (e.g., the 10 toy cars) transferred from Division S would be among the assets sold. Thus, in the toy car example, Corporation C would generate QPAI from the sale of Division B to the extent that the purchase price for Division B that is allocable to the 10 toy cars exceeded Division S's cost of producing the cars. Accordingly, we disagree with the government's view that the result in Example 10 (i.e., no DPGR generated upon the sale of the stock of B) replicates that which would apply if a true single entity sold Division B in a taxable sale.

The government's thinking is obviously influenced by the fact that there is no actual trigger event for S's intercompany item under Regs. §1.1502-13(c) (such as a sale by B of the subject property to a nonmember), with the result that the government is worried about prematurely generating DPGR. However, the recognition model under the acceleration rule analyzes S's intercompany items by viewing the sale of the S or B stock more like a sale of S's or B's assets outside the group, a transaction that clearly would generate DPGR. In Example 10, the government seems to want to respect the fact that B was sold in a stock sale rather than an asset sale, a transaction that would not generate any DPGR. The concept of a stock sale, however, is completely inconsistent with the single entity concept.[144]

There is an additional reason that S's intercompany item should be allowed to generate DPGR, even if, unlike the situation in Example 10, that result were not consistent with single entity treatment. Under the government's view, S's intercompany item should not generate DPGR because the transaction would not have existed, and therefore would not have created DPGR, if S and B were, in fact, divisions of the same corporation. Intercompany transactions, however, do exist. The acceleration rule is a recognition that intercompany transactions are actual transactions that cannot be disregarded. The rule applies to accelerate the

[142] Regs. §1.199-8(e)(1)(i). Activity attribution is also unavailable when property is distributed in a §731 transaction. *Id.* The rules regarding transactions between members of an EAG, transactions between EAG members and a related EAG partnership, and distributions from a qualified in-kind partnership under Regs. §1.199-9(i) operate as exceptions to this rule. *Id.*

[143] In the context of §351, *compare* Rev. Rul. 80-198, 1980-2 C.B. 113 (permitting a transferee corporation to deduct payments made to satisfy the trade accounts payable assumed in the §351 transaction, because the payments would have been deductible by the transferor if they had been paid by the transferor); Rev. Rul. 95-74, 1995-2 C.B. 36 (permitting a transferee corporation to deduct payments incurred to remediate land received in the §351 transaction that had been contaminated by the transferor's business, because the costs would have been deductible by the transferor if there had been no transfer and the costs had been incurred by the transferor).

[144] It is possible that the government is constructing a deemed §351 contribution by the single entity of the division that is sold, followed by a stock sale. However, it is hard to imagine why this hypothetical transaction would be preferable to following what Regs. §1.1502-13(d) actually says.

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recognition of S's and B's items "to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation."[145]

Thus, unlike the situation in Example 10, where triggering of S's intercompany item under the acceleration rule is consistent with single entity treatment (i.e., treating the sale of the B stock as a taxable sale of B's assets), the acceleration rule will apply in other cases to trigger recognition of intercompany transactions that would not be allowed to affect consolidated taxable income under a pure single entity approach. When a member departs the group at a time when there are intercompany transactions hanging in the balance, the rubber hits the road, so to speak, and the acceleration rule requires the intercompany items to be recognized and to affect consolidated taxable income, even if single entity treatment would disregard the intercompany transaction in perpetuity. When the acceleration rule requires S to recognize taxable income that would not exist if S and B were merely a divisions of a single corporation, S should not be denied §199 benefits for that taxable income on the grounds that such benefits would not exist if the two corporations were merely divisions, since, in that case, the taxable income would not exist either.

Thus, when an intercompany transaction is triggered by the acceleration rule, consolidated taxable income generally is affected by a transaction that would not have existed if the participating members were merely divisions of the same corporation. Accordingly, the acceleration rule is an exception to the general rule in Regs. §1.1502-13(a) providing that intercompany transactions should not affect consolidated taxable income. That is why the acceleration rule relies on hypothetical transactions with nonmembers in order to determine the attributes of intercompany transactions that are triggered by the acceleration rule. If the intercompany item is from an intercompany sale, exchange or disposition of property, and the acceleration event is the deconsolidation of S or B, the item's attributes are determined under the principles of the matching rule as if B had sold the property to a nonmember.

Accordingly, the Preamble to the Final Regulations overstates the effect of the consolidated return rules under §199, when it states "the regulations under §1.1502-13(c) already ensure that the section 199 deduction cannot be reduced on account of an intercompany transaction."[146] Because the acceleration rule allows consolidated taxable income to be affected in situations where single entity treatment can no longer be achieved, the acceleration rule should also be able to affect the amount of a §199 deduction.

Second, although we heed the IRS's point that allowing B to earn DPGR upon the subsequent sale of the QPP in Example 10 would represent a departure from pure single entity treatment, this departure is not a fluke but rather is the result intended under Regs. §1.1502-13(d). Accordingly, it is inappropriate to disregard the normal operation of the detailed provisions of the acceleration rule based on a general notion that such an override is necessary in order to achieve pure single entity treatment.

