MAXIMIZING THE BENEFITS OF SEC. 199 IN AN ASSET SALE

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Over the past several years, there has been a great deal of discussion regarding the implementation of Sec. 199, which allows a deduction equal to a percentage of a taxpayer's income attributable to domestic production activities.[1] Taxpayers often overlook the deduction, however, when they sell qualifying assets as part of the sale of an entire business in a transaction that is treated as an asset sale. This article addresses the opportunity to claim a Sec. 199 deduction when a business is sold in an asset sale or in a stock sale that is treated as an asset sale under a Sec. 338(h)(10) election.[2]

Sec. 199 Basics

For tax years beginning in 2010 and thereafter, the Sec. 199 deduction is equal to 9% of the *lesser of* a taxpayer's qualified production activities income (QPAI) or taxable income (modified adjusted gross income, in the case of individual taxpayers), determined without regard to the deduction itself. The deduction is phased in at 3% for tax years beginning in 2005 and 2006 and at 6% for tax years beginning in 2007 through 2009.[3] The QPAI for any tax year is equal to the taxpayer's domestic production gross receipts (DPGR) reduced by the sum of the cost of goods sold and below-the-line expenses allocable to DPGR.[4]

As relevant here, DPGR includes gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of tangible personal property, computer software, and certain sound recordings that were produced by the taxpayer in whole or in significant part within the United States.[5] For certain taxpayers regularly engaged in construction activities, DPGR also includes gross receipts derived from the construction of real property in the United States.[6] The allowance of the deduction for internally developed software and self-constructed real property is discussed in greater detail below, because such categories can present unique opportunities to claim a Sec. 199 deduction when a business is sold.

Purchase Price Allocations

Both parties to a sale of a group of assets that make up a trade or business must allocate the purchase price among the various assets sold in proportion to their fair market value (FMV), using the residual method. Under this method, assets are divided into seven classes, and priority is given to allocating purchase price, up to their FMV, to assets in classes that are easier to value, before any purchase price is allocated to more amorphous asset classes, such as goodwill and going concern value.[7] Furthermore, under Sec. 1060, the buyer and seller of the assets of a trade or business are bound by any written agreements allocating the purchase price, although the IRS may disregard allocations not in accordance with the residual method and FMV. In order for the IRS to determine whether the buyer and seller are reporting the transaction consistently, both parties are required to attach Form 8594, Asset Acquisition Statement Under Section 1060, to their income tax returns for the year of the sale, allocating the purchase price among the seven classes of assets specified under the residual method.

In order to avoid subsequent controversy, buyers and sellers in actual or deemed asset sales often agree on an allocation of the purchase price among the seven classes of transferred assets. This allocation typically has significant tax consequences for the buyer, particularly for assets that have a depreciable or amortizable base. The allocation generally has limited consequences for a corporate seller, however, because corporations do not benefit from a preferential rate on capital gains (although there can be important consequences for recapture items). Furthermore, until the enactment of Sec. 199, both buyers and sellers were generally neutral with respect to the allocation of FMV to certain classes of assets and therefore paid scant attention to these allocations.

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[1] The Sec. 199 deduction was the centerpiece of the American Jobs Creation Act of 2004, §102, P.L. 108-357 (October 22, 2004).

[2] A Sec. 338(h)(10) election is available if the target in a stock sale is a member of an affiliated group of corporations filing a consolidated tax return. Under the election, the target corporation is deemed to have sold all its assets for FMV and then liquidated into its corporate parent. Thus, the gain or loss on the stock sale is ignored. The old target corporation is then treated as a new target corporation that purchased all the assets.

[3] Sec. 199(a)(2).

[4] Sec. 199(c)(1). See generally Granwell and Rolfes, "Musings on Selected Provisions of the Final Section 199 Regulations Applicable to Corporate Manufacturers of Tangible Property," 47 *Tax Mgmt. Memo*, No. 18 (September 4, 2006): 355; Conjura, Zuber, and Breaks, "Practical Considerations in Implementing the Section 199 Regulations," 105 *J. Tax'n* (August 2006): 68.