In Example 10, the activities of S and B occurred before the deconsolidation, at a time when S and B were treated as divisions of a single entity. In this situation, Regs. §1.1502-13(d) endeavors to continue to take both S's and B's activities into account even after any deconsolidation of S or B. Accordingly, under the acceleration rule, S's activities (and any applicable holding period) before the intercompany transaction continue to affect the attributes of B's corresponding items, regardless of whether it is S or B that is sold and regardless of whether §381(a) applies to the sale transaction.[147]

Several factors influenced the design of Regs. §1.1502-13(d), including a desire to prevent taxpayers from avoiding unfavorable results under the matching rule of Regs. §1.1502-13(c) by simply deconsolidating one of the parties. For example, S might produce a machine that it sells to B for the use in B's business. Later, B might sell the machine in a situation where the single-entity characterization would be unfavorable. This could be the case if B expected to realize a loss on the sale of the machine, and single entity treatment would redetermine B's proceeds as DPGR, with the result that B would generate negative QPAI from the sale of the machine. A consolidated group might simply deconsolidate S or B in an effort to turn off Regs. §1.1502-13(c) in this situation.

Regs. §1.1502-13(d) is designed to prevent this type of manipulation. Its underlying concept requires flexibility regarding which companies are considered to embody the single entity after a deconsolidation, depending on whether S or B is sold. The goal is to properly characterize B's corresponding items under Regs. §1.1502-13(c) principles based on the activities of both S and B, regardless of whether it is S or B that leaves the group.

If S deconsolidates, the group simply continues, with B taking S's activities into account, since those activities occurred within the group before S left the group. If instead B deconsolidates, the single entity focus shifts to B, because B now owns the property

[145] Regs. §1.1502-13(d).

[146] Preamble, T.D. 9263.

[147] Regs. §1.1502-13(d)(2)(i)(B).

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outside the group. This case requires a more flexible approach in order to prevent B's later resale of the property received in the intercompany transaction from circumventing Regs. §1.1502-13(c). Under the regulations, this is achieved by treating B as the embodiment of B's former group for purposes of determining the attributes of B's corresponding items. Thus, even in this case, where it is actually B that leaves the group, the regulations treat S as the division that left the single entity for the limited purpose of determining the attributes of B's corresponding items. Accordingly, the attributes of B's corresponding items continue to be redetermined under the principles of the matching rule, as if the S division (but not the B division) was transferred by the single corporation to an unrelated person. In essence, the rules under Regs. §1.1502-13(d) were designed in order to prevent the disparate results depending on which member is sold that Example 10 seems to suggest.

Regs. §1.1502-13(d) provides detailed rules regarding the determination of the attributes of S's and B's items of income or expense arising from an intercompany transaction that is triggered by the acceleration rule. It seems inappropriate to disregard the normal operation of those rules on the grounds that such an override is necessary in order to achieve pure single entity treatment.

Treasury personnel indicated that the consolidated return rules operate of their own accord for purposes of §199 and that Treasury did not intend to write new substantive rules, but merely to demonstrate their application.[148] Nonetheless, until the issue is cleared up, where does Example 10 leave taxpayers trying to apply the Final Regulations, in light of what we believe is a conflict between the conclusion reached therein and the consolidated return rules? We think the correct answer is to follow the substantive provisions under the acceleration rule. However, in light of the regulatory example, such a return position would likely require disclosure as contrary to a rule or regulation.

2. Application of the Overall 5% De Minimis Exception

One change in the Final Regulations that will be highly significant for some consolidated groups is that the entity-level 5% de minimis exception enabling taxpayers to treat non-DPGR as DPGR is now measured at the consolidated group level, rather than at the separate entity level.[149] Contrary to the single entity concept, the Proposed Regulations provided that the entity-level de minimis exception applied at the individual corporate level in a consolidated group.[150] This change is likely to have significant weight in some taxpayers' decisions regarding which guidance to apply to Pre-Effective Date Years.

CONCLUSION

The §199 guidance is necessarily lengthy and complex in order to deal with the myriad situations for the universe of taxpayers potentially affected by the statute. Just as we cannot easily summarize the numerous rules required to implement this mini-Code provision, the drafters had little choice but to draft numerous rules, including the multitude of exceptions to those rules, and the exceptions to the exceptions.

The refinements made in each iteration of the guidance, together with the generous transition rules provided in the Final Regulations, provide an opportunity for taxpayers to make choices in terms of which guidance is most beneficial for Pre-Effective Date Taxable Years.

In conclusion, we would urge the IRS and Treasury to promulgate guidance that interprets seemingly similar policy objectives in a consistent manner, in order to provide tax simplification and also to avoid inadvertent foot-faults that may result when new guidance is promulgated in lieu of relying on existing guidance that has undergone critical analysis by taxpayers, the IRS and possibly the courts. Although we may have some differences in opinion on the policy choices that were made, we recognize and applaud the Herculean accomplishment of the IRS and Treasury drafters and reviewers in promulgating thoughtful guidance, after considering the numerous comments of taxpayers and their disparate circumstances.

148 Preamble, T.D. 9263.

149 Regs. §1.199-1(d)(3)(i).

150 Prop. Regs. §1.199-1(d)(2).

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