[5] Secs. 199(c)(4)(A)(i)(I) and (c)(5).

[6] Sec. 199(c)(4)(A)(ii).

[7] See generally Regs. Sec. 1.338-6(b). Accordingly, the allocation must be made in the following numerical order of the seven classes, up to the FMV of each class: (I) cash, (II) certificates of deposit, (III) accounts receivable and debt instruments, (IV) inventory, (V) all other assets other than class I, II, III, IV, VI, and VII assets, (VI) all Sec. 197 intangibles except goodwill and going concern value, and (VII) goodwill and going concern value (id.).

Sellers now should be mindful when negotiating purchase price allocations of the potential for significant benefits under Sec. 199 from allocating additional purchase price to certain assets.

The opportunity to claim a Sec. 199 deduction is most obvious for inventory produced within the United States, whether the inventory is sold in the ordinary course of business or as part of the sale of a business. The remainder of this article focuses on two other categories of property that may be overlooked as sources of additional Sec. 199 deduction in an asset sale.

Taxpayers are generally not aware of all the situations in which Sec. 199 applies.

Software

Among other activities, DPGR includes gross receipts from sales of software that the taxpayer developed in whole or in significant part within the United States.[8] Software is defined broadly for this purpose as "any program or routine or any sequence of machine-readable code that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine." Importantly, the definition also includes "the machine-readable code for video games and similar programs, for equipment that is an integral part of other property, and for typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, regardless of whether the code is designed to operate on a computer." Computer programs of all classes—for example, operating systems, assembly routines, and utility programs, as well as application programs—are included.[9]

Although many taxpayers who sell internally developed software to customers in the ordinary course of business have focused on the Sec. 199 benefits available for such sales, taxpayers who do not routinely sell software to customers may overlook the potential benefit when internally developed software is sold as part of a sale of the business in which the software is used.

In order to be eligible for Sec. 199 benefits, software need not have been produced for sale to customers. Software that the taxpayer produced for use within its own business is equally eligible for the deduction if the software subsequently is sold, as part of a sale of the business or otherwise. Furthermore, software that a taxpayer developed long before the 2004 enactment of Sec. 199 is eligible for the deduction. Eligibility requires only that (1) the taxpayer developed the software itself or hired a contractor to develop it at the taxpayer's risk, substantially within the United States, and (2) the sale of the software occurs in a tax year beginning after 2004. Accordingly, an asset deal can create a Sec. 199 deduction whenever the divested business includes custom software that is used in its research and development, product supply, accounting, or other functions.

Caution: Only one taxpayer may claim the Sec. 199 deduction for a particular production activity. If one taxpayer performs a qualifying production activity within the United States under a contract with another party, only the taxpayer that has the benefits and burdens of owning the property during the period in which the activity occurs is considered the producer and is therefore entitled to the Sec. 199 deduction.[10] In the case of software, the taxpayer that bears the economic risk that the software may not achieve the desired result will be viewed as having the benefits and burdens of owning the software during development. Thus, if the seller of a business previously had outsourced the development of software used in that business to a contractor, and the seller paid the contractor at a fixed rate, regardless of its success or failure in producing software that met the design specifications, the seller would be treated as the producer of the software under Sec. 199 and thus would be eligible for the deduction upon a subsequent sale of the software.

It is important for sellers to be aware of this opportunity when agreeing to purchase price allocations with buyers. Under the residual method of allocating purchase price, internally developed software is in a different asset class from goodwill and going concern value.[11] Taxpayers that do not focus on software that is part of a divested business may in effect cause the purchase price attributable thereto to be allocated to the residual category of goodwill and going concern.

Before the enactment of Sec. 199, buyers and sellers often had no incentive to allocate any purchase price specifically to internally developed software. Purchased software generally is depreciable over a 36-month useful life.[12] Sec. 197, however, includes within the definition of a Sec. 197 intangible software that is acquired as part of the acquisition of a trade or business.[13] Thus, such software must be amortized over 15 years, the same as for all other Sec. 197 intangibles, including goodwill and going concern value. As a consequence, buyers are tax neutral to allocating purchase price

[8] Secs. 199(c)(4)(A)(i)(I) and (c)(5)(B).

[9] Regs. Sec. 1.199-3(j)(3)(i).

[10] Regs. Sec. 1.199-3(f)(1).

[11] Note 7, above, lists the seven asset classes, in the order in which purchase price must be allocated. Class VI includes all Sec. 197 intangibles except goodwill and going concern value, and Class VII includes all goodwill and going concern value (Regs. Sec. 1.338-6(b)(1)). As explained in the text, software that is acquired as part of a business is a Sec. 197 intangible.

[12] Sec. 167(f)(1)(A). See also Rev. Proc. 2000-50, 2000-2 CB 601 (distinguishing between internally developed and purchased software).

[13] Sec. 197(e)(3). However, software that is publicly available for purchase is not treated as a Sec. 197 intangible, even when acquired in the acquisition of a trade or business.

among software and other Sec. 197 intangibles and should provide little resistance to a seller's request to allocate costs to the software purchased.

Apart from Sec. 199, sellers generally also would be unconcerned with the allocation of purchase price as between internally developed software and other intangibles, since they generally lack cost basis in all such assets. With the introduction of Sec. 199, however, astute sellers should be interested in an FMV allocation to internally developed software because it may produce a greater deduction under Sec. 199.

Real Estate

For taxpayers engaged in the active conduct of a construction business, DPGR includes gross receipts derived from the construction of real property performed in the United States in the ordinary course of the taxpayer's business.[14] Gross receipts derived from construction include gross receipts from the sale or exchange of real property constructed by the taxpayer.[15] Thus, taxpayers using self-constructed real estate assets in a business may be eligible for additional Sec. 199 deductions when that business is divested in an actual or deemed asset sale.

The key here is that the seller must have been engaged in a construction trade or business. Treasury has interpreted this requirement to mean that the taxpayer, when it constructed the real property, must have been engaged, on a regular and ongoing basis, in a trade or business that is considered construction for purposes of the North American Industry Classification System (NAICS). This primarily would include all construction activity under NAICS code 23.[16]

This requirement is not as restrictive as it might seem. First, it is not necessary that the construction trade or business be the taxpayer's primary or only trade or business.[17] For example, a hotel chain's primary business would fall under NAICS code 72, for accommodation and food services. Nonetheless, if, in developing new hotel properties, the hotel chain regularly engages in construction activities that are described under NAICS code 23, the hotel chain could qualify for a Sec. 199 deduction when it sells a hotel property, whether in a one-off transaction or as part of a divestiture of the entire business.

Moreover, in addition to construction activity under NAICS code 23, the regulations provide that construction activity in any other NAICS code will qualify as a construction trade or business, provided that the construction activity relates to the construction of real property.[18] The regulations provide the example of NAICS codes 213111 (drilling oil and gas wells) and 213112 (support activities for oil and gas operations) as other activities that, though not under code 23, would be considered a construction trade or business for purposes of Sec. 199.[19] Thus, it would seem that, by analogy, a utility company that regularly constructs power-generation real estate assets might be able to obtain a Sec. 199 deduction for the purchase price allocable to such assets if the utility were later sold in an asset sale.

Taxpayers whose primary business is not construction in the classic sense may overlook such opportunities to claim a Sec. 199 deduction when they sell self-constructed real estate assets as part of a divestiture of an entire business, a downsizing, or a one-off transaction.

Conclusion

Although Sec. 199 has been in effect for several years now, taxpayers generally are not aware of all the situations in which a domestic production deduction may be available. Practitioners with clients who are selling a trade or business in an actual or deemed asset sale should make sure that the clients are aware of the potential for Sec. 199 benefits in these transactions. **TTA**

[14] Sec. 199(c)(4)(A)(ii).
[15] Regs. Sec. 1.199-3(m)(6).
[16] Regs. Sec. 1.199-3(m)(6)(i).
[17] Id.
[18] Id.
[19] Id.